Capital Markets Union to disunion

Policy options and challenges for the UK

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Hard, soft or no Brexit, the UK faces policy challenges

Introduction

The post Brexit approach to regulating financial services in the UK and EU has been an area of continued focus for politicians and officials. Implications of change are as important for the real economy as for market participants and users of those markets.

Political and technical issues arise for both the UK and EU. Some important aspects are associated with how convergent the two jurisdictions should remain. This has been characterized in terms of the extent to which the UK should remain equivalent to the EU regime in order to gain access to EU markets. The characterization partly reflects the status quo; on day1 of the post exit era the two regimes will operate under identical legislation in the main. It arguably also reflects the relative bargaining power as the EU and UK endeavor to agree an exit deal.

Background

On the question of what extent the UK and EU grant access to their respective markets, from the UK's perspective the trade off is between remaining convergent in order to meet conditional access, versus being free to diverge and develop its own domestic regime. The former appears to be based on increasingly intrusive oversight from EU supervisors. The latter would enable the UK to prioritize UK interests in terms of managing the risks to and within its own economy as well as relating to third country jurisdictions in a competitive way.

Regulatory authorities in the UK have been firm in their view that the UK becoming a de facto rule taker, which is associated with EU oversight of implementation of the EU Rulebook, is not an acceptable outcome. The position of senior UK regulators[1][2] is the UK should remain convergent in terms of outcomes, and free to diverge on the technical detail of the rules on how to achieve those outcomes. This should be the basis of an agreement of mutual recognition. Diverging in the area of financial regulation is of great political value. The City has long held views on the over regulation of the sector pushed

[1] Andrew Bailey, Chief Executive of the FCA, on the future of financial conduct regulation, Bloomberg, London 23 April

[2] Andrew Bailey, Chief Executive of the FCA, also set out the FCA's early assessment on the regulatory landscape for financial services if the UK were to be considered a third country, wherein he also set out main features of an "ideal outcome": https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/FCA-letter-on-passporting-28-10-16.pdf

on to it by Brussels. For the UK, which has a difficult recent history in financial services regulatory discussions in Brussels, the political reality can be summed up for many as the need to make Brexit meaningful.

Discussions on the nature of equivalence regimes from a EU perspective have developed in both the Brexit discussions as well EU legislative discussions, including most notably under EMIR and the supervision of CCPs[3] and also the investment firms regulation. There is also a political reality within the EU about how member states relate to jurisdictions outside the EU. Member States have well settled attitudes towards relating on trade issues with third countries. France for instance has a more or less standing position on demands for reciprocity. Member states also have entrenched regulatory cultures based on intellectual traditions and market experience.

What divergence?

Diverging in the area of financial services holds benefits for the UK on a technical level also. Calibrating the regulatory regime to more appropriately reflect the risks associated with its own economy, that foster the competitiveness of its own market and sectors are important. It is equally important to influence the EU approach, now and in the future. Competitiveness of the UK as a financial centre is reliant on the robustness and competitiveness of the EU economy. Arguably, if the UK is not fully within the decision making process, this influence is best achieved from operating fully outside the EU. Enhancing the UK's influence in global discussions and competitive force from the outside may focus EU policy minds on substance and third country relations more than it would do under observer and rule taker status.

Relating on the basis of outcomes based recognition and equivalence regime and also adhering to global standards are part of the complications for UK authorities when considering which areas to diverge in. The fact the UK was a key architect of much of the post crisis and current EU legislation in force applicable to banking, insurance and capital markets sectors makes it difficult for regulators and policy makers to wholesale strip back the rulebook, as some politicians have suggested. This alone should allay fears of a regulatory race to the bottom. Meanwhile, the FCA has been clear there is no desire to abandon the status quo at a high level, but rather a focus on the degree of detail set out in legislation. UK regulators and supervisors have in many important areas taken a more stringent interpretation and application of rules than in the EU. So a key question that arises for the UK on financial services regulation is what aspects of the current EU regulatory regime should be reviewed and recalibrated with the stability and competitiveness of the UK as the clear and overarching priority?

[3] Text of the agreement between European Council and Parliament, which is yet to be published in the Official Journal of the European Union: https://data.consilium.europa.eu/doc/document/ST-7621-2019-ADD-1/en/pdf
Press release: http://europa.eu/rapid/press-release_IP-19-1657_en.htm

Policy makers have indicated this is the name of the game post exit, and that work has been underway for some time. They have not however indicated to any degree of detail what aspects of the existing regime may be on the agenda for review. Resources of authorities and industry are focused on preparing for exit, and more recently a potential no deal exit. The politics and uncertainty around the eventual outcome means policy makers have not been free to meaningfully engage with industry on laying the groundwork for what comes after.

Meanwhile, an incoming new Commission, Council and Parliament are expected to progress the EU agenda for the sector. This includes revamping the capital markets regime, engaging on the global movement to address ESG concerns, and engaging on the battle to lead on digital and data economies. Against this background the French securities regulator, the AMF, has set out key focus areas and initial proposals[4] from the perspective of France. In taking a step towards proposing the agenda for the EU, the AMF has arguably set it for the UK and its own domestic review of the regulatory regime.

The European Union's Capital Markets Union

The substantive aspects of the regulatory regime raised by Brussels and Paris are supervision, capital markets with a focus on asset management, sustainability, fintech and data.

Supervision

The supervisory approach floated by the AFM in France has two salient features; one, a more centralized model, and two, the approach to third country jurisdictions and treatment of third country entities active in the EU or relating to EU clients.

Centralization

Convergence within the EU in the area of financial supervision, with focus on a single pan EU supervisor has been a long-standing policy objective of the European Commission. France has been a strong political force supporting this. Legislative and supervisory discussions within the EU on arrangements for colleges and the relative oversight powers of home and host supervisory authorities for conduct and prudential oversight have periodically seen a push from France in favor of a more centralized approach involving ever more powers for European agencies. Since the development of European securities, banking and insurance and pensions Authorities in 2011 subsequent sector legislation have included further discussions on the extent to which ESMA in particular should be able to directly supervise firms.

[4] EU2024: Shaping EU27 Capital Markets to meet tomorrow's challenges, Focus areas and initial proposals of the French AMF: https://www.amf-france.org/technique/multimedia?docId=78900687-9efe-4fd0-88db-fd7c83738a7b

Proposals involving access to information and powers to make on spot inspections have had more traction in relation to non-EU entities than EU ones, and for more systemic entities. Powers for ESAs previously unsuccessfully pushed by France in relation to delegation and outsourcing of activity to non-EU entities, powers to scrutinize and even prohibit such arrangements by firms, have been reprioritized by the AMF as key elements of proposals to enhance supervision as part of preparation for Brexit. These are potentially retrograde approaches at a time when European markets require cohesion. There are also some positive priorities set out by the AMF, including the idea that ESMA should have powers to issue no action relief letters, and focusing on implementation management and appropriate use of level 1 legislation and level 2 and 3 regulatory and supervisory powers. These priorities imply an increased degree of coordination, proportionality and agility in EU wide supervision.

Third countries

The latest amendments in 2019[5] to the governing ESA 2011 legislation, and more importantly to the supervisory arrangements for CCPs active in the EU under so-called EMIR 2.2 has established a potential template to be applied more broadly across the financial sector. The critical feature of the EMIR supervisory regime is a '*tiering'* approach. Entities posing a higher degree of risk should attract a more prescriptive and intrusive supervisory approach from ESMA and relevant central banks. There is also a greater role for ESMA and central banks on colleges, and notably ESMA may consider the requirements designed to safeguard against market and systemic risks to be insufficient, and withhold or withdraw recognition.

Although the AMF has underlined the need to maintain sector specific third country approaches, it has endorsed the approach taken in EMIR 2.2 as an important basis on which to review existing third country regimes. Of course, the EMIR 2.2 approach operates on the basis that third country entities should have access to EU markets. France has in the past considered the same is not the case for all sectors. Third country recognised and authorized AIFMs for instance are not granted a license to operate across the EU. Indeed, the AMF proposes the current basis on which non-EU AIFMs are able to conditionally access the EU, namely on the basis of national private placement regimes, should also be reconsidered. It also proposes other national member state discretions in relation to non-EU entities, including under MiFIR and IFR, should also be reconsidered.

[5] Press release and fact sheet on the Review of the European System of Financial Supervision, legislation not yet published in the Official Journal: **Capital Markets Union: Creating a stronger and more integrated European financial supervisory architecture, including on anti-money laundering:** http://europa.eu/rapid/press-release_MEMO-19-1928_en.htm

The implication is that where it is decided non-EU entities should be granted conditional access, that should follow an extensive and arguably intrusive EMIR 2.2 approach, and where currently capital markets participants under AIFMD and MiFIR currently access member state markets on a bilateral basis, it should be reconsidered, with the clear implication that the practice should be restricted. Such an approach holds important downside risks for EU funding and investment. It also poses questions to UK authorities that come up against the broader Brexit on-shoring policy.

Asset management sector

Regulatory approaches to the asset management sector have traditionally been among the most difficult to agree in Brussels, for both wholesale and retail markets. Negotiations on the AIFMD in 2011[6] exposed deep differences in tradition and cultures towards investment and capital markets and the role of asset management in the economy.

The June paper sets out financing the real economy should be at the heart of the financial sector model in the EU and therefore an important ambition of the CMU. This chimes well with statements by Commissioners and Leaders in Brussels. Proposals to consider how best to simplify and harmonize aspects of asset management sector legislation, currently spread across multiple legislation, is a positive step. The reporting burdens alone arguably warrant a new approach. Consistency of application across member states is also a worthwhile ambition. Recognition of the fact of the industry, management companies, delegated mandates, fund domicile and services such as depositaries, operate across several member states is also positive, particularly if French and other European authorities are now promoting a true single market in areas such as depositary services. In the past France was among member states that have argued against cross border intra-EU licenses for such services.

The AMF proposes to simplify the legislation applicable to asset management sector, it appears mainly through alignment. It has proven a challenge to develop regimes for even subsectors of the asset management sector in a risk sensitive and proportionate way, mainly because participants have different risk profiles. Developing risk sensitive and proportionate regimes for the entire asset management sector will prove a significant challenge. Heterogeneous market players have different business models and risk profiles, relate to and offer a variety of services to different types of clients in a variety of instruments. French proposals based on aligning conduct rules under AIFMD with those under UCITS, have previously been considered disproportionate for wholesale market participants. Furthermore, existing rules on conflict of interests, reporting and

[6] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

disclosure to supervisors has been hard won and risking unraveling these, which presumably involves a reappraisal of MiFID, could come with a high cost.

Streamlining and harmonization of European asset management regulation is however a potentially positive step in some areas. The differences in application of EU legislation across the EU, particularly authorizations and registration, have been a frequent complaint for management companies and a major inhibitor to inward investment to the EU. The UK's ongoing Asset Management Study should consider the potential impact of these developments

One particular feature of the current EU regime that is highly valued is the reliance of inward investment channels on so called national private placements regimes. Non-EU investors are able to access EU markets based on individual member states recognition arrangements in relation to their home third country jurisdictions. Any proposals seeking to reconsider either continued availability of access based on NPPR regimes, or the discretion available to member states and their competent authorities in this area, risks inhibiting a valued channel of inbound investment to the EU economy. Further, it is understandable that individual member states should not undermine the EU single market by providing advantageous status for third country entities through bilateral recognition arrangements. However, developing a policy with the objective of promoting EU champions also runs the risk of undermining the EU's global competitiveness by sending the wrong message that incoming entities will be disadvantaged.

Policy measures that inhibit the growth and development of the EU Single Market, as well as access to it from non-EU jurisdictions are a significant concern for a post-Brexit UK and City of London. The City will continue to rely on a healthy EU market and economy. Such measures, including proposals to undermine existing business models and arrangements involving outsourcing and delegation of services and ancillary services should be challenged from within and also from outside the EU. As set out, from a post Brexit UK's perspective, pressure may most effectively be applied by being fully outside the EU decision-making process. Such defensive measures from the EU also emphasize the importance of the UK remaining a free and open investment destination focused on a risk sensitive regulatory approach.

Fundamental change in the EU is a potential mixed bag of good and bad from the UK's perspective. The same can be said from the perspective of the asset management sector. A stronger EU market is positive for the UK market, but it also throws down challenges for the UK to reconsider its own domestic regime, whatever the outcome of Brexit and the future relationship. At a basic level, any relationship that relies on convergence or equivalence means UK authorities must consider changes in order to meet EU alignment. At a deeper level, the asset management sector is an important feature when assessing various options available on the broader relationship. The EU's approach indicates a) an attitude in the EU towards the UK market and b) a shift in direction to the financial

sector. That is an important consideration when assessing the merits of membership of the single market.

Implications of a new approach in the EU at all levels mean the UK must consider fundamentally the approach to regulating asset management, its competitiveness as a management and fund domicile centre, as well as service providers, such as depositaries. The strength of the UK is its open market approach, with strong risk sensitive and proportionate regulation. Specifically, issues such as reporting, risks management and organizational arrangements, including authorized appointed representative regimes, are important for maintaining a sustainable ecosystem for small and medium sized fund managers. More fundamentally, issues such as developing a remuneration regime meaningful to business models, and risk sensitive and meaningful approaches to the use of leverage can help drive private lending and investment in the UK as well as maintain the UK's role as a financial service and risk management hub to the EU and globally.

Fintech and data

The data driven economy and digital and technological transition in financial services presents clients and consumers with increased choice. New and existing services and products, offered on a cross border basis, within and outside the EU represent all that is positive about the financial sector and its role in the wider economy. This is potential disruption on a scale not seen in financial markets for many decades. It presents in turn risks and opportunities, some traditional and some new.

Traditional risks include consumer protection challenges, legal risks, and potentially systemic risks. These traditional risks can be amplified by new business practices that arise due to the technological developments and also entrants to the market with significant customer reach.

New risks arise from technology enabling service offerings from new intermediaries able to price out incumbents on both existing services and products and new ones outright. In the payments field PSD2 in the EU and Open Banking in the UK continue to facilitate market entry for various types of services to compliment and compete with the traditional banking offer. The opportunities for consumers and new service providers have required increased regulatory focus on enhanced security and protection. At the other end of the scale, markets such as crypto and digital assets have seen development of business models where services previously provided by several entities have seen consolidation into a single entity. All this gives rise to a new basket of risks for regulators and policy makers to consider. They will need to approach oversight in new ways also.

Two important things are worth noting; one, innovation in these markets will push its reach deeper and wider – deeper in terms of the types of offerings, instruments and services for consumers, and wider in terms of the reach to

consumers, clients and counterparties, be that across multiple jurisdictions or across a broader cross-section of society. The implications for the currently unbanked in Bangladesh, Indonesia and Pakistan from gaining access to financial services are just as fundamental for the firms accessing their savings and spending habits. Two, just as technology drives forward such potential and growth, it is inevitable that it will also provide the solutions to associated risks. It would be short sighted to assess a new product or services offering based on current regulatory tools and the technology they are based on. The market needs to be able to respond to new offerings. The sandbox approach is a positive one and should be broadened through investment. The growth, opportunities and risks, all imply a need for policy and regulation to reflect the cross border nature and importantly the global perspective of technology driven markets.

Disruptive developments also raise important questions of competiveness of markets, domestic and international. Discussions on opportunity and risk, in say the payments landscape for instance, have at times reflected the interests of incumbents. The internationalization of financial services, for wholesale and retail markets, adds a further layer of complication for domestic regulators to consider the competitiveness of their markets and the competition landscape within their jurisdictions. Against this background, any policy to develop and encourage national or EU champions should be taken on with caution. Policies to promote European entities may be perceived as providing unfair advantage over international competitors, and an inhibition on fair competition in the interests of consumers. Beyond unfairly discriminating against non-EU companies, it indicates an attitude and culture towards incomers, including talent and foreign direct investment.

The UK's approach to open markets and actively encouraging incomers to enhance the competitive landscape for the benefit of consumers and users of markets provides a good basis to maintain its position as a global and the European Fintech hub. The fintech sector is also one that benefits from the UK as a skill destination for highly skilled technology and financial sector talent. It will be important for relevant Government departments to work together to ensure processes and the messaging is aligned and promotes the UK sector as destination for businesses and best talent.

The increasing reliance on cloud computing by all parts of the financial sector and developments in data security means Fintech and Regtech offer cost saving opportunities for the sector through Business Processing Outsourcing. Regulatory processes such as reporting, disclosures, confirmations, documentation and even sanctions screening are all areas that could appropriately be outsourced under authorized representative service regimes and lower the costs of back office and process type regulatory obligations. In instances this may raise questions about the regulatory perimeter, but such discussions should be considered if it enhances the overall outcome for consumers and users of the markets by supporting smaller firms.

Data

Data has been identified as a cross cutting theme across financial services and the wider digital and real economy. In a data driven economy important questions arise about the responsibility of entities such as trading venues that arguably enjoy a monopoly position. Issues have been raised about the conditions and costs of access to data by market participants, the ability for trading venues and index providers pricing policies. The SEC in the US has already for some time been active in scrutinizing exchanges in meeting Reg NMS (the regime regulating dissemination of market data). ESMA in the EU has launched a consultation process[7]. The FCA in the UK is now beginning to consider these markets from a competition perspective and it is hoped this will apply pressure to keep up in ensuring fair markets in this area. Any attempt to clean up European markets and potential dominant position behavior must involve a reappraisal by DG FISMA of the MiFIR[8] framework and the policy on a consolidated tape. It has also been argued that in relation to the index markets and pricing effective scrutiny is required from DG Competition. The UK's FCA already enjoys competition powers and the CMA is already active in financial markets, so this may be an area where ripe for regulatory action in concert.

Blockchain technology potentially presents a market solution in the area of market and reference data. The crypto and digital assets markets continue to develop with increasingly familiar traditional financial infrastructure, such as custodian and post trade services. However, there appears little development in the direction of data utility services.

Authorities should push forward an agenda on the role of blockchain technology in relation financial infrastructure, including data services, in the area of both regulatory reporting as well as market and reference data markets. This should run alongside ongoing work on identified competition concerns.

Sustainability

Technology and data, as two of the big issues in financial services and the broader economy in coming years, hold significant implications for a third important area – sustainability. ESG (Environment, sustainability and governance) is a stand-alone policy area for the EU. The role of the financial sector in driving forward environmental and climate related commitments are just one aspect of the ESG agenda from a capital markets perspective. Others include energy, transport and food policy.

As things stand, both the EU and UK continue to focus on the disclosure regimes through financial and non-financial reporting obligations. The EU has pushed

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[7] https://www.esma.europa.eu/press-news/esma-news/esma-launches-consultation-cost-market-data-and-consolidated-tape

[8] REGULATION (EU) No 600/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Regulation: https://eur-lex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

ahead further with work more directly focused on benchmarking and asset management sector specific disclosure. On-going work on the taxonomy of economic activity to inform financial investments and exposures is expected to see the EU lead global discussions. Those global discussions are complicated by diverging views on climate change and environmental challenges.

Despite a strong focus on disclosure, any framework that develops criteria to help industry and governments determine which economic activities and exposures qualify as ESG compliant is arguably creating a brand. The latest reports of the expert working group appointed to assist the European Commission in drawing up the necessary criteria has received criticism and objection from the nuclear sector for the implication it is not to be considered ESG compliant. That, it is contended, would impact investment in the sector, and this is at a time when nuclear energy is increasingly important in global de-carbonization efforts.

The AMF has indicated in its June paper that creating conditions for the market to take advantage of standards and labels has inherent positive knock-on effects throughout financial markets. The UK tradition has been to not to take such a physical hand in markets. The current mood and recent activity in the markets and the wider economy indicate its reliance on market and demand led approach may be more appropriate.

Technological and data developments are significant for pursuing a transparency and disclosure led approaches to sustainability in the UK and to date in the EU. The granularity of up to date verifiable information on financial instruments and their underlying economic basis will assist a broader and deeper market. Extracting the maximum potential positive outcomes for developing country markets and economies, by for instance incentivizing green economic business activities by channeling increased investment, makes it important to take on green fintech and data policy issues in a coordinated way. Such an approach will require working together internationally on specific issues such as regulation of fintech sector and mutual recognition of data standards where possible to enable more fluid markets in the green sector.

One key aspect of the UK's policy on sustainable finance is to increase the flow of private finance towards the green economy, both domestically and internationally. This is characterized as financing green and also candidly capturing the opportunity to position the UK as a global leader. A third and important aspect is to ensure financial sector risk and opportunities are appropriately reflected in the market.

Sustainable finance agendas are well underway in both the EU and UK. To date, and while the UK is still involved as co-legislature in the EU Council, we have seen a broadly common approach on issues such as disclosure and obligations on asset managers to consider ESG in investment decisions. Divergence however is beginning to appear on a more fundamental level about the approach to inducing private sector investment flows into the green economy. Against the broader

political issues, such as Brexit and equivalence, this may present challenges to the required degree of mutual recognition and access to realistically meet climate goals.

Conclusion

Hard, soft or no Brexit, and whatever the arrangements are for the future relations with the European Union, the UK faces policy challenges in the area of financial services. In the EU there is already a clear shift in approach on broader policy areas, such as sustainability, treatment of non-EU entities and the promotion of EU champions. The change in approach reflected in discussions and proposals on the asset management sector underlines this more acutely, as does an attitude towards the UK remaining the preeminent financial centre in the EU.

The UK must promote its own agenda and part of this must be asserting its approach on key issues already prioritized by members of the EU. In doing so it must maintain its traditional approach to markets and regulation: risk sensitive and proportionate. It must also drill down to the detail of aspects of the EU regime it considers inappropriate or disproportionate by reflecting a position in its own domestic regime. This will invariably involve divergence in areas. By putting its front foot first, the UK will face resistance and at times this may risk disruption to markets and relations.

Disruption arguably is already inevitable. The EU's equivalence decision in relation to Switzerland is openly and explicitly based on political considerations. The degree of equivalence as a question of fact is a secondary consideration if at all. This attitude of the EU inherently devalues objective of equivalence and remaining convergent for the EU's partners, including the UK.

Steering discussions on the global agenda, leading on the approach to regulating financial and related markets at a time the global economy is potentially entering a phase of further structural changes, and importantly, effectively influencing the EU's approach must begin with developing the right policy approaches. This should be the starting position for both the UK and the EU.