

Navigating the Brexit Wave

The Future of Regulation

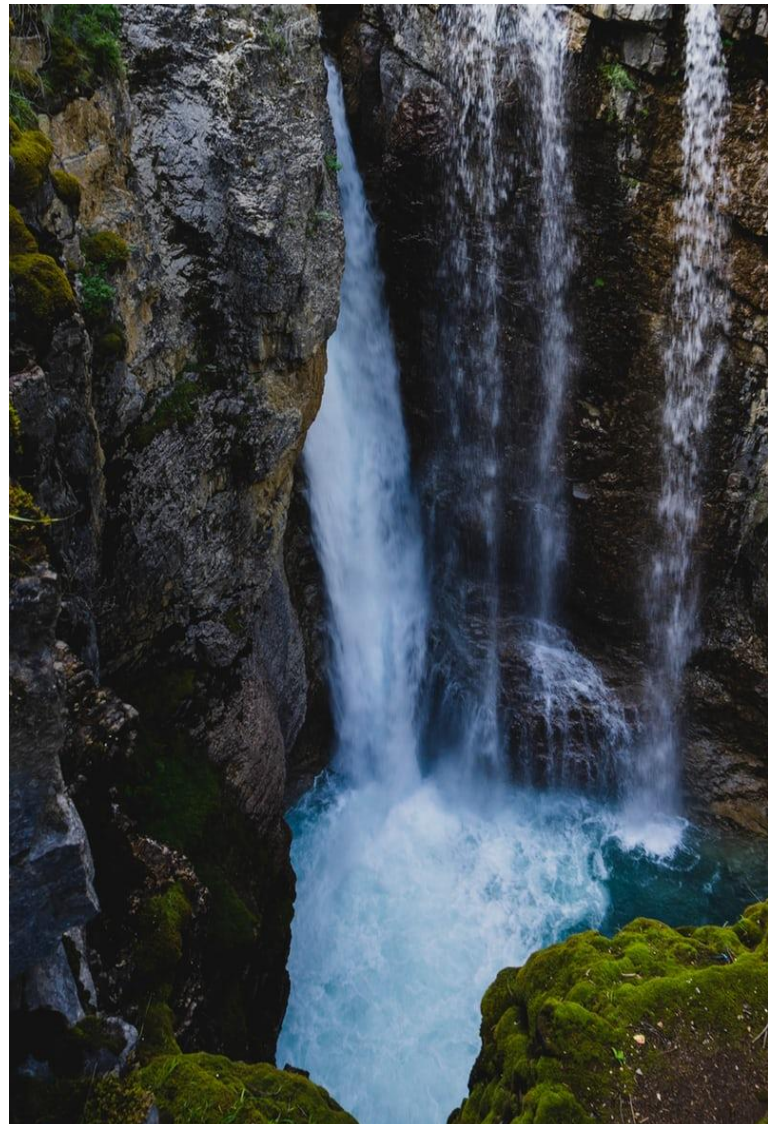
As we approach the end of October, still no clearer as to whether we will be in or out of the EU by the next publication of this newsletter, we thought it important to reflect on what the potential regulatory implications are, should Brexit actually happen.

Since we started on this journey back in June 2016, there has been significant concern and focus on post-Brexit planning. The industry has achieved a lot in the past three years, with new offices opening, new regulatory licences being obtained, and staff being hired or moved. Firms should be proud of these achievements.

Brexit provides UK regulators, particularly the FCA, with an opportunity to reconsider the regulatory framework. For the regulated business activities that will continue from the UK, the future of regulation is an important topic. There are a number of key considerations, including:

- What are the short term priorities for UK regulators post- Brexit?
- What are the key drivers and challenges that will impact the UK regulatory landscape post-Brexit?
- What are the emerging trends and areas of focus we expect to dominate the UK regulatory landscape?

We also briefly explore potential impacts and considerations for the European regulatory framework once the UK departs.



*Rules, of course, are a crucial mechanism for delivering outcomes, **delivering outcomes** we want to see for consumers and for markets. But they can also be interpreted so rigidly as to become what's often called a **box-ticking exercise**...any organisation that prioritises being within the rules over **doing the right thing** will not stand up to scrutiny for long.*



Andrew Bailey, FCA Annual Public Meeting, June 2019

Navigating the Brexit Wave

The Future of Regulation: short term priorities



Regulators have been busy preparing for Brexit. The FCA had more than 450 people working on Brexit at one point¹. We have identified a number of short term priorities, as the UK departs the European Union (“EU”).

1. Transitioning EU branches: EU branches in the UK are awaiting ‘landing slots’, which will only be announced once Brexit has taken place. This leaves a significant level of work for impacted firms to still do. This includes ensuring they have:

- Identified the additional UK rules applicable to them as a third country branch
- Applied these requirements to their existing governance, policy, and controls frameworks
- Reviewed any services provided to the branch by the headquartered bank, ensuring there is effective oversight of these activities from the UK (and these services comply with local UK requirements where appropriate)

2. Transitioning of existing legislation: The FCA needs to ensure existing legislation is transitioned effectively. This should extend beyond simply onshoring existing European requirements. There are a number of requirements, which came into force based on EU wide cost benefit analysis (e.g. the MiFID II mandatory trading obligation for shares). The FCA should ensure the implications of applying

these requirements in a UK only context are considered before onshoring them. Firms should consider proactively providing feedback on areas of European regulation they feel will be difficult to transition into UK regulatory requirements.

Work is ongoing to ensure UK specific data is available to firms, to enable them to meet their compliance obligations. For example, the FCA recently published an update on the MiFID transparency regime². Reliance is still being placed on existing ESMA calculations (e.g. annual determinations for MiFID II equity transparency). This means all UK based firms will still have some work to do as the FCA starts to diverge from the European regulatory framework over the next couple of years.

3. Guidance on upcoming EU regulatory initiatives: While the political negotiations and stand-offs continue, upcoming EU regulatory changes still require implementation. UK regulators will need to rapidly communicate their expectations to the market, once Brexit happens. This includes whether the proposed EU regulatory texts should be adopted in full, in part, or not at all, particularly in respect of the Securities Financing Transaction Regulation.

¹Andrew Bailey, *Speech at the Annual FCA Public Meeting*, 17 July 2019

²FCA, *Update to the supervisory statement on the operation of the MiFID transparency regime*, 9 October 2019

Navigating the Brexit Wave

The Future of Regulation: key drivers and challenges

Key drivers and challenges likely to impact the UK regulatory landscape post-Brexit

Robustness of regulatory supervision



The ability of the FCA to effectively regulate all 60,000 firms (and growing) within its remit, with limited resources, will be critical to ensure the UK regulatory framework remains robust. This is not a Brexit issue, but there is a risk that regulators could react more aggressively through policy rather than supervision, without the European regulatory framework.

UK regulators will need to work closely with their European counterparts and continue information sharing under memoranda of understanding.

Incentives to de-regulate



Maintaining a competitive financial services centre in the UK should be an important priority for the UK government. There are a number of levers the government has to enable this, including taxation. Greater flexibility in the regulatory framework might be another. Regulators will need to balance this with the need to protect clients and markets. We expect to see more enforcement action against individuals than firms, particularly in the short term, but we do not anticipate regulatory expectations receding.

Continued global harmonisation



Whilst Brexit presents an opportunity to diverge the UK's regulatory framework from Europe, in practice the UK will still seek to comply with global standards. For example, standards set by the Basel Committee on Banking Supervision or the Financial Stability Board. In practice, across key G20 initiatives, the key difference will be in respect of the timing of when and how the UK adopts, not if.

Ensuring competitiveness of UK firms



There is a widely held view that the UK has exported significant amounts of regulation to the EU. For example, the UK adopted the Retail Distribution Review years before independent advice and inducement bans were written into MiFID II. The PRA and the FCA will need to balance financial stability and good conduct outcomes, respectively, with the competitiveness of UK financial institutions against their peers operating abroad.

Navigating the Brexit Wave

The Future of Regulation: focus areas

The UK regulatory framework is likely to continue down the current trajectory, which is focused on senior management accountability, measuring outcomes rather than compliance with rules, and achieving a robust culture of challenge. We have highlighted some of the key areas of focus below.

Governance and Accountability

We expect the focus going forward will be on individuals, in particular senior managers, the 'reasonable steps' they have taken to ensure effective oversight, and what the outcomes were. We expect to see more investigations of individuals, compared to firms.

- Individuals should ensure they know what they are accountable for. This includes activities that might be outsourced.
- Individuals need to have access to the right data. The right data translates to meaningful information, which can be interpreted and used for decision making, not an overload of Management Information.
- Firms should start to consider their governance frameworks from an ESG perspective.

Culture and Conduct

Firms have done significant work around culture and conduct. However, a number of challenges remain:

- Ensuring all individuals (and not just senior management) understand and live the values of the organisation.
- Ensuring individuals can navigate the interests of clients, the market, and shareholders as they conduct business.
- Recognising conduct risk goes beyond front office (e.g. to all control functions, operations, and technology teams). If these functions are viewing their responsibilities through a conduct risk lens, then operational resilience will be easier to achieve.

- Going beyond box-ticking. The culture of an organisation should be to challenge whether the right outcomes are being achieved for clients every day, consistently throughout the organisation, and not just whether rules are being complied with.

Financial Stability

With the transition of EU branches to third country branches in the UK, financial stability will likely be a key concern. The debate around requiring subsidiarisation could continue, particularly if there is increased volatility in markets post-Brexit.

Liquidity will be a concern, at least in the short term. The contingency plans set out in the FCA's recent policy statement for certain funds investing in illiquid assets could be tested soon rather than later.

Regulatory Perimeter

Anyone who has had to read, understand, and interpret the Perimeter Guidance has our sympathy. Simplifying the regulatory perimeter would provide greater clarity to both customers and firms. The problem is not limited to only financial services regulation. We feel there is a broader issue where firms declare in communications who their regulator is (professional services firms and the ICAEW is one example), when in reality only a portion of their business is reviewed, challenged, and actively monitored by a regulator (cross business conflicts aside).

Regulators should consider how to deal with general communications from firms stating they are regulated, without specifying for what, including whether further clarification in disclosures might be needed.

Navigating the Brexit Wave

The Future of Regulation: EU framework

The Future of the European Union Regulatory Framework

There are likely to be many ramifications for the European regulatory framework, after the UK's departure. Despite examples of input from other countries into EU regulatory initiatives, the UK, either through its regulators or its civil servants, has been a strong driver and contributor. The capital markets union roadmap, instigated by Jonathan Hill, is just one example.

- **Greater de-centralisation.** The chair of the AMF earlier this year called for more flexibility in the way countries implement 'market rules'³. There has been an increasing trend to issue more requirements as 'regulation', which does not require local transposition by member states, rather than 'directives', which do require transposition, over the past few years. Pressure from regulators, such as the AMF, could lead to a reversal in this trend. Greater flexibility in the implementation of market rules by member states could also impact the long term viability of the capital markets union project for the EU.
- **Approach to third country firms.** There has been some effort over the last few years to harmonise the third country regime across the EU bloc, such as through MiFID II. It is worth noting though that even when a third country is not considered 'equivalent' by ESMA, national regulators still have flexibility for bilateral negotiations with the relevant third country. This is no different to the regulatory landscape before MIFID II.
- **ESMA supervisory convergence programme.** ESMA has been running a detailed programme to ensure supervisory convergence across the European states for some time now. Whilst this work will continue to be important, there remain challenges due to the economic imbalances between the states – not all member state National Competent Authorities ("NCAs") have the same level of financial means to implement, supervise, and enforce. Furthermore, not all countries appear to have the same will to enforce all regulation with equal rigour.

ESMA recently published the findings of a peer review on achieving data quality for EMIR. Of the six NCAs reviewed, it found only two (France and Ireland) that fully or broadly met the peer review's expectations across all six categories assessed⁴. The EMIR requirements have been in place since 2014 and the other four NCAs assessed included the FCA in the UK and BaFIN in Germany. The future of regulatory convergence for the EU after Brexit depends on the extent to which member states implement EU regulation – at some point, there has to be a trade off between the cost of drafting and negotiating requirements against the number of member states implementing these requirements.

³The Financial Times, 'French financial regulator wants more flexible market rules', 14 July 2019

⁴ESMA, *Final Report: Peer review into supervisory actions aiming at enhancing the quality of data reported under EMIR*, 17 October 2019

Navigating the Brexit Wave

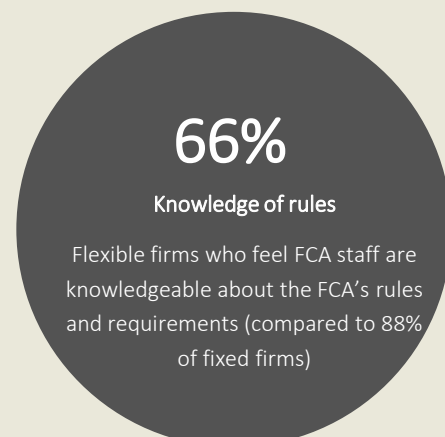
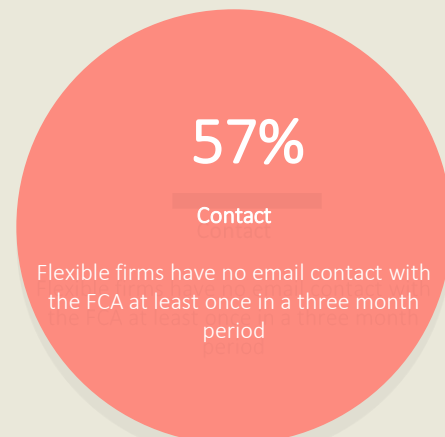
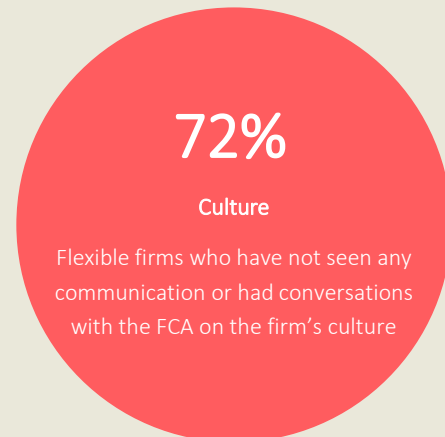
The Future of Regulation: regulators and oversight

Whilst not directly related to Brexit, we anticipate the regulatory landscape in the UK will shift as a result of greater adoption of digital and innovation capabilities by the FCA. Those firms which have not been under the FCA’s radar will, in time, face greater scrutiny.

The FCA regulates more than 60,000 firms in the UK. All of these firms will have been through some form of authorisation or approval process. For EU branches in the UK and those firms passporting, this may only have been a notification. However, the ongoing oversight and supervision of these firms varies and is risk based. This presents a number of challenges to the FCA in respect of overseeing firms which do not have a direct supervisor assigned. At times, this may also present a challenge to the firms impacted, who do not have a consistent point of contact.

The FCA is doing significant work in respect of digital and innovation. We feel that their adoption of digital solutions to extend their supervisory coverage will be critical to ensure their client conduct and market conduct objectives are achieved.

Level of FCA engagement with flexible firms⁵



⁵FCA and Practitioner Panel, 2019 Annual Report, July 2019

Navigating the Brexit Wave

The Future of Regulation: regulators and oversight

The Virtual Supervisor

A higher level of digital adoption by regulators could significantly shift the level of focus the majority of regulated firms have, forcing them to raise the regulatory bar. For example, virtual supervisors could be deployed to ensure there is sufficient coverage of regulated firms.

Regulators would need to balance the level of oversight. There is a risk that an overly interventionist approach could shift the first line of defence away from firms and to the regulator. If, or when, regulators start deploying virtual supervisors, it is important that the virtual supervisor remains a supervisor and is not treated as a line of control by firms.

