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Hogan Lovells

THE UK REGIME FOR OVERSEAS FIRMS

EXECUTIVE SUMMARY

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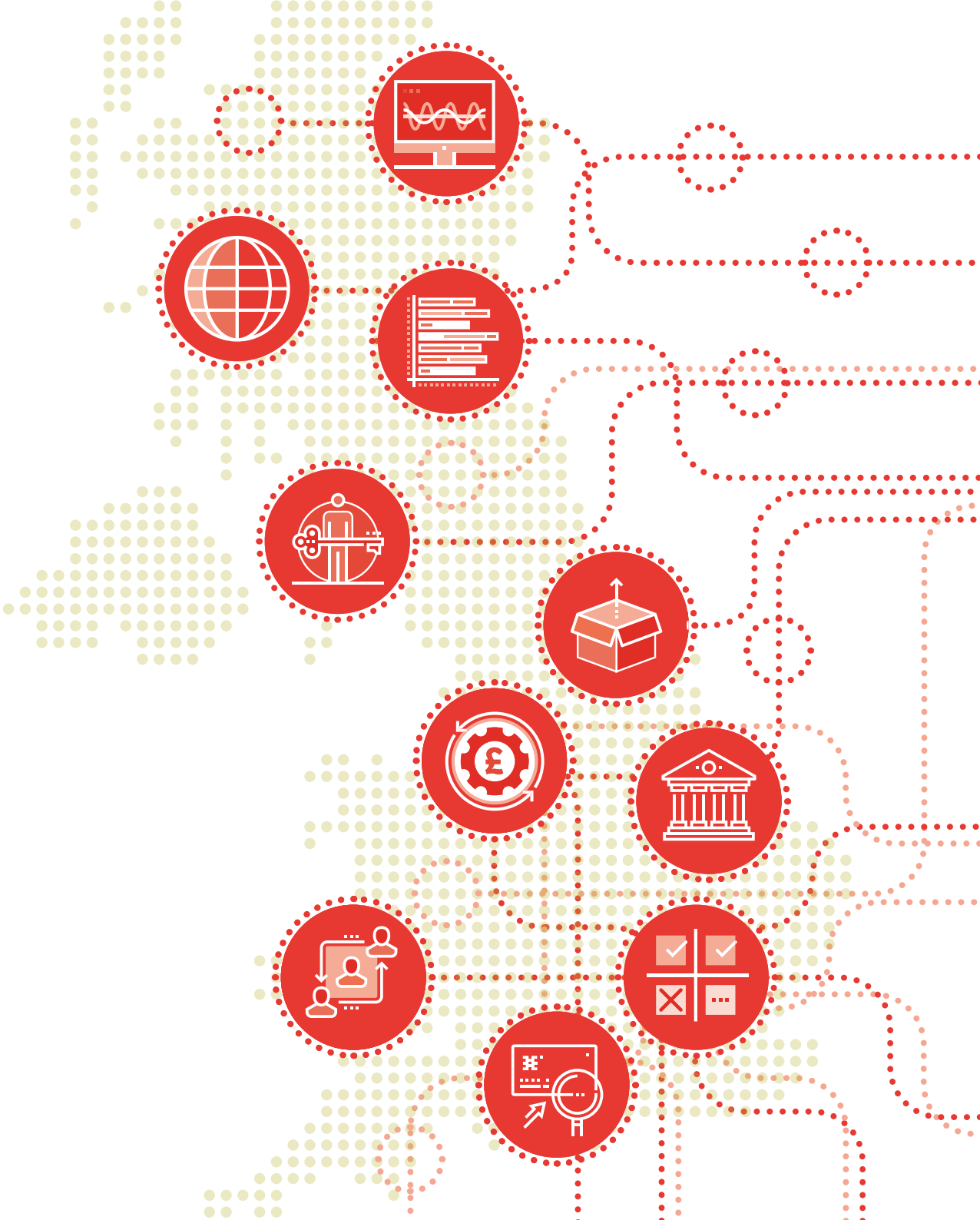

INTRODUCTION

The UK's regulatory regime is at a key juncture and much is being asked of it: to enable the UK-based financial services industry to play its role in the economic recovery, to finance the road to net zero, and to become digitally enabled. Adaptability has always been key to the competitiveness of the UK's financial services industry and events of recent years have tested this to the full.

Just over 12 months ago and a few months into the COVID-19 crisis, the UK's financial services industry was focused on supporting customers who had been hit with the economic consequences of the lockdown while itself navigating a rapid transition to remote working. With the final details of the UK-EU agreement yet to be put in place, and the end of transition in sight, the IRSG started to consider how the UK should think about its financial services regulatory regime and the position of overseas firms.

The UK's regulatory openness has long been regarded as a competitive advantage globally. However, this openness can only work as part of a strong and well-regulated regime. Any changes to the UK's regulatory regime are viable only if they enhance the existing framework.

The UK's regulatory regime has been framed by high standards. As the UK leads the G7, it is more important than ever that the UK shows global leadership in preserving openness and reducing regulatory fragmentation. The global financial system was tested through the COVID-19 crisis and proved to be resilient. The IRSG supports the UK's efforts to build a stronger and more coherent global regulatory system, to enable the industry to address common challenges such as climate change and financial crime.

During the course of the workstream's deliberations on these questions of openness and global competitiveness, the FCA, PRA and UK Treasury all asked industry for input into their thinking on how to deal with overseas firms. This report tries to look beyond individual elements of the UK's access mechanisms and instead sets out thinking about how the UK's regime works as a whole and what changes could be made to make the UK even more attractive to international business.

This report demonstrates how the UK's openness to international firms should be maintained, and identifies modest but important changes that should be made to the access regimes to ensure that they are clear and coherent. It addresses overlap between the different mechanisms, and provides guidance to help overseas firms better navigate them.

I would like to thank the many members of the workstream who contributed to this report. Particular thanks are due to Clifford Chance, Linklaters, and Norton Rose Fulbright, who led particular chapters of the report. We hope that this report is a useful contribution to the thinking of government and the regulators as they set out a future vision for the UK financial services industry.

Rachel Kent
Chair UK Regime for Overseas Firms workstream
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FOUR PARTS

In summary, the IRSG believes the UK's regime for overseas firms must focus on the following four areas:

1. THE REGULATORY PERIMETER FOR CROSS-BORDER BUSINESS

2. REGIMES FOR CROSS-BORDER ACCESS

3. REGULATION OF BRANCHES OF OVERSEAS FIRMS

4. EQUIVALENCE-BASED REGIMES

EXECUTIVE SUMMARY

In the financial services sector, an important part of the UK remaining globally competitive will be how easy it is for overseas firms to do business in the UK. This is important not only in terms of overseas firms being able to access UK markets and customers, but also in terms of UK users of financial services being able to access the products and services offered by overseas firms. The aim of this Report is to consider whether the current UK regulatory regime for overseas firms could be improved, with a view to enhancing the UK's global competitiveness.

The UK's regulatory regime is one of the best regarded in the world, as it has consistently evolved as business has evolved, and has been framed by the highest global standards. It is vital that the UK continues to evolve as a global financial centre for the benefit of consumers and in order to support the economic recovery. Now more than ever, the challenges that regulators face are global and must be tackled at a global level.

Since the IRSG started its work on the openness of the UK's regime in mid-2020, there have been a number of consultations issued by government and the regulators and amendments to the UK's regulatory regime, for example via the FS Act. This Report is a follow up the IRSG's Interim Report on the UK Regime for Overseas Firms[1] published in November 2020. This Report attempts to build on the issues raised and make recommendations to the UK government and regulators. Although it touches on issues raised in the various consultations and the HM Treasury call for evidence, it attempts to address questions of the UK's regime in the round and in many places goes beyond the scope of the many consultations. In addition, this Report attempts to tackle 'overlaps' and 'underlaps' between the various mechanisms which should be addressed to ensure a coherent and navigable regime.

1 https://www.irsg.co.uk/resources-and-commentary/interim-report-the-uk-regime-for-overseas-firmsnew-commentary/

The UK has historically followed a relatively open approach to market access. To enhance its global competitiveness in a global environment, and to maximise the benefits to UK markets and UK users of financial services, the IRSG calls for the UK to continue this open approach.

Any changes to the UK regime should incorporate the following objectives:

- openness to cross-border trade;
- appropriate protection for UK users of financial services;
- certainty for market participants and users of financial services;
- supporting the regulators in the furtherance of their statutory objectives;
- transparency; and
- coherence, clarity and ease of understanding.

This Report considers some of the options and competitiveness levers that the UK could avail itself of to remove perceived barriers to overseas firms and make its approach to market access clearer and more coherent. The IRSG underlines the importance of a stable and reliable framework for cross border business and welcomes that this principle was set out in the HMT call for evidence on the overseas framework.

This Report proposes that the UK's openness to international firms should be maintained and only minor changes should be made to the access regimes to ensure that they are clear and coherent, addressing some overlaps between the different mechanisms.

Bilateral trade or regulatory agreements may also facilitate access to the UK for international firms. This Report is not looking into these mechanisms. However, the IRSG believes that having an open non-preferential overseas framework is complementary to UK trade policy and does not undermine it.

This Report analyses the existing regimes and makes recommendations for the UK to consider. This Report considers, in particular:

a. whether any changes need to be made in relation to the UK's regulatory perimeter;

b. on what basis overseas firms, clients and counterparties should be able to access UK markets and UK users of financial services (and for those UK users be able to access overseas firms, clients and counterparties). In particular, the Report considers the following areas of UK law and how they might be improved:

i. the main regimes for accessing UK markets from overseas and related issues;

ii. the rules regarding the establishment of UK branches by overseas firms; and

iii. equivalence-based access regimes.

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THE REGULATORY PERIMETER

There are over sixty distinct regulated activities in the UK. They are subject to different approaches regarding the question of whether they are carried on "in the UK" and each is subject to different exemptions and approaches. In many cases, the regulatory perimeter is unclear and it is not always easy for an overseas firm to determine whether it is regarded as carrying on an activity in the UK in the first place (and therefore whether it may need authorisation in the UK).

The question of whether an activity is carried on "in the UK" is not as straightforward as it might sound. Where an overseas firm is providing a service or entering into a transaction with a UK-based customer, some elements of the service/transaction might happen in the UK and other parts might not. As technology advances and parties become more sophisticated in the means through which they do business, the question of where activities are carried on can become even more complex.

A further barrier that overseas firms face when doing business in the UK is the "financial promotion restriction" This restriction applies even if the person in question is not regarded as carrying on a regulated activity in the UK, and so can act as a barrier to overseas persons wishing to do business with UK customers and counterparties.

However in many cases, the UK takes a different – and significantly more open – approach to other jurisdictions – and typically, that means that the UK would not require an overseas firm to apply for authorisation where other jurisdictions would require that in an equivalent situation (e.g. in relation to insurance, deposit-taking, portfolio management and payment services). However, even where the UK takes such an approach and allows access more readily than other jurisdictions, that may not always be obvious to overseas firms and the overseas firms may not appreciate the opportunities available to them.

Therefore if the UK intends to rationalise its rules relating to the ability of overseas firms to do business in the UK, a sensible first step would be to look at the regulatory perimeter afresh and consider whether it has the balance right. Regardless of whether the regulatory perimeter needs to be changed, this would also be a good opportunity for the UK to make the perimeter clearer.

Any analysis of the current position should include the situation where overseas firms operate through representatives in the UK, and should consider whether the perimeter is appropriately drawn for them.

If the UK is revisiting questions regarding the regulatory perimeter, it should also consider whether the FPO exemptions need updating as well – for example, to consider whether there is scope to allow a wider range of financial promotions to be made into the UK by overseas firms who are not authorised in the UK.

THE OPE

The most well-known element of the UK's overseas framework is the Overseas Person Exclusion (OPE) which provides considerably more legal certainty and level of access to overseas firms than the regimes found in many other jurisdictions. Within the industry, the OPE is widely perceived as a major contributing factor to the success of the UK wholesale financial services sector. It enables a wide range of end users to access the services of overseas firms and enables UK firms to provide services to overseas clients and to deal

"In many cases, the UK takes a different – and significantly more open – approach to other jurisdictions."

with overseas counterparties without those clients or counterparties themselves requiring authorisation in the UK. In the long term, this open approach often results in international firms establishing a permanent presence in the UK as the volume of U.K. business they conduct grows.

However, the rules around the OPE are complex and the report illustrates practical difficulties firms face when interpreting them including the definitions of 'place of business', working with an agent or 'maintaining' a place of business. Similarly, digitisation presents new complexities which were not foreseen when the OPE was designed. In addition, there are limits to the use of the OPE which the report highlights, such as the non-availability of the OPE for non-UK Central Counterparties (CCPs) or non-UK Central Securities Depositaries (CSDs) which are subject to an equivalence decision. Most importantly the OPE will be disapplied in favour of MiFID Article 47 where an equivalence determination has been made which will result in a more restrictive access and more onerous requirements.

The OPE is a valuable part of the UK's overseas framework and should be maintained and potentially expanded in limited ways. The report recommends that the OPE also applies to 'investment professionals' and 'high net worth entities' (including with authorised persons acting on behalf of underlying clients) as well as extending the OPE in respect of consumer credit activities and home finance activities.

Any changes to the rules should focus on clarification such as its interaction with the Regulated Activities Order (RAO) and the Financial Promotion Order (FPO). Most importantly and in line with the report's call for regulatory openness, this report recommends to disapply overlapping measures which offer a more limited access to the UK than available through the OPE. Specifically, to disapply the provisions of MiFID (Article 47) in favour of the OPE or provide the optionality for CCPs and CSDs under EMIR (Article 25)

THE RECOGNISED OVERSEAS INVESTMENT EXCHANGE

For overseas investment exchanges, the UK operates an exemption regime whereby overseas investment exchanges may obtain "recognition" and qualify as Recognised Overseas Investment Exchanges (ROIEs) to operate in the UK as "exempt persons". The ROIE is a key element in the UK overseas framework as it enables UK market participants to access international trading markets and a broader range of trading opportunities in securities and risk management products. While primarily resting on deference to the home state authority for supervision, the robust registration process and ongoing reporting requirements provide means that the ROIE regime strikes an appropriate balance between facilitating cross-border business flows while ensuring a high-level of regulation. In addition, the FCA retains a range of powers with regards to ROIE activities, including the ability to issue directions and to withdraw recognition, if the ROIE is failing to comply with its obligations.

The existing ROIE regime as a parallel mechanism to the OPE provides a robust regime that allows UK firms to participate in foreign venues. This is because third country venues can rely on the OPE or on the ROIE regime depending on their specific business models.

It would be helpful to clarify legislation that the ROIE regime is available to any type of overseas trading venue operator (including trading venue operators that operate solely venues that qualify as MTFs or OTFs in the UK).

"The OPE will be disapplied in favour of MiFID Article 47 where an equivalence determination has been made which will result in a more restrictive access and more onerous requirements."

REGULATION OF BRANCHES OF OVERSEAS FIRMS

Usually, if an overseas firm wishes to carry on regulated activities from a place of business in the UK that firm will need to set up a subsidiary in the UK and apply to have that subsidiary authorised by the PRA or FCA. However, there are circumstances in which the UK regulators will allow an overseas firm to set up a branch office (i.e. without creating a separate legal entity) and apply for authorisation. This approach can be beneficial to the overseas firm, in that it may be able to use resources (both financial and otherwise) from its home country to satisfy the UK regulatory requirements and can support the attractiveness of the UK as a place to do business.

The legislative framework itself does not provide a determined, structured approach by which either the PRA or FCA should accommodate the particularities of branches and their home state legal entities in connection with the assessments to be made at authorisation. Therefore, the UK regulators have established approaches to the authorisation of branches of international financial institutions to conduct business in the UK. The PRA, together with the FCA, is responsible for the authorisation of deposit-taking and insurance (save for distribution) in respect of prudential and conduct matters, with the FCA being solely responsible for the authorisation of firms carrying on the balance of regulated activities by way of business in the UK. Both the PRA and FCA have recently consulted on their approach to overseas firms and the IRSG contributed industry views to both.

The approach of the regulators to branches of international firms can be described as a form of 'deference' to the home state's regimes and relies on supervisory co-operation. Although there is no formal equivalence regime for branches, regulators use the term 'equivalence assessments'. Equivalence assessments of branches is a dynamic concept and is based on the nature of the firm's activities and the risk presented by the branch but should be noted that this assessment is different to the process described in the final chapter of this report. Therefore, the judgement to authorise a branch or require the branch to subsidiarise is a sliding scale based on the balance of risk and the extent of supervisory co-operation. Consequently, it would be valuable to provide clarity and guidance to international firms on the application of the UK regulatory requirements. In addition, there are elements of the PRA and FCA rulebooks that could be made clearer, for example in relation to conduct of business requirements, market integrity obligations and capital requirements calculations for insurance branches.

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The Working Group has identified four discrete areas where the regulatory regime for UK branches could be improved. They are:

a. a clearer and more transparent framework relating to the approach of UK regulators to the division of responsibility between home state supervisory authorities, and the UK regulatory authority/ies (i.e. the scope of "deference");

b. establishing a process which the UK regulator(s) should adopt when making assessments of the home state legal, regulatory and supervisory regimes which may be set out in statute, or may be achieved through other means;

c. amending the UK regulators' "have regard to" factors to introduce a requirement that they "have regard to" the attractiveness of the UK as an inward investment destination, innovation and applicable international standards; and

d. simplifying and improving the navigability of the regulatory requirements applicable to UK branches of banks, investment firms, payment service providers and other firms providing services to UK consumers or retail clients (e.g. non-bank consumer credit lenders etc.).

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THE UK EQUIVALENCE FRAMEWORK

In preparing this Report, the IRSG has not attempted to assess if or how the UK's future relationship with the EU might be affected by whatever the UK decides to do in relation to its own equivalence regime. The question of equivalence has been approached on the basis that the UK is developing a regime of its own without any such constraints. These issues may need to be taken into account by policy makers at the relevant time. Therefore this report approached the question of equivalence regimes by asking: Regardless of the relationship with the EU, should equivalence-based regimes be a part of the UK's arrangements for market access, and if so, what should they look like?

The IRSG has long advocated that a policy of mutual regulatory "deference" is central to well-functioning cross-border regulatory regimes. Using an approach of mutual deference between the UK regulators and the home country regulators of an overseas firm can allow the UK to avoid imposing conflicting, inconsistent or duplicative requirements on overseas firms who wish to do business in the UK. Mutual deference reduces financial stability risk and market fragmentation.

It is easy to fixate on the terminology used to describe the arrangement. Equivalence is itself arguably a form of deference, but deference could also be construed to mean something less prescriptive than equivalence (particularly when considered against the EU's approach to the concept of equivalence). The November HMT 2020 guidance stated that equivalence is a form of regulatory deference. Regardless of what name is used to describe the assessment that would be made, the critical issue is to define what that test will be. The UK should follow a genuinely outcomes-based

"The UK should follow a genuinely outcomes-based approach, which focusses on delivering comparable outcomes rather than strictly 'equivalent' outcomes."

approach, which focusses on delivering comparable outcomes rather than strictly "equivalent" outcomes (in the sense used in the EU's TCRs). Different jurisdictions will naturally have different requirements for a number of reasons, including legal regime, market structure, and trading practices. The test needs to be flexible enough to allow this.

Any decisions on deference should take into account any appropriate international standards – including the Basel Standards, the FSB Principles, certain IOSCO standards, the FATF Recommendations and the Insurance Core Principles of the International Association of Insurance Supervisors. The Working Group also considers that there are likely to be benefits in following global standards and in proactively helping to shape those standards, and so we have assumed that, as a policy matter, the approach for the UK regime should be consistent with global standards where they exist and where that is appropriate for the UK market.

The IRSG had previously identified concerns about shortcomings in the EU's third county regimes which have now been onshored into UK legislation. These include granular assessments of the rules of the home authorities, lack of procedural protections and lack of predictability in case of withdrawal of equivalence. However the IRSG has noted that the HM Treasury Guidance acknowledges these concerns and has set out the principles that the UK intends to follow in relation to its equivalence framework.

Going forward, there are policy questions that the UK will need to address including reciprocity and potentially extending the scope of the UK's equivalence framework to other areas of financial services. The IRSG's guiding principle is that regulatory openness serves the competitiveness of the UK. In most cases there should be a presumption of openness even if access is not granted in return as that would benefit UK firms who wish to do business internationally. Each case for extending the scope of equivalence should be looked at on a case by case basis based on a proper analysis of whether it is likely to be beneficial to extend the regime into a new area of financial services.

The UK's equivalence framework should take into consideration other parts of the UK's overseas regime and address overlaps. In particular the UK's equivalence framework should not impose a more onerous treatment of international firms than would otherwise be the case. The example of the onshored MiFIR Art47 which effectively 'trumps' the OPE illustrates a potential narrowing of access as a consequence of the overlap.

Finally, consideration of the overseas framework should be viewed as part of a wider review of the UK's regulatory competitiveness. It will be necessary to assess how the various access mechanisms including the FCA and PRA's treatment of international firms work together with the UK equivalence regime. Therefore, the appropriateness of the UK equivalence framework should be reviewed in three years in light of the approach taken by HMT and its impact on the functioning of the overall overseas framework.

"Consideration of the overseas framework should be viewed as part of a wider review of the UK's regulatory competitiveness. It will be necessary to assess how the various access mechanisms including the FCA and PRA's treatment of international firms work together with the UK equivalence regime."

SUMMARY

The UK has historically followed a relatively open approach to market access.To enhance its competitiveness in a global environment, and to maximise the benefits to UK markets and UK users of financial services, the UK needs to continue this open approach. We recommend the following:

- The UK should take the opportunity now to make its approach to access its market clearer and more coherent, in order to remove perceived barriers to overseas firms.

- The UK regulatory perimeter is not as clear as it could be. New guidance should be issued in order to allow overseas firms to understand what services they can provide to UK users of financial services, either with or without authorisation in the UK. Consideration should also be given to updating the Financial Promotion Order (FPO) and broadening its scope to allow a wider range of financial promotions to be made.

- Regimes such as the overseas persons exclusion (OPE) and the exemption available to Recognised Overseas Investment Exchanges are valuable elements of the UK's regulatory perimeter which, in our view, should remain in place with minimal changes. However, there is some scope to rationalise the OPE and make it clearer. Any such improvement should not in any way restrict the OPE at least in relation to wholesale business.

- The regime for overseas firms to establish regulated branches in the UK should be updated to include, in particular:

  — a clearer framework, particularly with regard to the scope of "deference" to the home supervisor of the overseas firms);

  — establishing better processes through which applications will be considered;

  — amending the factors for authorisation to introduce a requirement that the UK regulators 'have regard to' the attractiveness of the UK as an inward investment destination, innovation and applicable international standards; and

  — simplifying and improving the navigability of the regulatory requirements applicable to UK branches.

- As regards cross-border access for overseas firms not covered by the mechanisms described above, the UK should continue to have an equivalence-style regime, but:

  — it should be based on an outcomes-based test (such as the concept of "deference") rather than an EU-style detailed analysis of equivalence;

  — it should have procedural protections in place, to provide additional certainty to third country firms and to the market generally;

  — if it is to be extended into new areas of financial services, this should be done only following proper analysis of the potential benefits this could bring; and

  — the equivalence-style regimes should not take precedence over other means of access – and, in particular, the existing situation in which firms that are within the scope of an equivalence-based regime are unable to rely on the OPR should be changed.

The IRSG wishes to thank the members of the workstream which have overseen the production of the Report. Please note that this Report should not be taken as representing the view of any individual firm which took part in the discussions:

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With an overall goal of promoting sustainable economic growth, the IRSG seeks to identify opportunities for engagement with governments, regulators and European and international institutions to advocate for an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing views.

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