House of Commons

European Scrutiny Committee

Sixteenth Report of Session 2017–19

Documents considered by the Committee on 28 February 2018

Report, together with formal minutes

Ordered by the House of Commons
to be printed 28 February 2018

HC 301-xvi
Published on 6 March 2018
by authority of the House of Commons

Notes

Numbering of documents

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

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

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

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

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

Abbreviations used in the headnotes and footnotes

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

Euros

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

Further information

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

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

Staff

The staff of the Committee are Dr Lynn Gardner (Clerk), Kilian Bourke, Alistair Dillon, Leigh Gibson and Foeke Noppert (Clerk Advisers), Arnold Ridout (Counsel for European Legislation), Françoise Spencer (Deputy Counsel for European Legislation), Joanne Dee (Assistant Counsel for European Legislation), Mike Winter (Second Clerk), Sarah Crandall (Senior Committee Assistant), Sue Beeby, Rob Dinsdale and Beatrice Woods (Committee Assistants), Ravi Abhayaratne and Paula Saunderson (Office Support Assistants).

Contacts

All correspondence should be addressed to the Clerk of the European Scrutiny Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is (020) 7219 3292/5465. The Committee's email address is escom@parliament.uk.

Contents

Meeting Summary 3

Documents not cleared

1	BEIS	Copyright in the Single Market	8
2	BEIS	High Performance Computing	13
3	DCMS	Data Protection and the EU institutions	19
4	DCMS	Import of cultural goods	24
5	DfT	Single European Sky	31
6	DfT	Port reception facilities for waste from ships	40
7	FCO	EU-Iraq Partnership and Cooperation Agreement	47
8	HMT	Prudential requirements for investment firms	55
9	HO	Interoperable EU information systems for security, border control and migration management	75

Documents cleared

10	BEIS	EU research funding: interim evaluation of Horizon 2020	87
11	FCO	European Security and Defence College: cyber-security	99
12	ONS	Quality of trade statistics	101

Annex: Estimates of UK balance of trade with selected EU countries 106

Documents not raising questions of sufficient legal or political importance to warrant a substantive report to the House 107

Formal Minutes 108

Standing Order and membership 109

Meeting Summary

The Committee looks at the significance of EU proposals and decides whether to clear the document from scrutiny or withhold clearance and ask questions of the Government. The Committee also has the power to recommend documents for debate.

Brexit-related issues

The Committee is now looking at documents in the light of the UK decision to withdraw from the EU. Issues are explored in greater detail in report chapters and, where appropriate, in the summaries below. The Committee notes that in the current week the following issues and questions have arisen in documents or in correspondence with Ministers:

Brexit implications

Interoperable EU information systems for security, border control and migration management

- Does the Government anticipate that the Commission's proposals to make EU border, migration and security information systems interoperable will make it easier or harder for the UK to negotiate access to them (should it wish to do so) as part of the UK's exit negotiations?
- Does the Government intend that these EU information systems should form part of a new post-exit strategic treaty with the EU on security and law enforcement cooperation?
- What assessment has the Government made of the costs likely to be entailed in securing access to these systems post-exit?

The Single European Sky (SES)

- What would be the practical implications for air traffic management of a non-negotiated UK exit from the EU?

Import of cultural goods

- The Committee considered an update from the Minister for Cultural Heritage on a new EU proposal for customs controls on cultural goods like artworks and archaeological artefacts. Given it requires EU and Irish customs authorities to carry out a new type of border control, the Committee discussed its implications for the flow of goods between the UK and the EU after Brexit, in particular at the Irish border.

Prudential requirements for investment firms

- The European Commission recently tabled legislative proposals for a new prudential regime for investment firms in the EU. The proposed legislation is partly driven by the UK's withdrawal from the EU, as the Commission expects

many EU investment firms—which are currently overwhelmingly based in the UK—to relocate at least some of their operations to an EU-27 country to retain their 'passport' within the Single Market after Brexit. The Commission has also proposed to tighten the 'equivalence' requirements for investment firms if the UK wanted to retain some level of preferential market access for its financial services industry after Brexit, with the intention of binding the UK's post-regulatory regime closely to the EU's prudential framework.

Quality of Trade Statistics

- The Committee considered two recent reports by Eurostat on the reliability of statistics on international trade and balance of payments. These reiterate the findings by the UK's Office for National Statistics that there are significant discrepancies in the trade surpluses and deficits recorded by HMRC with a number of the UK's major trading partners. The Committee is drawing the reports to the attention of the House, given the importance for the Government of having accurate statistics to inform its negotiating strategy for a post-Brexit free trade agreement with the EU.

Summary

Interoperable EU information systems for security, border control and migration management

The Commission has put forward two proposals to make EU security, border and migration information systems fully interoperable so that information on cross-border security threats and irregular migration can be shared more rapidly. The main features are the creation of a European search portal (a "one-stop shop" enabling multiple EU information systems to be searched simultaneously), a shared biometric matching service, a common identity repository and a multiple identity detector. All four features are intended to be mutually reinforcing, making it quicker and easier to spot individuals using multiple identities to evade detection. The UK is only entitled to participate in the first proposal covering two EU information systems in which the UK already takes part (the police cooperation elements of the Schengen Information System and the EU's asylum database, Eurodac) and a third system which the UK has opted into but is still under negotiation (ECRIS-TCN which will record the convictions of third country national offenders in the EU). The Commission's second proposal covers other Schengen-related information systems from which the UK is excluded. The Government indicates that the main factors in deciding whether to participate in the first proposal are the costs (expected to be substantial) set against the potential benefits for law enforcement and immigration control purposes. The European Scrutiny Committee requests further information on: the impact of interoperability on the rights of individuals whose data may be held in EU information systems (post-exit this will include the data of British citizens); the factors that will inform the Government's decision on participation in the first proposal; and the wider Brexit implications, including the scope and content of a future (post-exit) strategic treaty with the EU on security and law enforcement cooperation.

Not cleared from scrutiny; further information requested; drawn to the attention of the Home Affairs Committee, the Justice Committee and the Committee on Exiting the European Union.

Single European Sky

The Single European Sky (SES) is an EU programme to improve the efficiency of European air traffic management (ATM) and air navigation services to cope with traffic growth in a safe and cost-efficient manner. On the implications of EU exit for UK participation in the SES, the Government indicates that it recognises the need to ensure interoperability between the UK's arrangements for managing air traffic and those of the EU, and that there are mechanisms other than Functional airspace blocks (FABs) for organising air navigation services on a cross-border basis. The Committee concludes that the Single European Sky (SES) regime would cease upon withdrawal to apply to the UK, but notes that it is possible for European countries that conclude an agreement with the EU to participate in it. The Committee also observes that ATM issues are less critical in the context of Brexit than other challenges facing the sector, such as traffic rights, participation in EASA, and other arrangements affecting trade in aerospace products. The Committee requests further information from the Government about the implications of EU exit for air traffic management, and further detail regarding the UK's air navigation service provider NATS' preference to leave SES.

Waiver granted; further information requested; drawn to the attention of the Transport Committee.

Port reception facilities for waste from ships

As part of the Commission's strategy to reduce the amount of plastics in the marine environment, the Commission has proposed a number of improvements to ports' facilities for accepting waste from ships. The Committee notes that, under the proposal, fishing vessels would effectively pay to land plastic waste collected while fishing and considered that this does not seem consistent with the polluter pays principle. The deadline for implementing the legislation is 31 December 2020, but the requirements would in any event apply to UK vessels arriving at EU ports post-Brexit.

Not cleared; further information requested; drawn to the attention of the Transport Committee, Environmental Audit Committee and the Environment, Food and Rural Affairs Committee.

Import of cultural goods

The European Commission has proposed a change to EU customs legislation which would require national customs authorities to check the provenance of certain artworks and archaeological artefacts, to ensure they are not being trafficked into the EU for sale on the black market. The Government and the UK art market industry (the EU's largest), as well as other Member States, have expressed serious reservations about the implications of the proposal, in particular the costs of the additional resources required compared to the potentially very limited benefits.

The Committee has retained the proposal under scrutiny, and requested further information on the legislative negotiations as they progress. It concluded that the new customs requirements may have to be implemented by HMRC at UK borders if the new legislation takes effect during the proposed post-Brexit transitional period (during which the UK would stay in the Customs Union. It also noted the possible implications of the

proposal for the UK's future trade flows with the EU, in particular at the Irish border, if Ireland's customs authorities were required by EU law to perform checks on cultural goods transported from Northern Ireland into Ireland.

Not cleared from scrutiny; drawn to the attention of the Digital, Culture, Media & Sport Committee.

Data Protection and the EU institutions: Proposed Regulation

This proposed Regulation aims to adapt the rules of the new General Data Protection Regulation (GDPR) adopted in 2016 to the EU institutions and agencies. It would replace the existing institutional Regulation (45/2001). The proposal would have few immediate implications for the UK as requirements largely apply to data controllers/processors of EU bodies. The Commission's original plan was for the proposal to be adopted so that it would be directly applicable in May 2018. This would be before UK exit and any possible implementation/transitional period. However, despite a General Approach being agreed on 8 June 2017, the Government now reports that trilogues have stalled due to some "controversial amendments" from the EP. These concern the inclusion of Eurojust and Europol and the CSDP within the scope of the Regulation.

The previous Committee had questioned whether the proposal could assume a greater significance if, post Brexit, EU bodies process more data to enable "third country" UK citizens to travel to the EU or to work/provide services there. The Government seeks to answer that question by reassuring the Committee that EU bodies must process personal data according to the same rules, whether they come from EU citizens or not. However, we point out that the question asked was about the volume of data required about third countries citizens, not the way it is processed.

The Government also provides a very short update on a very significant and related proposal: the proposed e-Privacy Regulation which will provide specific rules on processing of e-communications data. We request a far more extensive update, dealing with the publicised difficulties of the pro-privacy position of the EP and how this sits with the UK's equally well publicised wish to access encrypted communications used by providers such as Whats App.

Until there is further progress in trilogue negotiations on the proposed Regulation on data protection and the EU institutions, we will retain it under scrutiny.

Not cleared from scrutiny; further information requested; drawn to the attention of the Digital, Culture, Media and Sport Committee.

Prudential requirements for investment firms

The European Commission has proposed to create a new legal framework on the capital requirements for investment firms, which are currently covered by the Capital Requirements Directive for banks. The new regime would be calibrated to the financial and market risks posed by investment firms specifically. The Government support the thrust of the proposals, which were informed by a European Banking Authority review which started four years ago and would lead to a more targeted prudential regime for the investment services sector. However, it has not commented on the assumption—made explicit repeatedly by the Commission—that UK-based investment firms will shift some of their operations to the EU after Brexit in an economically significant way, especially large Swiss, US and Japanese investment banks currently headquartered in London.

In view of the clear Brexit implications and the lack of information from the Government about the implications of the UK's exit from the Single Market for the financial services industry, the Committee retained the proposals under scrutiny.

Not cleared from scrutiny; further information requested; drawn to the attention of the Treasury Committee.

Documents drawn to the attention of select committees:

('NC' indicates document is 'not cleared' from scrutiny; 'C' indicates document is 'cleared')

Business, Energy and Industrial Strategy Committee: High Performance Computing [Proposed Regulation (NC)]; Copyright in the Single Market [Proposed Regulation (NC)]; EU research funding: interim evaluation of Horizon 2020 [Commission Communication (C)]

Defence Committee: EU-Iraq Partnership and Cooperation Agreement [(a) Council Decision (NC), (b) Commission Communication (C)]

Digital, Culture, Media and Sport Committee: Data Protection and the EU institutions [Proposed Regulation (NC)]; Import of cultural goods [Proposed Regulation (NC)]

Education Committee: EU research funding: interim evaluation of Horizon 2020 [Commission Communication (C)]

Environmental Audit Committee: Port reception facilities for waste from ships [Proposed Directive (NC)]

Environment, Food and Rural Affairs Committee: Port reception facilities for waste from ships [Proposed Directive (NC)]

Committee on Exiting the European Union: Interoperable EU information systems for security, border control and migration management [Commission Communication (C), (b) and (c) Proposed Regulations (NC)]

Foreign Affairs Committee: EU-Iraq Partnership and Cooperation Agreement [(a) Council Decision (NC), (b) Commission Communication (C)]

Home Affairs Committee: Interoperable EU information systems for security, border control and migration management [Commission Communication (C), (b) and (c) Proposed Regulations (NC)]

International Trade Committee: Quality of trade statistics [(a) Commission Report (C), (b) Staff Working document (C)]

Justice Committee: Interoperable EU information systems for security, border control and migration management [Commission Communication (C), (b) and (c) Proposed Regulations (NC)]

Public Administration and Constitutional Affairs Committee: Quality of trade statistics [(a) Commission Report (C), (b) Staff Working document (C)]

Science and Technology Committee: EU research funding: interim evaluation of Horizon 2020 [Commission Communication (C)]

Transport Committee: Single European Sky [Court of Auditors Report (NC)]; Port reception facilities for waste from ships [Proposed Directive (NC)]

Treasury Committee: Prudential requirements for investment firms [(a) Proposed Regulation (NC), (b) Proposed Directive (NC)]

1 Copyright in the Single Market

Committee's assessment	Legally and politically important
Committee's decision	Not cleared from scrutiny; further information requested; but scrutiny waiver granted; Drawn to the attention of the Business, Energy and Industrial Strategy Committee
Document details	Proposal for a Regulation laying down rules on the exercise of copyright and related rights applicable to certain online transmissions of broadcasting organisations and retransmission of television and radio programmes
Legal base	Article 114 TFEU; ordinary legislative procedure; QMV
Department	Business, Energy and Industrial Strategy
Document Number	(38077), 12258/16 + ADDs 1–4, COM(16) 594

Summary and Committee's conclusions

1.1 This Regulation forms part of the Commission's "Copyright In the Single Market" package of September 2016. Broadly it is intended to impose the country of origin principle (introduced by Directive 93/83 in respect of satellite and cable broadcasting) to online services which are ancillary to broadcasts (such as simulcasting[1] and catch up TV/radio services). It would also impose mandatory collective management of copyright for closed-circuit internet-protocol-based mobile and similar networks. The Regulation would not cover true on-demand services such as Netflix and Amazon Prime; nor pure webcasts such as BBC3. The Minister (Joseph Johnson) helpfully expands upon the purposes of the proposal in correspondence referred to below.

1.2 The other legislative component of the package is a proposed Directive on Copyright in the Digital Single Market. Its broad range of measures was summarised in the Report of our predecessor Committee, referenced at the end of this Chapter. Negotiations in the Council on that proposal are still ongoing.

1.3 In her original Explanatory Memorandum, the then Minister (Baroness Neville-Rolfe) highlighted the increasing market in on-demand services and for watching content from other countries. At that time consultation with stakeholders was ongoing.

1.4 In subsequent correspondence, the substance of which is reproduced below, it became clear that broadcasters were concerned that the extension of the country of origin principle to ancillary services could negatively impact financing and distribution models based on territorial licencing; and rights holders generally disliked the principle as it affected their ability to manage their exclusive rights. Therefore the Government has made it a priority to "to protect territorial licencing, while still seeking to ensure the Regulation delivers benefits for consumers". It expects to achieve this objective, including by narrowing the scope of the country of origin principle. It wishes to vote in favour of this text if it comes before the Council under the Bulgarian Presidency, which could be in the next few months.

1 Linear simultaneous transmission of a broadcast by the broadcaster.

1.5 The Legal Affairs Committee of the European Parliament has tabled a report to form the basis of informal trilogue discussions. Significantly, the draft report suggests that the European Parliament considers that the scope of the original Commission proposal was too narrow.

1.6 The Minister (Joseph Johnson) does not anticipate that the Regulation will come into force before the UK leaves the EU, and any continuation of the policy depends on reciprocity. Therefore, any continued alignment of the UK policy with that of the EU depends on the terms of the UK's future relationship with the EU.

1.7 **We are grateful for the responses from the Minister to the matters raised by our predecessor Committee, and the updates on the negotiations. We grant him a scrutiny waiver to vote in favour of a general approach during the Bulgarian Presidency. Should the matter not have reached this stage during the currency of this Presidency then the scrutiny waiver lapses. In any event we ask for a further update once a general approach is agreed or there are otherwise any significant developments. This should specifically address the terms of any transitional/implementing period that has been agreed and the Minister's assessment of the approach of the European Parliament.**

1.8 **We retain the proposal under scrutiny but draw it and this chapter to the attention of the Business, Energy and Industrial Strategy Committee.**

Full details of the documents

Proposal for a Regulation laying down rules on the exercise of copyright and related rights applicable to certain online transmissions of broadcasting organisations and retransmission of television and radio programmes: (38077), 12258/16 + ADDs 1–4, COM(16) 594.

Background

1.9 In his letter of 15 December 2017 the Minister sets out the background to the Regulation as follows:

> "The proposed Regulation on Online Transmissions seeks to facilitate greater cross-border availability of television and radio programmes, via the internet, within the European Union. The Regulation applies only to online services of broadcasters which are ancillary to an initial broadcast, namely:
>
> -simulcasting (linear simultaneous transmission of a broadcast by the broadcaster);
>
> —catch-up television and radio services (where broadcasts are made available online, on an on-demand basis, for a limited period of time following the initial broadcast);
>
> —material related to the initial broadcast (such as previews).

> "The Regulation does not apply to standalone video-on-demand services (such as Netflix), where content is unconnected with a broadcast transmission by the same broadcaster. Neither does it apply to pure webcasting services.
>
> "The Regulation seeks to enhance cross-border provision of such services via two mechanisms:
>
> "First, it proposes a "country of origin" rule. Under this rule, a transmission of an ancillary online service is deemed to take place solely in the country where the broadcasting organisation has its principal establishment, meaning that it does not need to seek additional copyright clearances to broadcast into other Member States. Rightholders would, however, be able to seek additional remuneration via licence agreements to reflect any increased audience for their audiovisual content.
>
> "Secondly, the Regulation proposes a system of mandatory collective licensing in relation to online retransmissions of broadcasts. This is limited to internet-protocol-based, mobile, and similar networks. Under this system, rightholders are only able to exercise their rights in relation to retransmissions of broadcasts on a collective basis, via collecting societies, rather than individually. This will allow operators of such services to gain all the relevant rights to retransmit content via a small number of collective licences rather than potentially having to negotiate multiple licences with individual rightholders.
>
> "Similar rules already exist in relation to satellite and cable broadcasts under the Satellite and Cable Directive (93/83/EEC)."

Stakeholder views

1.10 In his letter of 30 March 2017 the Minister first outlined stakeholder views in respect of the proposed package as a whole:

> "Regarding stakeholder views, in late 2016 the Intellectual Property Office conducted a 'call for views' on all aspects of the copyright package proposed by the European Commission, including the Regulation and the Directive in question, alongside ongoing direct engagement with stakeholders. Responses were mostly focussed on the specific aspects of the proposals in isolation rather than the potential impact of the UK's exit, however stakeholders have demonstrated support for the legal certainty currently offered by harmonisation of copyright law at EU level. As the call for views was not a formal consultation, the Government has not issued a response summarising stakeholder views."

1.11 Specifically, in respect of this proposal he indicated:

> "Broadcasters believe the proposal to extend the country of origin principle to broadcasters' ancillary services could negatively impact financing and distribution models which are based on territorial licensing. These stakeholders have particular concerns around the potential interplay between the Regulation and the ongoing EU competition inquiry into the

> Pay-TV sector. Their main comments on the retransmission element of the Regulation are that the broadcaster veto should be preserved and it must be clearer about what types of service are in scope.
>
> "Rightholders generally dislike extending the country of origin principle as it affects their ability to manage their exclusive rights. On retransmissions, they oppose mandatory collective licensing as being anti-competitive."

1.12 The objections raised by the film and television industry was reiterated in his letter of 15 December 2017:

> "During the course of the negotiation representatives of the film and television sectors have raised concerns that the country of origin rule may undermine their ability to license content on a territorial basis—something which is a common practice in these sectors, and which they argue is key to financing new productions. Although the Regulation does not expressly affect the freedom of rightholders to license works on a territorial basis, the concern is that a broad country of origin rule could in practice make territorial licensing difficult or impossible. The Government has made it a priority during these negotiations to protect territorial licensing, while still seeking to ensure the Regulation delivers benefits for consumers."

Amendments to the proposed Regulation

1.13 In his letter of 15 December 2017 the Minister outlines the progress of negotiations:

> "In view of the concerns of the audiovisual sector, the scope of the country of origin rule in the Regulation has been reduced since its proposal. In the Estonian Presidency's recent proposal (http://data.consilium.europa.eu/doc/document/ST-14380–2017-INIT/en/pdf), this mechanism has now been limited to cover only subject matter produced by the broadcasting organisation, commissioned by the broadcasting organisation, and certain material (not including extracts of films or television series incorporated in TV or radio programmes) co-produced with third parties (in Article 2(1a), subparagraphs a), b) and c), respectively. Video-on-demand services, and pure webcasts (without a broadcast to which they are ancillary) remain out of scope.
>
> "Broadcasters and rightholders continue to push for a narrowing of scope, or deletion, of the country of origin rule. We agree that the current proposal continues to pose possible risks to territorial licensing, though these have been reduced. We expect the rule to be narrowed further, potentially to cover only content produced or commissioned by the broadcasting organisation, or to only apply to news and current affairs broadcasts, and it is possible that such further narrowing will overcome objections from the majority of Member States, including a number which have previously raised concerns about possible risks to territorial licensing.
>
> "In the part of the Regulation relating to retransmissions of broadcasts, there is now an explicit obligation that where negotiations take place between

broadcasting organisations and operators of retransmissions services, regarding authorisation for retransmission under the Regulation, these must be conducted in good faith. The Regulation has also been limited to apply to retransmissions over open internet access services, only where they are provided to a "controlled circle of users".

"We understand that most Member States and many organisations representing rightholders and firms which retransmit broadcasts are broadly content with these changes, and with the proposal on retransmission as it now stands."

Costs, benefits, and impact

1.14 The Minister outlines the position as follows in the same letter of 15 December:

"Further to the Explanatory Memorandum (EM), which gave a summary of the European Commission's impact assessments (Documents SWD (2017) 302 final; SWD(2016) 301 final (Parts 1–3)), the extension of the country of origin rule, reduced in scope as outlined above, would:

- Have fewer impacts on rightsholders than those set out in the EM. Rightholders' ability to licence territorially would be preserved, and the country of origin rule would only apply to those categories of production referred to above.
- Benefit broadcasters to a lesser extent than set out in the EM. Broadcasters would be able to benefit from reduced and faster rights clearance costs for cross-border online transmissions, but only for those categories of production referred to above. In practice broadcasters are very likely to hold the rights in different territories for their own productions, and will often own the rights for commissioned works or co-productions. If the scope of the country of origin rule is maintained as currently proposed, or reduced further as is envisaged, only a small number of broadcasters are likely to receive additional benefit from the rule.
- Benefit consumers to a lesser extent than set out in the EM. Consumers could benefit from increased access to broadcasters' programmes across borders, but only for the categories of production referred to above.

"A reduced scope country of origin rule is unlikely to disrupt current territorial licensing practices to a significant extent and, the more its scope is reduced, the costs and benefits will tend towards zero.

"There is effectively no change to the scope of the retransmission provisions, and the impacts on transmission service providers, rights holders, and consumers, is expected to be as the Explanatory Memorandum."

Previous Committee Reports

Seventeenth Report HC 71–xv (2016–17), chapter 5 (2 November 2016).

2 High Performance Computing

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Business, Energy and Industrial Strategy Select Committee
Document details	Proposal for a Council Regulation on establishing the European High Performance Computing Joint Undertaking
Legal base	Article 187 TFEU; EP consultation; QMV
Department	Business, Energy and Industrial Strategy
Document Number	(39423), 5282/18 + ADDs 1–6, COM (18) 8 final

Summary and Committee's conclusions

2.1 As part of the digitisation of industry pillar of its Digital Single Market Strategy, on 12 January 2018 the European Commission proposed a Council Regulation[2] that will establish a public-private partnership to procure and deploy new High Performance Computing (HPC) infrastructure.

2.2 The proposed infrastructure will facilitate data-driven research that requires exascale computing capabilities—machines capable of a billion-billion calculations per second, with pre-exascale machines operating at around 20–50% of this capability. Applications for this technology include the simulation of a complete next-generation airplane; climate modelling; linking genome to health; understanding the human brain; and in silico testing of cosmetics to reduce animal testing. The Commission argues that this infrastructure will also reduce Europe's increasing reliance on infrastructure in other countries.

2.3 The Commission's proposal was previously trailed in the European Commission's 2016 Communication on the "European Cloud Initiative",[3] in which the Commission called for the establishment of a European Data Infrastructure based on the development of a full European High Performance Computing ecosystem capable of developing new European technology.

2.4 The Joint Undertaking (JU) will support the development of exascale performance systems by 2022–2023, and procure two HPC systems with pre-exascale performance in the meantime. The JU will oversee the deployment, interconnection and operation of these machines and manage access to them for a wide range of public and private users. It will also run a Research and Innovation Programme that will support the R&D required for building exascale machines by 2022–2023 and the first generation of European, low-power microprocessor technology. In 2019–2020 it will launch open calls for R&I proposals for funding HPC technology and application development activities.

2 Proposal for a Council Regulation on establishing the European High Performance Computing Joint Undertaking COM(2018) 8 final.

3 See HC 71–ii (2015–16) chapter 16 (25 May 2016).

2.5 The Government indicates in its Explanatory Memorandum,[4] submitted on 29 January 2018, that, although it is a leading participant in the working group developing the detailed planning and budget for the EuroHPC initiative, it has not yet formally signed-up to the project at this stage. The Minister (Sam Gyimah MP) indicates that decisions on future UK participation will be made as more detailed plans become available and in light of the UK Research Infrastructure Roadmap that is currently being developed by UK Research and Innovation. The Minister acknowledges that the UK's right to participate in the JU post-withdrawal is subject to EU exit negotiations.

2.6 So far thirteen countries have stated their intention to participate (France, Germany, Italy, Luxembourg, the Netherlands, Portugal, Spain, Belgium, Slovenia, Bulgaria, Greece, Croatia and Switzerland). Membership is also open to those countries that are associated to EU Framework Programmes for research and innovation (e.g. Horizon 2020). The regulation allows for new members to join at a later date should they wish. It is envisaged that the JU will be funded by the current Multiannual Financial Framework (MFF) budget to a value of around €486 million (approximately £431 million) and that this contribution will be matched by additional contributions from participating countries. The Minister states that the proposal has no direct financial implications for the UK.

2.7 **The European Commission's proposal to finance the development of a homegrown exascale computing system will help to promote the uptake of digital technologies by European industry and to promote the future growth of the European Union's digital economy. In this regard, the proposed European High Performance Computing Joint Undertaking (EuroHPC JU) has potential ramifications for the UK post-withdrawal, as the successful development of this capability—which is not, we note, a given—would potentially support data-driven innovation across a wide range of research-intensive sectors—sectors which are also integral to the UK's recently published Industrial Strategy.**[5]

2.8 **The question of how the Government intends to proceed in terms of High Performance Computing, both in relation to this proposal and more generally, is therefore a matter of some interest to the Committee. However, we note that the Government's ability to participate in the EuroHPC JU is contingent on the future relationship with the EU, and that the Government will await the development of the UK Research Infrastructure Roadmap—in Spring 2019, by which time the JU is intended be in operation—before deciding how to proceed.**

2.9 **We ask the Government to respond to the following questions:**

- **The Minister states that the UK is currently "one of the world leaders in this field (both in science research and use by industry)", however the Commission states that only one European computer (located in Stuttgart) ranks in the top ten worldwide.[6] What is the basis of the Government's assessment that it is a world leader? What HPC infrastructure is based in the UK, and where does it rank globally?**

4 The Minister's Explanatory Memorandum (published on 29 January 2018) is not yet available online, but the Department for Exiting the European Union should make it available soon on the relevant European Memoranda web-page.

5 HM Government, Industrial Strategy: Building a Britain fit for the future (27 November 2017).

6 The Minister's Explanatory Memorandum (published on 29 January 2018) is not yet available online, but the Department for Exiting the European Union should make it available soon on the relevant European Memoranda web-page.

- **Does the Government agree with the Commission that no single European country has the resources to develop a full European High Performance Computing ecosystem alone, or does it consider that the UK is capable of deploying world-class HPC (e.g. exascale computing) independently, outside the EU?**
- **What are the Government's plans for ensuring that the UK's businesses and research communities have access to world-class HPC infrastructure, and how do these compare to the Commission's proposal in terms of timescales, cost and processing power?**
- **Given the centrality of innovation to the Government's industrial strategy,[7] if, post-withdrawal, the Government is not able to participate in the EU's HPC JU, to what extent would the delivery of EU-based exascale[8] computing capabilities give European industry and research a competitive advantage relative to the UK?**
- **We note that UK officials, including UKREP, had limited sight of the proposed Regulation before it was presented by the Commission, hence the lack of detailed information in the Minister's Explanatory Memorandum about timescales for consideration of the proposal in the Council. Why was the UK not more involved in the development of the proposal? Does this suggest that there is a tension between UK and EU interests in this policy area specifically, or does it reflect the UK's growing marginalisation in the Council as its withdrawal from the EU approaches?**

2.10 **We retain this proposal under scrutiny and ask the Government to respond to our questions by 29 March 2017. We draw this report to the attention of the Business, Energy and Industrial Strategy Select Committee.**

Full details of the documents

Proposal for a Council Regulation on establishing the European High Performance Computing Joint Undertaking: (39423), 5282/18, COM (18) 8 final.

Background

Digital Single Market

2.11 On 6 May 2015 the European Commission adopted a Digital Single Market Strategy,[9] which identified a range of future initiatives intended to facilitate the growth of Europe's digital economy. The third pillar of the Strategy, "Maximising the growth potential of the Digital Economy", identified the need for investment in ICT infrastructures and technologies such as Cloud computing and Big Data, and research and innovation to boost industrial competitiveness, which would be taken forward in due course.

7 HM Government, Industrial Strategy: Building a Britain fit for the future (27 November 2017).
8 Exascale computing refers to computing systems capable of at least one exaFLOPS, or a billion billion calculations per second.
9 European Commission, Communication: A Digital Single Market Strategy for Europe COM(15) 192.

European Cloud Initiative

2.12 On 19 April 2016 the European Commission published a "European Cloud Initiative" Communication, which identified necessary steps to build a competitive data and knowledge economy.[10] The Communication stated that "there is surging demand in Europe for a world-class High Performance Computing (HPC) infrastructure to process data in science and engineering," and identified a range of types of research that required exascale computing capabilities. The Communication noted that the USA, China, Japan, Russia and India were advancing swiftly in this area, but that Europe was falling behind other regions as it failed to invest in its HPC ecosystem. The Communication stated that:

- EU industry consumed one third of HPC resources worldwide, but only provided about 5% of these HPC resources;
- the EU contained only one of ten leading HPC infrastructures in the world—Germany's Höchstleistungsrechenzentrum in Stuttgart ranking 8th—whereas the USA had five and China had the single fastest supercomputer; and
- no one Member State had the resources to develop the necessary HPC ecosystem in competitive time frames relative to the US, Japan or China.

2.13 On this basis, the Commission proposed that it and participating Member States should develop and deploy a large scale European High Performance Computing, data and network infrastructure (or "European Data Infrastructure"), through a proposal that would be brought forward in due course.

The proposal[11]

2.14 The European Commission proposes to establish, through a Council Regulation, a public-private partnership in the form of a Joint Undertaking (JU) to procure and deploy new High Performance Computing (HPC) infrastructure. This JU is designed to facilitate the necessary collaboration for Europe to deploy new HPC infrastructure and eliminate reliance on non-EU technologies.

2.15 In an Explanatory Memorandum which provides the rationale for the Commission's proposal, the Commission states that current European-HPC infrastructure does not meet the needs of scientists and industry, and researchers are increasingly reliant on non-EU technology for data processing. This risks the EU being deprived of strategic or technological know-how for innovation and competitiveness, and also carries risks regarding the protection of personal and sensitive data (e.g. commercial data or trade secrets). To mitigate this risk the EC is proposing to build its own supercomputer infrastructure with enough capacity for European users.

2.16 The Commission notes that the EU and its Member States (MS) generally invest less in HPC technology compared to other leading nations such as the USA, China and

10 European Commission, European Cloud Initiative—Building a competitive data and knowledge economy in Europe COM(2016) 178 final.

11 Proposal for a Council Regulation on establishing the European High Performance Computing Joint Undertaking COM(2018) 8 final.

Japan, and that the Union's investments in HPC remain largely uncoordinated and result in low industrial take-up. Compared to these countries it suggests that the Union is underinvesting by approximately €500–750 million per year.

2.17 The activities of the Joint Undertaking will be grouped around two main pillars:

- *Procurement and operation of HPC and data infrastructures:* The JU will procure two world-class pre-exascale machines of a few hundred petaflops[12] and co-finance the acquisition of at least two additional machines of the order of a few tens of petaflops. It will oversee their deployment, interconnection and operation; and manage access to these infrastructures for a wide range of public and private users;

- *An HPC research and innovation programme:* The JU will also run a Research and Innovation Programme that will support the R&D required for building exascale machines by 2022–2023 and the first generation of European, low-power microprocessor technology. In 2019–2020 it will launch open calls for R&I proposals for funding HPC technology and application development activities.

2.18 The public members of the JU will be the European Union (represented by the Commission) and EU Member States that wish to participate. Membership is also open to those countries that are associated to EU Framework Programmes for research and innovation (e.g. Horizon 2020). So far thirteen countries have stated their intention to participate (France, Germany, Italy, Luxembourg, The Netherlands, Portugal, Spain Belgium, Slovenia, Bulgaria, Greece, Croatia and Switzerland). Private sector members will include academic and industrial users, represented by the European Technology Platform for High Performance Computing (ETP4HPC) and the Big Data Value Association (BDVA). The regulation allows for new members to join at a later date should they wish.

2.19 It is envisaged that the EuroHPC JU will be funded by the current Multiannual Financial Framework (MFF) budget to a value of around €486 million (approximately £431 million) and that this contribution will be matched by additional contributions from participating countries. Detailed budgets and timelines are yet to be determined.

Explanatory Memorandum from the Minister dated 29 January 2018[13]

2.20 The Minister at the Department for Business, Energy and Industrial Strategy (Sam Gyimah MP) states that the UK is one of the world leaders in this field (both in science research and use by industry).

2.21 In relation to the proposed Joint Undertaking, the Minister states that:

- The UK is a leading participant in the working group developing the detailed planning and budget for the EuroHPC initiative;

- The UK has not formally signed-up to the project at this stage;

12 A unit of computing speed equal to one thousand million million floating-point operations per second.

13 The Minister's Explanatory Memorandum (published on 29 January 2018) is not yet available online, but the Department for Exiting the European Union should make it available soon on the relevant European Memoranda web-page.

- Decisions on future UK participation (and possible financial contributions) will be made as more detailed plans become available and in light of the UK Research Infrastructure Roadmap currently being developed by UK Research and Innovation;
- The UK's right to participate in the EURO HPC Joint Undertaking after it leaves the EU will be subject to ongoing EU exit negotiations; and
- The UK will look to establish an ambitious agreement on science and innovation with the EU that ensures the valuable research links between us continue to grow.

2.22 The Minister adds that there are no direct financial implications for the UK. The JU will draw funds from the budgets already prescribed under the current MFF of Horizon 2020 and the Connecting Europe Facility. The total contribution from this would be €486 million (approximately £431 million). Participating countries are expected to match this, and private companies are expected to contribute €422 million (approximately £384 million).

Previous Committee Reports

None on this proposal. The Committee has previously reported on a Commission Communication (The European Cloud Initiative) which outlined its intention to bring forward this proposal in HC 71–ii (2015–16) chapter 16 (25 May 2016).

3 Data Protection and the EU institutions

Committee's assessment	Legally important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Digital, Culture, Media and Sport Committee
Document details	Proposal for a Regulation on data protection rules applicable to EU institutions, bodies, offices and agencies, repealing Regulation (EC) No 45/2001 and Decision 1247/2002/EC
Legal base	Article 16(2) TFEU; ordinary legislative procedure; QMV
Department	Digital, Culture, Media and Sport
Document Number	(38446), 5034/17, COM(17) 8

Summary and Committee's conclusions

3.1 The General Data Protection Regulation (GDPR) adopted in 2016 applies rules on the processing and free movement of personal data to Member States and data controllers/processors within the EU.[14] It will be directly applicable in Member States from 25 May 2018. It is an important piece of EU legislation for facilitating the Digital Single Market. It will also update the EU's 1995 data protection rules in line with technological developments, strengthen online privacy rights and address divergent implementation by Member States. The Government has committed to ensuring that UK law complies with the GDPR by the May deadline. The Data Protection Bill is currently progressing through Parliament and is due its second reading in the Commons.

3.2 The purpose of this proposed Regulation is to adapt the new GDPR rules to EU institutions, agencies and other bodies. It also anticipates the proposed reform of the current e-Privacy Directive.[15] The proposal is a recast of the current Regulation (EC) 45/2001 applicable to the EC/EU institutions, agencies and other bodies which is based on the rules in the 1995 Data Protection Directive.

3.3 As the obligations in this proposal are imposed on data controllers and processors in EU bodies, the previous Government broadly assessed any impact on the UK to be minimal (excluding UK-based external processors used by the EU). However, it intended to ensure that, where possible, the same obligations and protections are applied to EU institutions as under the GDPR.

3.4 The Commission's intention was that the proposal would take effect at the same time as the GDPR. In other words, as a directly applicable Regulation it should apply to the UK from 25 May 2018, in advance of Brexit. However, despite the agreement of a general approach on 8 June 2017, the Minister for Digital and Creative industries (Margot James)

14 It will also be extended to the EEA.

15 Proposal for a Regulation of the Council and European Parliament concerning the respect for private life and the protection of personal data in electronic communications and repealing Directive 2002/58/EC (Regulation on Privacy and Electronic Communications): 5358/17.

now reports that trilogues have stalled due to some "controversial amendments" from the European Parliament (EP). These concern the inclusion of Eurojust and Europol and the CSDP within the scope of the Regulation.

3.5 **We thank the Minister for her letter updating us on the stalling of trilogue negotiations.**

3.6 **We support the Government's view that both of amendments suggested by the European Parliament are objectionable from the point of view of legal certainty (the inclusion of Europol and Eurojust), in the case of the Common Defence and Security, a lack of competence. Unless the issues concerned are quickly resolved in trilogues, we ask the Minister to confirm that it is unlikely that the proposal will apply from the same date as the General Data Protection Regulation on 25 May 2018.**

3.7 **We refer to our predecessors' question about the potential for the proposal to have a greater impact on UK citizens once they are citizens of a third country. The concern behind this question was that as third country citizens, UK citizens might have to submit a greater volume of data to the EU to travel and work in the EU when they no longer have the free movement rights of EU citizens. We should clarify therefore that we and our predecessors were not concerned, as the Minister assumes, about different data protection rules applying to the EU institutions depending on whether the data of third country or EU citizens was being processed.**

3.8 **We thank the Minister for the brief update on the proposed E-Privacy Regulation[16] which we currently have under scrutiny. While this is helpful, we expect a fuller explanation in due course of why there has been a lack of progress on this proposal from a UK point of view. In particular, have there been any UK objections to restrictions in the text under negotiation or to amendments being proposed by the European Parliament (EP) to prevent or limit the ability of UK authorities to access encrypted communications used by some "Over-the-top" (OTT) providers such as What's App for national security purposes? We note in this respect that:**

- **the Lauristin Report of the EP's LIBE Committee,[17] adopted by the EP on 23 October 2017, proposes a new recital to the text as follows "(26 a) In order to safeguard the security and integrity of networks and services, the use of end-to-end encryption should be promoted and, where necessary, be mandatory in accordance with the principles of security and privacy by design. Member States should not impose any obligation on encryption providers, on providers of electronic communications services or on any other organisations (at any level of the supply chain) that would result in the weakening of the security of**

16 Proposal for a Regulation concerning the respect for private life and the protection of personal data in electronic communications and repealing Directive 2002/58/EC (Regulation on Privacy and Electronic Communications), 5358/17, COM (2017) 10.

17 Report of the Civil Liberties, Justice and Home Affairs Committee of the EP dated 20 October 2017, A8–0324/2017,

their networks and services, such as the creation or facilitation of 'backdoors'." The proposed prohibition is contained in the amendment to Article 17 of the proposed Regulation (new paragraph 1(a));[18] and

- **The Home Secretary (Amber Rudd) has spoken on many occasions about the Government's desire to access such encrypted communications, in the fight against terrorism. See for example, her interview with the BBC reported on 1 August 2017[19] prior to her meeting with tech companies in Silicon Valley on the subject of Counter-Terrorism.**

3.9 **Pending the Minister's responses, we retain the current proposal under scrutiny. We draw the document and this chapter to the attention of the Digital, Culture, Media and Sport Committee.**

Full details of the documents

Proposal for a Regulation on data protection rules applicable to EU institutions, bodies, offices and agencies, repealing Regulation (EC) No 45/2001 and Decision 1247/2002/EC: (38446), 5034/17, COM(17) 8.

The Minister's letter of 7 February 2018

3.10 The Minister for Digital and the Creative Industries at the Department for Digital, Culture, Media and Sport (Margot James) first provides background to the current proposal:

> "As you will be aware, the European Institutions Regulation (5034/17) sets out the rules for processing personal data by the European Union institutions and bodies. The Regulations require that EU bodies must process all personal data under the same rules, whether they come from EU citizens or not.
>
> "As the existing rules were heavily based on the 1995 Directive, differences exist between the current Regulation and the General Data Protection Regulation (GDPR). In accordance with Article 2(3) of the GDPR, the European Institutions Regulation therefore needs to be updated so as to create a coherent data protection framework.

3.11 Next, she updates us on the stalled trilogue negotiations on the proposal:

> "In relation to the current status of this Regulation, the Estonian Presidency began trilogue in late autumn 2017. These talks have reached an impasse because of some controversial amendments being proposed by the European Parliament namely:

18 "(1a) Providers of electronic communications services shall ensure that there is sufficient protection in place against unauthorised access or alterations to the electronic communications data, and that the confidentiality and integrity of the communication in transmission or stored are also guaranteed by technical measures according to the state of the art, such as cryptographic methods including end-to-end encryption of the electronic communications data. When encryption of electronic communications data is used, decryption by anybody else than the user shall be prohibited. Notwithstanding Articles 11a and 11b of this Regulation, member States shall not impose any obligations on electronic communications service providers or software manufacturers that would result in the weakening of the confidentiality and integrity of their networks and services or the terminal equipment, including the encryption methods used."

19 BBC Website, 1 August 2017.

> "a. The inclusion of Eurojust and Europol under the measure's scope. The Government notes that these bodies' data processing is already covered by strong, comprehensive data protection provisions which are specifically tailored to meet the operational needs of law enforcement agencies, in their respective Regulations. In each of the founding acts for the Justice and Home Affairs agencies, data protection law was thoroughly discussed, taken into account and recently improved. The proposed amendments foreseeing a "one size fits all" approach is thus not necessary and also risks generating gaps and creating legal uncertainty.
>
> "b. The inclusion of Common Security and Defence Policy in these Regulations: The Government notes that these matters are not within EU competence."

3.12 She adds that:

> "No resolution of the above matters has been reached under the Estonian Presidency, and they will be passed to the Bulgarian Presidency in the New Year for further discussion."

3.13 The Minister also addresses previous scrutiny questions about the extent to which the European Data Protection Supervisor (EDPS)'s recommendations were taken into account in relation to the General Approach on this current proposal. She responds, by listing the key recommendations of the EDPS in turn:

> "(a) In relation to the various derogations in the proposal (Article 25), the EDPS advised that restrictions on rights and obligations should only be permitted where set out in legal acts based on the Treaties and not just in administrative rules. This is to align with the GDPR requirement for Member States to enact such restrictions in national legislation. This has been partially addressed by virtue of the fact that, although the ability of Institutions and Bodies to set internal rules will remain, this will be subject to certain conditions and various safeguards, ensuring internal rules are published and transparent, and can be legally challengeable.
>
> "(b) The EU institutions exercising public authority should not be able to outsource the function of a Data Protection Officer. This recommendation was not followed in the Council's General Approach.
>
> "(c) Article 66, which would grant the EDPS the power to impose administrative fines on the EU institutions was justified because otherwise they would enjoy a privileged position compared with public sector institutions in Member States under the GDPR. This recommendation was accepted, with the text permitting the EPDS to fine EU bodies."

3.14 The Minister then turns to the previous scrutiny questions about the impact of the proposed Regulation on UK citizens as third country nationals after the UK has left the EU. She says:

> "The EU Institutions Regulation has the same effect as the GDPR but regulate processing for the EU Institutions and Bodies. It requires EU institutions, bodies, and agencies to process personal data in the same way, whether they relate to EU citizens or third country nationals."

3.15 Finally, the Minister also provides us with a short update on the proposed e-Privacy Regulation. Discussions have not progressed on this proposal in Council. This is partially due to great uncertainty over the text's effect and its relation to the GDPR, with many Member States yet to take a position. She adds:

> "In addition to the crossover with the GDPR, discussions have focused on seeking clarity about which types of processing fall under the proposal's scope, on the effects of the proposed limited range of circumstances for processing e-comms data, and on the proposed new cookies rules. The UK has posed six questions to the Commission on the effect of the proposed rules for cookies. These questions were adopted by the Presidency, and the Commission has recently produced a non-paper in response. The Government is currently analysing the Commission's answers."

Previous Committee Reports

First Report, HC 301–i (2017–19), chapter 12 (21 November 2017); Thirty-first Report HC 71–xxix (2016–17), chapter 5 (8 February 2017).

4 Import of cultural goods

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Digital, Culture, Media and Sport Committee
Document details	Proposal for a Regulation of the European Parliament and of the Council on the import of cultural goods
Legal base	Article 207 TFEU; ordinary legislative procedure; QMV
Department	Digital, Culture, Media and Sport
Document Number	(38915), 11272/17 + ADDs 1–3, COM(17) 375

Summary and Committee's conclusions

4.1 In July 2017 the European Commission proposed a new customs regime under which cultural goods older than 250 years coming into the European Union would be subject to an import licence (for artefacts considered most at risk, such as parts of ancient monuments) or a self-certification system, affirming the legal exportation of the goods before they could enter the EU for free circulation.[20] It is driven primarily by the perception that illicit trade of archaeological artefacts is a significant source of revenue for organised crime and terrorist groups, including Da'esh in Syria and Iraq.[21]

4.2 The then-Parliamentary Under Secretary of State for Cultural Heritage (John Glen) submitted an Explanatory Memorandum on the proposed Cultural Goods Regulation in August 2017.[22] The Minister expressed concerns about the effectiveness of the new regime in preventing illicit trade in cultural goods, as well as the lack of data provided by the Commission to link trafficked artefacts to terrorist financing. He also noted that the UK, as the world's second-largest market for works of art, would be impacted by the proposal more than any other EU country.

4.3 We first considered the proposed Regulation in November 2017.[23] We concluded that the Government could be under an obligation to implement the new legislation if it took effect during the post-Brexit transitional period.[24] Moreover, the proposal could impact on future trade between the UK and the EU, as exports of cultural goods to an EU country would be subject to its provisions once the UK effectively leaves the Customs Union. Given the questions around the effectiveness of the new customs regime and the disproportionate impact it would have for the UK, we retained the proposal under scrutiny and requested some additional information from the Minister.

20 See Commission document COM(2017) 375.
21 See ECOFIN Council, "Council conclusions on the fight against the financing of terrorism" (12 February 2016), paragraph 12.
22 Explanatory Memorandum submitted by the Department for Digital, Culture, Media & Sport (16 August 2017).
23 See Report of 29 November 2017.
24 During the transitional period, the UK would effectively stay in the Customs Union and be under an obligation to implement EU customs law (including new legislation which takes effect during this period).

4.4 In February 2018 the new Minister for Cultural Heritage (Michael Ellis) responded to the questions we raised in our November 2017 Report.[25] As we have set out in more detail in paragraphs 4.22 to 4.26 below, the letter indicates that the Government:

- has still not been provided with any empirical evidence to prove the sale of archaeological artefacts is a significant source of revenue for terrorist groups in the Middle East;
- believes the self-certification regime for cultural goods deemed at lower risk of trafficking could facilitate rather than hinder illicit trade in such goods; and
- consulted the British Art Market Federation (BAMF), which expressed "strong concern" that the proposal could "create an unfortunate perception that the UK is a more complicated place for art sales and potentially hinder our global competitiveness".

4.5 As result, the Minister says:

> "As it currently stands this proposal potentially introduces significant administrative burdens without demonstrating a significant contribution to addressing its stated objectives. We are engaging with the Commission and Member States to further develop the proposal to ensure that it is as efficient and effective as possible in preventing any potential use of cultural goods to finance terrorism, for example by focusing on cultural goods that are deemed to be most at risk of use for terrorist financing."

4.6 With respect to the implications of Brexit for UK-EU trade in artworks after the UK leaves the Customs Union and the Single Market, the Minister simply reiterates the Government's ambition to negotiate a new "customs arrangement" with the EU which makes trade as frictionless as possible; avoids a 'hard border' between Ireland and Northern Ireland; and allow the UK to establish an independent international trade policy.

4.7 The Bulgarian Presidency of the Council has not scheduled the proposal for consideration by the Council in the first half of 2018, and the European Parliament's International Trade Committee is expected to establish its position on the proposed Regulation in July. As such, it is currently unclear when the new customs regime for cultural goods would become operational.

4.8 **We have taken note of the concerns expressed by both the Minister and the BAMF about the ramifications of the proposal as it stands for the UK's art market, and will keep the negotiations on the new customs regime under close review.**

4.9 **In this respect, we are concerned that, if the proposed Regulation takes effect before or during the transitional period, the UK will have to apply it despite the clear concerns about the effectiveness of the new regime and the new burden on both customs authorities and art dealers. Moreover, if the Regulation is already in effect before the end of the transition, the UK may find it more difficult to abolish the system while negotiations with the EU on a new customs agreement—which are likely to rely to a large extent on continued regulatory convergence to maintain trust—were underway.**

25 Letter from Michael Ellis to Sir William Cash (1 February 2018).

Any efforts to revoke or repeal substantive EU customs legislation during this period could complicate efforts to agree streamlined customs processes with the European Commission.

4.10 **After EU law ceases to apply to the UK, and if it has not voluntarily agreed to stay aligned with the substance of EU customs law, the UK will still be affected by the Regulation insofar as trade with the EU-27 is concerned. The Minister has clarified that the Government's existing export licensing regime for cultural goods would not need modification to supply UK traders with the necessary documentation if they wish to acquire an EU import licence for a cultural good covered by the new Regulation. However, the need for exporters to apply for such documentation before they can sell cultural goods to EU-based customers will still represent a significant non-tariff barrier to trade that is currently absent.**

4.11 **Moreover, while the Minister reiterated the objective of avoiding any physical infrastructure on the border between Ireland and Northern Ireland, he has provided no detail on how this would work in practice.**

4.12 **In the context of the Cultural Goods Regulation specifically, Irish customs authorities would be required to "check whether the import licence corresponds to the goods presented" for any art works subject to the import licensing regime under the new legislation. If it did not check goods entering the EU via Northern Ireland, importers could circumvent the entire system with relative ease by importing a cultural good into the UK and then transport it into Ireland without any additional controls. If the UK does not apply the same regime at its borders, it is unclear how Ireland—or any other EU country—could legally rely on the assurances given by the UK's export licensing authorities that the checks on the provenance of a cultural good met the requirements of the new Regulation.**

4.13 **Given the potential implications of the proposed customs regime for the UK art market, both before and after EU law ceases to apply in the UK, we retain the proposal under scrutiny. As the Minister has not clarified the substance or scope of the "additional measures" aimed at tackling illicit trade in cultural goods, which the Commission said would be "put in place in the near future" back in July 2017, we ask him to provide this information without delay.**

4.14 **We also draw the Minister's letter to the attention of the Digital, Culture, Media & Sport Committee.**

Full details of the documents

Proposal for a Regulation of the European Parliament and of the Council on the import of cultural goods: (38915), 11272/17 + ADDs 1–3, COM(17) 375.

Background

4.15 The EU is the second largest market for cultural goods such as art works, antiquities and manuscripts in the world, estimated to be worth $22 billion (£17 billion) annually, of which the UK alone accounts for over sixty per cent. The UK imported between £2.8

billion and £4.1 billion worth of art in the last three years, while exports during that same period ranged between £4.7 billion and £6 billion.[26] Intra-EU trade is significant for the UK market, accounting for some 15 to 20 per cent of UK art sales.[27]

4.16 In 2016, EU Finance Ministers called on the European Commission to propose legislative measures in the "fight against illicit trade in cultural goods", based on the perception that sales of art and archaeological artefacts were significant sources of revenue for organised crime and terrorist groups, including Da'esh. As a result, the Commission in July 2017 proposed a new customs regime under which cultural goods would be subject to an import licence (for artefacts considered most at risk, such as parts of ancient monuments) or a self-certification system, affirming the legal exportation of the goods before they could enter the EU for free circulation.

4.17 The Commission noted that the proposed Regulation would complement other EU initiatives to address trafficking of cultural goods, including an EU-UNESCO pilot project to design training modules for national authorities; funding a comprehensive study on illicit trade in cultural goods; and capacity-building for law enforcement authorities in non-EU countries through the Commission's Technical Assistance and Information Exchange instrument (TAIEX).[28] It also announced that "additional measures aimed at facilitating implementation of the proposed Regulation and supporting its objectives" were to be put in place "in the near future".[29]

Our consideration of the proposal

4.18 The then-Parliamentary Under Secretary of State for Arts, Heritage and Tourism at the Department for Digital, Culture, Media and Sport (John Glen) submitted an Explanatory Memorandum on the proposal in August 2017.[30] The Minister emphasised the UK's support for the objectives of the proposal, but expressed concerns about the additional resources it would require from customs and import authorities, as well as the lack of data on the flow of trafficked cultural goods and the connection between illicit trade in antiquities and terrorist financing. He also noted that the UK, as the world's second-largest market for works of art, would be impacted by the proposal more than any other Member State.

4.19 When we first considered the proposal, in November 2017, we expressed our support for initiatives to improve coordination of efforts across the EU to prevent the unlawful entry and sale of cultural goods.[31] However, we expressed concern about:

- the lack of evidence adduced by the Commission for the size of the black market for cultural goods, and the extent to which it provides any significant income stream for terrorist organisations (the reasoning provided by EU Finance Ministers to call for the proposal back in February 2016);[32]

26 The British Art Market Federation (BAMF), "The British Art Market 2017" (September 2017).

27 The BAMF has said: "While the US was the most important trading partner by value, for some of the major auction houses, consignments from EU member states accounted for up to 25% of their UK sales on average, while up to 20% of their exports were destined to EU buyers. In the dealer sector also, the main dealer associations reported that on average between 10% and 22% of dealers' purchases for subsequent sale were made in the EU, and EU purchasers accounted for 15%—20% of all their sales."

28 See https://ec.europa.eu/neighbourhood-enlargement/tenders/taiex_en.

29 See Commission document COM(2017) 375, p. 4.

30 Explanatory Memorandum submitted by the Department for Digital, Culture, Media & Sport (16 August 2017).

31 See Report of 29 November 2017.

32 See ECOFIN Council, "Council conclusions on the fight against the financing of terrorism" (12 February 2016), paragraph 12.

- the additional resource requirements the Regulation could impose on the UK's customs and import licensing authorities if HM Revenue and Customs had to apply it during the post-Brexit transitional period; and
- the adverse impact a more onerous import regime could have on the UK's substantial market for works of art and other cultural goods.

4.20 We also considered the proposal in the context of the UK's withdrawal from the EU:

- firstly, during the proposed post-Brexit transitional period, the UK would effectively stay in the Customs Union and be under an obligation to implement EU customs law—including this new regime for importation of cultural goods, if it takes effect before or during the transition;[33]
- secondly, as the Regulation affects trade between EU and non-EU countries, it would affect UK exports of cultural goods to the EU once the UK becomes a "third country". In particular, under articles 4 and 5 of the proposed Regulation, any goods in scope exported from the UK into the EU would need to be accompanied by a licence or self-certified statement that the good was lawfully exported from the UK; and[34]
- alternatively, depending on the scope of the post-Brexit UK-EU partnership on customs, the UK could agree to apply the new Regulation on imports of cultural goods coming from outside the EU, to reduce the need for customs controls when such goods are subsequently exported from the UK to an EU country.[35]

4.21 As a result, the Committee considered the proposal politically important, and retained it under scrutiny. We asked the Minister to provide us with the following information to assist in assessing the implications of the Regulation:

- the evidence base for the level of illicit trade in cultural goods in the EU, especially the suggested link between this black market and terrorist groups;
- the Government's view on the substance of the proposal, including the effectiveness of the proposed self-certification regime; the consequences if customs authorities determined a cultural good was being trafficked into the EU; and the proposed ability for the Commission to vary the scope of the Regulation by Delegated and Implementing Acts;
- further information on the "additional measures aimed at facilitating implementation of the proposed regulation and supporting its objectives", which the European Commission said in July 2017 would be put in place "in the near future";[36] and

33 If the Regulation becomes applicable on 1 January 2019 as proposed by the Commission, the Government would have to apply it in full as well and it would, in principle, be incorporated into UK law on Brexit Day under the EU (Withdrawal) Bill.

34 However, as we noted in our previous Report, the UK, in conformity with EU law, already requires an export licence to be issued before certain types of cultural goods. We concluded it was reasonable to presume that the provision of the necessary documentation by the Government to exporters should be relatively straightforward.

35 The Government's paper on the future UK-EU customs partnership envisages continuing some (unspecified) "existing arrangements between the UK and the EU", or even "mirroring the EU's requirements for imports from the rest of the world where their final destination is the EU".

36 Deloitte, "Fighting Illicit Trafficking in Cultural Goods: analysis of customs issues in the EU" (June 2017).

- the potential impact of the Regulation, and the re-imposition of customs controls on UK-EU flows of goods more generally, on the market for artworks in the UK, after Brexit.

The Minister's letter of 1 February 2018

4.22 In February, the new Minister for Cultural Heritage (Michael Ellis) responded to the questions we raised in our earlier Report.[37] This makes clear that:

- the Council provisionally endorsed the European Commission's suggestion for a new customs regime for cultural goods based on the latter's assertion that there was a "clear link" that Da'esh in particular was using archaeological artefacts looted from Iraq and Syria as a source of income. However, the Commission's external study on this link,[38] published *after* its legislative proposal, provided only "anecdotal evidence rather than empirical data";

- the Government questions the effectiveness of the proposed self-certification regime under article 5 of the Regulation for cultural goods not perceived to be at high risk of trafficking. In particular, the Minister states that "there is a danger that self-certification could be used to support a false provenance, aggravating the problem rather than alleviating it";

- there is no provision within the proposed Regulation on what would happen if customs authorities determined that a cultural good presented at the border was not lawfully exported, but the Government "is considering how such cases should be handled", the Minister undertakes to provide further information to the Committee in due course, as negotiations on the proposal progress; and

- the Government is not opposed, in principle, to the use of Delegated Acts to provide the Commission with the flexibility to update the Regulation to "keep pace with any new developments in terrorist financing, for example to enable changes to be made to the list of cultural goods to which the Regulation applies".

4.23 With respect to the potential impact of the Regulation on the UK while it remains bound by EU law, the Minister explains that the British Art Market Federation (BAMF) has expressed "strong concern" that the proposal would affect the UK more than any other EU Member State because of the size of its art market and our dependence on cross-border trade, and "create an unfortunate perception that the UK is a more complicated place for art sales and potentially hinder our global competitiveness".[39]

4.24 As a result of the above, the Government is clearly unconvinced of the effectiveness of what the Commission has proposed. The Minister says in his letter:

> "As it currently stands this proposal potentially introduces significant administrative burdens without demonstrating a significant contribution

37 Letter from Michael Ellis to Sir William Cash (1 February 2018).

38 Deloitte, "Fighting Illicit Trafficking in Cultural Goods: analysis of customs issues in the EU" (June 2017).

39 The BAMF has also identified a number of opportunities for the UK art market arising from Brexit, notably the ability for the UK to negotiate more streamlined customs processes with non-EU countries directly (although it also notes that "satisfactory arrangements for trade with the EU will (…) be paramount"); the "removal of unnecessary red tape and regulation"; and the abolition of import VAT on artworks. See also BAMF, "The British Art Market: Opportunities for the Future" (September 2017).

> to addressing its stated objectives. We are engaging with the Commission and Member States to further develop the proposal to ensure that it is as efficient and effective as possible in preventing any potential use of cultural goods to finance terrorism, for example by focusing on cultural goods that are deemed to be most at risk of use for terrorist financing."

4.25 With respect to the implications of Brexit for UK-EU trade in artworks after the UK leaves the Customs Union and the Single Market (at the end of the transitional period, or in March 2019 if no transition is agreed), the Minister clarifies that the UK's current export licensing regime for cultural goods would "require no modification in order for importers of cultural goods from the UK to the EU to obtain documentation necessary" to comply with the proposed certification regime for the most at-risk cultural goods post-exit. He also reiterates the Government's hopes to negate any barriers to trade arising from Brexit by negotiating a new "customs arrangement" with the EU which makes trade as frictionless as possible; avoids a 'hard border' between Ireland and Northern Ireland; and allows the UK to establish an independent international trade policy.

4.26 The Bulgarian Presidency of the Council has not scheduled the proposal for consideration by the Council in the first half of 2018. The European Parliament is expected to establish its position on the proposed Regulation in July. As such, it is unlikely the new Regulation would be agreed in time for entry into force by January 2019, as envisaged by the European Commission.

Previous Committee Reports

Second Report HC 301–iii (2017–19), chapter 3 (29 November 2017).

5 Single European Sky

Committee's assessment	Politically important
Committee's decision	Waiver granted; further information requested; drawn to the attention of the Transport Committee
Document details	Court of Auditors: Special report No 18/2017: Single European Sky: a changed culture but not a single sky
Legal base	—
Department	Transport
Document Number	(39300), Unnumbered

Summary and Committee's conclusions

5.1 The European Court of Auditors has issued a report[40] following a review of whether the EU Single European Sky (SES) air traffic management initiative is meeting its objectives. Given the UK's impending departure from the EU, the Committee has chosen to use this chapter as an opportunity to consider the implications of EU exit for air traffic management.

5.2 Single European Sky (SES) is an EU programme to improve the efficiency of European air traffic management (ATM) and air navigation services to cope with traffic growth in a safe and cost efficient manner. SES comprises a set of regulations which establish a number of tools and cooperative arrangements to drive improvements in this area, as well as a project to develop and deploy new operating concepts and technology called SESAR (the Single European Sky Air Traffic Management Research project).

5.3 Published on 30 November 2017, the Court of Auditors' Report, "Single European Sky: a changed culture but not a single sky",[41] found that the SES initiative was justified because European ATM was hindered by national monopolies and fragmentation. Although it found that the SES had fostered a culture of efficiency and transparency, it concluded that the results had not met original expectations, and provides a number of recommendations to enable it to do so in future.

5.4 On 18 December 2017 the Parliamentary Under Secretary of State at the Department for Transport (Baroness Sugg) submitted an Explanatory Memorandum[42] to Parliament in which she outlined the Government's position in relation to the report. The Minister states that the Government welcomes the report, that the actions identified in it do not include any proposals for new EU legislation, and that there are no immediate actions required of the UK. She responds to a number of individual points raised by the report and briefly addresses the implications of EU exit for UK air traffic management.

40 European Court of Auditors, Special report No 18/2017: Single European Sky: a changed culture but not a single sky (30 November 2017).

41 European Court of Auditors, Special report No 18/2017: Single European Sky: a changed culture but not a single sky (30 November 2017).

42 Explanatory Memorandum from the Minister, DFT (18 December 2017).

5.5 We thank the Minister for her Explanatory Memorandum concerning the Court of Auditors' report on the Single European Sky. Regarding EU exit, we note the Government's comments that:

- **it recognises the need to ensure interoperability between the UK's arrangements for managing air traffic and those of the EU;**
- **whether the UK remains part of the UK-Ireland Functional Airspace Block (FAB) is a matter for negotiations with the EU; and**
- **there are mechanisms other than FABs, such as the "Borealis" partnership, for organising air navigation services on a cross-border basis.**

5.6 We conclude that the Single European Sky (SES) regime will cease upon withdrawal to apply to the UK, and that subsequent UK-EU arrangements will be subject to negotiation. Although the UK could unilaterally retain some aspects of SES rules in UK law through the EU (Withdrawal) Bill, many SES provisions are cross-border and reciprocal in character, and will therefore no longer function outside the Union.

5.7 We note that European third countries that conclude agreements with the EU can participate in the SES airspace and regulatory regime, and that participation has been extended to signatories of the European Common Aviation Area Agreement (ECAA);[43] however, these countries apply the EU aviation acquis as well as a wide range of associated environmental, social and consumer protection rules. Participation also entails accepting the indirect jurisdiction of the Court of Justice of the European Union (CJEU).

5.8 Implications for UK air traffic management of an exit from the SES include: the need to renegotiate on a bilateral basis ATM arrangements with the EU (including charging arrangements); the effects of a likely reduction over time in the interoperability between UK and EU ATMS, as the UK becomes less involved in the development of the EU system; the loss of EU funding relating to ATM initiatives; and the cost to the UK of developing its own ATM technological research programme. While these issues pose policy challenges, we consider them less critical than other challenges facing the sector, such as traffic rights, participation in the European Aviation Safety Agency (EASA), and other arrangements affecting trade in goods. In the context of the Article 50 negotiations, we note that it is unclear to what extent these issues can be disaggregated, and that the European Commission's slides on aviation[44] suggest that it may treat them as a package.

5.9 To enable us to conclude our scrutiny of the implications of EU exit for air traffic management, we ask the Government to respond to the following questions:

- **Does the Government seek continued participation, as a third country, in the Single European Sky regime? Does it intend to do so through remaining a member of the European Common Aviation Area (ECAA), albeit as a third country? If not, what type of arrangement does it envision?**

43 Official Journal L 285 (16 October 2006) p. 3–46, Multilateral Agreement between the European Community and its Member States, the Republic of Albania, Bosnia and Herzegovina, the Republic of Bulgaria, the Republic of Croatia, the former Yugoslav Republic of Macedonia, the Republic of Iceland, the Republic of Montenegro, the Kingdom of Norway, Romania, the Republic of Serbia and the United Nations Interim Administration Mission in Kosovo on the establishment of a European Common Aviation Area.

44 Taskforce 50, Internal EU27 preparatory discussions on the framework for the future relationship: "Aviation" (17 January 2018).

- **Will the Government seek to remain associated to SESAR and SESAR-JU, and how would such a status differ from current arrangements for the UK, in terms of its rights and obligations? Were the UK to leave SESAR and SESAR-JU, would the Government have to develop a UK equivalent? What would the financial implications of this be?**

- **What would be the practical implications for air traffic management of a non-negotiated UK exit from the EU?**

- **We understand that the UK air navigation service provider NATS supports leaving the EU air traffic management system, as the EU performance and charging regime could potentially constrain NATS' ability to increase the charges it applies to airspace users, which would in turn limit its ability to subsidise the deficit relating to the group's defined benefit pension scheme.[45] Will NATS' pension deficit be a factor in the Government's decision as to whether to leave SES? If the UK leaves SES, will the Government allow the Civil Aviation Authority (CAA) to apply a more lenient regime, which would enable NATS to offset its pension deficit by increasing charges as necessary, even though these increases may ultimately be passed on to passengers?**

- **Would the Government/CAA preventing NATS from increasing its charges to subsidise its pension deficit breach the Government's obligations under its contract with NATS not to do anything which would affect NATS's future financing?**

- **Does the Government consider that the need to ensure interoperability between the UK's arrangements for managing air traffic and those of the EU will, in practice, require us to closely follow the EU regime, or does the Government believe that it will be possible to advantageously diverge from the EU regime in certain respects, without unnecessarily increasing costs for stakeholders (please provide examples)?**

- **What funding do UK stakeholders currently receive from EU funding sources in relation to ATM and to what extent is loss of this funding probable post-withdrawal?[46]**

- **If the Government chooses to leave the SES regime, what key policy choices will have to be made in developing a replacement domestic regime?**

- **How does the Government intend to respond to pressure to unblock the EU's proposed SES II+ legislation?**

5.10 **We grant the Government a waiver to agree Council conclusions which might recommend legislative action, provided that they are in line with the recommendations of the CoA report and the Government's reflections thereon as provided in its**

45 NATS Limited, Annual Report and Accounts 2017. The company's financial statements for the year ended 31 March 2017 state that, according to an evaluation at 31 December 2015, the company's defined benefit pension scheme reported a funding deficit of £458.7m, an increase of £76.1m from a 2012 valuation.

46 We note that NATS receives funding for its national SESAR programme through the Connecting Europe Facility, and has applied for EU funding to develop Borealis FreeRoute Airspace, as reported in AirTrafficManagement.net, Brexit fallout for Single Sky remains unclear (June 24 2016).

Explanatory Memorandum.[47] We ask the Government to respond to the above questions by March 28 2018. In the meantime, we retain the proposal under scrutiny, and draw it to the attention of the House of Commons Transport Select Committee.

Full details of the documents

Court of Auditors: Special report No 18/2017: Single European Sky: a changed culture but not a single sky: (39300), Unnumbered.

Background

Air traffic management

5.11 Air traffic management is needed to ensure safe and efficient air transport in a context of growing air traffic using a limited volume of airspace. It consists of three primary activities:

- ensuring separation between aircraft;
- balancing supply (of air traffic control) with demand (flights), aiming at a safe and efficient flow of air traffic; and
- providing aeronautical information to airspace users (e.g. navigational aids, weather information).

5.12 Air carriers are charged for the air traffic management services they receive on the basis of the type of aircraft and the distance flown within the area of responsibility of each air navigation service provider (ANSP), according to the planned trajectory, paying a European average of around 900 euro per flight.

5.13 Air traffic management has traditionally been developed and provided at a national level by air navigation service providers (ANSPs). NATS is the UK's air navigation service provider (ANSP) providing air traffic control services handling 2.4 million flights and 250 million passengers in UK airspace each year.[48] NATS is a public private partnership between the Airline Group, NATS staff, UK airport operator LHR Airports Limited, and the Government. It is regulated by the CAA under a licence covering en-route services and services provided in a portion of the North Atlantic. Many elements of its economic and safety regulation are governed currently by EU regulations set under the Single European Sky legislative framework.

47 The Scrutiny Reserve Resolution applies, inter alia, to any "agreement to a programme, plan or recommendation for European Community legislation". While Council conclusions regarding Court of Auditors' reports do not always meet this threshold, some of the recommendations in the Court of Auditors' report could be addressed by legislative means, in which case the scrutiny reserve would apply; hence our decision to waive the scrutiny reserve.

48 See NATS website: https://www.nats.aero/about-us/what-we-do/atc-explained/.

Single European Sky (SES)

5.14 Because European airspace was organised along national lines and managed by national ANSPs, this meant that each ANSP operated used its own procedures and support equipment, which limited interoperability and economies of scale. This led to delays, uneconomical flight trajectories and unreasonable air-traffic control costs.

5.15 In response, the EU adopted in 2004 the first SES legislative package, which was revised and extended in 2009 in the "SES II" package.[49] SES consists of a regulatory framework coupled with a technological modernization programme, as well as financial support to SESAR. The SES area includes all 28 Member States of the European Union and extends also to Switzerland and Norway.

5.16 The key objectives of the SES legislative framework are:

- to restructure European airspace as a function of air traffic flows;
- to create additional airspace capacity; and
- to increase the overall efficiency of the ATM system.

5.17 Key strands of the SES regime include:

- Functional airspace blocks (FABs)—In order to effectively manage the growth of airspace traffic, the EU proposed to move European airspace management away from irrational national boundaries to the use of 'functional airspace blocks' based on traffic flows, the boundaries of which would be designed to maximise the efficiency of the airspace. To achieve this objective, common rules and procedures at European level, hence the creation of SES.
- Performance-based regulatory framework and charging schemes—In 2012 the European Commission introduced a regulatory framework in support of the Single European Sky, which aimed at setting and implementing binding targets for EU Member States in the key performance areas of safety, environment, airspace capacity and cost efficiency.[50] Member States put forward proposals as part of Functional Airspace Blocks (FABs) to the European Commission for its approval based on its assessment of whether the plans make a sufficient contribution to the key performance areas. The framework includes charging schemes which require ANSPs to illustrate the cost-base for the charges they propose to apply to their customers during a reference period, and to demonstrate compliance with a number of rules and conditions, before they are approved. Union-wide targets for the second reference period were set by a Commission Implementing Decision of 11 March 2014.[51]
- The Single European Sky Air traffic management Research programme (SESAR)—On the technology side, SES is supported by the SESAR Programme,

49 The SES legislative framework consists of four Basic Regulations (549/2004, 550/2004, 551/2004 and 552/2004) covering the provision of air navigation services (ANS), the organisation and use of airspace and the interoperability of the European Air traffic management Network (EATMN). These were amended by Regulation 1070/2009 (SES II). The consolidated text of the four Regulations, as subsequently amended, is available here.

50 European Commission, Performance and Charging Schemes (accessed 19 February 2018).

51 Commission Implementing Decision 2014/132 setting the Union-wide performance targets for the air traffic management network and alert thresholds for the second reference period 2015–19 (11 March 2014).

> which aims to provide advanced technologies and procedures with a view to modernising and optimising the future European ATM network. This is supported by the SESAR Joint Undertaking (SJU), a public-private partnership set up to manage the research and development of SESAR with EU funding provided under Horizon 2020 rules.

5.18 EASA and the European Commission develop SES rules.

Third country provisions

5.19 The Single European Sky Regulations contain a number of third country provisions. Article 7 (Relations with European third countries) of Regulation 549/2004,[52] states that:

> "The Community and its Member States shall aim at and support the extension of the single European sky to countries which are not members of the European Union. To that end, they shall endeavour, either in the framework of agreements concluded with neighbouring third countries or in the context of agreements on functional airspace blocks, to extend the application of this Regulation, and of the measures referred to in Article 3, to those countries."

5.20 Article 9a (Functional Airspace Blocks) states that, "Where relevant, cooperation may also include third countries taking part in functional airspace blocks."

5.21 In December 2005, the EU concluded an agreement on the European Common Aviation Area (ECAA),[53] which extended the aviation acquis, including the SES, to Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Kosovo under UNSCR 1244, Norway and Iceland.

5.22 Article 13 of the ECAA Agreement provides that the contracting parties shall cooperate in the field of air traffic management with a view to extending the Single European Sky to the ECAA. To facilitate the application of the SES acquis in their territories, the Associated Parties must adjust their ATM institutional structures to the SES. The Union undertakes to associate the Associated Parties with any operational initiative in the fields of air navigation services, airspace and interoperability that stem from the SES, in particular through an early involvement of the relevant Contracting Parties' efforts to establish FABs.

5.23 One of the principles of the ECAA Agreement is that full compliance with the ECAA rules—which are based on the EU aviation acquis, set out in Annexes to the Agreement–is required for the Contracting Parties to enjoy the benefits of the ECAA, including market access. Annex 1 requires conformity not only with the EU aviation rules, but also a wide range of associated EU legislation, including environmental, social, consumer protection and other rules.

---

52 European Commission, SES I and II consolidated text: The 4 Regulations creating the Single European Sky, Article 7 of Regulation 549/2004 (February 2010).

53 Official Journal L 285 (16 October 2006) pp. 3–46, Multilateral Agreement between the European Community and its Member States, the Republic of Albania, Bosnia and Herzegovina, the Republic of Bulgaria, the Republic of Croatia, the former Yugoslav Republic of Macedonia, the Republic of Iceland, the Republic of Montenegro, the Kingdom of Norway, Romania, the Republic of Serbia and the United Nations Interim Administration Mission in Kosovo on the establishment of a European Common Aviation Area.

Eurocontrol

5.24 Eurocontrol, the European organisation for the safety of air navigation, is an inter-governmental organisation set up by its Member States to facilitate collaboration and ensure safe and seamless ATM across Europe. It currently has 41 member states, including non-EU States such as Turkey and the Ukraine. Eurocontrol provides the operational co-ordination of the European air traffic system, technical expertise and legislative assistance to the Commission, industry and Eurocontrol member states. Operationally, Eurocontrol ensures that air traffic is planned daily against available airspace capacity. It works to minimise delays in the event of crisis situations or strikes. The UK is a signatory to the Eurocontrol convention in its own right, independent of its membership of the EU.

5.25 Although it is not an EU agency, the EU has designated Eurocontrol to carry out certain functions under the SES legislative framework, for example: administering regulations; assisting the Commission's work in the Performance Review Body. In 2011 the Commission designated Eurocontrol the Network Manager for all European airspace. This involves tasks including airspace design and flow management.

5.26 Eurocontrol also runs the Central Route Charges Office (CRCO), through which airspace users pay for the air traffic services they use. The CRCO calculates the route charges due to the Member States for the services provided, bills the airspace users and distributes the route charges to the States concerned.

Court of Auditors' Report[54]

5.27 The Court of Auditors' report, "Single European Sky: a changed culture but not a single sky", finds that:

- the SES initiative was justified because European air traffic management was hindered by national monopolies and fragmentation;
- subsequent changes in traffic patterns meant that the high level goals established in 2005 for the initiative became partly unachievable and partly irrelevant;
- The performance and charging schemes aim at mitigating the negative effects of a monopolistic service provision have fostered a culture of efficiency and transparency at the level of air navigation service providers (ANSPs), but the quantitative results fell below expectations; the absence of substantive defragmentation, coupled with slower traffic growth, are key contributors to the lacklustre quantitative results shown by the performance scheme;
- Functional Airspace Blocks (FABs) essentially provide a forum for cooperation between stakeholders of neighbouring States but have proved ineffective in targeting fragmentation;

54 European Court of Auditors, Special report No 18/2017: Single European Sky: a changed culture but not a single sky (30 November 2017).

- The oversight role attributed to National Supervisory Authorities (NSAs) is hampered by the fact that they are not always fully independent from ANSPs and in some cases do not have the necessary resources to fulfil it; and
- The process of adopting targets for the performance scheme is lengthy and complex.

5.28 The report recommends that the Commission should:

- review the SES high level goals;
- analyse other policy options targeting defragmentation;
- ensure full independence and capacity of NSAs and cover the inspection gap at the level of the charging scheme;
- streamline the performance scheme;
- review certain key performance indicators;
- review the EU's support structure to R&D in light of its objectives;
- reinforce the accountability of the SESAR JU; and
- prioritize EU support to R&D solutions that promote defragmentation and a competitive environment.

5.29 In its response, provided at the end of the report, the Commission accepts all of the recommendations and explains how it intends to act on them.

The Minister's Explanatory Memorandum of 18 December 2017[55]

5.30 The Parliamentary Under Secretary of State at the Department for Transport (Baroness Sugg) states that the Government welcomes the report and notes that the actions identified in it do not include any proposals for new EU legislation and that there are no immediate actions required of the UK. She also notes that many of the recommendations in the report would be addressed by the proposal to amend the basic SES legislation (SES II+), which has been stalled since 2014 following the dispute between Spain and UK over Gibraltar.

5.31 Regarding the implications of EU exit for UK air traffic management, the Minister states that the UK's future relationship with the EU SES programme is a matter for exit negotiations with the EU. She also notes that:

- the Government recognises the need to ensure interoperability between the UK's arrangements for managing air traffic and those of the EU;
- the Government is fully involving the Government of Gibraltar to make sure their priorities are taken into account;
- whether the UK remains part of the UK-Ireland FAB is a matter for negotiations with the EU on our future involvement in SES, but the Government recognises the need to continue collaboration with Ireland on ATM matters; and

55 Explanatory Memorandum from the Minister, DFT (18 December 2017).

- there are other mechanisms than FABs to reorganise the provision of air navigation services to offer more flexibility to airlines on the routes they fly, such as the 'Borealis' industrial partnership of Air Navigation Service Providers (ANSPs) which is delivering a large scale free route airspace project which is outside of the scope of SES regulations. NATS is a member of along with the ANSPs of Denmark, Estonia, Finland, Iceland, Latvia, Norway and Sweden.

5.32 In conclusion, the Minister states that the Government is supportive of the Report and that the Commission response is both proportionate and appropriate. However, she does state that the Report will put pressure on unblocking the EU's proposed SES II+ legislation. The Minister states that the Government will take this into account as part of the UK's forthcoming negotiations with the EU on its future relationship, whilst protecting the interests of the UK and Gibraltar.

Previous Committee Reports

None.

6 Port reception facilities for waste from ships

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Transport Committee, Environmental Audit Committee and Environment, Food and Rural Affairs Committee
Document details	Proposal for a Directive of the European Parliament and of the Council on port reception facilities for the delivery of waste from ships, repealing Directive 2000/59/EC and amending Directive 2009/16/EC and Directive 2010/65/EU
Legal base	Article 100(2) TFEU; ordinary legislative procedure; QMV
Department	Transport
Document Number	(39447), 5454/18 + ADDs 1–4, COM(18) 33

Summary and Committee's conclusions

6.1 The marine environment is increasingly threatened by both discharges of waste from ships and marine litter deriving mostly from land-based activities. One of the underlying problems is a lack of adequate facilities in ports to receive waste from ships. As part of its Plastics Strategy[56] and following a review of the existing framework, the European Commission therefore proposes an overhaul of the current legislation covering port reception facilities (PRF) to collect waste from ships.

6.2 The proposal aims to update and revise the PRF Directive, including by alignment with the latest MARPOL (International Convention for the Prevention of Pollution from Ships) requirements, and with a special focus on marine litter. It also aims to provide consistency with other EU Acts and monitoring and reporting obligations. It seeks to clarify and strengthen implementation, monitoring and enforcement through a combination of incentive and enforcement measures. These include amended requirements on cost recovery, which are extended to fishing vessels. Under the proposals, vessels will pay a flat "indirect" fee to the port/harbour irrespective of whether they deliver any waste or not. However, this should also give these ships the right to deliver all their garbage without having to pay any additional fees, including any derelict fishing gear and passively fished waste. For other forms of waste, a top-up "direct" fee can be charged based on the volume of waste and other criteria.

6.3 The Parliamentary Under-Secretary of State for Transport (Nusrat Ghani) signals the Government's support for the overall approach and principles of the proposal, which aligns with Government's own objectives to reduce plastic waste, and forms a contribution to the UK's 25-year environmental plan.

56 A European Strategy for Plastics in a Circular Economy.

6.4 While the majority of the proposals are in line with the UK's existing implementation of the current PFR Directive, some will require further clarification and the Government is still considering its position on four elements:

- introduction of an indirect fee for garbage;
- the issuing of a waste delivery receipt;
- separate collection of waste from ships in port; and
- delivery of passively-fished waste (waste collected in nets during fishing)—the Minister notes that the fishing industry is likely to bear the greatest burden of paying for delivery of this waste for which it is not largely responsible, thus not reflecting the 'polluter pays principle'.

The Government's initial concerns about these issues are set out in more detail below.

6.5 The Government is undertaking stakeholder engagement, the initial indications from which suggest that stakeholders share the Government's concerns. The Government will participate in negotiations with a view to ensuring that the proposal does not result in a measure that contains anything that goes beyond MARPOL requirements and, wherever possible, is proportionate, while removing red tape and lowering costs.

6.6 Turning to Brexit, it is relevant to note that the transposition deadline is 31 December 2020, which may fall at the very end of any post-Brexit transition period. The Minister notes that the proposal will affect third countries using EU and EEA (European Economic Area) ports, thus clarifying that the legislation will remain relevant to the UK post-Brexit. She adds that, post-Brexit, the UK will continue to play an important role in the international organisations that regulate shipping and will continue to work with other European countries on matters of common interest, such as the exchange of information on the safety of shipping and on pollution.

6.7 **Like the Government, we are supportive of measures to reduce waste in the marine environment, and particularly to tackle the growing problem of plastic waste.**

6.8 **We note the Government's intention to negotiate with a view to ensuring that the proposal does not result in a measure that contains anything that goes beyond the international (MARPOL) requirements. Should the Government be successful in that regard, the Brexit implication is that EU requirements would not differ from international requirements. On the other hand, any differences between EU and international requirements would affect the UK post-Brexit as a third country using EU ports. We ask the Minister to set out the instances where the proposal goes beyond the MARPOL requirements.**

6.9 **On the details of the proposal, we consider the cost recovery provisions to be particularly contentious, and notably those relating to fishing vessels. As the Minister observes, the proposal could impose on the fishing industry the greatest burden of paying for delivery of passively-fished marine litter even though much of the litter will result from other offshore and onshore activities. When the Minister next writes**

to update us on progress, we would welcome information on the current approach to collection of marine litter by the fishing industry, including the work of voluntary initiatives such as Fishing For Litter.[57]

6.10 **Taking into account concerns over the provisions on cost recovery, we would ask the Minister to reflect on an approach which supports the Commission's objectives, but leaves the detail of cost recovery to each Member State. Any such detail might bear in mind the proposed requirement in Article 4 that "the fees charged for delivery [should] not create a disincentive for ships to use the port reception facilities". This requirement strikes us as a helpful principle, which might usefully underpin the discussion on the proposal.**

6.11 **The Government's assessment of the proposal is ongoing, and stakeholder consultation is taking place. We ask for an update on the Government's position once it is clearer and we ask too for any available indication of the positions to be taken by other Member States.**

6.12 **We retain the proposal under scrutiny and draw it to the attention of the Environment, Food and Rural Affairs Committee, the Environmental Audit Committee and the Transport Committee.**

Full details of the documents

Proposal for a Directive of the European Parliament and of the Council on port reception facilities for the delivery of waste from ships, repealing Directive 2000/59/EC and amending Directive 2009/16/EC and Directive 2010/65/EU: (39447), 5454/18 + ADDs 1–4, COM(18) 33.

Background

6.13 Recently, the problem of marine litter has come to the fore, as evidence increases of the effects on marine ecosystems and of the impacts on human health. Although most sources of marine litter are land-based, shipping also has an important role to play in discharges of household waste and operational waste at sea.

6.14 The European Commission's proposal is part of the Regulatory Fitness and Performance (REFIT) programme and follows an evaluation in 2016 of the current Directive 2000/59/EC on Port Reception Facilities (the PRF Directive). The proposal is intended to repeal and replace the PRF Directive and amend related Directives 2009/16/EC on Port State Control and 2010/65/EU on Reporting Formalities.

6.15 Operational discharges of waste from ships are controlled under the International Convention for the Prevention of Pollution from Ships (the MARPOL Convention), adopted by the International Maritime Organisation (IMO) in 1973. This requires the Contracting Parties to provide for port reception facilities for waste that ships are not allowed to discharge into the sea.

6.16 The PRF Directive is based on MARPOL requirements, and aims to harmonise the operation of PRF across the EU to further reduce the discharge of ship-generated waste

57 http://www.fishingforlitter.org.uk/.

and cargo residues into the sea, especially illegal discharges, by improving the availability and use of PRFs, and providing an effective enforcement mechanism. The EU PRF system focuses mainly on the shore-side adequacy of the PRF through waste reception handling plans, cost recovery systems, and appropriate enforcement. It is intended to complement MARPOL, which primarily focuses on ship-based operations.

The Commission's proposal

6.17 The most important changes introduced by the new Directive are outlined below.

Cost recovery

6.18 All vessels calling at a port will be charged a flat "indirect" fee to cover indirect administrative costs (such as those relating to the preparation of waste reception and handling plans) and a significant part of the direct operational costs. Vessels may also be charged a "direct" fee on the basis of the types and quantities of waste actually delivered by the ship as well as the nature of the ship. A reduced fee should be applied for ships that can demonstrate sustainable waste management on board.

6.19 Similar to other vessels, fishing vessels will be required to pay the indirect fee to the port/harbour irrespective of whether they deliver any waste or not. Payment of this fee will, however, cover delivery of all garbage, including any derelict fishing gear and passively-fished waste without having to pay any additional direct fees (based on volumes).

Definitions

6.20 The definition of "waste from ships" is expanded to include all waste dealt with by MARPOL, including passively fished waste.

Adequacy of port reception facilities

6.21 The notion of 'adequate port reception facilities' has been more clearly described in line with IMO guidance. The requirement for separate collection of waste stemming from the Waste Framework Directive has been expressly included. It is also the case that fees charged for waste delivery should not create a disincentive for ships to use the port reception facilities.

6.22 As regards the waste reception and handling plans, which are instrumental for achieving adequacy of port reception facilities, stronger emphasis has been placed on the requirements to consult port users or their representatives.

Delivery arrangements

6.23 Ships (other than fishing vessels and recreational craft below 45 metres) must give advance notice of their arrival in port. The necessary advance waste notification form has been fully aligned with that of the relevant IMO voluntary Circular and is set out in a new Annex. Having arrived at port and delivered their waste, ships must be issued with a waste receipt.

Exemptions

6.24 There are a number of exemptions from the obligation to deliver waste, including:

- ships engaged in scheduled traffic with frequent and regular port calls; and/or
- there is an arrangement to ensure the delivery of the waste and payment of the fees in a port along the ship's route.

The Minister's Explanatory Memorandum of 12 February 2018

6.25 The Minister welcomes the overall approach and principles of the proposal, which aligns with Government's own objectives to reduce plastic waste, and forms a contribution to the UK's 25 year environmental plan. The majority of the suggestions, she says, are in line with the UK's existing implementation of the current PRF Directive, except for a few minor modifications. For example, the Government welcomes the proposal for exemption provisions as it mirrors the approach already adopted by the UK. A few provisions will require further clarification throughout the negotiation process, for example definitions, reporting, and the provisions for delegated and implementing acts.

6.26 The Government is still considering four elements of the proposal, affecting ports and shipping sectors. These are: introduction of an indirect fee for garbage; issuing of a waste delivery receipt; separate collection of waste from ships in port; and delivery of passively fished waste.

6.27 On the introduction of an indirect fee for garbage, the Government has concerns that introducing a one fee system may have unintended consequences. The proposal would permit that fee to be set at a level which covers all the costs of port reception facilities for garbage. This means the fee would reflect the considerably higher cost of the subsequent treatment of dangerous or hazardous waste (which can fall within the garbage category). Thus, vessels which do not discharge dangerous or hazardous waste, or do so in only small quantities, would be faced with disproportionate costs. This brings into question the proper application of the 'polluter pays' principle.

6.28 Regarding the issuing of a waste delivery receipt (WDR), the Government accepts the overall principle to help improve enforcement of the delivery of waste to shore by more accurately capturing the quantity and type of waste generated and delivered by ships. The delivery of specialist wastes (e.g oil, sewage etc) which are delivered and paid directly to the licenced waste contractor, is already required to be measured through a flow metre (a gauge which measures the flow rate of liquid) and a receipt issued. However, waste such as paper, plastics, packaging, glass etc are measured in cubic meters done by visual estimate, which is subjective, less accurate than weighing and therefore subject to discrepancies.

6.29 Ports in the UK typically incentivise the delivery of waste by minimising the waste fee through the provision of a communal bin or skip to receive wastes, which are filled by the ship's crew. These are replaced when filled. This proposal would require a licenced waste contractor to receive and verify waste from an individual ship before issuing a receipt, adding time and cost to the delivery process. This is likely to be welcomed by certain sectors (waste contractors, cruise industry and environmental groups) but seen as disproportionately burdensome by others.

6.30 Concerning the separate collection of waste from ships in port, the Government is concerned as to the practical effect of the proposal, particularly on smaller ports where it may be impractical to permit the separate collection of wastes due to the limited/restricted size or access to the port.

6.31 On the delivery of passively-fished waste, the Minister says:

> "The Government welcomes the principles of passively-fished waste being delivered ashore because it assists in removing marine litter from our oceans. Under the proposal, passively-fished waste is captured as part of the 'indirect fee'. The intended effect of the proposal is that no single shipping sector will bear the cost as it will be spread across the shipping sectors. This brings into question the 'polluter pays principle', as passive-fished waste results from many sectors, such as shipping, tourism, sewage systems, etc. However, due to the nature of the fishing sector, which has fishing-specific ports whose fees will reflect the quantities of passively-fished waste received, the fishing industry is likely to bear the greatest proportion of the cost burden for the passively-fished waste they deliver. Again, this is not in line with the 'polluter pays' principle', and may not meet the Commission's intention of spreading the cost across the shipping industry.
>
> "Further clarification is needed to ensure the principle of 'polluter pays' and how in practical terms passively-fished waste may be delivered without disadvantaging a single sector."

6.32 Early indications from the Government's stakeholder engagement on the proposal suggest that stakeholders share the Government's concerns. The Government, says the Minister, will continue to participate in negotiations on the proposal with a view to ensuring that it does not result in a measure that contains anything that goes beyond MARPOL requirements and, wherever possible is proportionate, while removing red tape and lowering costs in line with the principles of REFIT.

6.33 The Minister observes that the proposal will apply to third countries using EU and EEA ports but adds that the impact of this is likely to be limited since the proposed provisions closely follow the existing international MARPOL provisions.

6.34 On the UK's role in shipping policy post-Brexit, the Minister says:

> "Shipping is a global industry, and after EU exit, the UK will continue to play an important role in the international organisations—the International Maritime Organization and the International Labour Organization—that regulate it. The UK already has a strong voice at the IMO, working closely with both EU and non-EU states on areas of common interest. We are committed to continuing to work with other European countries on matters of common interest, for example the exchange of information on the safety of shipping and on pollution."

6.35 The Government notes the Commission impact assessment, which found that substantial savings could arise from the proposals to harmonise and streamline the administration and enforcement of PRF requirements as they should result in more effective inspections. The Government understands that this was calculated on the basis

of the base line cost of all Member States having fully implemented the current Directive according to the Commission's guidelines, but it is apparent that implementation has in fact been divergent.

6.36 The Minister agrees with the Commission's assessment that additional compliance and operational costs will be associated with full implementation of the proposal. The Government is consulting key industry stakeholders (ports, harbour masters and shipping sectors) and is awaiting their input.

6.37 The Bulgarian Presidency aims to give a progress report or achieve a general approach at the June 2018 Transport Council.

Previous Committee Reports

None.

7 EU-Iraq Partnership and Cooperation Agreement

Committee's assessment	Legally and politically important
Committee's decision	(a) Not cleared from scrutiny; further information requested; drawn to the attention of the Defence and Foreign Affairs Committees; (b) Cleared from scrutiny
Document details	(a) Council Decision on the conclusion of the Partnership and Cooperation Agreement between the EU and its Member States, of the one part, and the Republic of Iraq, of the other part; (b) Joint Communication to the European Parliament and the Council: Elements for an EU strategy for Iraq
Legal base	(a) Articles 91, 100, 207, 209 TFEU in conjunction with Article 218(6)(a) TFEU; unanimity; (b)—
Department	Foreign and Commonwealth Office
Document Numbers	(a) (39481), 10209/12/REV1; (b) (39409), 5148/18, JOIN(18) 1

Summary and Committee's conclusions

7.1 The EU and its Member States signed a Partnership and Cooperation Agreement with Iraq in 2012. The objectives of this Partnership are:

- to provide an appropriate framework for the political dialogue between the Parties allowing the development of political relations;
- to promote trade and investment and harmonious economic relations between the Parties and so to foster their sustainable economic development; and
- to provide a basis for legislative, economic, social, financial and cultural cooperation.

7.2 Certain elements of the PCA have been provisionally applied since August 2012:

- Article 2: Respect for Human Rights;
- Title II: Trade and Investment;
- Title III: Areas of Cooperation;
- Title V: Institutional and General provisions.

7.3 The Titles covering (a) political dialogue and cooperation in the field of foreign and security policy and (b) justice, freedom and security have not been provisionally applied.

7.4 The full conclusion of the Agreement was 'parked' after it was signed in 2012, while the EU's individual Member States ratified the treaty at national level. In the intervening period, the Foreign Affairs Council has endorsed two separate EU strategies for engagements

with Iraq to reflect developments in the political and security situation in the country (in particular the annexation of parts of its territory by Da'esh, and their subsequent recapture by the Iraqi Government with western support). The latest Iraq Strategy was proposed by the European External Action Service in December 2017, and endorsed by the Foreign Affairs Council—including the UK—in January 2018 (see paragraphs 7.28 to 7.33).

7.5 Separately, after Ireland became the last Member State to ratify the EU-Iraq PCA in summer 2017,[58] the Council initiated the formal process to enable the EU to conclude (ratify) the PCA.

7.6 The draft decisions enabling the EU to sign the PCA and earlier versions of the proposal enabling the EU to conclude it were embroiled in legal uncertainty as to whether the UK opt-in under Protocol 21 was engaged in respect of the provisions of the PCA relating to justice, freedom and security (for which EU competence is found in Part Three Title V TFEU relating to an area of freedom, security and justice).[59] The Government consider that if an agreement covers subject matter falling within Title V (other than provisions which are merely aspirational or do not involve any concrete obligations), then the UK opt-in is engaged. Our predecessor Committee, ourselves, and the EU institutions consider that the UK opt-in is not engaged unless the EU Decisions, either authorising signature or conclusion, have a Title V TFEU legal base.

7.7 In the event the Government secured a Title V legal base to the Decision authorising the EU to sign and provisionally apply the PCA[60] insofar as the agreement concerned readmission, and so there was no doubt that the UK opt-in was engaged, at least to that extent. It does not appear to have been exercised. Subsequently case law of the Court of Justice has made the addition of a Title V legal base for this proposal untenable.

7.8 Therefore, the current position is that the EU Council has submitted a revised draft of the Council Decision to the European Parliament for its consent for the adoption of the proposal. The text of the draft is not available, but the Explanatory Memorandum from the Minister (Sir Alan Duncan) indicates that the legal bases are different from the original 2010 Commission proposal.

7.9 On 13 February the Minister wrote to us indicating that he would be overriding scrutiny at the Council on 15 February to approve a request for the consent of the European Parliament to conclusion of the Agreement, with no indication why this matter had become urgent, but indicating that the Explanatory Memorandum had passed scrutiny in the Lords.

Conclusion of the EU-Iraq Cooperation and Partnership Agreement

7.10 **We note that the decision to seek the consent of the European Parliament on the EU-Iraq CPA was an override of scrutiny, and that this matter has been outstanding for several years. The consent of the European Parliament is not going to be obtained quickly as it normally takes several months.**

58 See http://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2011007&DocLanguage=en.

59 See our predecessors' Report of 5 December 2012 for more information.

60 Decision 2012/418.

7.11 **In his Explanatory Memorandum of 1 February, the Minister (Sir Alan Duncan) gave no indication of urgency and merely indicated that the draft Council Decision would be adopted by the EU once the UK lifts its scrutiny reserve. We consider the explanation for the override of scrutiny inadequate, particularly in the light of his Explanatory Memorandum. It does not give any explanation at all why it was necessary for the UK to suddenly lift its scrutiny reserve.**

7.12 **We ask the Minister to provide an assessment of the success or otherwise of those parts of the PCA that have been provisionally applied since 2012.**

7.13 **In relation to the opt-in we ask the Minister (Sir Alan Duncan) to confirm whether or not the UK still asserts that the UK opt-in is engaged despite the UK acceptance that there should be no legal base from Title V TFEU. If so, can he indicate the provisions of the PCA in respect of which the opt-in is asserted, how this is reflected in the legal text, and whether or not the UK intends to opt-in.**

7.14 **This is a mixed agreement signed by both the EU and the Member States separately, each exercising competence over parts of the PCA. The 2012 Decision does not give any indication of the provisions of the PCA where the EU is exercising competence and the provisions where the Member States are exercising competence. This lack of transparency impacts adversely on the Government's policy that normally the EU should only exercise competence in respect of provisions over which it has exclusive competence, leaving Member States to exercise provisions which are shared competence. We therefore ask the Minister to indicate whether the text submitted to the European Parliament indicates or delimits the extent to which the EU is exercising competence; and if not whether he intends to take any steps, such as a minute statement, to make it clear that the UK considers that the EU is only exercising exclusive competence.**

7.15 **We also ask whether the UK has taken any steps to continue the PCA on a bilateral UK-Iraq basis after the UK's exit from the EU or after the expiry of any transitional/implementing period. In the meantime the proposal for a Council Decision remains under scrutiny.**

New EU Strategy for engagement with Iraq

7.16 **We thank the Minister for his Explanatory Memorandum on the EU's new Iraq Strategy. We note that it was endorsed by all EU countries at the Foreign Affairs Council on 22 January 2018. We are content to clear the document from scrutiny.**

7.17 **The Iraq Strategy itself does not raise any immediate issues for the UK in the context of Brexit. However, the Strategy will need to be implemented—for example through the EU's Development Cooperation Instrument and its successor programme from 2021 onwards—in the coming years. Despite the UK's interest in ensuring these policies are implemented in a way that complements its own strategic objectives, it does not appear the UK will be represented—even in a non-voting capacity—in the EU's foreign policy structures during the post-Brexit transitional position. This**

would mean there will be no UK voice on the Foreign Affairs Council; the Political and Security Committee; or the EU Military Committee, and the Government will be unable to veto new Common Foreign & Security Policy (CFSP) initiatives.[61]

7.18 **Moreover, as we have stressed before, the exact implications of Brexit for the UK's foreign policy cooperation with the EU beyond the transitional period also remain unclear. While the Government has called for an "unprecedented partnership" with "continuous, transparent and automatic access"**[62] **to the EU's foreign policy decision-making mechanisms, there is no detail yet about the institutional or legal mechanisms to make this a reality. The Foreign Office and the Department for International Development has expressed an interest in being able to participate in the EU's external funding programmes and CFSP missions "on a case-by-case basis". In this respect, the Committee will apply intensive scrutiny to the negotiations on the "Global Europe" heading in the post-2021 Multiannual Financial Framework, to assess the opportunities for continued UK participation after Brexit—and any requirements the EU may establish as regards, for example, a financial contribution.**

7.19 **More generally, considering its remit, the Committee will keep a close eye on the negotiations on a new defence and security agreement with the EU, and the legal, policy and financial implications of any continued alignment with EU foreign policy.**

7.20 **We also draw these developments to the attention of the Foreign Affairs Committee and, in light of the UK's significant military presence in Iraq, the Defence Committee.**

Full details of the documents

(a) Council Decision on the conclusion of the Partnership and Cooperation Agreement between the EU and its Member States, of the one part, and the Republic of Iraq, of the other part: (39481), 10209/12/REV1; (b) Joint Communication to the European Parliament and the Council: Elements for an EU strategy for Iraq: (39409), 5148/18, JOIN(18) 1.

Background

7.21 Following the formal withdrawal of US troops from Iraq in 2011, the security situation in the country deteriorated. Sectarian violence intensified between Shia and Sunni groups. In parallel, neighbouring Syria descended into civil war between various factions, among them the so-called Islamic State (known as ISIL or Da'esh) which aimed to establish a caliphate.

7.22 In 2014, Da'esh's activities spilled over from Syria into Iraq as they took control of Mosul, Tikrit and other cities in the country's west and north-west. In response, the US sent troops to prevent any further encroachment into Iraqi territory, and conducted air strikes against the insurgents. Iraqi forces—with international support, including from the UK—have begun to retake territory from the insurgents in recent months.

61 The Foreign Affairs Committee has recommended that the Government should "seek a status on the Political and Security Committee that allows the UK to have a representative in PSC meetings with speaking (if not voting) rights, except in circumstances agreed in advance by protocol".

62 Foreign Affairs Committee, "The future of UK diplomacy in Europe" (February 2018).

7.23 The Foreign Office recently summed up the current situation in Iraq as follows:

> "The military campaign to defeat Daesh has gone as well as could be expected: the Caliphate no longer exists; Mosul (and Raqqa) are liberated; and the Iraqi Security Forces are increasingly capable and mature. But the underlying political and economic grievances which led to Daesh's rise remain unaddressed and there is a risk of Daesh, al-Qaeda or something like it, re-emerging and again threatening the UK and our interests in the region. If we are to protect the UK we need to get Iraq on—and keep it on—a path towards stability."

The EU's engagement with Iraq

7.24 The EU and its Member States take a strong interest in returning Iraq and the wider region to stability and promoting its economic and political development.

7.25 The day-to-day bilateral EU-Iraq relationship is underpinned by a Partnership and Cooperation Agreement (PCA), which has been partially in force since August 2012 pending its formal conclusion (ratification) by all Member States and the EU itself. The PCA established the legal framework for improving cooperation in a range of areas, including trade relations and regulatory cooperation. In early 2018, the EU began taking the necessary procedural steps to conclude the Agreement on behalf of the EU following its ratification by the last EU Member State (Ireland) in summer 2017 (see paragraphs 7.34 to 7.35 below).

7.26 The EU has also had a presence on the ground in Iraq in view of the political and security situation. An EU civilian mission to improve adherence to the rule of law in Iraq, called Just-Lex, operated from 2005 until 2013. In August 2014, the European Council said it was "determined to contribute" to countering Da'esh in Iraq and Syria. It did so in response to the deterioration of the security and humanitarian situation in Iraq as a result of the occupation of parts of their territory by the self-styled Islamic State in Iraq and the Levant (ISIL); the indiscriminate killings and human rights violations perpetrated by this and other terrorist organisations, by describing the creation of an Islamic Caliphate in Iraq and Syria; the Islamist-extremist export of terrorism on which it is based, as a direct threat to the European security.

7.27 The Council subsequently adopted an EU Strategy towards Syria and Iraq in 2015, which focused on countering Da'esh; providing humanitarian assistance where necessary; and preventing spill-over of the conflict in the wider region.[63] Following a request by the Iraqi authorities, in summer 2017 the EU established an Advisory Mission in support of Security Sector Reform in Iraq (EUAM Iraq), with the UK's support.[64] Its focus is on the provision of strategic advice to the Iraqi Ministry of Interior and Office of the Iraqi National Security Adviser, including supporting implementation of Iraq's National Security Strategy. EUAM Iraq's initial mandate is for one year, with a budget of €14 million (£12.6 million), with a review of its operations due by the end of 2018.

63 See our predecessors' Report of 9 September 2015.
64 See our Report of 29 November 2017.

The 2018 EU Iraq Strategy

7.28 Following the success of Iraqi forces in recapturing territory from Da'esh, EU Foreign Ministers at the Foreign Affairs Council on 19 June 2017 tasked the European External Action Service (EEAS) and the European Commission to produce a strategy which gives guidance on the next steps in the EU's engagement with Iraq. A Joint Communication to that effect was published on 8 January 2018. The " Elements for an EU strategy for Iraq" described three main purposes:

- to define the considerable challenges that Iraq faces;
- to identify the EU's interests and strategic objectives in its relations with Iraq; and
- to identify priorities for EU action.

7.29 The principal elements of the strategy are to address the challenges that Iraq faces in political, economic and security terms. It wants to do so by helping the Iraqi Government to protect its territorial integrity, strengthen its political and judicial systems, and promote sustainable economic growth. The EU also wants to establish a "migration dialogue" with Iraq, in view of the fact that one in ten of those seeking asylum in the European Union are Iraqi nationals.[65]

7.30 Specific policies the European Commission proposed to implement the Strategy include:

- The continued delivery of humanitarian aid and resilience support to Iraq's internally displaced people;
- Provision of financial and technical support to support political reform, improved governance, an independent judiciary and an improved education system, through the Development Cooperation Instrument;
- The stabilisation of liberated territories and support for the return of displaced persons;
- Restructure and support the civilian security sector, for example via the new EU Advisory Mission in Iraq on security sector reform; and
- Support resolution of disputes between the Government of Iraq and Kurdistan Regional Government.

7.31 The Joint Communication was endorsed unanimously by the EU's Member States at the 22 January Foreign Affairs Council. The Minister for Europe (Sir Alan Duncan) submitted an Explanatory Memorandum on the proposed Strategy the following day.[66] In it, he noted that the Government has three priorities in Iraq:

- to protect the UK from terrorist threats;
- to defeat Daesh and limit any future insurgency; and
- to work towards a more resilient Iraqi state.

65 http://ec.europa.eu/eurostat/statistics-explained/index.php/Asylum_statistics.

66 Explanatory Memorandum submitted by the Foreign and Commonwealth Office (23 January 2018). The Council conclusions were not subject to the scrutiny reserve, so this did not constitute a scrutiny override.

7.32 The Minister added that the UK cannot achieve any of these objectives alone and must continue to work closely with its international partners in Iraq, such as the US, France and Germany, but also international organisations including NATO, the UN and the EU. With respect to the latter, the Minister states that the new EU Iraq Strategy "complements and supports" the UK's own strategic objectives in Iraq. He singles out a number of areas where the Government believes the EU can "add significant value", such as judicial reform, rule of law, and civilian security sector reform. He notes:

> "[The Strategy] also underlines [– as the UK has done -] the need for enhancing coordination with other actors on the ground, such as the Global Coalition and NATO, while recognising that ultimately all solutions must be Iraqi owned and led. As a result, the Government supported the new strategy as the framework for the EU's future engagement in Iraq [when it came before the Foreign Affairs Council in January 2018.]"

7.33 The Minister added:

> "The EU has an important role to play in enhancing the capacity of the Government of Iraq to ensure that all Iraqis have access to security, justice and government services. Under the EU-Iraq Partnership and Cooperation Agreement, the EU is already working to enhance the Rule of Law in Iraq and we expect the EU Iraq Strategy to open new opportunities for the EU to provide additional capacity building support to the executive, with a particular focus on the civilian security sector, political and economic reform, and the immediate stabilisation of liberated areas."

The EU-Iraq Partnership Agreement

7.34 As part of the Strategy, the EU is also formalising the conclusion of the EU-Iraq Partnership and Cooperation Agreement (PCA) so that the remaining elements of the Agreement. This follows the ratification of the Agreement by the last Member State to do so (Ireland) in July 2017. In his Explanatory Memorandum on the conclusion of the Agreement, the Minister for Europe (Sir Alan Duncan) stated:

> "The EU-Iraq PCA was signed on 11 May 2012. It provides a legal framework for the EU, its member States and Iraq covering issues such as regular political dialogue, trade relations, and development assistance. The PCA also provides for regulatory cooperation in the fields of energy, transport, investment, human rights, education, science and technology, justice, migration and asylum. Although ratified by all EU Member States except Ireland, the agreement is yet to be formally adopted by the EU Council.
>
> "The PCA was laid before Parliament as a Command Paper on 22 November 2013 for 21 sitting days as required by the Constitutional Reform and Governance (CRaG) Act 2010. It cleared parliamentary scrutiny and no objections were raised. An Order specifying the PCA as an EU Treaty was laid before Parliament on 9 June 2014, and debated in the House of Lords on 1 July 2014 and the House of Commons on 7 July 2014. It passed both Houses, and was then considered and approved by the Privy Council at their meeting on 16 July 2014.

> "The agreement is now ready for adoption by the EU. EU-Iraq cooperation in the agreement is underlined by different legal bases for each area of competence (for example transport, justice, home affairs etc). Since UK parliamentary approval was obtained, ruling by the European Court of Justice has set a precedent that a separate legal base is no longer needed for each individual area of competence if it falls under development cooperation policy.
>
> "When applied to the Iraq PCA, this suggests that the legal bases covering environment, readmission and energy are no longer relevant as they are covered under Article 209 in the Treaty for the European Union.
>
> "The remaining legal bases in the EU-Iraq PCA are therefore:
>
> Articles 91 and 100 (Transport)
>
> Article 207 (Common Commercial Policy)
>
> Article 209 (Development)
>
> Article 218.6 (Procedural Base)
>
> "We support the EU position of omitting the Justice and Home Affairs legal base and maintaining the transport legal bases, since certain trade and transport related provisions in the EU-Iraq PCA (Article 23) contain significant obligations that go beyond an undertaking to cooperate or enter into dialogue.
>
> "The proposed change in legal base would not have an impact on the UK transitioning the agreement when we leave the EU."

7.35 In a subsequent letter, dated 13 February, the Minister indicates that scrutiny will be overridden in the following terms:

> "We submitted an Explanatory Memorandum to the committee on 1 February. I regret that I find myself in the position of having to agree to the adoption of this Council Decision before your Committee had an opportunity to scrutinise the document. The decision on sending the PCA to the European Parliament is now scheduled for adoption at Council on 15 February. This has left insufficient time for the committee to consider the Explanatory Memorandum ahead of the adoption date. The Explanatory Memorandum has, however, passed scrutiny in the Lords through the Chairman's sift."

Previous Committee Reports

None but see also Sixth Report HC 83–vi (2013–14), chapter 11 (19 June 2013); Twenty-second Report HC 86–xxii (2012–13), chapter 7 (5 December 2012).

8 Prudential requirements for investment firms

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Treasury Committee
Document details	(a) Proposal for a Regulation on prudential requirements for investment firms; (b) Proposal for a Directive on the prudential supervision of investment firms
Legal base	(a) Article 114 TFEU; ordinary legislative procedure; QMV; (b) Article 53 TFEU; ordinary legislative procedure; QMV
Department	Treasury
Document Numbers	(a) (39397), 16017/17 + ADD 1, COM(17) 790; (b) (39400), 16011/17 + ADD 1, COM(17) 791

Summary and Committee's conclusions

8.1 The European Commission in December 2017 published legislative proposals for a prudential regime for investment firms, after a review found that the current capital requirements for the smaller companies in the industry, based on the prudential regime for banks, was too complex and did not adequately take into account the specific prudential risks faced by investment firms.

8.2 The Commission has proposed to create a new classification system for investment firms governed by the Markets in Financial Instruments Directive and Regulation (MiFID II and MiFIR), consisting of class 1 (systemically-important investment banks), class 2 (important but non-systemic firms) and class 3 (small firms). Class 2 and class 3 firms would fall under a new prudential framework calibrated specifically to the risks of the investment industry.

8.3 In anticipation of an expected shift of operations by UK-based large investment banks to the Eurozone due to Brexit, the Commission also proposes to make class 1 firms subject to centralised supervision by the European Central Bank's Single Supervisory Mechanism (SSM), while remaining subject to the same capital requirements as large banks (as they are under the current rules).[67] This ties in with a separate proposal to amend the Capital Requirements Directive, which we considered recently, under which UK investment firms which fall into class 1 (as well as large non-EU banks) could be required to establish an independently-capitalised and authorised intermediate parent undertaking (IPU) within the EU after Brexit if they had significant operations within the EU-27.[68]

67 The Single Supervisory Mechanism applies to large banks in the so-called "Banking Union", which is compulsory for Eurozone countries but voluntary for non-Eurozone countries. At present, none of the latter have chosen to participate.

68 See our Report on Banking Reform of 21 February 2018. The proposed IPU requirement would apply to both banks and investment firms insofar as they are covered by the Capital Requirements Directive.

8.4 The UK's exit from the EU is also the driving force behind the final element of the proposals, namely to increase the threshold for "equivalence" decisions under MiFIR, which would allow UK-based investment firms to service professional customers within the EU after Brexit without the need to establish a separate, independently-capitalised legal presence within the EU itself.

8.5 The Economic Secretary to the Treasury (John Glen) submitted an Explanatory Memorandum on the proposals in January 2018.[69] Overall, the Minister has welcomed the approach taken by the Commission, which it says would "provide a good basis for a new prudential regime for investment firms" which could "have significant benefits for UK industry" given the concentration of such firms in the UK. With respect to the proposed changes to the MiFIR equivalence regime, he states only that the Government will seek to "agree stable, reciprocal arrangements" for trade in financial services which would by-pass the need for the UK industry relying on equivalence provisions.

8.6 **The Government has welcomed the Commission proposals. We agree that it makes sense to rationalise the prudential regime for investment firms in view of their specific business models and the risks they pose to their customers and the wider market. The proposals are clearly of great relevance to the UK given it is home to the majority of Europe's investment activity, in terms of both businesses and assets.**

The implications of Brexit

8.7 **The investment firm proposals also raise a number of further questions in the context of the UK's withdrawal from the EU. They are the latest in a series of financial services proposals by the Commission that directly and explicitly reference the UK's withdrawal from the EU as a driving force.**[70]

8.8 **Firstly, as with other pending EU legislative proposals, we expect that the UK may have to apply these new rules if they are formally adopted and take effect or have to be implemented before the end of the post-Brexit transition period sought by the Government. Given the continuing uncertainty about the maximum length of the transitional arrangement, the same applies to these proposals (which are unlikely to take effect before 2021).**[71]

8.9 **Secondly, the substance of the proposals themselves is in part driven by Brexit in two ways:**

- **under the new prudential framework, the approach to "class 1" investment firms is clearly predicated on the assumption that the EU's systemically important firms—which are all based in the UK—will relocate some of their activities to the Eurozone following the UK's withdrawal and must therefore be brought within the scope of the Single Supervisory Mechanism; and**

69 Explanatory Memorandum submitted by HM Treasury (22 January 2018).

70 The others include recent proposals on location requirements for clearinghouses, additional capital requirements for large UK banks with EU operations, and centralised EU-level supervisory responsibilities for non-EU providers of capital markets services seeking to access the EU market.

71 The EU has proposed the transition should end by 31 December 2020, but both the Prime Minister and the Secretary of State for Exiting the EU have indicated a longer period may be needed.

- **the Commission has also proposed to raise the threshold before the UK (or any other country) could be granted equivalence to provide cross-border investment services under MiFIR, with the implicit aim of incentivising the UK to maintain continued convergence with the EU's prudential regime post-Brexit if it wants to secure preferential market access.**

8.10 **In the absence of a clear impact assessment by the Government of the decision to leave the Single Market, it is very difficult to assess whether the Commission's proposals with respect to class 1 investment firms are political posturing, or whether they respond to a genuine likelihood of an economically significant shift of operations from the UK to the EU.**

8.11 **However, the Government has acknowledged that the equivalence regime alone would be insufficient to accommodate current flows of investment services between the UK and the EU-27.[72] This is also reflected by the position of the financial services industry itself, namely that the provision of many services—which are currently provided by UK firms cross-border to EU clients under Single Market legislation—will become substantially costlier or even legally impossible after Brexit, unless the UK obtains a specific legal agreement to the contrary.[73]**

8.12 **Given the UK is the EU's largest financial centre, the logical conclusion is that the provision of such services to EU-based customers will either become more expensive because British firms will face higher compliance costs when operating as "third country" providers, or because there will be fewer market operators if specific UK firms might decide to cease offering such services to EU customers altogether. This has also been acknowledged by EU financial regulators.[74]**

8.13 **In the context of the Commission proposals for investment services specifically, we note that UK investment firms could partially mitigate the loss of their MiFID passport through other means, in particular equivalence regimes (see paragraph 8.68 to 8.74), but also potentially through reverse solicitation and outsourcing or delegating of investment activities back to UK entities (see paragraphs 8.82 to 8.84). However, both the European Commission and UK Finance have taken the position that, even cumulatively, these mechanisms cannot amount to substantially the same level of market access as is granted to firms operating from a country within the European Economic Area.**

8.14 **Therefore, to overcome these new market access barriers while still leaving the Single Market's regulatory union, the Government has repeatedly indicated that it wants to negotiate a "new process for establishing regulatory requirements for cross-**

72 Letter from John Glen to Sir William Cash (31 January 2018): "The Chancellor has been clear that these [equivalence] regimes would not support the scale and complexity of trade in financial services that exists between the UK and the EU. (…) The UK and the EU will need to agree a new process for conducting cross-border business".

73 E.g. UK Finance, "What is 'passporting' and why does it matter?" (accessed 20 February 2018).

74 See for example "Collaboration instead of rivalry: thoughts on a digital financial centre of Europe", a speech given by Professor Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank on 15 February 2018: "Financial institutions domiciled in the United Kingdom must be prepared to shift any continental business that can no longer be carried out from there to the EU. (…) Large foreign institutions could also move parts of the value chain back to their home countries, or business with continental European clients could simply be discontinued entirely if an EU presence is not worthwhile. (…) As a result, Brexit could, at least in theory, reduce the range of financial intermediation services available in the EU, weaken institutions' productivity, and reduce market depth. In a nutshell, it could entail higher costs."

border business between the UK and EU".[75] This, it has said, would render the need for UK firms to rely on sectoral equivalence provisions unnecessary.[76] However, nearly a year after formally initiating the EU exit process, it has not formally set out the details of its proposals for a financial services chapter in a future UK-EU free trade agreement.[77]

8.15 **As the Government has ruled out the UK formally staying part of the Single Market, the current indications are that the Government will follow the financial services industry's own suggestions for a new legal framework under which the UK and the EU would operate a system of mutual recognition, allowing financial services authorisations and licences to be recognised by regulators in either jurisdiction without the need for firms to establish a new legal entity in the other territory.[78] While regulatory alignment would be encouraged where necessary, the UK would not be under a legal obligation to apply EU financial services law as it would be outside the Single Market.**

8.16 **We recognise the clear benefits of such an arrangement for both UK industry and their EU-based customers, by preventing further fragmentation of Europe's capital markets. However, we are concerned that, in practice, it could simply require the UK to align itself with EU financial services legislation rather than providing for a truly symmetrical system that gave both sides equal flexibility in setting financial services regulation. Moreover, the EU has expressed scepticism about the feasibility of a mutual recognition agreement without regulatory harmonisation,[79] and—even if it did accept it as a premise for a financial services agreement—would likely insist on stringent safeguard measures allowing for unilateral termination of market access in case of regulatory divergence.**

8.17 **It is also unclear to us why the EU would be willing to accept mutual recognition of the UK's post-Brexit standards in financial services without regulatory harmonisation, while the Council and Parliament—mostly with the UK's support—have only established the existing financial services passporting regimes (which effectively embody mutual recognition of regulatory and supervisory standards) in conjunction with harmonising legislation.[80] We note in this respect that the trend in recent years has been for EU financial services legislation to move from Directives to directly-**

75 Mansion House Speech by Philip Hammond (September 2017).

76 Letter from John Glen to Sir William Cash (31 January 2018): "The Chancellor has been clear that these [equivalence] regimes would not support the scale and complexity of trade in financial services that exists between the UK and the EU. (…) The UK and the EU will need to agree a new process for conducting cross-border business".

77 *Financial Times*, "UK aims to keep financial rules close to EU after Brexit" (16 February 2018).

78 E.g. UK Finance, "Supporting Europe's Economies and Citizens: A modern approach to financial services in an EU-UK Trade Agreement" (16 November 2017) and IRSG, "A new basis for access to EU/UK financial services post-Brexit" (September 2017).

79 See for example: https://ec.europa.eu/commission/sites/beta-political/files/services.pdf. Similarly, for the German Bundesbank, Dr Andreas Dombret, "The future relationship between Germany and the UK in finance after Brexit" (8 February 2018). The latter said: "I am sceptical as to whether the mutual recognition framework proposed is actually 100 percent feasible. By giving substantial powers to technical cooperative committees of supervisors, it would most likely undermine national sovereignty and democratic legitimacy—thereby crossing the UK's red lines and also infuriating those critical of the EU for undermining national parliaments."

80 The EU does operate a non-harmonised mutual recognition principle for goods, under which any product *not* subject to harmonised Single Market rules which is lawfully sold in one EU country can be sold in another. This is possible even if the product does not fully comply with the technical rules of the other country. Most trade in goods within the EU is in harmonised goods for which EU technical rules exist, such as chemicals, pharmaceuticals and vehicles. There is no general principle of mutual recognition of services within the EU.

applicable Regulations, entailing a greater level of harmonisation.[81] In addition, such an agreement on mutual recognition could trigger the "Most Favoured Nation" clause in the EU's trade agreements with other countries, notably Canada, requiring it to extend any preferential market access for UK investment firms to Canadian operators.[82]

8.18 **In any event, even if these political and legal obstacles could be overcome in time, negotiations cannot begin until the Government sets out a formal prospectus for consideration by the other Member States. Given the current vacuum in that respect, the EU is clearly operating under the assumption that the UK will become a "third country", subject to the same market access restrictions (and opportunities to seek equivalence) as all other countries outside the Single Market.**

8.19 **In these circumstances, the only prudent option for the Committee is to assume that the Commission proposals on a prudential regime for investment firms could have a constraining effect on the UK's regulatory autonomy after Brexit: either under the terms of any agreement on financial services which provides preferential market access in return for continued regulatory convergence, or because it modifies the conditions under which UK firms could obtain market access based on the existing MiFIR equivalence regime. In both scenarios, the proposals are clearly of political and economic importance.**

8.20 **While we await further information about the Government's overarching approach to a possible new UK-EU financial services agreement, we would be grateful if the Minister could clarify the following issues that arise from the prudential proposals for investment firms:**

- **whether UK-based class 1 investment firms would still have to establish an independently-capitalised intermediate parent undertaking in the EU under the proposed amendments to the Capital Requirements Directive, if the definition of "credit institution" is amended as suggested by the Commission in the investment firm proposals;**
- **if so, how many UK-based investment firms would be affected by this new requirement;**
- **what changes the Government will seek to the "definitions and designations" for classifying "class 1" investment firms, so that these "work for UK financial stability"; and**
- **whether the Government will seek any changes to the new prudential regime for class 2 and 3 firms, or whether it believes the EBA recommendations as contained in the Commission proposal do not need any further calibration or alteration.**

8.21 **In the meantime, we retain the proposals under scrutiny, and draw them to the attention of the Treasury Committee.**

81 For example, the Credit Requirements Regulation; the Markets in Financial Instruments Regulation; the Market Abuse Regulation; and the Prospectus Regulation.

82 Notably, CETA's MFN clause would be triggered unless the EU's preferential agreement with the UK created an internal market (which would have to encompass services, capital and persons); creates a right of establishment, which in itself does not entail a right to provide cross-border services as sought by the UK; or requires the approximation of legislation (either the UK's acceptance of EU law, or a process for setting regulation jointly).

Full details of the documents

(a) Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010: (39397), 16017/17 + ADD 1, COM(17) 790; (b) Proposal for a Directive of the European Parliament and of the Council on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU: (39400), 16011/17 + ADD 1, COM(17) 791.

Background

8.22 This report sets out the substance and context of recent proposals by the European Commission to create a new prudential regime for investment firms in the European Union. We have paid particular attention to the links between the UK's withdrawal from the EU and certain elements of the proposals related to third (i.e. non-EU) countries, and the impact this legislation could have on British investment firms even after Brexit.

8.23 Investment firms provide a range of services which provide both retail and professional investors with access to securities and derivatives markets, such as investment advice, portfolio management and brokerage. According to the European Banking Authority (EBA), there were just over 6,000 investment firms in the European Economic Area (EEA) at the end of 2015. The UK acts as an important hub for capital markets and investment activities, as approximately half of all investment firms within the EEA are based there. The EBA also estimates that eight investment firms, all based in the UK, control around 80 per cent of the assets of all investment firms in Europe.[83]

Current EU regulation of investment firms

8.24 The Market in Financial Instruments Directive (MiFID), the latest version of which took effect in early 2018,[84] sets out the conduct and organisational requirements investment firms must meet to be authorised, and to operate.[85]

8.25 Under MiFID, investment firms can be licenced to perform between one and eight investment services. The Directive, like other pieces of EU financial services legislation,[86] also creates a "passport" for investment firms, meaning that—once authorised by any EEA country—they can provide their services throughout the European Economic Area without having to establish a presence, or seek regulatory authorisation, in other countries. In August 2016, there were over 2,200 UK-based investment firms which had applied for a "passport" under MiFID.[87]

83 See for more information the EBA's 2015 Report, "Report on Investment Firms" (Other important host countries for EU-based investment firms are Germany, France, the Netherlands and Spain.

84 Directive 2014/65/EU.

85 Banks which provide investment services are also subject to MiFID, aligning the conduct of business requirements for the provision of investment services between investment firms and credit institutions.

86 UK Finance has identified nine different passports, "each covering a different sort of financial service, including core banking services such as lending and deposit taking, market services such as sales and trading, asset management, payments services and electronic money services".

87 https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF.

8.26 Since 1993 investment firms have also been subject to prudential requirements under EU law.[88] They are covered by the prudential regime for created banks, which is currently laid down in the 2013 Capital Requirements Directive[89] (CRD) and Regulation (CRR).[90] These set out the capital, liquidity and other risk management requirements with which both banks and investment firms must comply with, or lose their authorisation to operate. The logic for investment firms' inclusion in this prudential framework is that they can compete with banks for the provision of investment services, which the latter can offer under their banking licence.

8.27 However, considering that the two types of institutions have very different business models, the EU has always exempted smaller investment firms from some of the capital requirements which apply to banks. In practice, investment firms which conduct a broad range of services are therefore subject to the same requirements as banks in terms of capital requirements for credit, market and operational risk, and potentially liquidity, leverage, remuneration and governance rules. Over time, the prudential framework and the various exemptions for investment firms have become more complex. Currently, such firms can be grouped into eleven categories, with their classification determined primarily by the investment services they are authorised to undertake under MiFID, and whether they hold money and securities belonging to their clients. On a basic level, however, the capital requirements for investment firms are still determined by a system designed to "secure the lending and deposit-taking functions of credit institutions through economic cycles", and not the specific prudential risks faced by investment firms.

8.28 In light of the complexities of the current system and the lack of a prudential regime calibrated specifically to the investment industry, the 2013 Capital Requirements Regulation required the European Commission to review the options for an "appropriate application of capital, liquidity and other key prudential requirements" for investment firms.

The review of the prudential framework for investment firms

8.29 To fulfil its obligations under the CRR, in December 2014 the European Commission asked the European Banking Authority (EBA) and the European Securities & Markets Authority (ESMA) to assess whether the EU's prudential requirements for investment firms were "appropriate or whether they should be modified, and, if so, how".

8.30 By the end of 2015, the two Authorities published the outcome of their review. They concluded that the current regime was not fit for purpose:[91]

- first, while the framework caters to some extent to the different types of business profiles of investment firms in the form of exemptions, it is a source of considerable **regulatory complexity** for many firms in general;

88 Investment firms have been subject to EU prudential rules since 1993, the year in which the first EU framework governing the activities of investment firms entered into force. See Council Directive 93/22/EEC on investment services in the securities field.

89 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

90 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

91 EBA, "Report on investment firms" (15 December 2015).

- second, its detailed requirements and exemptions constitute a "**crude and risk-insensitive proxy**" for the actual risks incurred and posed by investment firms, which differ from those of banks; and
- third, due to its inherent complexity and lack of risk sensitivity, the way the rules are implemented by EU countries has given rise to **fragmentation in the overall regulatory landscape**, increasing opportunities for "harmful regulatory arbitrage" by investment firms.

8.31 The two Authorities therefore recommended that the EU should create a new prudential regime for investment firms based on three statutory classes for firms, ranging from systemic "bank-like" firms which would remain subject to the strictest prudential requirements, to the smallest investment firms which would be exempt from many risk management requirements.

8.32 In June 2016, having considered these recommendations, the Commission accepted them on a provisional basis, and asked the EBA and ESMA to develop the exact criteria and thresholds for each of the three proposed classes of firms. It also asked them to provide a proposal for a new prudential framework applicable to class 2 and class 3 investment firms.[92] The EBA and ESMA published their advice to the Commission on the design and calibration of the new prudential regime, including initial and on-going capital requirements and a liquidity regime, in September 2017.[93] That same month, the European Commission announced that it was in the final stages of preparing "a more effective prudential and supervisory framework for investment firms".[94]

8.33 Following the UK's formal notification of its withdrawal from the EU in March 2017, the EBA also issued a separate Opinion in October 2017 on the need for any UK-based systemic investment firms, which relocate part of their activities to a Eurozone country after Brexit, to be supervised by the European Central Bank as part of the Single Supervisory Mechanism and not by the national regulator of their new EU host country.[95]

The Commission proposals

8.34 The European Commission published legislative proposals for a prudential framework for investment firms, based on the EBA's recommendations, in December 2017. The package consists of a Directive and a Regulation for consideration by the European Parliament and the Council under the ordinary legislative procedure.[96]

8.35 Having concluded that the EBA's recommendations were an "appropriate and proportionate means" of establishing a "prudential framework for investment firms that can both ensure that they operate on a sound financial basis while not hindering their commercial prospects", the Commission has mostly followed them except for the methodology for identifying systemic investment firms (see paragraphs 8.45 to 8.54).

92 European Commission, "Call for advice to the EBA for the purposes of the report on the prudential requirements applicable to investment firms" (13 June 2016).

93 EBA, "Opinion in response to the European Commission's Call for Advice on Investment Firms" (29 September 2017).

94 See COM(2017) 292.

95 See European Banking Authority Opinion EBA/Op/2017/12 (12 October 2017).

96 This mirrors the structure of the capital requirements framework for banks, which also consists of a Directive and a Regulation.

8.36 As set out in more detail below, the proposals:

- create a **new classification system for investment firms**, namely class 1 (systemic), class 2 (important but non-systemic firms) and class 3 (small firms);
- establish a **new prudential framework for non-systemic (class 2 and 3) firms**, including requirements on capital buffers, liquidity and risk management; and
- make **systemic (class 1) investment firms within the Eurozone subject to supervision by the Single Supervisory Mechanism** of the European Central Bank.

8.37 The Commission proposals refer repeatedly to the need for adjusting the capital requirements and prudential supervision regime for investment firms in the light of Brexit, given the concentration of investment activity in Britain. In particular, it has assumed that that some investment activity, including that of systemically-important firms, will relocate to the EU when the UK leaves the Single Market and its financial services industry loses the 'passport' under MiFID.

8.38 In particular, the Commission goes further than the EBA's recommendations by also tabling amendments to the EU's "equivalence" regime under MiFIR, which governs market access for non-EU investment firms which do not relocate their activities but provide their services to EU customers (retail and wholesale) cross-border or through branches.[97] The Commission is seeking to introduce new disclosure obligations for third-country firms carrying out investment activities within the EU to allow it to monitor the extent to which UK firms are accessing the Single Market in this way after Brexit, and tighten the requirements before the UK's prudential regime could be recognised as "equivalent" after Brexit (which would provide more extensive market access rights for UK firms; see paragraphs 8.68 to 8.74).

8.39 The new prudential regime would become applicable 18 months after its formal adoption by the Council and the European Parliament. This means it is likely to take effect no earlier than late 2020, and possibly even later.

8.40 The Economic Secretary to the Treasury (John Glen) submitted an Explanatory Memorandum on the proposals in January 2018.[98] Overall, the Minister has welcomed the approach taken by the Commission, which it says would "provide a good basis for a new prudential regime for investment firms" which could "have significant benefits for UK industry" given the concentration of such firms in the UK. The Government is also "satisfied that no subsidiarity concerns arise as a consequence of these proposals".

8.41 We have referred to the Government's position in our summary of the individual elements of the proposed legislation below.

97 A branch in this context is a place of business which is a part of an authorised investment firm, but which has no legal personality of its own and is not subject to separate authorisation.

98 Explanatory Memorandum submitted by HM Treasury (22 January 2018).

Classification of investment firms

8.42 The Commission proposal would create a new categorisation of investment firms authorised by an EU Member State.[99] Rather than the 11 existing categories, there would be three classes as per the EBA's December 2015 recommendation:

- **Class 1**: systemic investment firms, which would remain subject to the Capital Requirements Directive and Regulation. The principal criteria for falling into this category is that a firm must hold assets exceeding €30 billion (£26.6 billion),[100] and perform underwriting services[101] and dealing on own account.[102] All eight EU-based firms in this category are currently established in the UK but operate throughout the EU (see paragraphs 8.45 to 8.54);
- **Class 2**: non-systemic firms which still incur market and credit risk, or hold client money or assets above a certain threshold. They will be subject to a new capital regime based on a number of so-called "K-factors", as a result of which many of them would face different prudential requirements than they do at present. The EBA estimates that approximately two-thirds of firms would fall into this category (see paragraphs 8.55 to 8.57);[103] and
- **Class 3**: the smallest investment firms, which do not meet the criteria for class 1 or class 2 status. They are required to calculate their capital requirements in relation to fixed overheads or as equal to the level of initial capital they will be required to hold under the new system, whichever is higher (see paragraph 8.58). This focuses their requirements solely on facilitating an orderly wind-down if necessary, as they pose no risk to wider financial stability. Class 3 would represent approximately a third of firms.

8.43 The consequences of the proposals for each class of investment firm are set out in more detail below.

Class 1: systemic firms

8.44 In addition to its proposals to replace the current fragmented prudential regime for investment firms with a more streamlined, bespoke version, the European Commission also took the view that the EU's regulatory architecture needed to be modified to take into account the UK's decision to withdraw from the EU. In particular, the Commission expects that class 1 firms—which are eight UK-based systemic investment firms, "typically subsidiaries of US, Swiss or Japanese banking groups/broker-dealers"—are "likely" to relocate part of their activities to the EU as a consequence of Brexit by establishing a new legal, capitalised entity in one of the 27 remaining Member States.[104]

99 The EFTA-EEA countries Norway, Iceland and Liechtenstein will be expected to incorporate the legislation under the EEA Agreement after it is adopted by the EU.

100 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

101 Underwriting is a commitment to take up on own books financial instruments when others do not buy them.

102 An investment firm deals on own account when it trades in financial instruments against its own proprietary capital.

103 However, the EBA has stated that its data is biased towards Class 2 firms since smaller firms (prospective Class 3 firms) contributed less data to its survey of the investment firm population in the EEA.

104 Regarding the scale of the activities which are expected to be relocated to the Eurozone, the Commission says there are "some indications to suggest that over time this will constitute a sizeable share". It refers to research published by the Bruegel think tank, which estimates that "35 percent of London wholesale banking is related to EU27-based clients, varying from about one fifth for UK-headquartered banks to a third for US-headquartered banks and half for EU27-headquartered banks. Thus, about €1.8 trillion (or 17 percent) of all UK banking assets might be on the move as a direct consequence of Brexit".

8.45 It is unclear to what extent the UK's largest investment firms are considering relocating activities to subsidiaries within the EU to maintain their MiFID 'passport' after Brexit. However, a separate proposal to amend the Capital Requirements Directive could *require* some British firms which fall into class 1 to establish an intermediate parent undertaking (IPU) within the EU after the UK's withdrawal, if they had significant operations within the Union.[105] Any such IPUs would be subject to independent prudential requirements, and need authorisation from an EU regulator.

8.46 This, the Commission argues, raises an issue of prudential supervision and the potential for regulatory arbitrage. Even though these firms, insofar as they relocate activities to the EU, would remain subject to the same prudential obligations as they are at present under the Capital Requirements Regulation, their authorisation and prudential supervision would be carried out by the national regulator of their chosen host EU country. By contrast, systemically important banks established within the Eurozone are subject to the centralised "Single Supervisory Mechanism" (SSM) within the European Central Bank, not a national regulator.[106]

8.47 The Commission has taken the view that systemic investment firms within the Eurozone should also be subject to the SSM, because:

- national supervisors which currently supervise investment banks may "lack the expertise and overall perspective that is essential to effectively address the prudential risks" associated with systemically-important firms, as within the EU they are all currently supervised by the UK's Prudential Regulation Authority; and
- this, in turn, creates the risk of supervisory arbitrage, where these firms—should they decide to relocate some of their activities following Brexit—could select a host Member State based on the likelihood that they would be allowed to outsource relocated activity back to a parent company located in the UK, or be able to obtain designation as a "class 2" firm and therefore operate outside of the Capital Requirements Regulation.

8.48 Therefore, the Commission wants the new prudential framework to make any systemic investment firms relocated to the Eurozone subject to the SSM, which it believes has the capacity to take a stricter and more effective supervisory approach.

8.49 To achieve this, it has made one simple but significant alteration to the recommendations by the European Banking Authority for the new prudential regime: it wants to lay down the criteria for "class 1" firms in the Capital Requirements Regulation directly, rather than—as the EBA had suggested[107]—using an Implementing Regulation for the identification of systemic investment firms. The EBA's approach would have postponed the determination of the exact criteria for "class 1" firms until after the legal basis for the new prudential framework had been agreed between the Member States and the European Parliament.

105 See our Report on Banking Reform of 21 February 2018.

106 See for more information on the Single Supervisory Mechanism our Report of 21 February 2018 on the European Deposit Insurance Scheme.

107 EBA Opinion on investment firms (September 2017), Recommendation 4: "In order to identify Class 1 firms, the EBA should develop dedicated Level 2 Regulatory Technical Standards in order to carry out such identification, taking into account the specificities of investment firms".

8.50 Instead, the Commission has proposed to amend the definition of "credit institution" in the CRR to include the "most risky and systemically critical investment services".[108] The new definition would essentially cover investment firms which carry out the riskiest investment services and hold assets at individual or group level exceeding €30 billion (£27 billion). This latter criterion mirrors the proposed threshold for the IPU requirement for non-EU credit institutions and investment firms under the Capital Requirements Directive.[109] As a result:

- any class 1 firms which relocate to a Eurozone country would be subject to authorisation and supervision by the European Central Bank, not a national prudential regulator;
- the contributions of these investment firms to resolution funds that would facilitate their orderly wind-down would no longer be made to national funds, but to the Eurozone-wide Single Resolution Fund (SRF) under the Single Resolution Mechanism;
- however, the actual prudential requirements for systemic firms which relocate activities to the EU-27 from the UK would remain unchanged (as the CRR already applies to all class 1 firms).

8.51 Although the Commission proposal would not make class 1 investment firms subject to the Single Supervisory Mechanism if they relocated from the UK to a non-Eurozone EU country, the Commission says that "based on anecdotal information, at this stage the indications are that the preferred locations for these firms' EU27-operations are in financial centres in Euro Area Member States (Germany, Ireland, Netherlands, Luxembourg, France)".

8.52 In his Explanatory Memorandum on the proposals, the Minister supports treating systemically important investment firms as bank-like and continuing to make them subject to the full Capital Requirements Regulation, as they "pose similar risks to banks and that therefore a bank-like treatment is important for financial stability". However, the Minister has said the Treasury will "seek to ensure definitions and designations in the EU text work for UK financial stability", without specifying the nature of the amendments sought.

8.53 The Minister has also not commented on the assumption underpinning the Commission proposal that systemically important investment firms will relocate part of

108 The Commission also considered amending the criteria for being identified as a global or other systemically important institution (G-SII/O-SII), which should continue to fall under CRR/CRDIV could be tightened to ensure systemic firms are effectively caught and Member States' discretion to designate them is reduced. However, it concluded that, while this would have the advantage of making the G-SII/O-SII criteria more tailored for investment firms, "it could involve an extensive and lengthy examination of the criteria, with little work and consensus achieved so far on what these changes should consist of. It would also involve revisiting provisions which were difficult to agree in the current framework. Even if the changes did not affect the designation of banks and were limited to investment firms, tightening the O-SII criteria to minimise some more subjective and discretionary elements could be controversial for many Member States keen to retain the flexibility of the current framework. The current level of discretion was a conscious choice by the legislators considering that the O-SII framework was conceived as a macroprudential tool."

109 Under a separate legislative proposal to amend the capital requirements framework for banks (which currently also covers investment firms), non-EU systemically-important institutions (i.e. including class 1 investment firms) would be required to establish an intermediate parent undertaking (IPU) within the EU, if they held assets exceeding €30 billion. See our Report of 21 February 2018 on banking reform for more information.

their activities to the EU after Brexit. This is curious as the EU would not need to legislate for them to be subject to the Single Supervisory Mechanism if no relocation takes place, since no such firms are currently established in any EU country except Britain, and the new prudential framework is not expected to take effect until after the UK ceases to be bound by EU law (see paragraph 8.8).

Prudential requirements for class 2 investment firms

8.54 The Commission has proposed that investment firms would fall into "class 2" if they exceed any one of a number of size thresholds, such as assets under management valued at more than €1.2 billion (£1.1 billion) or a balance sheet higher than €100 million (£88 million). Firms would also fall into this category if they administer any client assets or hold any client money.

8.55 The prudential requirements for these firms would be different from those applying to banks under the Capital Requirements Regulation. For the class 2 firms with the least risky business model, the minimum capital would be set as for the smallest (class 3) investment firms (see below). For the others, their capital requirements would be calculated according to a new "K-factor approach" for measuring risks in three categories (to the firm, to its customers and to the market) from the services and activities undertaken. The necessary capital buffer would be derived from the volume of each activity.

8.56 The European Banking Authority has stated that the impact on capital requirements for investment firms in Class 2 could be "substantial", as it would capture certain risks and set concomitant prudential requirements for the first time.[110] However, it takes the view that the largest impact "would be concentrated in a relatively small number of individual firms", likely to be investment advisors, execution brokers, firms which place securities and portfolio managers. Conversely, the new regime is likely to decrease capital requirements for trading firms and custodians.

Class 3: Prudential requirements and supervision

8.57 For firms in Class 3, the minimum capital would be either the level of initial capital required for their authorisation in line with the new prudential regime—€75,000 (£67,000)—or a quarter of their fixed costs (overheads) for the previous year, whichever is higher. The EBA has said that most Class 3 firms "ought to comfortably meet the new requirements based on their existing levels of own funds".

Other prudential requirements for class 2 and class 3 firms

8.58 Other elements of the Commission proposals for the new regime for class 2 and class 3 firms are that:

- new requirements on **initial capital** before authorisation can be granted, ranging from €75,000 (£66,000) to €750,000 (£664,000) depending on the type of investment activities undertaken;

110 See Commission Impact Assessment SWD(2017) 481, p. 20. New risks included, which are not covered by the CRR, include assets under management; client money held; and daily trading flow.

- investment firms should have internal procedures to monitor and manage their **liquidity needs**, and be required to hold a minimum of one third of their fixed operating costs ("overheads requirements") in liquid assets;

- all investment firms are required to monitor and control their **concentration risk**, including in relation to their customers. In particular, firms that deal on own account or execute client orders in their own name cannot normally exceed an exposure to a single or to connected counterparties equal to 25 per cent of their regulatory capital;

- new, investment-firm specific **governance arrangements** for class 2 firms,[111] including remuneration policies. Although there is no equivalent to the "bonus cap" that applies to banks under the Capital Requirements Regulation, the proposal would require investment firms to set "appropriate ratios" for variable remuneration;

- detailed **supervisory and reporting requirements** will be laid down in an Implementing Act after the new legal framework has been agreed; and

- **transitional provisions** will apply for the new capital requirements, where these lead to higher requirements for a firm than currently under the Capital Requirements Regulation. The exact nature of the transitional derogations will differ on a case-by-case basis, depending on the firm-specific required increase to regulatory capital.[112]

8.59 In his Explanatory Memorandum, the Minister supports the proposals for the new prudential regime for non-systemic (class 2 and class 3) investment firms. However, he added that the Government would discuss the specific implications of the new capital requirements with industry, given that some firms may need to hold more capital than they do at present. The Economic Secretary also welcomed "the absence of a bonus cap" for investment firms, and will seek to ensure that "the thresholds for applying other remuneration tools are appropriately calibrated so that there is sufficient proportionality in their application".

8.60 The proposals also appear to have the support of the European investment industry itself, with AFME—the Association for Financial Markets in Europe—commenting that it welcome the Commission's proposals, as "prudential rules that are specifically tailored to the business models and risks assumed by investment firms should further the development of the Capital Markets Union" while the "introduction of direct ECB oversight of such firms for their Euro area activities is also welcome as it will foster a supervisory level playing field".[113]

111 Class 3 firms will remain subject to the governance requirements laid down in MiFID II, but would not face any additional requirements in this area under the Commission proposals.

112 For example, firms whose capital requirement would *more* than double under the new rules would be able to initially limit that increase to double their current capital requirement for a period of five years after the new regime takes effect.

113 AFME, "AFME welcomes Commission proposal for new prudential regime for investment firms" (20 December 2017). AFME's members include Bank of America, Deutsche Bank, HSBC and Standard Chartered.

Treatment of third country firms

8.61 The final element of the Commission proposals relates to the treatment of non-EU investment firms which operate within the EU. As we have noted, the new prudential regime is partially driven by the UK's exit from the EU, to "ensure that third-country firms providing services cross-border in the EU do not enjoy a more favourable treatment than EU firms in terms of prudential, tax and supervisory requirements".

8.62 Firstly, the Commission argues that the new, less convoluted classification system for investment firms—and in particular the allocation of centralised supervisory responsibilities to the European Central Bank for any systemic investment firms which relocate activities from the UK to the Eurozone—will reduce the opportunities for "regulatory arbitrage" by British firms seeking to establish a subsidiary within the EU (see paragraphs 8.45 to 8.54).

8.63 Secondly, the Commission is also making "targeted amendments" to the provisions of MiFID (on branches) and MiFIR (equivalence) that govern access for non-EU firms seeking to provide investment services to EU-based customers. The conditions for such access depend on the type of customer the firm is seeking to deal with (i.e. a retail or professional investor). We have described the current regulatory framework for third country access to the Single Market, and the changes proposed by the Commission, below.

Cross-border investment services for retail and elective professional clients

8.64 Under article 39 of MiFID, EU Member States can authorise non-EU investment firms intending to provide services to retail or elective professional clients[114] within their territory to establish a branch (i.e. a presence that has no legal personality of its own). A branch, since it is not an EU establishment, does not have the right to "passport" its services to other EU countries.

8.65 The UK does not currently avail itself of this option to require a branch. For Member States that do, third country investment firms that do not want to establish an independently-capitalised and authorised subsidiary in the EU may have to establish branches in every EU country where they wish to service retail or elective professional clients, subject to national laws. Different rules apply where the investment firm wants to provide services to other types of professional or sophisticated clients (see below).

8.66 Under MiFID, there is no mandatory reporting requirement on the activities of non-EU branches in the Union. In light of Brexit, and the concerns ESMA and the EBA have expressed about British firms attempting to establish "letter-box" entities in the EU after they lose their "passporting" rights under MiFID,[115] the Commission has proposed to require third country branches under Article 39 MiFID to report annually on the scale and scope of their activities; their turnover and assets; the arrangement for investor

114 Under MiFID, retail investors can elect to be treated as a "professional client", which would allow them to invest in certain types of products that are not open to retail investors because of their risks or complexity. However, in doing so they also waive some of the regulatory protections afforded to retail investors.

115 EBA, "Opinion on issues related to the departure of the United Kingdom from the European Union" (12 October 2017) and ESMA, "General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union" (31 May 2017).

protection; and their risk management policy. The information gathered in this way would then be used to assess to what extent investment services were provided subject to effective supervision within the EU itself.

Cross-border investment services for eligible counterparties and per se professional investors

8.67 MiFID II also allows non-EU investment firm to provide investment services to EU-based *per se* professional customers,[116] including eligible counterparties,[117] without establishing a subsidiary or branch within the European Union. However, this is only possible where the following conditions are met:

- the investment firm has authorisation from its home regulator to perform investment services;
- the European Commission, with the support of a qualified majority of EU countries, has recognised the regulatory regime of the home country for investment firms as "equivalent" to that of the EU under MiFID II/MiFIR;[118]
- a bilateral cooperation agreement between the European Securities & Markets Authority (ESMA) and the regulator of the home country is in place; and
- the individual investment firm has been registered with ESMA on its Register of Third Country Firms.

8.68 If all these conditions are met, the investment firm can provide investment services in any EU country without needing to establish a branch or subsidiary. However, it is restricted to dealing with eligible counterparties or *per se* professional clients based. To provide services to retail or elective professional clients, individual EU Member States can still require the establishment of a branch (see above), and even an equivalence decision does not allow these types of clients to be serviced from a single EU-based branch.

8.69 The Commission has now proposed to modify the conditions before equivalence can be granted, to take into account the concentration of Europe's investment firms in the UK.

8.70 Specifically, it wants to attach more stringent conditions to the equivalence process by requiring a "detailed and granular assessment" that also takes into account the third country's "supervisory convergence".[119] It is unclear what the practical effect of this amendment would be if the UK were to apply for equivalence under Article 47 MiFIR, as the regime is untested: the Regulation only took effect in January 2018, and the

116 *Per se* professional clients are those "who possesses the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that it incurs". They include large companies, national and regional governments, and financial institutions. They typically enjoy less regulatory protection than retail clients. See section I of Annex II to Directive 2014/65/EU.

117 Eligible counterparties under MiFID are the most sophisticated type of market participant, including most types of regulated financial institution (e.g. banks, insurance companies and investment firms).

118 There is not currently any equivalence decision under article 47 MiFIR, as the Regulation only took effect in January 2018.

119 Article 61 of the proposed Regulation: "Where the services provided and the activities performed by third-country firms in the Union following the adoption of the [equivalence] decision (…) are likely to be of systemic importance for the Union, the [the third country's] legally binding prudential and business conduct requirements (…) may only be considered to have equivalent effect to the [EU's] requirements (…) after a detailed and granular assessment. For these purposes, the Commission shall also assess and take into account the supervisory convergence between the third country concerned and the Union."

Government insists that the post-Brexit UK-EU free trade agreement will obviate the need for relying on equivalence in any event (see below). However, the clear purpose is to give the Commission more leeway to reject the request or seek to put pressure on the UK to keep its regulatory regime for investment firm aligns with that of the EU after Brexit.

8.71 Separately, the Commission has also proposed a reporting requirement for third country firms registered with ESMA under the equivalence regime which mirror those for branches of non-EU firms under article 39 MiFID. They would have to inform the Authority annually about the scale and scope of their activities; their turnover and assets; the arrangement for investor protection; and their risk management policy.

8.72 In his Explanatory Memorandum, the Minister states:

> "The Government notes the amendments to MiFIR equivalence provisions. What our future relationship with the EU will look like in financial services is subject to negotiation, but we are confident that we can agree stable, reciprocal arrangements based on close cooperation with our EU counterparts as part of an ambitious economic partnership". This hypothetical new financial services agreement with the EU would by-pass the need for relying on equivalence provisions under MiFIR."

8.73 Given that the Government has not been forthcoming with details about these "stable, reciprocal" post-Brexit market access arrangements for the financial services industry, we have summarised several other options for post-Brexit access to the EU market for UK-based investment firms in more detail below.

Access to the EU market for UK investment firms after Brexit

8.74 Opinions vary about the likely impact that the loss of the MiFID "passport" will have for the UK's investment services industry and therefore the potential value of an equivalence decision. As noted, the European Commission in its proposals refers to research by the Brueghel think tank, which estimated that up to 17 per cent of assets held by the UK's investment industry could relocate as a result of Brexit.

8.75 However, various other mitigation mechanisms have also been put forward to replace the 'passport', including equivalence; reverse solicitation; and use of delegation or outsourcing by EU-based branches and subsidiaries to UK-based sister entities.

Equivalence

8.76 To some extent, for provision of investment services to wholesale customers, a significant and formal level of market access could be preserved through an equivalence decision under article 47 MiFIR (see paragraphs 8.68 to 8.74 above). However, given this provision has only recently taken effect, there is no precedent for the process of obtaining equivalence in this area, and there are likely to be technical as well as political hurdles.[120]

8.77 For example, the European Commission is clearly intent on making any post-Brexit equivalence decision with respect to the UK's prudential and conduct requirements for

120 This view is shared by UK Finance, which has said: "Securing an equivalence judgement from the EU can be a time-consuming and complicated process potentially lasting a number of years. Nor is it entirely divorced from political considerations".

wholesale investment firms dependent on continued regulatory alignment with the EU (see paragraph 8.71). The potential for the politicisation of the equivalence process is demonstrated by the recent decision by the Commission to grant equivalence to the Swiss stock exchange under MiFID II for only one year, to exert pressure on Switzerland in the protracted negotiations over a new institutional framework for the bilateral EU-Swiss relationship.[121]

8.78 The equivalence regime under MiFIR is also unusual in that it specifically creates a market access regime for cross-border operations where the relevant conditions are met. Most other equivalence regimes under EU financial services law instead provide derogations rom the typically stricter requirements when EU-based companies deal with foreign financial services providers. UK Finance has referred to the example of the Capital Requirements Directive, under which EU-based banks which enter into transactions with banks in countries that have been found equivalent by the EU for the purposes of prudential bank regulation "may generally hold less capital against that risk than for banks from countries that have not".[122]

8.79 Relying on equivalence also has other general drawbacks, as the industry itself has pointed out:[123]

> "Equivalence is not a substitute for the operational rights created by the EU passporting system for [investment] banks. It operates in fewer areas, covers fewer services and is inherently less secure. Some of the more significant equivalence regimes for foreign banks will not come into effect for several more years. (…)
>
> "Equivalence is not negotiated, but requested. Assessments are launched at the EU's discretion. It can also be withdrawn, along with any rights that depend on it, at the EU's discretion if a country is judged to have diverged from EU standards for any reason."

8.80 Despite these drawbacks it is the only legal mechanism currently available under EU law to provide statutory relief from certain prudential requirements, or to provide preferential access into the EU market for firms without a separate legal presence in an EU Member State (with the exception of specific trade arrangements that require the full application of EU financial services legislation).[124]

Reverse solicitation

8.81 Some analysts have argued that a lack of formalised cross-border access into the Single Market could be mitigated under the MiFID "reverse solicitation" provision, which

121 This decision was approved by the Member States only because an equivalence regime needed to be in place before MiFID II took effect in early January, or cause disruption to existing arrangements. It has since been reported that a number of EU countries have complained to the European Commission about forcing through the temporary equivalence decision at short notice.

122 UK Finance, "What is 'equivalence' and how does it work?" (accessed 16 February 2018).

123 Idem.

124 For example, Annex IX to the EEA Agreement with Norway, Iceland and Liechtenstein and Appendix XVII-2 to the EU-Ukraine Association Agreement both provide for full Single Market participation but in return for acceptance of EU law. With respect to the latter, once Ukraine has fully applied the EU financial services *acquis*, it can be granted "internal market treatment" which would effectively give its financial services providers the same passporting rights as EU-EEA firms.

allows EU-based customers to seek out non-EU investment services providers directly.[125] However, UK Finance expects this to only offer limited opportunities as it cannot be used where a non-EU firm advertises in the EU to inform clients about the services it offers, and at Member State level national legislation restricts its use.[126]

Delegation and outsourcing

8.82 After Brexit, the EU-based subsidiaries of British firms could outsource substantive operations back to related parties or to branches in the UK. MiFID II only allows outsourcing this if the arrangement does not "impair materially the quality of [the firm's] internal control and the ability of the supervisor to monitor the firm's compliance with all obligations".[127]

8.83 The potential for subsidiaries of UK investment firms outsourcing their operations back to the UK after Brexit has been a particular point of concern for the EU's financial regulators. ESMA, the EU body responsible for overseeing the implementation of MiFID, has expressed concerns that extensive delegation or outsourcing of operations back to the UK after a nominal subsidiary has been established in the EU could result in "letter-box entities":

> "In the course of the UK withdrawing from the EU, UK-based market participants may seek to relocate entities, activities or functions to the EU27 in order to maintain access to EU financial markets. (…) These market participants may seek to minimise the transfer of the effective performance of those activities or functions in the EU27, i.e. by relying on the outsourcing or delegation of certain activities or functions to UK-based entities, including affiliates. (…) Outsourcing or delegation arrangements, under which entities confer either a substantial degree of activities or critical functions to other entities, should not result in those entities becoming letter-box entities."[128]

8.84 Similarly, the European Commission has expressly stated EU investment firms which delegate operations to a UK-based branch need to base this decision "on objective reasons linked to the services provided in the non-EU jurisdiction" and "not result in a situation where such non-EU branches perform material functions or provide services back into the EU".[129] The full extent to which this supervisory approach will restrict delegation or outsourcing of investment services from the EU to UK-based entities is not yet clear.

8.85 In view of the inherent limitations on market access for UK firms of all these alternatives to the Single Market's 'passporting' arrangement, the Committee has asked

125 Under MiFID, where a client which requests services on their own exclusive initiative, there is no requirement for a third-country investment firm to set up a branch (in the case of a retail or elective professional client) or register or be authorised by ESMA (in the case of professional clients or an eligible counterparty). For its potential use post-Brexit, see for example http://www.cityam.com/275570/great-repeal-bill-helping-remove-phantom-financial-services.

126 See https://www.ukfinance.org.uk/wp-content/uploads/2017/11/EU27-report-ONLINE-FINAL.pdf. Although the paper focuses on reverse solicitation for the banking sector, its overall conclusion is that "the combination of outright prohibition, legal uncertainty and regulatory hostility does not provide a sound foundation on which to base a business model for banking".

127 See Article 16(5) of Directive 2014/65/EU.

128 https://www.esma.europa.eu/sites/default/files/library/esma42–110–433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf.

129 https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-financial-instruments_en.pdf.

the Government to clarify without delay the details of its proposal for a new UK-EU financial services agreement. While negotiations on the future economic partnership are not yet concluded, and in light of the continued application of the EU acquis during the transitional period, the Committee will continue to assess the political and legal implications of new EU financial services legislation.

Previous Committee Reports

None.

9 Interoperable EU information systems for security, border control and migration management

Committee's assessment	Legally and politically important
Committee's decision	(a) Cleared from scrutiny (b) and (c) Not cleared from scrutiny; further information requested; drawn to the attention of the Home Affairs and the Justice Committees and the Committee on Exiting the European Union
Document details	(a) Commission Communication: *Twelfth progress report towards an effective and genuine Security Union*; (b) Proposal for a Regulation establishing a framework for interoperability between EU information systems (police and judicial cooperation, asylum and migration); (c) Proposal for a Regulation establishing a framework for interoperability between EU information systems (borders and visas)
Legal base	(a)— (b) Articles 16(2), 74, 78(2)(e), 79(2)(c), 82(1)(d), 85(1), 87(2)(a) and 88(2) TFEU, ordinary legislative procedure, QMV (c) Articles 16(2), 74, 77(2)(a), (b), (d) and (e) TFEU, ordinary legislative procedure, QMV
Department	Home Office
Document Numbers	(a) (39380), 15861/17, COM(17) 779; (b) (39366), 15729/17 + ADDs 1–3, COM(17) 794; (c) (39368), 15119/17 + ADDs 1–3, COM(17) 793

Summary and Committee's conclusions

9.1 The EU has developed various information systems to strengthen controls at the external Schengen border, improve the way in which asylum and migration are managed and enhance internal security. These systems were developed for specific purposes and do not work together effectively, creating information gaps and "blind spots" which terrorists have been able to exploit. Since 2016, the Commission has been developing proposals to make existing and planned new EU information systems interoperable so that information can be shared more rapidly. The Commission Communication—document (a)—describes the progress made in three areas:

- maximising the benefits of existing EU information systems;[130]
- developing new EU systems to plug information gaps;[131] and
- enhancing interoperability between these systems.

9.2 The Communication is accompanied by two proposed Regulations which seek to implement the recommendations made in May 2017 by a high-level expert group on information systems and interoperability.[132] The first—document (b)—covers two existing EU information systems (the Eurodac asylum database and the police cooperation parts of the Schengen Information System—SIS II) and one new EU information system which is expected to be agreed shortly (the European Criminal Records Information System for Third Country Nationals—ECRIS-TCN). The UK participates in Eurodac and SIS II and has opted into the proposed ECRIS-TCN information system. The second—document (c)—covers existing or proposed new EU information systems in which the UK is unable to participate as they are based on parts of the Schengen rule book dealing with border control and visas which do not apply to the UK.

9.3 The aim of the proposed Regulations is to ensure that police and immigration officers "have the right information at the right time to do their job".[133] According to the Commission's First Vice-President (Frans Timmermans):

> "Speed counts when it comes to protecting our citizens against terrorism and saving lives. At this moment our EU information systems for security and border management are working separately which slows down law enforcement. With our proposal they will become fully interoperable. That means that law enforcement anywhere in the EU will be able to work directly and instantly with all the available information."[134]

9.4 The Commission makes clear that interoperability "does not mean pooling all data or collecting additional categories of information". Nor would it allow information held in one system automatically to be shared across all other systems. Rather, "interoperability is about a targeted and intelligent way of using existing data to best effect while at the same time ensuring full respect of fundamental rights, in particular data protection requirements".[135] The Commission anticipates that it may take until the end of 2023 to develop and test all the technical components needed to make EU border, migration and security information systems interoperable.[136]

130 The Commission has proposed changes to the Schengen Information System (SIS II), Eurodac and the European Criminals Records Information System (ECRIS) and is supporting Member States' efforts to implement the Passenger Name Records (PNR) Directive and the Prüm Decisions establishing a framework for the exchange of vehicle registration, fingerprint and DNA data.

131 A political agreement has been reached on the EU Entry/Exit System and negotiations are continuing on the proposed European Travel Information and Authorisation System (ETIAS).

132 See the final report of the high-level expert group and the European Commission's fact sheet on interoperability.

133 See the European Commission's press release issued on 12 December 2017.

134 Ibid.

135 See the European Commission's fact sheet on the interoperability of EU information systems for security, border and migration management.

136 See the timeframe set out on p.96 of the Commission's legislative financial statement attached to document (b).

9.5 The Minister for Policing and the Fire Service (Mr Nick Hurd) tells us:

> "Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation."[137]

9.6 He explains that the proposed Regulation on the interoperability of EU asylum and law enforcement information systems—document (b)—is subject to the UK's Title V (justice and home affairs) opt-in Protocol and the UK's Schengen opt-out Protocol. This means that if the Government wishes to participate, it will need to *opt in to* the non-Schengen elements of the proposal—Eurodac and ECRIS-TCN—within the three-month opt-in deadline which will expire on 21 May. The UK will be automatically bound by the Schengen elements of the proposal—SIS II—unless the Government decides to *opt out* within the same three-month period.

9.7 The Minister anticipates that the Commission's interoperability proposals will require "significant investment and technical changes". Whilst he broadly supports the Commission's aims, he says that the Government will need to consider whether the "additional benefits" for the UK and the "likely level of usage" by UK law enforcement and immigration officials are sufficient to justify "the high costs".[138]

9.8 **These are highly technical proposals but their impact could be far-reaching if they achieve the Commission's goal of closing information gaps and removing the blind spots which hinder effective cross-border security cooperation. Our focus at this stage is on:**

- **the impact of interoperability on the rights of individuals whose data may be held in EU information systems;**
- **the factors that will inform the Government's decision on participation in document (b); and**
- **the wider Brexit implications of the proposals.**

The impact of interoperability on individual rights

9.9 **The Commission's legislative proposals are based on recommendations made last May by the High-Level Expert Group on Information Systems and Interoperability. Commenting on these recommendations, the EU Counter-Terrorism Coordinator (Gilles de Kerchove) underlined the need for "a paradigm shift in the way we deal with information systems", adding:**

> **"Given the threat picture, the current fragmentation of EU databases and the separation of border security, migration and counter-terrorism purposes of databases no longer reflect reality."[139]**

The European Data Protection Supervisor ("EDPS"—Giovanni Buttarelli) adopted a more cautious approach, describing the Commission's vision of interoperability as

137 See para 11 of the Minister's Explanatory Memorandum.
138 See para 20 of the Minister's Explanatory Memorandum.
139 See Annex 5 to the final report of the High-Level Group issued in May 2017.

"ambitious" and entailing "a fundamental change to the current architecture of large-scale IT systems". He indicated that the proposed biometric matching service would require further "careful analysis" and that the proposed common repository of identity data raised "serious" data protection issues. The EU Fundamental Rights Agency made clear that "any interoperable solution or solutions selected for EU information systems will need to be designed in a manner which does not unduly affect core data protection principles".[140]

9.10 **Now that the Commission has published its proposals on interoperability, we ask the Minister:**

- **how confident he is that they will make a difference in closing information gaps and improving security within the EU;**
- **whether he considers that they adequately address the concerns expressed by the EDPS and Fundamental Rights Agency; and**
- **whether he is satisfied that there are robust safeguards to ensure the protection of individual rights (particularly important in the context of Brexit—see below).**

UK participation in document (b)

9.11 **The UK is only entitled to participate in document (b). The Minister indicates that the main factors informing the Government's decision on participation are the prospective additional benefits that interoperable information systems would bring the UK set against the "high costs". Both factors are contingent on the timetable for adopting and implementing the proposals and the outcome of negotiations on a post-exit transitional/implementation period. The Commission originally envisaged making EU security, border and migration information systems interoperable by 2020. The proposals indicate that it may take until 2023 for these systems to be fully interoperable, making any benefits for the UK highly uncertain. We ask the Minister:**

- **whether he expects the Commission's legislative proposals to be adopted before the UK leaves the EU on 29 March 2019—this would mean that document (b) would apply to the UK during a transitional/implementation period (if agreed as part of exit negotiations);**
- **whether the EU information systems covered by document (b)—Eurodac, SIS II (police cooperation) and ECRIS-TCN—are likely to be fully interoperable before the end of a transitional/implementation period of around two years, meaning that there would be some short-term benefit for the UK; and**
- **whether the UK would have to self-fund any adaptations to its national interfaces with each of the systems covered by document (b) as it does not participate in the EU Internal Security Fund (Borders component).**

140 See Annexes 3 and 4 to the final report of the High-level expert group on information systems and interoperability published in May 2017 which includes the observations made by the EU Counter-Terrorism Coordinator, the EDPS and the EU Fundamental Rights Agency.

9.12 **If the Government decides not to participate in document (b), the Minister says it will be important to ensure that "non-participation does not preclude individual access to the information systems that the UK is currently participating in".[141] We ask him whether he considers that a decision not to participate might put the UK at risk of being ejected from these systems.**

Brexit implications

9.13 **We do not consider that it is feasible to disentangle the Government's decision on participation in document (b) from its longer-term aspiration for a post-exit strategic treaty on security and law enforcement cooperation. The Minister recognises that participation in document (b) would entail "significant investment and technical changes". It is difficult to see how the Government could justify making a substantial investment unless it intends to negotiate continued UK participation in EU security and migration information systems post-exit. We ask the Minister to:**

- **tell us whether the Government envisages that the EU information systems covered by document (b) should form part of a new post-exit strategic treaty with the EU; and**
- **provide an initial assessment of the costs that the UK might be expected to incur in connecting to the new systems and developing the appropriate end user interfaces for UK agencies.**

9.14 **We note that the bulk of funding to implement the proposals would come from the EU's post-2020 budget and would be allocated to the EU agency (eu-LISA) responsible for delivering interoperable systems. If the UK were to participate in document (b) beyond a transitional period ending in December 2020, it would doubtless be required to make a financial contribution for several years beyond 2020 but would have no say in setting the overall expenditure limits. We ask the Minister what assessment he has made of the potential costs for the UK after 2020.**

9.15 **Except for the Schengen Information System, the remaining five information systems covered by the Commission proposals focus exclusively on third country (non-EU) nationals, meaning that their impact on British citizens will differ before and after Brexit. The Minister considers that the Commission proposals increase the functionality of the underlying systems and so do not constitute a "fundamental change". It is clear, however, that substantially more data on British citizens will be held on EU information systems post-exit than is currently the case. It is imperative that the Government engages seriously with any concerns expressed by the EDPS and Fundamental Rights Agency on data protection standards and safeguards and on the means for obtaining redress if data is inaccurate or used inappropriately.**

9.16 **One of the safeguards highlighted by the EU Fundamental Rights Agency is the need to ensure that "the rules on sharing of data with third countries as laid down in the individual legal instruments are adhered to in the case of interoperability". Article 48 of both Commission proposals provides:**

> **"Personal data stored in or accessed by the interoperability components shall not be transferred or made available to any third country, to any international organisation or to any private party."**

141 See para 28 of the Minister's Explanatory Memorandum.

We ask the Minister:

- **what assessment the Government has made of the (often restrictive) provisions on third country access contained in the EU information systems covered by the Commission proposals;**
- **whether and how these restrictions could be overcome to enable the UK to continue to participate in these systems post-exit; and**
- **whether he anticipates that the Commission's goal of making these systems interoperable will make it easier or harder for the UK to negotiate access to them (should it wish to do so) as part of the UK's exit negotiations.**

9.17 **We clear the Commission Communication—document (a)—from scrutiny. Pending further information, we are holding both legislative proposals—documents (b) and (c)—under scrutiny. We draw this chapter to the attention of the Home Affairs Committee, the Justice Committee and the Committee on Exiting the European Union.**

Full details of the documents

(a) Commission Communication: *Twelfth progress report towards an effective and genuine Security Union*: (39380), 15861/17, COM(17) 779. (b) Proposal for a Regulation establishing a framework for interoperability between EU information systems (police and judicial cooperation, asylum and migration): (39366), 15729/17 + ADDs 1–3, COM(17) 794. (c) Proposal for a Regulation establishing a framework for interoperability between EU information systems (borders and visas) and amending Council Decision 2004/512/EC, Regulation (EC) No 767/2008, Council Decision 2008/633/JHA, Regulation (EU) 2016/399 and Regulation (EU) 2017/2226: (39368), 15119/17 + ADDs 1–3, COM(17) 793.

Background

9.18 The EU has established three centralised information databases which underpin cooperation on asylum, border management and law enforcement:

- the Eurodac database which contains the fingerprints of individuals who have applied for asylum in the EU—the Commission has proposed changes to develop it into a broader migration management tool and to include facial images as well as fingerprints;[142]
- the Visa Information System (VIS) which contains information on individuals applying for short-stay visas to visit the Schengen area, including their fingerprints and facial images; and
- the Schengen Information System (SIS II) which contains information ("alerts") on individuals (including fingerprints and photographs, where available) and objects likely to be of interest to border control and law enforcement authorities.[143]

142 See our predecessors' Sixth Report HC 71–iv (2016–17), chapter 2 (15 June 2016).
143 See our predecessors' Thirtieth Report HC 71–xxviii (2016–17), chapter 1 (1 February 2017).

9.19 A new EU Agency—eu-LISA—was set up in 2012 to oversee the operational management of these information systems and ensure effective, secure and continuous data exchange between Member States.[144] Each system has its own founding instrument which contains detailed rules on the information that can be stored in each database, the purposes for which it may be used, and data protection requirements. The systems cannot communicate with one another through the exchange of data or sharing of information unless their founding instruments allow them to do so.

9.20 The Regulation setting up eu-LISA provides that the Agency may be made responsible for the preparation, development and operational management of other large-scale EU information systems dealing with asylum, migration, civil and criminal law cooperation and cross-border police cooperation. A number of new information systems are envisaged.[145] They include:

- an EU Entry/Exit System ("EES") which will contain information on third country (non-EU) nationals travelling to and from the Schengen area;[146]
- a European Travel Information and Authorisation System ("ETIAS") which will process information provided by visa-exempt third country nationals before they travel to the Schengen area and screen for any risks to security, immigration control or public health;[147] and
- a system ("ECRIS-TCN") for obtaining information on the previous convictions of third country national offenders within the EU, to supplement the existing European Criminal Records Information System.[148]

9.21 The table shows which of the existing or proposed EU information systems are open to UK participation.

Information system	Schengen or non-Schengen	UK position
Visa Information System—VIS	Schengen	UK excluded
Schengen Information System—SIS II (border control component)	Schengen	UK excluded
Schengen Information System—SIS II (law enforcement)	Schengen	UK participates in existing SIS II and is also participating in a Commission proposal to strengthen the law enforcement component of SIS II
EU Entry/Exit System—EES	Schengen	UK excluded

144 See Regulation (EU) No 1077/2011 establishing a European Agency for the operational management of large-scale IT systems in the area of freedom, security and justice, as amended by Regulation (EU) No 603/2013 establishing Eurodac.

145 See the European Commission's fact sheet on EU Information Systems: Security and Borders.

146 See our predecessors' Third Report HC 71–ii (2016–17), chapter 14 (25 May 2016).

147 See our predecessors' Twenty-fifth Report HC 71–xxiii (2016–17), chapter 12 (11 January 2017), Thirty-first Report HC 71–xxix (2016–17), chapter 12 (8 February 2017), Thirty-fifth Report HC 71–xxxiii (2016–17), chapter 7 (15 March 2017) and Fortieth Report HC 71–xxxvii (2016–17), chapter 18 (25 April 2017).

148 See our First Report HC 301–i (2017–19), chapter 22 (13 November 2017).

European Travel Information and Authorisation System—ETIAS	Schengen	UK excluded
Eurodac	Non-Schengen	UK participates in the existing Eurodac database. The UK has opted into the Commission's proposal to expand its scope
European Criminal Records and Information System—extension to third country nationals (ECRIS-TCN)	Non-Schengen	UK participates in ECRIS and has opted into a supplementary proposal extending ECRIS to third country national offenders

9.22 The Commission has proposed changes to the Regulation establishing eu-LISA. One of its new tasks will be to make existing and future EU information systems for security, border and migration management interoperable by 2020, a goal endorsed by EU leaders in June 2017.[149]

The Commission's proposals on interoperability

9.23 The Commission describes its legislative proposals on interoperability as "a step-change not only in the way the EU manages information for security, border and migration management but also in making that data available to national authorities to ensure that they have the information they need when and where they need it".[150] The proposals encompass six centralised EU information systems, of which three (Eurodac, SIS II and VIS) are already operational and three are "on the brink of development" (the EES, ETIAS and ECRIS-TCN). With the exception of SIS II, the remaining five information systems are "exclusively focussed on third country nationals".[151]

9.24 The UK is only entitled to participate in document (b) covering Eurodac, ECRIS-TCN and the police cooperation parts of SIS II. This proposal also applies to a limited extent to Europol data and to certain Interpol databases, such as the Stolen and Lost Travel Document database. The UK cannot participate in document (c) which covers the visa and border control provisions of SIS II, VIS, EES and ETIAS. The Commission makes clear that national information systems (such as the Police National Computer) and decentralised EU information systems (such as the Prüm framework for exchanging vehicle registration, fingerprint and DNA data) are outside the scope of its proposals.

9.25 The Commission proposals have four operational objectives:

- ensuring that end-users (mainly police, immigration and judicial authorities) have "fast, seamless, systematic and controlled access to the information that they need to perform their tasks";
- providing a means to detect multiple identities linked to the same set of biometric data—terrorists have been able to use multiple identities to evade border and law enforcement authorities;

149 See the Conclusions of the June 2017 European Council and our First Report HC 301–i (2017–19), chapter 26 (13 November 2017).

150 See p.1 of the Commission Communication.

151 See p.5 of the Commission's explanatory memorandum on document (b).

- making it easier to check the identity of third country nationals within the EU; and
- streamlining law enforcement access to information held in EU systems where necessary to prevent, investigate, detect or prosecute serious crime and terrorism.[152]

9.26 The Commission identifies four "technical components" or tools to achieve these operational objectives:

- a **European search portal** which would operate as a "one-stop shop", enabling authorised users to carry out a simultaneous search on multiple EU information systems (as well as relevant Interpol systems and Europol data) using both biographical and biometric data;
- a **shared biometric matching service** which would use biometric data (fingerprints and facial images) to discover links between information on the same person held in different EU information systems—this service would not apply to the ETIAS as it will not contain biometric data;
- a **common identity repository** which would contain biographical and biometric information on third country nationals whose data are recorded in Eurodac, VIS and (in the future) the EES, ETIAS and ECRIS-TCN, providing a quick and efficient means of checking identity; and
- a **multiple identity detector** which would check whether identity data exist in different EU systems and help combat identity fraud.

9.27 These technical components would be supported by three additional features:

- a **central repository for reporting and statistics** which would generate anonymous statistical data for policy, operational and data quality purposes;
- the use of the **Universal Message Format** as the standard technical language for EU information systems in the justice and home affairs field; and
- the introduction of **automated data quality control mechanisms** to ensure that data entered into EU information systems meets a high quality threshold.

9.28 The Commission proposals also seek to streamline and speed up the process for law enforcement access to EU asylum and migration information systems (Eurodac, EES, ETIAS and VIS) by enabling law enforcement officers to carry out out an initial search against the information stored in the common identity repository. This search would operate on a "hit/no-hit" basis, meaning that it would only flag whether data on a particular individual is held in one or more of these EU information systems. Law enforcement officers would not have direct access to any relevant data flagged up by the search, but would be required to request access on the terms specified for each information system (including prior authorisation by a designated authority).

152 See p.4 of the Commission's explanatory memorandum accompanying document (b).

9.29 Taken as a whole, the Commission considers that its legislative proposals will:

> "[…] lead to faster, more systematic access to information for authorised users, simplifying the current complex and diverse access conditions to ensure that information is more easily available to people who have the right to see it, in line with the rights set out in the legislation governing each system. They will make it easier for end-users to determine when people have been registered with multiple identities, both facilitating travel for legitimate travellers and combating identity fraud. They will make it easier for authorised officers to reliably identify third-country nationals who are entering, or who are already on, the territory of the Schengen area."[153]

9.30 The Commission considers that the proposed Regulations comply with fundamental rights as the provisions on interoperability complement existing EU information systems:

> "Each system will keep its specific purpose limitation, access rules and data retention rules. The proposed measures will also not lead to an increase in the collection of new data. They provide a targeted and intelligent way of using existing information held in EU systems to best effect."[154]

It says that the proposals "embed" all of the EU's data protection rules and are based on the principles of "data protection by design and by default".[155]

9.31 The Commission estimates that it will cost around €425 million (£377 million)[156] spread over nine years (from 2019–27) to implement the proposals on interoperability. Just over half (€225 million or £260 million) would be allocated to eu-LISA to develop, implement and maintain the technical features underpinning interoperability, with Member States receiving €136 million (£121 million) to adapt their national systems and provide training on how to use the interoperability features. The remaining funding would be shared between Europol (€49 million to upgrade its IT systems), the European Border and Coast Guard Agency, the EU Agency for Law Enforcement Training (CEPOL) and the Commission. The EU's current Multiannual Financial Framework (MFF) will expire at the end of 2020. The Commission says it will re-allocate the €32.9 million (£29 million) available under the Internal Security Fund (Borders) Regulation to implement its interoperability proposals during the current MFF.

The Government's position

9.32 In his Explanatory Memorandum of 23 January 2018 on the Commission Communication, the Security Minister (Mr Ben Wallace) says that the Government is "generally supportive of the work to date on facilitating the interoperability of the EU's immigration and security databases", adding:

> "We support the overarching goal of improving interoperability of systems as this prevents fraudulent, fragmented or inaccurate data propagating throughout systems. Such siloing provides opportunities to criminals and terrorists to create false identities and can inconvenience the honest traveller with inaccurate information."[157]

153 See the European Commission's fact sheet on the interoperability of EU information systems for security, border and migration management.

154 See p.3 of the Commission Communication.

155 See p.22 of the Commission's explanatory memorandum accompanying document (b).

156 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

157 See para 20 of the Minister's Explanatory Memorandum.

9.33 In a separate Explanatory Memorandum of 25 January 2018 on the proposed Regulations—documents (b) and (c)—the Minister for Policing and the Fire Service (Mr Nick Hurd) similarly "supports efforts to make the exchange of data within the EU more efficient and more useful particularly where this can improve security or prevent crime" and agrees with the main aims of the proposals: combating identity fraud, improving data quality and streamlining the conditions for law enforcement access.[158] He continues:

> "In particular, the Government welcomes that the proposal intends to make it is easier for the appropriate law enforcement officers or immigration officials to obtain all of the available information at the EU level, provided they are entitled to see it. The Government doesn't see this as fundamental change, but the adding of increased functionality to the underlying systems which will close potential gaps between the systems."[159]

9.34 The Minister underlines the need to maintain "strong data protection standards", adding:

> "The Government will aim to ensure that the proposal does not compromise data ownership rules and handling codes. It is also important that data owners retain control of how their data is used. The Government welcomes the approach taken of ensuring logs are generated of users activities as this provides an effective and proportionate tool for data protection purposes."[160]

9.35 The Minister recognises that "the benefits associated with improving the interoperability of EU JHA [justice and home affairs] information systems need to be balanced against the potential impact on fundamental rights", highlighting in particular the right to the protection of personal data under Article 8 of the EU Charter on Fundamental Rights ('the Charter') and the right to respect for private and family life under Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms and Article 7 of the EU Charter. He concludes that any interference with these rights is justified, not least because the proposed Regulations are "complementary to" the EU's existing (or planned) information systems and so "should not alter or impact in any greater way on fundamental rights or human rights than is the case for such databases".[161]

9.36 The Minister notes that the UK is only entitled to participate in the proposed Regulation covering Eurodac, SIS II (the law enforcement aspects only) and ECRIS-TCN—document (b)—and that the UK's Title V (justice and home affairs) opt-in and Schengen opt-out Protocols are relevant:

> "Eurodac and ECRIS-TCN are not Schengen-building measures. Therefore, to the extent that the provisions of the Regulation relate to these measures, they will only apply to us if we notify the Council, within the three months of the publication of the last language version of the proposal, that we wish to opt in.
>
> "To the extent that the Regulation builds on the police and judicial cooperation aspects of SIS II, then the UK will be bound by it unless we notify the Council, within three months of the publication of the last language version of the proposal that we wish to opt-out."

158 See paras 17 and 23 of the Minister's Explanatory Memorandum.
159 See para 23 of the Minister's Explanatory Memorandum.
160 See para 29 of the Minister's Explanatory Memorandum.
161 See the fundamental rights analysis in the Minister's Explanatory Memorandum.

9.37 The Minister undertakes to inform us of the date on which the three-month opt-in/out deadline will expire "as soon as this becomes available".[162] Home Office officials have since confirmed that it will expire on 21 May.

9.38 The Minister explains that all opt-in and opt-out decisions are taken "on a case-by-case basis, putting the national interest at the heart of the decision making process" and that in reaching a decision on participation in document (b), the Government will "consider whether there are any additional benefits to participating in the four interoperability components beyond what our current access to these databases currently provides, and whether these benefits outweigh the likely financial implications".[163] The Government will also:

> "[…] assess what the likely level of usage would be of the new system by UK law enforcement and immigration officials. As the proposals are likely to require significant investment and technical changes, we will need to carefully consider whether the high costs of participating in the measure will be outweighed by the benefits that it may deliver."[164]

As well as the cost to the UK in developing appropriate end-user interfaces to connect to the interoperable systems, the Government will also take into account the time needed to implement each of the interoperability components and the likely start of operations.[165] The Minister anticipates that "technical implementation of the proposal could take place by 2021".[166]

9.39 If the Government were to decide to opt into document (b), the proposal is unlikely to have any significant implications for UK law. Some changes may nevertheless be required:

> "Article 20(1) on 'access to the Common Identity Repository (CIR) for identification' provides that Member State police authorities may, where empowered by national legislative measures, query the CIR using biometric data, identity data and travel document data in certain cases. If the UK chose to participate in the proposal and wished to make use of this provision, it would need to adopt legislative measures specifying the precise purposes of identity checks. In addition, it would need to designate the police authorities competent to make use of the provision and specify the procedures, conditions and criteria of such checks."[167]

9.40 If the Government decides not to participate, the Minister says it will be important to ensure that "non-participation does not preclude individual access to the information systems that the UK is currently participating in".[168]

Previous Committee Reports

None on these documents. Our earlier Reports on the Commission's seventh progress report towards an effective and genuine Security Union are relevant: First Report HC 301–i (2017–19), chapter 25 (13 November 2017) and Ninth Report HC 301–ix (2017–19), chapter 12 (10 January 2018).

162 See para 16 of the Minister's Explanatory Memorandum.
163 See para 15 of the Minister's Explanatory Memorandum.
164 See para 20 of the Minister's Explanatory Memorandum.
165 See paras 21 and 30 of the Minister's Explanatory Memorandum.
166 See para 22 of the Minister's Explanatory Memorandum.
167 See the section of the Minister's Explanatory Memorandum on the impact on UK law.
168 See para 28 of the Minister's Explanatory Memorandum.

10 EU research funding: interim evaluation of Horizon 2020

Committee's assessment	Politically important
Committee's decision	Cleared from scrutiny; drawn to the attention of the Business, Energy & Industrial Strategy, Education and Science & Technology Committees
Document details	Communication from the Commission—Horizon 2020 interim evaluation: maximising the impact of EU research and innovation
Legal base	—
Department	Business, Energy and Industrial Strategy
Document Number	(39425), 5271/18, COM(18) 2

Summary and Committee's conclusions

10.1 The Treaties give the EU the power to establish a "Framework Programme" for research, which funds scientific research and innovation projects across Europe. The current, eighth, Framework Programme was named "Horizon 2020", and runs from 2014 to 2020 with contributions totalling €77 billion (£68 billion)[169] from the EU budget.[170] The UK is currently the second-largest recipient of funding under the programme, after Germany.[171] The EU also operates supplementary research programmes in particularly sensitive areas, namely defence, space and nuclear energy.

10.2 In January 2018 the European Commission published a policy paper which reflected on the implications of its interim evaluation of Horizon 2020 and how the Commission will use those results to inform the design of the successor Framework Programme (FP9). Negotiations on the legal framework for FP9 are due to begin later this year, and it is due to become operational in January 2021. Among the main changes being considered by the Commission are a substantial increase in the proposed financial endowment of the next Framework Programme; further simplification of the application and funding process for researchers; and—important in the context of the UK's exit from the EU—increasing the participation of third country researchers in EU-funded projects, based on reciprocal co-funding in partner countries.

10.3 We have set out the current framework for the EU's research programmes, and the details of the Commission's reflections, in more detail in "Background" below.

169 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

170 See Regulation 1291/2013 establishing Horizon 2020. The proposal establishing the Framework Programme was last discussed by the previous European Scrutiny Committee on 21 May 2013. The total financial allocation will be higher as non-EU countries which have formal 'association' with the Programme make additional contributions (see "Background" for more information).

171 See https://www.gov.uk/government/statistics/uks-participation-in-horizon-2020-september-2017 (accessed 19 February 2018). In 2015, UK-based organisations received €1.59 billion (£1.47 billion) in EU funding for research & development. This constituted 12% of all EU R&D expenditure that year. R&D funding also represented 21% of total EU expenditure in the UK in 2015, compared to an EU average of 10%.

10.4 The Minister of State for Higher Education (Sam Gyimah) submitted an Explanatory Memorandum on the Commission document in late January 2018.[172] This reiterated that the joint position the Government reached with the European Commission in December 2017 would entitle UK researchers to continue full participation in the remaining two years of Horizon 2020 and the sectoral research programmes until the end of 2020.[173] It also noted that the Government "will seek to agree a far-reaching science and innovation agreement with the EU that establishes a framework for future [post-Brexit] collaboration", including "discussing possible options for participating in FP9". The Government has also said separately that it wants to stay involved in supplementary EU research programmes for defence, nuclear energy, and space.[174]

10.5 **We have taken note of the interim evaluation of Horizon 2020, and the "lessons learned". The document provides a useful insight into the likely substance of the European Commission's upcoming proposals for the next EU Framework Programme for Research (FP9), which will form part of the next Multiannual Financial Framework from January 2021 onwards.**

10.6 **Overall, the Government appears supportive of the conclusions drawn by the Commission and the proposed changes to the Framework Programme after 2020. However, we are concerned about the lack of detail provided by the Minister about the UK's priorities for FP9 and the scope of its involvement in that Programme, the design of which will undoubtedly be of great interest to British researchers irrespective of the exact legal form of the UK's post-Brexit involvement.**

10.7 **In particular, we consider that the design of FP9 will be important in two different scenarios, depending on the outcome of the Article 50 negotiations:**

- **during the post-Brexit transitional period, the EU has said the UK would need to stay part of all EU law and budgetary instruments as they apply to EU Member States. The Government has previously taken the view that the transition could last well into 2021, in which case the UK could automatically be a participant in—and contributor to—FP9, even though it would have no vote over its budget or funding priorities;[175] and**

- **after the UK ceases to be an automatic participant in EU funding programmes at the end of the transition, the situation will change. In order for UK researchers to remain eligible for funding from the next Framework Programme, the Government would need to apply for what the current legal framework calls "association". This associate status, which 16 non-EU countries currently have under Horizon 2020, would be subject to the conditions—including a financial contribution—to be agreed with the EU (see paragraphs 10.35 to 10.43). "Associate" status appears to be the Government's objective, although the Minister's Memorandum does not say so explicitly (as it refers instead to unspecified "possible options for participating").**

172 Explanatory Memorandum submitted by the Department for Business, Energy & Industrial Strategy (29 January 2018).

173 See our Report of 19 December 2017 for more information on the Brexit financial settlement.

174 See DExEU, "Collaboration on science and innovation: a future partnership paper" (September 2017).

175 The Committee wrote to the Treasury on 21 February 2018 about the financial and political implications of the UK's participation in and contribution to EU funding programmes (including FP9), if the post-Brexit transitional period lasts beyond 31 December 2020.

10.8 **Given the Government's insistence that it will seek a "far-reaching […] agreement" with the EU, which in practice is likely, we consider it necessary for Parliament to be kept informed of developments in the design and financial endowment of the next Framework Programme. The Committee will therefore closely follow the negotiations on the next Multiannual Financial Framework and FP9, and draw important developments to the attention of the House and the relevant departmental Select Committees as necessary.**

10.9 **We also draw the attention of the House to the EU's partial suspension of Switzerland's participation in Horizon 2020 between 2014 and 2016, after it refused to extend freedom of movement to Croatian nationals (see paragraph 10.42).**[176] **This shows that the EU has been willing to make a third country's participation in its research programmes conditional on securing agreement in areas of its bilateral relationship which are not directly related to science and innovation. In case the negotiations are protracted, the Government will also need to consider how it might mitigate the financial implications for UK researchers of any gap between the end of the transitional period and the entry into force of a new UK-EU agreement on research cooperation.**

10.10 **This could present a particular problem for UK-EU relations given that the withdrawal negotiations will take place in parallel to discussions on many other politically sensitive aspects of the post-Brexit UK-EU relationship. Given the politically fraught nature of the Brexit negotiations so far, it cannot be ruled out that similar complications could arise. The UK's continued involvement in the successor to Horizon 2020 should therefore not be taken as a given.**

10.11 **Overall, we are concerned that the lack of detail about the Government's long-term approach to cooperation with the EU on research matters—combined with the fact that the UK's continued participation in Horizon in 2019 and 2020 is not yet legally water-tight—could be deterring researchers from other Member States and associated countries from applying for research funding with UK undertakings. We note in this respect that the latest statistics on UK participation in the Framework Programme show that between May and September last year the UK stopped being the country with the largest share of participants in Horizon 2020.**[177]

10.12 **Given the above, we would be grateful if the Minister could write to us by 14 March 2018 to confirm that the Government will seek for the UK to become "associated" (or the equivalent term under the future legal framework after 2020) with the next Framework Programme, or, if not, which other "options for participating" the Government is exploring. In either case, we expect the Minister to provide more substantive detail about the Government's proposals for a "more ambitious and close partnership with the EU than any yet agreed between the EU and a non-EU country", and how it would, in the Government's opinion, differ in practice from the close association enjoyed by both Switzerland and Norway with Horizon 2020 and its predecessors.**

176 See European Commission, "Swiss participation in Horizon 2020" (accessed 19 February 2018). We have described the circumstances of Switzerland's temporary suspension from parts of the Framework Programme in the "Background" section.

177 Department for Business, Energy & Industrial Strategy: statistics on UK participation in Horizon 2020 on 30 September 2017 and on 31 May 2017.

10.13 **We have drawn the Commission report to the attention of the Business, Energy & Industrial Strategy, Education and Science & Technology Committees, given their remit with respect to UK science and higher education policy.**

Full details of the documents

Communication from the Commission—Horizon 2020 interim evaluation: maximising the impact of EU research and innovation: (39425), 5271/18, COM(18) 2.

Background

10.14 The Treaty on the Functioning of the EU requires the establishment of a "multiannual framework programme" providing financial support for research and innovation. The legal framework for Framework Programmes for Research is adopted under the ordinary legislative procedure by the European Parliament and the Council.

10.15 The current, eighth, EU Framework Programme for Research and Innovation is "Horizon 2020", which runs from 2014 to 2020 with a budget of €77 billion (£68 billion). It has been described by the European Commission as a "key EU asset" to stimulate economic growth, promoting scientific excellence and industrial leadership, and tackling societal challenges.[178] It is structured around three "pillars": excellent science; industrial leadership; and societal challenges, which have "their own specific objectives and broad lines of actions".[179] The EU also supports research activities through other means, for example the European Institute of Innovation & Technology (EIT),[180] which supports the launch of innovative products and services by funding collaborative research projects between companies and universities.[181]

10.16 Funding opportunities under Horizon 2020 are typically only available to consortia of researchers from multiple participating countries. Non-EU countries can participate in the Framework Programme, with the widest level of involvement being granted through a formal agreement for "association" with Horizon 2020 with the EU, principally in return for a financial contribution.[182] Given the obvious importance of this aspect of the Framework Programme for the UK in the context of Brexit, we have discussed the implications of the UK participating as a non-Member State in more detail in paragraphs 10.33 to 10.47 below.

178 Regulation (EU) No 1291/2013.

179 See Commission document SWD(2017) 220, p. 7.

180 The EIT is funded from Horizon 2020, but manages its own grant process.

181 In addition, the EU Treaty provides the basis for both Public-Public and Public-Private research partnerships under Articles 185 and 187 TFEU respectively. Under the former, the EU can contribute financially to multiannual research programmes proposed by EU Member States or countries associated to the Framework Programme. The latter provides the legal basis for EU-driven Public-Private Partnerships, called Joint Undertakings. A recent Commission review of Article 185 partnerships remains under scrutiny.

182 For example, the EU made Switzerland's full participation in Horizon 2020 conditional on accepting the free movement of persons. It suspended Swiss access to parts of the Framework Programme after Switzerland failed to extend free movement to nationals of Croatia after it joined the EU in 2013.

10.17 In addition to the general funding programme for research under Horizon 2020, the EU also operates sector-specific research programmes for areas with military or national security implications, namely:

- the Euratom nuclear energy research programme, which funds research into both fusion and fission energy. The UK is currently a major recipient of funding from this programme, as it runs a prominent fusion energy centre (the Joint European Torus or JET) in Oxfordshire. Via Euratom the UK is also a party to the ITER Agreement, an international research project to develop commercially-viable fusion energy;

- the European Defence Fund, a new initiative which will finance the development and acquisition of new military technology by EU countries. It has a research component, currently in its preparatory phase, which is likely to evolve into a fully-fledged European Defence Research Programme from 2021 onwards;[183] and

- the EU space programme, which governs and funds three separate programmes: Copernicus (an earth observation programme which captures environmental and land-use data);[184] Galileo (a prospective global satellite navigation system to reduce the EU's dependency on American and Russian systems like GPS)[185] and EGNOS (the operational precursor to Galileo, which already provides a number of services including improving navigational accuracy for aircraft).[186] Although all both are funded and owned by the EU, they are managed in partnership between the European Commission and the European Space Agency (a non-EU body to which the UK is independently a party).

10.18 The Committee discussed the implications of Brexit for UK involvement in the Euratom research programme[187] and the European Defence Fund[188] recently. It will consider the impact on the UK's participation in the Galileo and Copernicus initiatives separately in the near future.

The interim evaluation of Horizon 2020

10.19 Article 32 of the Regulation establishing Horizon 2020 required the European Commission to conduct a review of the Framework Programme and associated activities. In May 2017 the European Commission published the results of its interim evaluation.[189]

10.20 The main substantive findings of the review were that Horizon 2020 funding is "attractive and relevant", with macro-economic models projecting its impact to be "in the order of €600 billion (£532)[190] and 179,000 jobs by 2030". Scientific publications

183 The European Defence Fund will also have a funding stream for the construction of prototypes for new defence equipment, called the European Defence Industrial Development Programme (EDIDP). Negotiations on the launch of the EDIDP are still on-going at EU-level. See our Report of 31 January 2018 for more information.

184 The legal basis for Copernicus is Regulation 377/2014, cleared from scrutiny on 27 November 2013. See https://ec.europa.eu/growth/sectors/space/galileo_en.

185 The legal basis for both Galileo and EGNOS is Regulation 1285/2013, cleared from scrutiny on 4 July 2012. See also https://ec.europa.eu/growth/sectors/space/galileo_en.

186 See https://ec.europa.eu/growth/sectors/space/egnos_en.

187 For more information on the Euratom research programme, see our Report of 21 February 2018.

188 For more information on the European Defence Fund, our Reports of 13 November 2017 and 31 January 2018.

189 See Commission document SWD(2017) 220.

190 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

resulting from EU-funded research are "cited at twice the world average rate", and "patents produced through the programme are of higher quality and likely commercial value" than similar patents produced elsewhere. The simplification of the funding application process compared to the previous Framework Programme has allowed grant decisions to be taken, on average, 110 days faster than under FP7.

10.21 Nevertheless, the Commission acknowledges that challenges remain to make EU research funding more efficient and effective. For example, with its current financial envelope, the Programme has had to reject funding applications that meet all relevant quality thresholds.[191] A large proportion of scientific publications produced with Horizon 2020 funding are still not publicly accessible, and the fragmentation of specific funding instruments under Horizon 2020 could lead to money flowing to those who understand the system rather than those with the best case for EU research funding.

10.22 The Commission also established a "High Level Group" of experts, led by Pascal Lamy, in September 2016, with a mandate to provide advice on how to maximise the impact of the EU's investment in research and innovation in the future. The group started its work in December 2016, and its final report was published in July 2017.[192] It recommended, among other things, a doubling of the next long-term EU research budget to €144 billion (£128 billion); the establishment of a European Innovation Council which would be able to invest the EU budget in "risky innovations that have rapid scale-up potential"; the use of lump sums to reimburse researchers;[193] and increasing formal involvement by non-EU researchers (subject to co-financing by their host country).

10.23 The European Parliament endorsed the findings of the Interim Evaluation in June 2017,[194] as did EU Science Ministers at the Competitiveness Council in December.[195]

Lessons for the next Framework Programme for Research

10.24 In January 2018 the European Commission published a follow-up policy paper which aimed to translate the results of the interim evaluation, and the findings of the High Level Group, into concrete initiatives to improve the implementation of Horizon 2020 in its last three years (2018—2020). It also sets out how the Commission will use the evaluation results to inform the design of Horizon 2020's successor Framework Programme (FP9), formal negotiations on which will begin between the Member States and the European Parliament later this year.

191 In recognition of the funding constraints, the European Commission in 2015 established a "Seal of Excellence" which is awarded to projects submitted to Horizon 2020 which were deemed to deserve funding but did not receive it due to budget limits. It recognises the value of the proposal and supports the search for alternative funding.

192 See Report of the independent High Level Group , "Investing in the European future we want" (July 2017).

193 One of the main administrative burdens for recipients of Horizon 2020 funding is the requirement to document incurred costs through extensive financial reporting, which are then reimbursed by the EU. A lump funding system would remove cost reporting obligations, instead defining at the start of the project what outputs will be delivered in return for the financial contribution.

194 European Parliament resolution of 13 June 2017 on the assessment of Horizon 2020 implementation in view of its interim evaluation and the Framework Programme 9 proposal.

195 Council of the EU, "From the Interim Evaluation of Horizon 2020 towards the ninth Framework Programme" (1 December 2017).

10.25 Among the main changes being considered by the Commission are:

- **substantially increasing the budget for the next Framework Programme**, given that an additional €62.4 billion (£55.3 billion) would have been needed since 2014 to provide funding for every Horizon 2020 application to date which met the requisite quality thresholds. Whether the budget after 2020 is actually increased will depend primarily on the remaining Member States, which each have a veto over the expenditure ceilings for the Framework Programme in the post-2020 Multiannual Financial Framework;

- further **simplification of the application and funding process**, for example by simplifying the real cost reimbursement system; increase acceptance of usual accounting practices; increase the use of lump-sum project funding against fulfilment of activities and other simplified forms of funding; reduce the burden for preparing and submitting proposals; reduce the 'time to grant'; and improve feedback given to applicants;

- increase EU financial support for high-risk, high-return innovative products and services through a **European Innovation Council**. The Commission has launched a first pilot phase of a future European Innovation Council in the last Work Programme of Horizon 2020,[196] and the experience gained will provide a basis for further decision-making on a fully-fledged EIC under the next Framework Programme;

- improving the **linkages between EU research funding and wider EU policy priorities**, by building the next Framework Programme around clear and quantified expected long-term impacts, medium- term results and short-term outputs, for example related to the UN Sustainable Development Goals or the implementation of the Paris Climate Change Agreement;

- **rationalising the number of different EU research funding instruments**, in particular partnerships under Articles 185 and 187 TFEU, and **improving coherence with other post-2020 EU funding programmes**, like the successors to the Common Agricultural Policy, the European Structural and Investment Funds and the Connecting Europe Facility. This will be done by bringing priorities more in line with each other and making co-funding schemes more flexible in order to pool resources at EU level; and

- increasing the **participation of third country researchers in EU-funded projects**, based on reciprocal co-funding in partner countries. When it proposes the rules for participation and dissemination for FP9, the Commission will consider the specific need for "associating third countries based on excellence in R&I".

10.26 In addition, the Commission has already implemented some of the High Level Group's recommendations in the final Horizon 2020 Work Programme for 2018–2020. For example, it has established a pilot version of the European Innovation Council by jointly implementing various existing Horizon 2020 instruments that can already be used

196 https://ec.europa.eu/research/participants/data/ref/h2020/wp/2018–2020/main/h2020-wp1820-intro_en.pdf.

to support start-ups developing high-risk, high-return projects.[197] The Commission is also testing the use of lump sums as an alternative to cost reimbursement for researchers in some areas.[198]

10.27 The new Minister of State for Universities (Sam Gyimah) submitted an Explanatory Memorandum on the document on 29 January 2018.[199] It makes no substantive assessment of the Commission's reflections and their possible impact on the design on the next Framework Programme for Research. The Minister does reiterate the Government's ambition of concluding a "far-reaching science and innovation agreement with the EU", including "possible options for participating FP9".

UK-EU research cooperation after Brexit

10.28 The European Commission's policy paper on the future of the EU's research funding programme has clear implications for the UK, despite its withdrawal from the EU.

10.29 Firstly, some changes have already been introduced as part of the 2018–2020 Work Programme for Horizon 2020. Although the UK is expected to cease being an EU Member State in March 2019, the Government and the EU have provisionally[200] agreed that the UK will remain a contributor to—and participant in—all EU funding programmes until the end of the current budgetary cycle in December 2020. As such, UK undertakings will remain eligible to apply for Horizon 2020 funding for the remainder of the programme, and will receive any monies due even if payment falls after Brexit.

10.30 Secondly, the Government has been clear that it wants to remain involved in the successor programme to Horizon 2020 from 2021 onwards.[201] In its September 2017 "future partnership paper" on cooperation with the EU on science and research, the Department for Exiting the EU said it would seek to "agree a far-reaching science and innovation agreement with the EU" after Brexit. The paper notes that this would be in the interest of both sides, especially in the field of medicine and health, but the Government wants to discuss continued UK involvement across the spectrum of EU research policy (i.e. the Framework Programme, as well as the EU's separate research programmes for the defence, space and nuclear industries).

10.31 However, the conditions and implications for UK's involvement in the successor to Horizon 2020 and the industry-specific programmes are unclear. They all follow the EU's long-term budgetary cycle, which currently runs until the end of 2020. Each programme's legal framework—including its budgetary endowment and the conditions for participation by non-EU countries—for 2021 onwards are yet to be established by the Council and the European Parliament. The Commission is due to present formal proposals for discussion later this year. The UK will not have any formal input in the legislative process after it ceases to be a Member State, although it may be informally consulted.

197 See https://ec.europa.eu/research/eic/index.cfm. The EIC pilot has a budget of €2.7 billion (£2.4 billion) between 2018 and 2020 by bringing together different existing strands of Horizon 2020 funding.

198 https://ec.europa.eu/programmes/horizon2020/sites/horizon2020/files/lump_sum_factsheet_2018–2020.pdf.

199 Explanatory Memorandum submitted by the Department for Business, Energy and Industrial Strategy (29 January 2018).

200 See Joint Report of 8 December 2017. This agreement would still need to be legally ratified as part of the UK's overall Withdrawal Agreement under Article 50 TEU, negotiations on which are on-going.

201 DExEU, "Collaboration on science and innovation: a future partnership paper" (September 2017).

Conditions for non-EU participation in the next Framework Programme

10.32 After the end of the post-Brexit transitional period, during which the UK will remain an automatic participant in (and contributor) to all EU funding programmes, the Government will have to negotiate a new partnership agreement with the EU on cooperation in science and technology.

10.33 The European Commission is due to present legislative proposals for the next Framework Programme by the end of 2018, but, based on experience in previous multi-annual funding rounds, final agreement is unlikely to emerge between the Council and the Parliament until mid-2020. Therefore, it is impossible to say with certainty under what conditions the UK, as a non-EU country, will be able to participate in EU research funding programmes after 2020. However, the basic elements of the current framework for third country participation are likely to be maintained. We have described these below.

"Association" with Horizon 2020

10.34 The framework for Horizon 2020 provides for a formalised form of participation by non-EU countries called "association".[202] This option is available to all four EFTA countries; to candidates for EU accession; and to countries covered by the European Neighbourhood Policy (ENP) or associated with the 7th Framework Programme.[203] At present, there are 16 Horizon 2020 "associated countries", including Norway, Switzerland, Iceland, Turkey, Israel and Ukraine.[204]

10.35 In practical terms, associate status means that funding applications from researchers in that country are treated the same way as those from an EU Member State. As such, they are automatically eligible to apply to any Horizon 2020 call for proposals, and they are counted towards the minimum number of participants required to access funding from the Framework Programme (which is usually three from three different participating countries).[205]

10.36 Association with the Framework Programme requires non-EU participating countries to make an annual financial contribution to its budget. For industrialised countries like Norway and Switzerland, the financial contribution is normally calculated annually, by taking the overall contribution from the EU budget to the Programme that year (as determined by the Council and the European Parliament) and applying a "proportionality factor": the associated country's proportion of the overall GDP of the EU plus that of the third country in question.[206] As a result, wealthier countries pay

202 Liechtenstein has chosen not to participate in Horizon 2020.

203 It follows that, from a purely legal perspective, the eligibility requirements for association would need to be amended to permit the UK to participate, as it does not meet any of the current geographical or political criteria.

204 http://ec.europa.eu/research/participants/data/ref/h2020/grants_manual/hi/3cpart/h2020-hi-list-ac_en.pdf.

205 In most cases, funding from the EU budget will only be made available if they an application is made jointly by researchers from three different participating countries.

206 For example, Norway's proportionality factor in 2017 was 2.34 per cent. That year, the EU budget for Horizon 2020 (commitment appropriations) was €10.35 billion, so Norway would make an additional contribution of 2.34 per cent (€242 million or £214 million). The UK's contribution under this methodology would be substantially higher given its larger GDP.

proportionally more for association with the Framework Programme than poorer ones, but the exact contribution is established annually through a pre-defined methodology and not negotiated separately.[207]

10.37 Researchers from countries which are not eligible for associate status (or which have not successfully applied for it) can also participate in projects funded by Horizon 2020. However, they are usually not eligible for any funding from the EU budget, meaning that their home country would normally finance their participation directly. Their involvement can also be restricted depending on the nature of any individual research project, for example those with defence application. Moreover, members of a research consortia based in a non-associated country do not count towards the minimum number of participants needed to qualify a project for funding from the EU budget. This clearly makes researchers from non-associated countries less attractive as core research partners, as they do not help meet funding eligibility requirements.

10.38 As such, associate status—or the equivalent under the post-2020 legal framework—would be the most straightforward route for the UK to remain closely involved in the EU's Framework Programme for Research after Brexit. It would also minimise the risk that researchers from other participating countries would forgo collaboration with UK counterparts when applying for EU funding.

10.39 Given that the EU institutions have themselves emphasised the need for greater international collaboration in the field of research, we expect FP9 legal framework to offer at least the same—if not improved[208]—levels of participation as those of Horizon 2020. However, there will nevertheless be a substantive difference in the Government's influence over the overall direction of the next Framework Programme compared to its current position:

- the **overall financial envelope, design and strategic priorities** for the next Framework Programme will be decided by the Council and the European Parliament after the UK leaves the EU, and therefore the Government will have no formal input into the legislative or budgetary decision-making process;
- in return for "associate" status, the UK would be expected to make a programme-specific **financial contribution** each year, as described above. It is unlikely there would be a rebate for the UK's contribution, especially as it is a net beneficiary of the current Framework Programme;
- the UK would have **limited influence over the strategic planning of spending priorities** for the Framework Programme after its basic legal framework is agreed. The Government recognised this in its partnership paper, in which it noted that associated countries can attend Horizon 2020 Programme Committee meetings as observers, but have no vote over sector-specific work programmes and associated funding priorities;[209] and

207 A similar methodology is used for non-EU countries' participation in other EU programmes. Overall, in 2017, Norway was expected to make a gross contribution in this manner for participation in various EU programmes amounting to approximately €354 million (£x).

208 As noted, the interim evaluation of Horizon 2020 suggests the Commission will broaden opportunities for non-EU participation in the next Framework Programme, including a non-geographical criterion "based on excellence in R&I".

209 The Programme Committee, which meets in 14 different configurations in Brussels, was established under Council Decision 2013/743. They are a forum for Member States—and associate countries—to discuss strategic planning for the Framework Programme, including by approving Work Programmes, and to ensure the EU takes account of nationally-funded research activities. Discussions on strategic planning and on ensuring links to nationally funded activities is an essential part of their work.

- there would also be some **legal implications**. Participating British undertakings would have to observe the rules for participation as laid down by the EU founding regulations, and the Government would be expected to facilitate the mobility of non-UK researchers involved in EU-funded research projects that include a UK participant organisation. There might also be some limited jurisdiction by the European Court of Justice, in particular over the legality of decisions by the European Commission to recover payments from UK undertakings which did not meet the conditions of their grant agreement.

10.40 The EU can also impose additional conditions when granting "associate" status with the Framework Programme, which depend on the overall political relationship with the third country in question.

10.41 For example, under the terms of Switzerland's 2014 agreement on association with Horizon 2020,[210] Swiss researchers could only participate as 'associated' researchers in specific aspects of the Framework Programme. The EU withheld full participation in response to a Swiss referendum which prevented the country's Government from extending a pre-existing EU-Switzerland agreement on free movement to Croatia, which had joined the EU in July 2013. In all other parts of the Programme, the Swiss were considered "non-associated" as described in paragraph 10.38. They obtained full association with Horizon 2020 on 1 January 2017, after the Government in Bern extended existing free movement rights for EU nationals to Croatian citizens.[211] If it had not done so, the country would have automatically lost associate status under Horizon 2020 altogether.[212]

10.42 The potential political difficulties if the EU links the UK's participation in the Framework Programme after Brexit to other elements of the negotiations on a new partnership are not acknowledged in the Government's "future partnership paper" on science and innovation. Instead, it says it wants a "more ambitious and close partnership with the EU than any yet agreed between the EU and a non-EU country". There has been no indication as to how how this partnership would be materially different from those the EU has with, for example, Norway or Switzerland, in the field of research.

Future UK participation in the EU research programmes for defence, nuclear energy and space

10.43 The Government's policy paper on post-Brexit cooperation and science and innovation also sets out its ambition of ensuring the UK's continued involvement in the EU's supplementary research programmes for defence, space and nuclear energy (see paragraph 10.18 above).

10.44 The rules for non-EU participation in Horizon 2020 as described above do not necessarily apply to these research programmes, as these are established on separate legal terms. Given the political sensitivities around the scientific research they finance, many EU countries have particular concerns about participation by countries outside of the EU's legal framework in these areas.

210 EU-Switzerland agreement on scientific and technological cooperation.
211 See https://www.euresearch.ch/en/european-programmes/horizon-2020/swiss-participation-in-horizon-2020/.
212 See article 13 of the EU-Switzerland agreement.

10.45 As with the Framework Programme the legal foundations for these specific research programmes will also be comprehensively revisited in the coming years ahead of the start of the next EU budgetary cycle in January 2021 (the Multiannual Financial Framework), as their current funding from the EU budget will run out at the end of 2020. However, if the current rules for participation were carried over, the ability of the UK to participate in these programmes after Brexit will vary on a case-by-case basis:

- the **Euratom nuclear energy research programme** is open to "association" by third countries in much the same way as the Framework Programme.[213] That is to say, the UK could apply for continued participation in return for a continued annual financial contribution proportional to its GDP, and with observer status only in the Euratom Programme Committee where work programmes and funding decisions are voted on;

- with respect to the research strand of the European Defence Fund, the **European Defence Research Programme**, the rules for non-EU participation are still under consideration. There is no long-term precedent, as EU funding for defence research is a relatively new development. While Norway participates in a 'preparatory action' (a scaled-up pilot project),[214] the conditions for participation in the fully-fledged programme from 2021 onwards are yet to be determined by the Council and the European Parliament;[215] and

- finally, as regards the **EU's space programmes Galileo and Copernicus**, both allow for third country participation subject to a dedicated legal agreement with the EU to that effect. However, the level of UK access to data generated by these services may be restricted compared to the rights of EU Member States (especially where data has military application).[216] The Committee will further explore the implications of this for Government access to data generated by these programmes (and for UK companies seeking to supply goods or services to them) separately in the near future.

10.46 As can be seen, the modalities for UK participation in these programmes after Brexit will depend not only on the Government's negotiations with the EU, but also on the legal boundaries for third country involvement that the EU institutions adopt during the negotiations on the next long-term EU budgetary cycle. We will continue to press the Government for the details of its proposals for the future cooperation agreement with the EU on these matters, and follow closely the EU-level negotiations on the successors to the current EU research programmes under the next Multiannual Financial Framework.

Previous Committee Reports

None.

213 For more information on the Euratom research programme, see our Report of 21 February 2018.

214 For more information on the Defence Research Programme, see our Report of 13 November 2017.

215 Similarly, the second strand of the EDF—the European Defence Industrial Development Programme (EDIDP), which will fund military prototypes—is not yet operational in any capacity. Under the proposed legal framework, both Member States and the European Parliament are seeking to prevent non-EU undertakings from participating in any EU-funded projects directly. The Committee is following these discussions closely, and will continue to do when the Commission tables further proposals for the research and development strands for the Fund after 2020.

216 For example on 17 February 2018 the Daily Telegraph reported that the transitional agreement will already exclude the UK from access to Galileo's military applications.

11 European Security and Defence College: cyber-security

Committee's assessment	Politically important
Committee's decision	Cleared from scrutiny
Document details	Council Decision amending Decision 2016/2382/CFSP, establishing a European Security and Defence College
Legal base	Articles 28(1), 42(4) and 43(2) TEU; unanimity
Department	Foreign and Commonwealth Office
Document Number	(39489),—

Summary and Committee's conclusions

11.1 The European Security and Defence College (ESDC) was established in 2005 to coordinate and provide strategic level training to prepare Member States for participation in specific EU Common Security and Defence Policy (CSDP) operations, and to disseminate best practice in the fields covered by the EU's foreign and defence policy.[217]

11.2 The ESDC is organised as a network of EU Member State's military training institutions, with the UK represented by the Defence Academy in Shrivenham.[218] As such, the College's activity is directed by the EU Member States (whose representatives make up its Steering Committee), with the support of a Secretariat provided by the European External Action Service.

11.3 The courses provided by the College are targeted at both military and civilian personnel, mirroring the military and civilian nature of CSDP operations and missions, and are primarily delivered by Member States' training institutions. They are open to third countries, meaning UK participation in courses provided by the College would remain possible after Brexit. However, the network of institutions that comprise the ESDC does not have members from non-EU countries.

11.4 In September 2017, the European Commission presented a new Cybersecurity Strategy.[219] The EU Military Committee[220] and the European Defence Agency subsequently proposed the creation of a Cyber Defence Training platform under the ESDC, which the Foreign Affairs Council endorsed on 13 November.[221] A draft Council Decision to that effect was submitted for scrutiny by the Minister for Europe (Sir Alan Duncan) in February 2018.[222] According to the Minister, the ESDC's proposed "Cyber Education,

217 The current legal basis for the ESDC is Council Decision 2016/2382.

218 See http://eeas.europa.eu/archives/docs/csdp/structures-instruments-agencies/european-security-defence-college/pdf/network_partners/2016_03_16_-_list_of_network_members_with_logos.pdf.

219 Document 39050,12211/17. It was discussed by the Committee on 6 December 2017 and retained under scrutiny.

220 The European Union Military Committee (EUMC) is the highest military body set up within the Council. It is composed of the Chiefs of Defence (CHODs) of the Member States, who are regularly represented by their permanent Military Representatives in Brussels (MilReps). The EUMC provides the Political and Security Committee (PSC) with advice and recommendations on all military matters within the EU.

221 http://www.consilium.europa.eu/media/31520/ccs-on-security-and-defence.pdf.

222 Explanatory Memorandum submitted by the Foreign and Commonwealth Office (8 February 2018).

Training, Evaluation and Exercise" (ETEE) platform will "address cyber training needs among civilian and military personnel as identified by the EU Military and Civilian Training Groups", including the development of curricula and coordination of Member States' training programmes in this field.

11.5 The proposal includes an increase in the College's budget for 2018, to allow it to engage three new members of staff to provide the envisaged cybersecurity training (in addition to the contributions of national secondees, who will continue to be paid by their home institution). The new budget for the ECSD for the remainder of the year would be set at €1,315,000 (£1,158,000),[223] an increase of €390,000 (£344,000), to account for the additional expenditure on the ETEE platform.[224] There will be no additional costs for the UK as a result of the Council Decision, as the ESDC is funded from the EU's Common Foreign and Security budget and not through the Athena mechanism.[225]

11.6 The Minister has welcomed the proposal, as cybersecurity is a UK priority. The Minister says the proposed Council Decision "ensures that the platform's activities are fully complementary to activities undertaken by NATO, including through the NATO Cooperative Cyber Defence Centre of Excellence in Tallinn". The intention is for the Foreign Affairs Council to adopt the proposal at by April 2018 at the latest.

11.7 **We thank the Minister for his Explanatory Memorandum on the proposed expansion of the European Security and Defence College. In view of the continuing uncertainty about the scope and depth of the UK's future partnership on defence matters with the EU after Brexit, we consider the proposed Council Decision to be of political importance. Accordingly, we draw it to the attention of the House.**

Full details of the documents

Council Decision amending Decision 2016/2382/CFSP, establishing a European Security and Defence College: (39489),—.

Previous Committee Reports

None.

223 €1 = £0.88723 or £1 = €1.12710 as at 29 December.

224 The Minister added that the ESDC budget "represents only 0.1% of the total CFSP budget. We judge that this figure is too low to represent a real opportunity cost in terms of overall CFSP budget".

225 The Athena mechanism funds the common costs of the EU's military operations under the Common Security and Defence Policy, as the Treaties prohibit these costs from being met by the general EU budget.

12 Quality of trade statistics

Committee's assessment	Politically important
Committee's decision	Cleared from scrutiny; drawn to the attention of the International Trade and Public Administration and Constitutional Affairs Committees
Document details	(a) Report from the Commission on statistics concerning balance of payments, international trade in services and foreign direct investment; (b) Commission Staff Working Document: Quality Report on Balance of Payments, International Trade in Services Statistics and Foreign Direct Investment Statistics 2016
Legal base	(a); (b):—; (see Article 4(3) of Regulation 184/2005)
Department	Office for National Statistics
Document Numbers	(a) (39479), 5754/18, COM(2018) 47; (b) (39456), 5537/18, SWD(2018) 39

Summary and Committee's conclusions

12.1 Eurostat, the statistical office of the European Commission, has published its latest assessment of the quality of EU Member States' statistics on their balance of payments and international trade in services.[226] The reports emphasise the persistence of bilateral asymmetries in the statistics as reported by the EU's national international trade authorities, meaning that there is a mismatch in the data on trade flows—in both directions—between the EU countries, including the UK. In particular, Eurostat found that EU countries are recording larger volumes of exports than imports between themselves, when in reality the two figures must necessarily be the same.[227]

12.2 With respect to the UK's balance of payments specifically, these findings chime with the Office for National Statistics (ONS) own conclusions on trade asymmetries.[228] These show that the UK often records a larger volume of exports of both goods and services to a number of major trading partners than the statistical authorities of those countries record for UK imports, and vice versa. For example, in 2014 the UK estimated it had trade surpluses in services with Ireland, Luxembourg and the Netherlands, while those countries also recorded surpluses on the same metric for their trade with the UK.[229]

12.3 In her Explanatory Memorandum on the documents, the Parliamentary Secretary to the Cabinet Office (Chloe Smith) welcomed Eurostat's findings.[230] She added the Government "is actively working" with the OECD and other countries' National Statistical Organisations on "understanding and addressing the bilateral asymmetries" in trade data, to improve their overall accuracy.

226 The Eurostat documents are available here.
227 See Commission document SWD(2018) 39, p. 30.
228 See ONS, "Asymmetries in trade data—diving deeper into UK bilateral trade data" (accessed 14 February 2018).
229 See the Annex to this Report for specific examples of balance of payments asymmetries in the UK's trade with EU countries.
230 Explanatory Memorandum submitted by the Office for National Statistics (9 February 2018).

12.4 **These Eurostat documents on the balance of payments statistics are routine publications which, in themselves, have no policy implications for the UK. No legislative changes to the regulatory framework for the production of these statistics are currently foreseen, and any future amendments would take effect well after Brexit. However, we believe the reports may be of interest to the House because of the discrepancies they highlight in the UK's recording of its trade in goods and services with other EU countries compared to trade with the UK as recorded by HMRC's counterparts overseas.**

12.5 **The bilateral asymmetry in the ONS' trade statistics is especially important in the context of the UK's withdrawal from the EU, as Brexit requires the Government to take full responsibility for the UK's international trade policy for the first time since 1973. In order for the efforts of the Government's trade negotiators to be focussed appropriately during these talks, they must have accurate information on current trade deficits and surpluses by sector, and use this information to inform the UK's negotiating objectives and strategy appropriately.**

12.6 **In the immediate post-Brexit period, the UK's trade relationship with the EU is expected to remain broadly unchanged, as it will effectively stay in the Single Market and the Customs Union during the proposed transition period.[231] The Government is also seeking the European Commission's assistance in persuading non-EU countries, with whom the UK currently has trade agreements by virtue of its EU membership, to maintain the effects of those agreements for the duration of the transition.[232]**

12.7 **Nevertheless, preparations for the UK's independent trade negotiations—with both the EU and other countries—are underway within the Department for Exiting the EU and the Department for International Trade, to negotiate the legal underpinning for new economic partnerships with both the EU and non-EU countries. The aim is for these to take effect as soon as possible after the end of the transitional period. The availability of accurate statistics on the trade balance of different sectors of the UK economy will be indispensable to allow the Government to formulate trade objectives and a strategy that will maximise the economic benefits of any resulting trade agreements.**

12.8 **The Government itself has already recognised the need to address the causes of the asymmetries in the UK's balance of trade records. Eurostat's recent reports on trade statistics complements the Office for National Statistics' own on-going efforts to identify and rectify the causes for bilateral asymmetries in international trade data (see "Background" below). We therefore consider these documents politically important, and accordingly draw them to the attention of the House and of the International Trade Committee. We also consider they may be of interest to the Public Administration and Constitutional Affairs Committee, given its scrutiny of the UK Statistics Authority.**

231 The European Council has proposed a transitional arrangement during which the UK will remain bound by EU law, including new EU legislation, but without political representation in the EU institutions.

232 Department for Exiting the EU, "Technical note: international agreements during the implementation period" (8 February 2018).

Full details of the documents

(a) Report from the Commission on the implementation of Regulation (EC) No 184/2005 of the European Parliament and of the Council of 12 January 2005 on Community statistics concerning balance of payments, international trade in services and foreign direct investment: (39479), 5754/18, COM(2018) 47; (b) Commission Staff Working Document: Quality Report on Balance of Payments, International Trade in Services Statistics and Foreign Direct Investment Statistics 2016: (39456), 5537/18, SWD(2018) 39.

Background

12.9 The Balance of Payments (BoP) Regulation[233] requires EU countries to submit quarterly and annual statistics to Eurostat on their balance of payments, international trade in services and foreign direct investment. It also established a common framework and statistical quality standards for the systematic production statistics on these subjects.

Quality assessment of statistics provided

12.10 In January 2018 the European Commission published its latest annual report on the extent to which the statistics provided by EU Member States under the Regulation comply with the quality principles that guide the European Statistical System (ESS).[234] The Commission Report collates the data submitted by each national statistical office in the European Economic Area.[235]

12.11 As it did last year,[236] the Commission notes that the quality assessment "meets expectations and that the overall quality of data transmitted is good as well as generally positive". The report makes a number of recommendations for the UK's Office for National Statistics (ONS).[237] The most important of these relates to the need for reducing bilateral asymmetries, a mismatch in the data on trade flows, in both directions, between the UK and other EU countries.[238] Such asymmetries can be caused by a range of conceptual, definitional and measurement variations between the statistical approaches taken by different countries.

12.12 The Commission's Quality Report found that intra-EU asymmetries (i.e. discrepancies in the recording of flows of goods and services between EU countries) continue to show a positive imbalance for trade in goods and services. This means that collectively EU countries are recording larger volumes of exports ("credits") than imports

233 Regulation (EC) No 184/2005.

234 The quality principles are relevance; accuracy; timeliness and punctuality; accessibility and clarity; comparability; and coherence.

235 Norway and Iceland apply EU statistics legislation as part of their obligations under the European Economic Area (EEA) Agreement. Liechtenstein, while in the EEA, does not have to apply the BoP Regulation given its small economy.

236 Document 38589, 6912/17. Cleared as "not legally or politically important" on 29 March 2017.

237 The other two recommendations relevant to the UK relate to the need to rectify "fairly large" statistical discrepancies between specific accounts (which are "within current tolerances"), and reducing the use of "confidential" or "non-publishable" markets for statistical data, which can impact on data availability to users.

238 The ONS explains trade asymmetry as follows: "When goods and services are traded (imported and exported) between countries, the transactions are reported twice: once by each country in the bilateral relationship. Simplistically the credits (exports) recorded by one country and the debits (imports) recorded by the bilateral partner from that country should be identical. In reality, this is rarely the case and the discrepancy is known as an "asymmetry"."

("debits") between themselves, when in reality the two must be symmetrical.[239] Eurostat has been running workshops since 2016, providing a forum for EU countries to "bilaterally discuss the reasons behind the reported values in an informal way and to agree on specific future actions to minimise existing asymmetries".

12.13 With respect to the UK's balance of payments specifically, these findings chime with the ONS own conclusions on trade asymmetries.[240] These show that the UK often records a larger volume of exports of both goods and services to a number of major trading partners than the statistical authorities of those countries record for UK imports, and vice versa. For example, the UK and the US both reported a trade surplus in services with each other in 2014.[241] The discrepancies for the estimates of trade flows between the UK and its major EU trading partners are shown in the Annex to this Report.

12.14 It should be noted that the existence of bilateral asymmetry in trade statistics in itself does not mean that the UK's estimates of its imports and exports are incorrect. The "true" value of trade flows between two countries is unknown, and, as the ONS has said, could lie between their respective estimates, or even outside that range altogether. However, the discrepancies do matter, because it necessarily follows that two countries reporting different trade flows with each other cannot both be right. As the UK leaves the EU, and the Government takes over responsibility for international trade policy from the European Commission, it will need the most accurate possible statistics on its balance of trade.

12.15 In recognition of this, the ONS' "Trade Development Plan" has as one of its objectives the need to improve data on international transactions, and in particular "the causes of bi-lateral trade asymmetries between particular countries".[242] This point has also been made in evidence submitted by the financial services industry to the Public Bill Committee for the Trade Bill.[243]

12.16 The Parliamentary Secretary to the Cabinet Office (Chloe Smith) submitted an Explanatory Memorandum on the documents in February 2018.[244] In it, she welcomed the findings of both reports and the continued improvements made by Member States in the production of statistics on trade. She added the Government "is actively working" on improvements in the areas identified by the Commission. This includes engagement with the OECD as well as other National Statistical Organisations on understanding and addressing the bilateral asymmetries in trade data, to improve their overall accuracy.

239 See Commission document SWD(2018) 39, p. 30.

240 See ONS, "Asymmetries in trade data—diving deeper into UK bilateral trade data" (accessed 14 February 2018).

241 For example, ONS figures show that, in 2014, the UK's data recorded a cumulative trade deficit in goods with 10 countries including the US, Germany, Ireland and France totalling $64.3 billion. However, the data held by these countries on trade with the UK showed a trade deficit of $98.1 billion.

242 ONS, "UK trade development plan: 2017" (accessed 14 February 2018).

243 For example, financial services body TheCityUK told the Public Bill Committee in January 2018: "The government will need to devise improved systems for collecting and recording information on the UK's trade in service (…). Given the importance to the UK of trade and investment in services, it is ironic that the international statistical data for services trade is patchy and poor (…). Unless these factors can be established with reasonable certainty, it will be hard to set objectives to be achieved in future trade and investment negotiations."

244 Explanatory Memorandum submitted by the Office for National Statistics (9 February 2018).

Report on implementation of the BoP Regulation

12.17 The annual quality report on trade statistics was accompanied by a separate Commission report on the overall implementation of the Balance of Payments Regulation (the first such report since 2010).[245] The document examines the principal aspects of the Member States' implementation of the Regulation, and the measures which the Commission itself has taken to ensure that EU-level statistics on balance of payments, international trade in services and foreign direct investment meet high quality standards.

12.18 It concludes that the BoP Regulation has helped to further harmonise EU-wide statistics, and has also helped ensure that data are available at the appropriate time and that users have access to more detailed data. The Commission does not consider any amendments to the legislation necessary at this stage. However, in 2018 Eurostat will carry out a pilot project on production of statistics on annual foreign direct investment (FDI) based on the ultimate ownership concept,[246] and on FDI statistics that distinguish between 'greenfield' foreign direct investment from takeovers.[247]

12.19 Depending on the outcome of these pilots, the Commission may propose to include new requirements in the Regulation in 2019. Any amendments would presumably not apply as a matter of law in the UK, as their date of application would fall well beyond the projected end of the post-Brexit transition period in December 2020.

12.20 In her Explanatory Memorandum, the Minister notes that the Commission report does not contain any "explicit regulatory proposals" for revision of the BoP Regulation at this stage, and as such there are no policy implications arising from the document.

Previous Committee Reports

None.

245 The Commission published its last review of the BoP Regulation in June 2010; see COM(2010) 307. It was cleared as "not legally or politically important" by the previous Committee on 13 October 2010.

246 Ultimate ownership of FDI aims to identify the country where the company that ultimate controls an investment is based, rather than the host country of the entity directly responsible for the investment. For example, many multinationals channel their investment through subsidiary entities in Luxembourg, the Netherlands or Switzerland.

247 There are three main types of FDI: cross-border takeovers; greenfield investments; and the extension of existing capacity. Greenfield FDI refers to "the creation of a firm from scratch by one or more non-resident investors".

Annex: Estimates of UK balance of trade with selected EU countries

12.21 Figures provided by the Office for National Statistics[248] show the overall discrepancies in the UK's balance of trade with its major trading partners in the European Economic Area, as estimated by HMRC and its counterparts (the "mirror estimate") in the countries concerned. These indicate that the other countries almost always record higher trade surpluses or smaller trade deficits with the UK than HMRC does.

12.22 Figures are in billions of US dollars. A negative amount denotes a UK trade deficit.

Country	Goods		Services	
	UK estimate of trade balance	Mirror estimate of trade balance	UK estimate of trade balance	Mirror estimate of trade balance
Belgium	-$13.20	-$17.30	$1.20	-$0.80
France	-$11.00	-$14.20	-$0.50	-$5.50
Germany	-$48.30	-$54.20	$3.80	$0.60
Ireland	$9.90	$5.10	$7.20	-$11.70
Luxembourg	—	—	$2.60	-$2.20
Netherlands	-$16.90	-$15.10	$11.10	-$4.70
Norway	-$21.60	-$27.10	—	—
Sweden	—	—	$3.40	$1.20

248 See ONS, "Asymmetries in trade data—diving deeper into UK bilateral trade data" (accessed 14 February 2018).

13 Documents not raising questions of sufficient legal or political importance to warrant a substantive report to the House

Department for Business, Energy and Industrial Strategy

(39442) 5461/18 + ADD 1 COM(18) 26	Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the implementation of EU standardisation policy and the contribution of European standards to EU policies.

Department for Education

(39441) 5462/18 + ADD 1 COM(18) 23	Proposal for a Council Recommendation on promoting common values, inclusive education, and the European dimension of teaching.

Department for Environment, Food and Rural Affairs

(39461) — COM(18) 30	Proposal for a Council Decision on the position of the European Union in the EU-Algeria Association Committee regarding the modification of the conditions of application of the preferential tariffs for agricultural products and processed agricultural products set out in Article 14 of the Euro-Mediterranean Agreement establishing an Association between the European Community and its Member States, of the one part, and the People's Democratic Republic of Algeria, of the other part.

Department for Transport

(39499) 6170/18 + ADD 1 COM(18) 69	Proposal for a Council Decision on the position to be taken on behalf of the European Union in the relevant Committees of the United Nations Economic Commission for Europe as regards the proposals for amendments to UN Regulations Nos 6, 13, 13-H, 30, 37, 41, 43, 46, 51, 67, 79, 90, 107, 110, 118, 121, 122, 128, 140 and 142, to Consolidated Resolutions R.E.3 and R.E.5 and to Mutual Resolution M.R.1, and as regards a proposal for one new UN Global Technical Regulation.
(39396) 6034/18 + ADD 1 COM(18) 63	Proposal for a Council Decision on the position to be taken on behalf of the European Union at the 26th session of the OTIF Revision Committee as regards certain amendments to the Convention concerning International Carriage by Rail (COTIF) and to the Appendixes thereto.

Formal Minutes

Wednesday 28 February 2018

Members present:

Sir William Cash, in the Chair

Douglas Chapman	Kelvin Hopkins
Richard Drax	Darren Jones
Marcus Fysh	Mr David Jones
Kate Green	Michael Tomlinson

4. Scrutiny Report

Draft Report, proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1.1 to 12 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Sixteenth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

[Adjourned till Monday 5 March at 4.20 pm.

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)

Douglas Chapman MP (*Scottish National Party, Dunfermline and West Fife*)

Geraint Davies MP (*Labour/Cooperative, Swansea West*)

Steve Double MP (*Conservative, St Austell and Newquay*)

Richard Drax MP (*Conservative, South Dorset*)

Mr Marcus Fysh MP (*Conservative, Yeovil*)

Kate Green MP (*Labour, Stretford and Urmston*)

Kate Hoey MP (*Labour, Vauxhall*)

Kelvin Hopkins MP (*Independent, Luton North*)

Darren Jones MP (*Labour, Bristol North West*)

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

Stephen Kinnock MP (*Labour, Aberavon*)

Andrew Lewer MP (*Conservative, Northampton South*)

Michael Tomlinson MP (*Conservative, Mid Dorset and North Poole*)

David Warburton MP (*Conservative, Somerton and Frome*)

Dr Philippa Whitford MP (*Scottish National Party, Central Ayrshire*)