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Hogan Lovells

THE UK REGIME FOR OVERSEAS FIRMS

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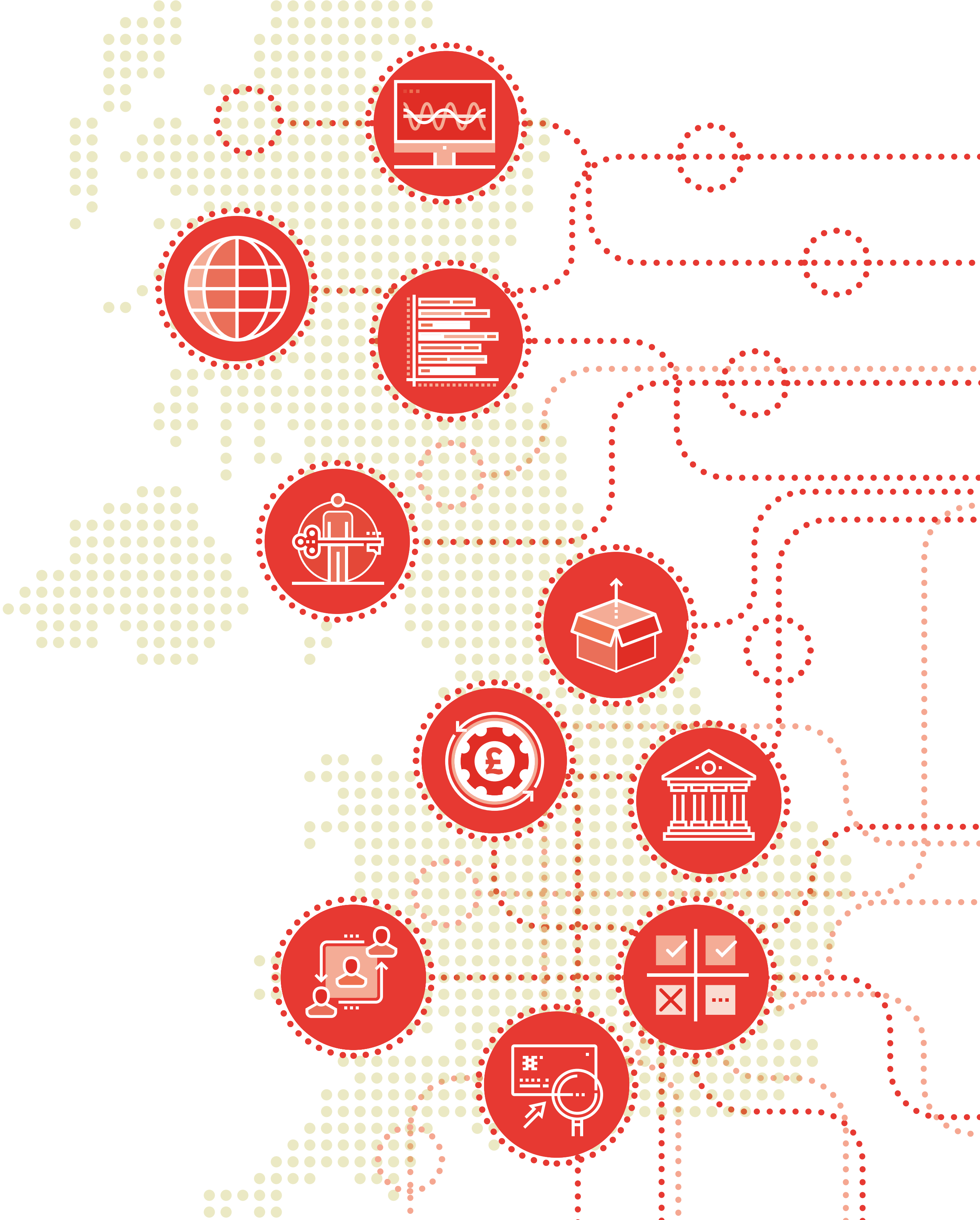

INTRODUCTION

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
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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.

"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."

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.

“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.”

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.).

"The IRSG has long advocated that a policy of mutual regulatory "deference" is central to well-functioning cross-border regulatory regimes."

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.

1. THE REGULATORY PERIMETER FOR CROSS-BORDER BUSINESS

SUMMARY OF RECOMMENDATIONS

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.

CURRENT POSITION

The keystone of the UK financial services is the so-called "general prohibition" in the Financial Services and Markets Act 2000 (FSMA), which says that no person may carry on a regulated activity in the UK, or purport to do so, unless that person is an authorised person (i.e. authorised by the PRA or FCA) or an exempt person.

The general prohibition applies where the person is carrying on the regulated activity "in the UK". In producing this Report, one of the themes that emerged from the Working Group was a concern that the regulatory perimeter for cross-border business is not always clear – in that it is not always easy for an overseas firm to determine whether it is regarded as carrying on an activity <u>in</u> 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. In some cases, there may be clear guidance on whether an activity is regarding as taking place in the UK (e.g. for investment advice and insurance distribution).

But in other cases the position may be more complex – for example:

a. If a UK customer places money on deposit with a bank in Australia, is the regulated activity of "accepting deposits" being carried on in Australia or the UK? The money would be paid to an institution in Australia but the customer would receive repayment in the UK.

b. If a financial adviser based in Australia provides investment management services to a UK-based customer, is the regulated activity of "managing investments" taking place where the adviser is located, where the customer is located, or in both places?

c. If a firm in Australia wishes to enter into a derivatives contract with a UK counterparty, is the Australian firm carrying on the activity of "dealing" in the UK as well as in Australia?

In addition, 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.

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There are over sixty distinct regulated activities. 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. For example:

a. In some cases, there is no express guidance at all on whether the activity is carried on in the UK in the first place. For example, if a firm wanted to carry out the regulated activities of "dealing" or "arranging deals" in relation to securities, there is no express guidance from the FCA.

b. In some cases, the guidance can be obscure or difficult to find. For example, in relation to the question of where the activity of "accepting deposits" is carried on, industry practitioners still have regard to guidance that was issued by the former Financial Services Authority (FSA) in relation to the Banking Act 1987. They would also have to have regard to a 2011 paper published by HM Treasury responding to issues raised by Swiss banks. Another example is the guidance on when overseas firms are required to register with HMRC under the UK anti-money laundering legislation, where the relevant guidance is found in a 2007 FSA paper only available in the national archive.

c. In some cases, the rules involve distinctions that are difficult to justify. For example, in relation to the activity of "dealing" in contracts of insurance, the question of whether an overseas firm is regarded as carrying on the activity in the UK can differ according to the mode of communication used.

d. The rules can involve concepts which are difficult to understand. For example, a person can be required to have FCA authorisation as a result of "agreeing" in the UK to carry on a regulated activity for the client outside the UK. A person may not be clear about when they would be regarded as carrying on the activity of "agreeing" in the UK.

e. In many cases, the UK takes a different 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.

f. The UK regime also contains complex "deeming" provisions in section 418 of the Financial Services and Markets Act 2000, in which a person who would not otherwise be regarded as carrying on an activity in the UK is nevertheless to be regarded as carrying on that activity in the UK (and therefore needing authorisation in the UK) in certain situations. For example, if a firm which has its registered office in the UK carries on activities from a location outside the UK but the day-to-day management of those activities takes place in the UK, the firm will be deemed to be doing those activities in the UK.

"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."

RECOMMENDATIONS

- 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.

- A further barrier that overseas firms face when doing business in the UK is the "financial promotion restriction" – which provides, in summary, that a person can only solicit business from UK customers and counterparties if that person is authorised by the PRA or FCA, the communication is approved by a person that is authorised by the PRA or FCA or the communication comes within one of the exemptions in the FSMA (Financial Promotion) Order 2005 (FPO). 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.

- The exemptions contained in the FPO allow certain kinds of communications to be made to UK customers and counterparties without the communicator needing authorisation in the UK. These exemptions apply to certain types of activity (e.g. deposit taking and insurance, where less onerous rules apply) and to promotions to certain types of customer or counterparty who are not considered to require the same degree of protection (e.g. for securities and derivatives business, many institutional investors).

- 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. It is also worth noting that some elements of market access – in particular, via the overseas persons exclusion referred to in Part 2 below – depend on whether the person in question can avoid breaching the financial promotion restriction. It is therefore appropriate to consider the financial promotion restriction as part of the question of how overseas firms can access the UK.

2. REGIMES FOR CROSS-BORDER ACCESS

SUMMARY OF RECOMMENDATIONS

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.

CURRENT POSITION

In addition to the relatively liberal approach that the UK takes in relation to whether an activity is done in the UK in the first place (as discussed in Part 1), the UK also has the overseas persons exclusion (OPE), which allows an overseas person (see paragraph 2(a) below) to carry on certain regulated activities in the UK without needing UK authorisation. 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" for the purposes of FSMA.

The main features of the OPE are as follows:

a. The OPE is an exclusion, as such its effect is that a person who benefits from it is deemed not to be carrying on regulated activities at all. No UK regulatory requirements apply to excluded activities.

b. It applies for the benefit of an "overseas person" – that is, a person who carries out certain types of activity that are regulated in the UK, but does not do so (or offer to do so) from a permanent place of business maintained by it in the UK.

c. The OPE only applies in relation to certain types of regulated activity. It covers most types of securities and derivatives business and insurance distribution but not, for example, the regulated activities of accepting deposits or effecting or carrying out insurance contracts (although those activities may be regarded as being performed outside the territorial scope of the UK's perimeter in certain circumstances) .

d. It only applies insofar as the regulated activities in question would be considered to be carried on in the UK in the first place – see Part 1. Certain regulated activities, such as portfolio management, would not be regarded as being generally carried on in the UK if they were carried on by an overseas person – which means an overseas firm would not need to use the OPE for those activities, although an overseas person may need to rely on the OPE if it agrees in the UK to provide portfolio management services even if those services are to be provided outside the UK.

e. In most cases, the ability of the overseas person to rely on the exclusion depends on whether that person is transacting with entities that fall within FPO exemptions (such as UK authorised persons, other "investment professionals" or "high net worth entities"). In practice, this means that the exclusion is mostly limited to wholesale business rather than for business with retail customers.

f. Overseas firms that can rely on the OPE do not need authorisation in the UK, and they are not required to notify the UK regulators that they are doing so.

g. Overseas firms that can rely on the OPE are only subject to a limited range of rules when conducting business with UK persons. They are not, for example, subject to the FCA's rules on conduct, record-keeping, transparency, transaction reporting and trading that would apply to a regulated firm.

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h. Overseas firms that are within the scope of the "on-shored" equivalence regime under Article 46 MiFIR cannot rely on the OPE. Firms from jurisdictions determined to be equivalent under the on-shored Article 46 MiFIR would be subject to more restrictions than overseas firms that rely on the OPE would be, because: (i) firms from those jurisdictions could only rely on the on-shored equivalence regime where they are authorised and supervised in the relevant jurisdiction; (ii) those firms would have to be registered with the FCA before they can make use of the regime; and (iii) those firms would have to comply with certain conduct obligations when dealing with UK clients and counterparties (disclosing their regulatory status and offering to submit any disputes to settlement in a UK forum). Overseas persons that can rely on the OPE are not subject to these requirements.

The main features of the ROIE regime are as follows:

a. The ROIE regime allows overseas exchanges to be recognised, and thereby exempt from the general prohibition in respect of any activities which form part of the exchange's business as an investment exchange.

b. ROIEs are granted this status through a recognition order by the FCA deriving from section 295 of FSMA.

c. Unlike the OPE, this regime operates on the basis of an exemption meaning that from a regulatory perspective regulated activities are being performed. The person performing them does not have to obtain an authorisation.

d. The ROIE regime is not only available to overseas investment exchange who do not operate places of business in the UK. It is possible to obtain recognition as an overseas investment exchange and operate a place of business in the UK.

e. The regime requires ROIEs to continuously meet the recognition requirements which essentially impose a high-level of supervisory control which includes reporting requirements and certain standards of client protection.

The OPE 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 financial services sector. It enables UK-based firms, institutional investors and large corporates readily to access the services of overseas firms and enables UK firms to provide services to overseas clients and to deal with overseas counterparties without those clients or counterparties themselves requiring authorisation in the UK. The range of firms relying on the OPE include overseas based broker dealers and banks operating in the wholesale space but overseas established private banks are also known to rely on the OPE in respect of some of the securities trading services they may provide to high net worth individuals.

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The position is more complex where an overseas firm is authorised in the UK and has a branch here but also conducts cross-border activities with UK persons from offices outside the UK or where it uses that UK branch to arrange transactions that are booked in non-UK offices. The firm may have to determine the extent to which UK conduct or other rules to which the firm is subject as an authorised person apply to those activities by performing a careful assessment of the entire rulebook applicable to it. For example, there are specific exemptions from the UK conduct of business rules for activities that would have fallen within the OPE if those non-UK offices were separate legal entities and certain other rules in the FCA handbook apply only in respect of activities performed from an establishment in the UK. However, some rules may apply to the entity as a whole while in other cases the territorial application is not entirely clear.

Overseas firms may also face added complexities where they conduct cross-border business with UK clients and counterparties if their representatives make temporary visits to the UK or they use agents or intermediaries in the UK. They may have to determine whether their activities in the UK are carried on from a place of business maintained by them in the UK (which can be a source of uncertainty in itself), whether any activities of their representatives during their UK visits themselves amount to regulated activities (such as arranging deals in investments) which fall outside the OPE and whether any agents or intermediaries are appropriately authorised in the UK and the extent of the overseas firm's responsibility for any failures of compliance by those agents or intermediaries.

To illustrate some of the practical difficulties firms face when interpreting the OPE we set out certain sample scenarios below:

a. What amounts to a place of business in the UK and what amounts to maintaining it?

As noted above, an overseas person carries on out certain types of activity that are regulated in the UK, but does not do so (or offer to do so) from a permanent place of business maintained by it in the UK.

Issues can arise regarding the meaning of "place of business" as electronic trading has become more prevalent. For example, it is not clear from the wording in the RAO or any other legal provision that the maintenance of a server in the UK would not constitute a place of business. The fact that clients might be able to obtain regulated services through the server could be taken to suggest that the server itself is a place of business. Market practice takes the view that the UK-based server would simply be a means of inputting instructions that are routed to overseas trading arrangements or sales staff for execution/ interaction. However, it may be necessary to clarify that the location of technology does not determine a place of business. Instead it is necessary to focus on whether or not staff or individuals operate from a place of business maintained in the UK.

Another difficult question concerns circumstances where an overseas persons relies on UK agents to transact for them. This may arise in the context of large groups where an affiliate of an overseas firm is tasked to carry on certain activities from the UK. In this context, the issue turns on whether a place of business is "maintained" by the overseas person in the UK. The word maintaining seems likely to encompass making arrangements to keep some type of office

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space. So, whilst an overseas principal's business can undoubtedly be carried on in the UK through a UK agent with delegated authority, the UK agent may have other strands to its business and, by any ordinary understanding of the term "maintained", be regarded as the person who is maintaining the place of business for the purpose of providing services including those of an agent to the overseas principal. In other words, in some cases all the overseas principal is maintaining is the agency agreement/relationship. It would be helpful to obtain clarity in this respect.

b. Arranging transactions in investments

As set out above, the OPE is relied on in the context of sales and trading of specified investments. In that context, a firm that deals (as principal or as agent) may conclude transactions (1) with authorised persons (or exempt persons) in the UK or (2) transactions with any person as long as the transaction is the result of a legitimate approach. In contrast, in respect of arranging activities in Article 25 RAO the OPE is only available in respect of arrangements made by the overseas person with an authorised person (or exempt person). The result is that an overseas intermediating broker who receives and transmits orders (and is not party to transactions) must rely on the argument that any arrangements are not carried out in the UK which unavoidably creates a level of legal uncertainty. The consequence of this issue is also illustrated in the example at paragraph (e) below.

c. Home finance activities and consumer credit

The OPE includes a limited exclusion in the context of home finance activities (e.g. the provision of regulated mortgages, regulated home reversion plans, regulated home purchase plans etc.). For these activities, the OPE is generally limited to "qualifying agreements" – i.e. agreements entered with a client who was not normally resident in the UK when entering into them.

The existing exclusion is beneficial particularly for overseas finance providers whose client moves to the UK as the exclusion would allow the continued servicing of the financing arrangements even though the borrower now has a UK address.

However, mortgage contracts entered into after 31 December 2020 would only be treated as regulated mortgage products where they are secured by land in the UK and the other conditions are met. Lending secured on land outside the UK will generally be treated as a consumer credit activity. Therefore, the exclusion will no longer benefit a non-UK lender that, after that date, lends money secured on non-UK property if the borrower subsequently moves to the UK. In addition, the existing regime makes it difficult for a UK resident to obtain mortgage finance in order to buy property outside of the UK. A non-UK lender risks being treated as engaging in regulated consumer credit activities in the UK if it makes such a mortgage loan to a UK resident. However, UK lenders may also not wish to provide a UK resident with a mortgages on land outside of the UK because they do not wish to engage in consumer credit activities.

"The existing exclusion is beneficial particularly for overseas finance providers whose client moves to the UK as the exclusion would allow the continued servicing of the financing arrangements even though the borrower now has a UK address."

In respect of consumer credit activities more generally, when the responsibilities for consumer credit were transferred to the FCA, the regulatory perimeter for consumer credit activities was not expanded to benefit from the OPE. However, many overseas finance providers typically also provide products that in the UK may qualify as consumer credit agreements. This creates particular difficulties for overseas providers as the exclusion is only available for some of their services for the particular client. By way of illustration, an overseas bank may be able to accept deposits from a UK resident on the basis of a territorial scope analysis of the activity. However, where any resulting account also includes overdrafts or any other type of credit it is not entirely clear whether this activity is deemed to be provided in the UK. This creates practical issues for UK residents that may need to access banking products or services outside the UK to make ordinary transactions such as local payments.

d. Participation of non-authorised UK entities on an overseas trading venue as a direct member of that venue

It is currently unclear when the operator of a non-UK trading venue can admit UK non-authorised persons as direct participants on the venue without the operator of such venue being regarded as performing the regulated activity of operating an MTF under Article 25D RAO in the UK (particularly where the non-UK venue brings together multiple trading interests but does not act as counterparty to any transactions). For example, UK based corporate group treasury entities may wish to become direct participants on overseas venues in order to enter into hedging transactions. Similarly, UK companies active in the energy or commodities markets may wish to become direct participants on non-UK venues in order to trade for own account on those venues in the ordinary course of their business, this is because it may not always or practical for such UK companies to trade on the non-UK venue through brokers. Any arrangements by the venue operators with authorised firms in UK benefit from Article 72(3) and (4) RAO and so are excluded from constitution the operation of an MTF in the UK. However, this exclusion is not available in respect of non-authorised UK participants. While it may be possible to argue that a venue which operates entirely outside of the UK is not carrying on any arranging or operating activities in the UK, there may be facts or circumstances that make this argument more difficult to sustain in some cases.

Direct participation on a non-UK trading venue may also trigger authorisation requirements for a UK entity. For example, a non-authorised UK entity that trades in derivatives as a direct participant on a non-UK trading venue would have to be satisfied that all its counterparties on the venue are either non-UK persons whose activities are of a kind described in Article 16(1)(b) RAO or UK authorised or exempt persons covered by Article 16(1)(a) RAO. This may not be practicable in all types of venues.

Non-UK venues can address these issues by obtaining recognition as an ROIE. ROIE status also permits the non-UK venue to operate in the UK through a local presence and gives it greater flexibility to market its business to a wider class of users because of the exemption available under the financial promotions regime. As such, the ROIE regime is a valuable mechanism which 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-

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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. It is clear that non-UK investment exchanges who in addition to operating markets that would qualify as regulated markets in the UK are permitted to rely on the ROIE regime to operate other multilateral systems (including those that would qualify as MTFs or OTFs). However, the availability of the ROIE regime for non-UK investment firms that only operate an MTF or an OTF is more complex. There is no provision that specifically prevents a non-UK firm which operates a trading venue that would qualify as an MTF or OTF from applying for recognition under sections 287 and 292 of FSMA (the operative provisions of the ROIE regime). However, the point is not entirely free from doubt when considering the relevant recognition requirements and in particular SI 2001 N0.995. 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).

In conclusion, subject to clarifications to address the issues explained above, 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.

e. Non-availability of the OPE for other market infrastructure

The main provisions of the OPE are generally not available for non-UK Central Counterparties (CCPs) as a result of paragraph 9 of Article 72 RAO. Article 25 of UK EMIR requires non-UK CCPs to obtain recognition in the UK if they wish to admit UK clearing members and to provide clearing services to UK venues. Recognition also means that the CCP is exempt from the general prohibition, is an eligible clearing venue for counterparties subject to the clearing obligation under UK EMIR, benefits from insolvency protections under Part 7 of the Companies Act 1989 and is treated as a 'QCCP' for regulatory capital purposes for UK institutions subject to the UK Capital Requirements Regulation.

All CCPs seeking recognition must meet the full conditions for recognition set out in Article 25 of UK EMIR, including an equivalence determination, the existence of a memorandum of understanding between the Bank of England and local regulators and assessment for systemic importance (and ongoing requirements), even if the CCP does not want or need all the benefits consequential on recognition. For example, non-UK CCPs need to seek recognition in the UK to provide clearing services to local branches of UK firms, even if the CCP does not intend to provide clearing services to clearing members in the UK or to UK trading venues or to clear products subject to the UK clearing obligation. Similarly, non-UK CCPs may in practice need to seek recognition in the UK in order to obtain QCCP status (because local consolidated subsidiaries of UK institutions are clearing members of the CCP or because UK institutions indirectly clear transactions on the CCP), even though the CCP does not wish to provide services to UK clearing members or trading venues or to clear products subject to the UK clearing obligation. In our view, there is a case for allowing non-UK CCPs to rely on the OPE in the same way as other firms, while creating a differentiated regime which enables non-UK CCPs to seek recognition for specific purposes, subject to conditions and review appropriate to the status that they are seeking, as an alternative to full recognition under Article 25 UK EMIR.

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A similar issue arises in respect of non-UK Central Securities Depositaries (CSDs). Under existing transitional provisions, non-UK CSDs can rely on the OPE unless and until an equivalence decision is made in respect of its home state by HM Treasury, after which part of the the OPE will cease to be available as a result of Article 72(9A) RAO if the CSD provides services of the kind for which recognition is required under the UK Central Securities Depositories Regulation (UK CSDR). Non-UK CCPs can also seek recognised overseas clearing house (RCOH) status although there are no existing RCOHs.

> **"In our view, there is a case for simplifying the current regime by removing the requirement for recognition of non-UK CSDs."**

In our view, there is a case for simplifying the current regime by removing the requirement for recognition of non-UK CSDs. It is not clear that there is a compelling policy justification for the provisions of Article 25 of UK CSDR seeking to restrict the ability of non-UK CSDs to clear instruments governed by UK law, given that this may restrict the ability of UK issuers to list their shares outside the UK and the use of English law for international securities. In any event, the current regime only applies to CSDs from jurisdictions the subject of an equivalence decision, meaning that CSDs from equivalent jurisdictions are subject to more burdensome requirements, while other non-UK CSDs are able to continue to provide the specified services without restriction.

This change would restore the previous regime under which non-UK CSDs can fully rely on the OPE, so long as they do not operate through an establishment in the UK, or seek RCOH status if they wish to obtain the benefits of exempt status in the UK.

It is important that the UK regime has practical and clear arrangements for non-UK market infrastructure as this makes it easier for UK-based firms to operate on international markets.

RECOMMENDATIONS

- The OPE and ROIE are in their current form considered to be a valuable asset in the competitiveness of the UK financial services sector. There is a strong case for retaining the ROIE in its current form. Similarly, we are of the strong view that the OPE should be retained (including so that both regimes remain available to overseas trading venues). Generally, our recommendations are focused on reducing the complexity of the OPE allowing overseas firms to navigate it with a higher degree of legal certainty and at the same time allowing UK firms to transact with their overseas partners or service providers without unnecessary friction.

- In our view, the route of access to the UK market provided by the OPE is adequate and furthers UK firm's access to international services as well as permits international firms to service UK firms. However, to enhance predictability and legal certainty we would welcome clarifications (or confirmations of the current market views) around:

  a. the interaction of the overseas persons definition for financial services groups who may provide cross-border services in combination with UK affiliates; and

  b. alignment of the scope of the OPE for arranging activities and dealing activities. As mentioned above, the activity of "arranging deals in investments" is only explicitly covered by the OPE if the deal is arranged with a UK-authorised person (and so would not apply if the party to the deal was a sophisticated investor but not authorised).

- Additionally, it would improve the navigability of the OPE if the RAO were amended to include:

  a. an additional specific exemption making clear that the OPE applies where an overseas firm carries on the regulated activities covered by the OPE with or for authorised persons, other 'investment professionals' and 'high net worth entities' (including with authorised persons acting on behalf of underlying clients). This would also lead to a more uniform approach towards the activities of overseas persons, as the tests are currently different for the different activities; and

  b. extending the OPE in respect of consumer credit activities and home finance activities.

- It would also be possible to better align the scope of the OPE and the FPO with the domestic investor protection regime by extending the exemptions in the FPO to cover financial promotions to counterparties and clients that are categorised as 'eligible counterparties' and 'per se professional clients' under the FCA rulebook (thus expanding the scope of the OPE to cover regulated activities with these counterparties and clients to the extent that they are not already authorised persons, other 'investment professionals' or 'high net worth entities').

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"Our recommendations are focused on reducing the complexity of the OPE allowing overseas firms to navigate it with a higher degree of legal certainty and at the same time allowing UK firms to transact with their overseas partners or service providers without unnecessary friction."

- In respect of trading venues, in our view, the existing position which allows the ROIE regime to complement the use of the OPE by foreign trading venues creates a robust access framework. As mentioned above, reliance on the OPE and more importantly, legal certainty for UK firms when accessing overseas trading venues could be improved by clarifying that the scope of the OPE and in particular extending exclusions in Article 16 RAO to participation on foreign trading venues. Additionally, it would be a welcome clarification that the ROIE regime is available to any type of foreign trading venue (including those that qualify as MTFs or OTFs), although we note that this has been accepted in practice by the FCA.

- We would welcome simplification and clarification of the treatment of non-UK CCPs and CSDs to facilitate the access of UK-based firms to international markets.

- We have already seen that the OPE is disapplied in relation to MiFID activities insofar as a firm that might seek to rely on the OPE is from a third country that has been the subject of an equivalence determination more than three years previously. This means that overseas firms from such countries are in a worse position than overseas firms from other countries where no such determination has been made, even though the former are likely to be subject to more similar regulation to the UK that the latter. In order to redress this balance, the UK should consider removing the rule that disapplies the OPE and allowing all overseas firms to rely on the OPE in the same way even if an equivalence determination has been made in respect of their home state. We are of the view that the existing equivalence regime should not prejudice the ability of overseas firms to rely on the OPE.

- In addition, insofar as the UK decides to make equivalence determinations the basis of access in areas of financial services where they are not currently used (see Part 4 of this Report), the UK should ensure that such a regime does not encroach upon the areas covered by the OPE. Such regimes should only apply insofar as the OPE does not apply.

"In respect of trading venues, in our view, the existing position which allows the ROIE regime to complement the use of the OPE by foreign trading venues creates a robust access framework."

3. REGULATION OF BRANCHES OF OVERSEAS FIRMS

SUMMARY OF RECOMMENDATIONS

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.

THE CURRENT POSITION REGARDING THE REGULATION OF THIRD COUNTRY BRANCHES

The starting point is that 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.

As described below, the PRA has a relatively developed approach to the regulation (by which we mean authorisation, and ongoing supervision) of UK branches of international banks and insurers. From the perspective of market participants, the FCA's approach to the regulation of branches which do not conduct deposit-taking or insurance business has been less formalised. That position is changing, and the FCA and PRA have recently consulted on their overall approach to the regulation of branches of international banks.

This Part is structured as follows: it begins with an overview of the PRA's and FCA's approaches to the regulation of UK branches within their respective areas. This overview includes some targeted observations on the current consultation texts referred to above. This first section is followed by comments on possible areas of reform to the regulation of branches, structured thematically, so as to inform the developing policy agenda in this area.

"FCA and PRA have recently consulted on their overall approach to the regulation of branches of international banks."

AUTHORISATION AND SUPERVISION

In accordance with the statutory framework for the conduct of regulated activities by way of business in the UK, the PRA and the FCA are responsible for the authorisation of UK branches of international financial institutions to conduct regulated activities in the UK. Since the branch is a part of the legal entity incorporated outside the UK, the authorisation process is an assessment of that legal entity (not just the branch).

The legislative requirements surrounding the assessment by the regulators for authorisation of a branch are well-established, centred on the threshold conditions for authorisation per s.55B(3), FSMA. Compliance with the threshold conditions must be demonstrated at authorisation and on an ongoing basis, and, therefore, links to the supervision (and, more recently, supervisability) of authorised firms.

Authorisation by the PRA or the FCA will depend on the scope of activities intended to be performed. 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.

The legislative framework itself does not clearly set out the way in which the UK regulator will assess the compliance of the overall firm in its home state with the threshold conditions capable of being met only on a 'legal entity' basis and how in supervisory terms "deference" to the home state legal and regulatory regime will apply. Certain of the threshold conditions (most obviously relating to the adequacy of financial and non-financial resources, and the ability of the firm to be effectively supervised) necessarily require an assessment of the home state jurisdiction's requirements on the firm (in legal, regulatory and supervisory terms) and the firm's compliance with those requirements. However, the primary legislation 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.[2]

The PRA has a reasonably well-developed position, articulated through its supervisory statements (particularly SS 1/18 and SS 2/18), regarding the assessment to be made at authorisation.

The PRA consulted on revisions to SS 1/18, through its consultation paper CP 2/21 which was released on 11 January 2021. The consultation appends a revised supervisory statement setting out the PRA's approach to the supervision of international bank branches and subsidiaries (the 'Draft SS'). Our comments below are based on the PRA's current approach, as articulated in SS 1/18 and SS 2/18. At appropriate points, we have included comments on aspects of the Draft SS.

2 Section 55D, FSMA requires that the UK regulator "may" have regard to any opinion from a home state supervisor relating to the firm, which appears to be relevant to its assessment of compliance with the threshold conditions. In deciding how much weight (if any) to attach to the opinion, the UK regulator must have regard to the nature and scope of the supervision exercised in relation to the non-EEA firm by the overseas regulator.

The PRA's authorisation assessment is described as being centred on a "range of factors" including (but, presumably, non-exclusively):

a. whether the whole firm meets the PRA's Threshold Conditions;

b. the degree of equivalence of the home state supervisor's regulatory regime in meeting international standards and delivering appropriate outcomes consistent with the PRA's objectives;

c. the degree of supervisory cooperation with the home state supervisor and the home resolution authority (which usually means that there has to be a memorandum of understanding in place between the PRA and those authorities); and

d. the extent to which the PRA, in consultation with the Bank of England acting in its capacity as the UK resolution authority, has appropriate assurance over the resolution arrangements for the firm and its UK operations.[3]

In the Draft SS, prepared at a point in time when the PRA is assessing the authorisation applications for a large number of EU headquartered branches and subsidiaries, the PRA also sets out its '*firm-specific expectations for effective supervision*', in light of its general approach to authorisation (which broadly maintains the position described above). This is said to include whether:

a. the PRA receives sufficient co-operation, and financial and regulatory information on the overseas risks and financial position connected with the firm, from its group or head office and relevant overseas supervisory authorities;

b. any wider group to which the firm belongs has the capacity and willingness to support the firm;

c. where the firm's governance is provided by individuals with roles in a wider group, that governance is effective in taking into account the risks to the firm and, conversely, where the firm's governance is provided by individuals whose only role is within the firm, those individuals have appropriate influence within the wider group's management;

d. booking arrangements are transparent and effective, and the firm appropriately manages the risks that it originates, receives, and transfers out to affiliates;

e. operational resilience arrangements that are in place with other group members are sufficient to allow compliance with PRA operational resilience requirements; and

f. a credible group resolution strategy, or plans to support or wind up the firm in line with the Bank's resolution objectives, are in place.

3 For insurance, consideration is also given to the priority of UK policyholders on an insolvency event, the impact of the failure of the firm with the UK branch and the scale of activity of the branch which would be covered by the FSCS.

The PRA refers to an "equivalence assessment" which it will have conducted in connection with different third countries, and their legal and regulatory regimes for the supervision of financial services firms with branches in the UK. This assessment is not part of the market access granting equivalence framework through which financial services can be provided into the UK on a cross-border basis. "Equivalence" for the PRA's purposes here is dynamic and will be determined according to the nature of the firm's activities in the UK. Systemically important activity in the UK will require "greater" equivalence. The assessment is described as focusing on the home state supervisor's compliance with Basel principles "in terms of supervisory approach, tools and practices" and takes into account the IMF assessments and FSB reviews. This could be described as a form of deference to the home state prudential regime, and the home state supervisor's supervision of the firm in its home state in this regard.

Supervisory cooperation between the PRA and the home state supervisor is a key feature of the authorisation process and ongoing supervision for a UK branch conducting deposit-taking or insurance. The PRA states that it will seek to establish acceptance of prudential responsibility by the home state supervisor, for the UK branch and an agreement with the home state supervisor in connection with the split of prudential supervision of branches.

"Supervisory cooperation between the PRA and the home state supervisor is a key feature of the authorisation process and ongoing supervision for a UK branch conducting deposit-taking or insurance."

By contrast, the FCA has only recently articulated a strategic approach to international firms seeking to do regulated business in the UK, through the publication of its 'Approach to International Firms' in February 2021. The assessments to be made by the FCA when authorising solo-regulated firms, and when supporting the authorisation decisions of the PRA for dual-regulated firms, are necessarily different to the PRA in view of its operational objectives. It is also important to note that the FCA's threshold conditions for authorisation are different for solo-regulated firms than for dual-regulated firms. This is important context to the FCA's overall approach to authorisation and supervision of branches. The FCA's 'Approach Document' appears to leave open the prospect of different approaches to solo and dual-regulated firms (and their UK branches), within the framework of the FCA's overall approach.

The FCA's approach to authorisation and supervision of branches is set in terms of the '*risk of harm*' presented by a branch, in contrast to that of a subsidiary. In particular, the FCA considers that it will be concerned to understand the potential application of insolvency law in the jurisdiction of the head office to the UK branch, and the extent to which regulatory requirements from the home jurisdiction could cover the branch and 'overlap' with FCA requirements. The FCA will also, in common with other international firms, seek to understand the risks presented by the branch from the perspective of '*retail harm*', '*client assets harm*' and '*wholesale harm*' and the extent to which the firm is (and remains) ready, willing and organised to meet the requirements for authorisation.

In view of the jurisdictional differences applying to firms' head offices it is clear that supervisory cooperation with home state regulators will form a key plank of the FCA's decisions around the authorisation of branches of international firms conducting FCA-regulated activities. The FCA will expect to assess the potential for any increased risk of harms materialising as a result of a branch establishment. Effective supervisory cooperation can provide a helpful tool for the FCA to understand this possibility, and to mitigate risks which the FCA may otherwise consider to be present and, from the branch's perspective, mitigate the possibility of specific requirements or limitations being imposed on it.

Consequently, it is clear that supervisory cooperation is imperative and that further clarity on how the FCA will approach this assessment, and the factors to which it will have regard when conducting it, would be welcome. The spectre of duplicative regulatory obligations remains one of the key concerns of investment firms operating between the UK/EU. References in the consultation to the possibility of 'overlapping' regulatory requirements are a welcome acknowledgement of the challenges that this poses to regulators as well as firms. Acknowledging that supervisory cooperation has a strong role to play in mitigating barriers to trade and business model inefficiencies, clarity and guidance on matters of territoriality and the application of UK regulatory requirements to head office (e.g. management arrangements, systems and controls) would be valuable.

REQUIREMENT TO SUBSIDIARISE

There is a presumption that where the factors described on page 29 (paragraphs b to d), exceed the PRA's risk tolerance then the firm will be required to establish a subsidiary in the UK in order for the PRA to have sufficient supervisory oversight and control. This is largely a subjective exercise carried out by the PRA/Bank of England. For systemically important wholesale bank branches, the PRA will require a greater degree of supervisory cooperation, for example through regular information exchange and joint supervisory work. The presumption is that the PRA will seek to work with the home state supervisor and/or resolution authority first, to ensure that its supervision of the UK branch meets its expectations. In the event of concern, the PRA may then seek to apply additional requirements to the branch through statutory powers (e.g. additional governance arrangements, local liquidity, operational continuity in resolution requirements and/or restrictions on scope or volume of business) before forming the view that it is necessary to subsidiarise.

Continues...

"It is clear that supervisory cooperation with home state regulators will form a key plank of the FCA's decisions around the authorisation of branches of international firms conducting FCA-regulated activities."

There are also certain activities for which the PRA has stated that, in general it will not be content for an international bank or insurer to operate as a UK branch:

a. where branch liabilities to the FSCS in respect of covered deposits or protected insurance claims exceed £500m;[4] or

b. where the branch undertakes retail and small-company deposit-taking of more than £100m or has more than 5,000 retail and small-company customers with transactional accounts.

Whilst noting that the FCA's approach to international firms remains (at time of drafting) in consultation, the direction of travel appears to afford less certainty as to when the FCA will be content to authorise an international firm branch, and when it considers that the various identified 'harms' (i.e. 'retail harm', 'client assets harm' and 'wholesale harm') are insufficiently mitigated by the firm and/or its jurisdiction of incorporation, such that a subsidiary would be required in order for FCA authorisation to be granted. Clarity on this area would be welcome in the final policy statement.

4 The £500m FSCS limit arguably imposes an artificial demarcation between international and UK domestic business which could lead to market distortion. Firms with smaller FSCS liabilities are given a competitive advantage to those with larger exposures, as the small firms can save costs by being able to operate through a branch structure instead of having to subsidiarise. This will potentially reduce the willingness of larger firms to continue writing business in the UK market (in particular, for lines of business which operate with low margins) and thus weaken innovation, competition and investment in the UK. One way to address this concern would be to allow the firms the option to split liabilities between individual and commercial customers.

OPERATIONAL REQUIREMENTS

There are operational elements of the PRA and FCA rulebooks that differ from each other and could be made clearer.

In relation to conduct of business requirements in connection with some aspects of consumer protection legislation, the FCA supervises UK branches of overseas firms. In view of the branch's legal status as a UK establishment incorporated in another jurisdiction, there are necessarily bespoke provisions for branches in many areas of the FCA Handbook, such as the Senior Managers Regime and general organisational requirements. There are, however, more complicated application provisions for certain market integrity obligations, for example in relation to transparency.

The navigability of specific branch requirements within the PRA Rulebook is generally less easily achieved, in part due to the differing nature of the regulatory requirements and the deference to home state supervisors referred to above. The FCA Handbook does not maintain a comprehensive approach to branch requirements, though there are particular application provisions for certain rules.

Branches of insurance undertakings are required to calculate capital requirements separately for the branch activity and are required to hold assets covering the notional capital requirement in the UK.[5] An internal model that has been approved by the home state regulator for determining capital requirements can only be used for this purpose if it has been separately approved by the PRA (with ongoing major changes also requiring duplicate approval).[6]

5 From 1 January 2021

6 For reinsurers, the model is based on a single capital pool and the need to split UK requirements would be an additional regulatory burden. In addition, it would be a burden for overseas firms operating in the London Market which already have approved models to have to have those models approved by the PRA as well. At the very least, some kind of grandfathering of approvals should be permitted.

RECOMMENDATIONS: FUTURE REGULATION OF BRANCHES OF OVERSEAS FIRMS

The summary below refers to overseas firms in general although it begins to draw some sectoral distinctions. In due course, it is likely that there will be a greater focus on particular regulatory requirements to be met by UK branches which will vary between institutions depending on the nature of their UK business.[7]

The IRSG 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.).

Further detail on each of these issues is set out below.

7 Examples include the use of internal models by insurers and approval to use the IRB approach by banks which currently require approval by both the home state regulator and the PRA as branch regulator.

A CLEARER FRAMEWORK

As noted above, it is important that the FCA regime which emerges as it operationalises its 'Approach to International Firms' creates sufficient certainty for investment firms on the precise criteria by reference to which a branch rather than a subsidiary will be acceptable. The following points relate to both regulators.

Section 55D, FSMA permits either regulator to "have regard to" any opinion notified to it by an overseas regulator, when determining whether or not the UK branch is satisfying, or will satisfy the threshold conditions for authorisation. This approach could be enhanced, to create a framework of deference by the UK regulatory authorities in connection with either:

a. prudential matters – be they capital, liquidity or local control, for example the requirement that insurance undertakings maintain assets representing a notional capital requirement for the branch in the UK; and

b. UK conduct of business requirements where an assessment has been carried out of the "equivalence" of the legal, regulatory and supervisory regime to which the firm is subject in the home jurisdiction. Whilst, generally conduct of business requirements would be reserved to the UK regulators, there may be some scope for certain matters to be within scope of deference. For example, certain organisational requirements which sit with the legal entity in the home jurisdiction as a matter of company organisation, might accommodate UK requirements without the need for separate UK bodies/functions.

There may be a case to accommodate a degree of deference in respect of the resolution of branches of overseas firms, whilst not reducing the formal powers of the PRA or FCA in this regard.

A principle of seeking to eliminate duplicative requirements and minimise overlapping requirements (in each case, between the UK requirements and those in the home state where deferral would be appropriate) could guide the creation of the statutory framework, in a way which is consistent with the regulators' existing (overriding) statutory objectives.

Overall, the framework should be transparent, so that firms understand the "base case" parameters of regulatory requirements for a UK branch conducting particular types of business; and the circumstances in which the UK regulators will have the powers to exert greater local control of branches in particular (as distinct from general powers). If this principle is accepted, further consideration should be given to whether the changes are implemented at a statutory level or through revised, detailed guidance to be issued by the PRA or FCA.

In particular, due weight should be given to decisions of colleges where the UK regulators have been able to be active participants in the college, and the use of colleges for internationally active groups should be encouraged.

"There may be a case to accommodate a degree of deference in respect of the resolution of branches of overseas firms, whilst not reducing the formal powers of the PRA or FCA in this regard."

A FORMALISED PROCESS FOR THE ASSESSMENT OF HOME STATE LEGAL, REGULATORY AND SUPERVISORY REGIMES

In order to deliver certainty to firms seeking to establish a UK branch, and from the perspective of UK competitiveness, the process by which the regulators will make assessments of home state regimes, and of firms' compliance with the Threshold Conditions in the home state should be set out in secondary legislation. This gives HM Treasury flexibility to adjust the parameters of the assessment without the need for primary legislation.

The process should be guided by a principle that assessments are referable to certain international standards. This would assist in delivering greater harmonisation at an international level. The precise standards to which assessments would have regard, in considering home state regimes/supervisory approaches could in principle include: 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 power to set the applicable standards may be reserved to HM Treasury, to provide flexibility as well as accountability.

This ambition has an obvious read-across to the cross-border workstream, and the examination of the current equivalence-based mechanism for cross-border trade in financial services.

AMENDING THE REGULATORS' PRINCIPLES OF GOOD REGULATION

The Working Group saw the benefit of an amendment to the regulators' principles of good regulation[8] in connection with competitiveness of the UK regime and a drive to deliver innovation amongst participants. This approach may be in line with HM Treasury's developing policy approach. Questions for exploration and analysis include the way in which the objective is framed ("have regard to" etc.) and its interaction with other objectives (i.e. hierarchy).

It is possible that, in framing the principles, there is a more specific tie across to the supervisory activities of the regulators in connection with branches, and the supervisory split between home and host regimes and supervisors. For example, when considering competitiveness, the UK branch regulator may be required to consider certain known areas of interest or concern – such as the existence (or not) of depositor or policyholder preference in the home state.

"In order to deliver certainty to firms seeking to establish a UK branch, and from the perspective of UK competitiveness, the process by which the regulators will make assessments of home state regimes, and of firms' compliance with the Threshold Conditions in the home state should be set out in secondary legislation."

8 See the FCA principles of good regulation. https://www.fca.org.uk/about/principles-good-regulation

SIMPLIFYING THE REGIME FOR UK BRANCHES

In order to enhance the attractiveness of the UK as a host jurisdiction for branches, recognising their inherent capital efficiency (but also the consequent financial stability risks of hosting) the IRSG agreed that transparency of regulatory requirements was key.

The legal and regulatory requirements applicable to branches could be more coherently set out, to encourage branch organisation in the UK. This includes the PRA Rulebook/FCA Handbook, but is a principle applicable to wider legal and regulatory requirements. For example, both the PRA Rulebook and the FCA Handbook could be reordered, with branch-specific parts applicable to different businesses (rather than the current approach, which is to modify or amend individual parts of the rulebook, or individual rules for application to branches of overseas firms). In addition, the rulebooks should make clear where requirements apply to an overseas firm with a UK branch with respect to its activities conducted from non-UK offices and to the overseas firm as a whole. There is a particular concern that the PRA Rulebook is not well organised from a branch business perspective.

One cross-cutting theme, but which is most relevant to this ambition, is the extent to which the regulatory regime for branches inter-relates with other concepts or frameworks. The obvious example of this is the 'foreign business carve-out' which exists within the FCA's rulebook. The foreign business carve-out is a particular application provision which is relevant to the conduct of cross-border business, and which (in summary) provides that investment business conduct rules are disapplied in relation to business carried out by a firm authorised in the UK (i.e. 'Head Office' of a UK-authorised branch) with a UK client, from an establishment overseas (i.e. Head Office) in circumstances where the 'overseas persons exclusion' would have been available to the overseas establishment, in connection with the conduct of the relevant activity were it not for the establishment of the UK branch.

Clearly, this rule is significant in preserving efficiencies for international firms and in delivering certain policy objectives associated with the overseas persons exclusion. Any consideration of reform to the exclusion should bear this in mind.

For UK branches of international firms providing products and services in the retail sector, and in particular those providing services to consumers, there is a case for HM Treasury, working with the FCA to develop a resource for UK branches (or those international firms considering establishing a UK branch) which explains the interlinkages between different legal and regulatory requirements in this space. There is a panoply of consumer protection legislation, headed by (but not limited to) the Consumer Rights Act 2015 with which firms in this sector must comply. However, there are also additional requirements imposed on firms by the FCA with, in some cases, similar (or complementary) objectives. Although the point is not strictly limited in its relevance to branches, a body of work which brings together and explains these requirements at least in outline would provide some clarity to international firms seeking to establish a UK branch with retail business exposure, as part of a wider package of reforms to improve the transparency of the regulatory requirements for branches.

"In order to enhance the attractiveness of the UK as a host jurisdiction for branches, recognising their inherent capital efficiency (but also the consequent financial stability risks of hosting) the IRSG agreed that transparency of regulatory requirements was key."

STRATEGIC COMMENTS ON THE PRA'S DRAFT SS

Although this paper is not intended to be a detailed consideration and response to the PRA's CP 2/21 or the Draft SS, there are nonetheless some observations which can be made at this stage from the perspective of the four ambitions set above to inform HM Treasury's developing policy work in this area.

The PRA's recognition of the efficiencies associated with the globally integrated financial services business, and the continued, explicit acknowledgement of the role of branches within this are both to be welcomed.

As described further above in connection with the PRA's approach to branch authorisation and supervision, the inclusion of firm-specific expectations for effective supervision will be welcomed in so far as it provides clarity to firms on the variable expectations of the PRA for firms depending on their nature, size and the systemic importance of their UK operations. However, the articulation of these firm-specific expectations, in common with the drafting elsewhere in the Draft SS, may raise as many questions as it answers for firms as it appears to reserve not insignificant discretion to the PRA in deciding whether any particular firm meets its expectations. UK branches and subsidiaries of international banks will note with interest the PRA's expectation that it should receive '*sufficient*' financial and regulatory information, which must include information on the degree of interconnection with the overseas part of the firm and group. Understanding the PRA's expectations in respect of information flows as between UK branch, UK regulatory authorities, head office and home state regulatory authorities is a key area of interest for UK branches given that they underpin wider supervisory requirements and expectations

This 'expectation' to receive sufficient financial and regulatory information, reflects a broader theme of the Draft SS when compared to SS 1/18 which could be understood as the PRA expecting more information, and having greater oversight (and to an extent, control) over risks arising outside the UK but which might affect the UK branch or subsidiary. This is particularly so for so-called '*systemic branches*' of wholesale firms where, amongst other things the PRA expects to meet with the CEO or CRO of Head Office at least annually, to discuss the PRA's expectations on information sharing. A further example of this is the PRA's expectation regarding booking models for international firms operating in the UK, which must be '*sufficiently transparent and effective*'. At one level, in view of the new operating environment for the UK regulators post-Brexit, the revised articulation of the PRA's expectations is unsurprising. However, the level of discretion in the current drafting could be usefully tightened in some areas to provide certainty to market participants, and potential market participants considering the UK as a target jurisdiction in (or from) which to provide financial services in the future.

The Draft SS expands on the PRA's expectations regarding the oversight of booking arrangements, which, for systemic wholesale branches, could require SMF7 approval for individuals located overseas with significant influence over the branch's booking arrangements. The PRA acknowledges, in the Draft SS the various different business models which exist amongst bank branches and subsidiaries, and it is a clear ambition to retain the flexibility to tailor requirements to those variations. Symbiotically, firms will be keen to retain the flexibility to maintain governance arrangements, within the context of the specific rules applicable to the UK branch, which best meet their particular business models. To the extent that UK management have sufficient control over booking models which affect the branch, then they alone might be expected to be within scope of the SMCR.

"There is a case for HM Treasury, working with the FCA to develop a resource for UK branches (or those international firms considering establishing a UK branch) which explains the interlinkages between different legal and regulatory requirements in this space."

From the perspective of the UK's attractiveness to overseas firms as a jurisdiction in which to conduct financial services business, the explicit acknowledgement, that the nature and extent of information sharing, and the PRA's expectations around booking models will be 'proportionate', will certainly be welcome. There do remain a number of questions on interpretation arising from the Draft SS, however, and which we recommend are considered further. In addition to those mentioned above, and at a strategic level, the practicalities associated with the PRA's '*expectations*' of supervisory cooperation remain to be seen. Whilst there is currently no formal '*equivalence regime for branches*', the PRA's expectation that the home state regulator will specifically confirm to it that the entire firm meets the UK threshold conditions may not, as a practical matter, be something which many home state authorities are able to provide. Similarly, the extent to which home state supervisors are ready, willing and able to meet PRA expectations as to the form of 'agreement' needed for information sharing in connection with particular firms will be an important question to be determined in the months and years to come.

"A body of work which brings together and explains these requirements at least in outline would provide some clarity to international firms seeking to establish a UK branch with retail business exposure, as part of a wider package of reforms to improve the transparency of the regulatory requirements for branches."

4. EQUIVALENCE-BASED REGIMES

SUMMARY OF RECOMMENDATIONS

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.

CURRENT POSITION

The EU currently has equivalence-based regimes (known as third country regimes or "**TCRs**") under which firms from countries outside the EU are able to do regulated business with EU-based counterparties and customers. The TCRs provide for preferential treatment for overseas market participants as long as the regulatory and supervisory framework in the firm's home country has been determined to be equivalent to that of the EU.

The main problems with the EU's current TCRs have been documented by the IRSG in a previous report.[9] Those problems are that:

a. the TCRs only apply to a limited range of regulated activities and services (mostly around investment business and market infrastructure);

b. there is a lack of consistency and coherence between the different TCRs;

c. there is a lack of clarity around what "equivalent" means; and

d. there is a lack of procedural protections under the TCRs (which means, for example, that the benefits for the third country firm can be withdrawn with little or no notice).

As a consequence of the UK's approach of "onshoring" EU law into UK legislation and rules, each of the TCRs that existed under the EU regime at the end of the implementation period has become part of the UK regulatory regime – save that the UK's test is whether the regulatory and supervisory framework of the firm's home country is equivalent to that of the UK, not the EU. In this Part of the Report, we have referred to these TCRs as the "**Onshored TCRs**".

The IRSG has considered the extent to which future access to UK markets should involve an equivalence-based regime like the TCRs, and if it does, what that regime would look like. This could involve removing Onshored TCRs from the UK regime altogether, or retaining them and addressing their shortcomings. It could also mean using an equivalence-based regime more widely than the Onshored TCRs do – for example, by extending them to cover financial services that are not currently covered by the Onshored TCRs.

9 IRSG Report on the EU's Third Country Regimes and Alternatives to Passporting (23 January 2017): https://www.irsg.co.uk/resources-and-commentary/irsg-report-on-the-eu-s-third-country-regimes-and-alternatives-to-passporting/

From the EU's perspective, the UK is a third country and so the UK would need to be determined to be equivalent under the EU's TCRs in order to access the EU. Any review by the EU of the UK's equivalence may include consideration of whether the UK itself has TCRs that are equivalent to that of the EU. This criterion is expressly included in EMIR and MiFIR and might apply in relation to other TCRs too. It creates a question mark over the extent to which the UK

i. could expand its own TCRs without losing the benefit of any equivalence decision made by the EU or

ii. would need to amend its own TCRs to remain consistent with the EU TCRs if the EU TCRs were to change in the future.

In preparing this Report, we have therefore disregarded the question of 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. We have approached the question of equivalence on the basis that the UK is able to develop a regime of its own without any such constraints.

In this Part of the Report we have 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?

"In preparing this Report, we have therefore disregarded the question of 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."

RECOMMENDATIONS

If the UK does have its own equivalence-based regime in the longer term, there is concern regarding the approach that the EU currently follows in relation to its own TCRs. That approach tends to involve a very detailed, granular consideration of the extent to which the rules of the third country are equivalent to that of the EU. This issue was identified as a potential concern in the IRSG's previous report.[10]

The EU is continuing to follow a restrictive approach in relation to equivalence. By way of example, the EU's Investment Firms Regulation provides that third country investment firms which are likely to be of systemic importance for the EU should be subject to a "detailed and granular assessment" of the third country's prudential and business conduct requirements, and that for these purposes, the European Commission must assess and take into account the supervisory convergence between the third country concerned and the EU. Indeed, the trend at an EU level is towards even the analysis becoming even more granular and on EU standards being applied on an extra-territorial basis: for example, the overall effect of the EU's proposed EMIR 2.2 amendments is that systemically important third country CCPs have to adhere closely to certain specific requirements that apply to EU CCPs.

The IRSG is concerned that if the UK itself applied a granular assessment of equivalence based around one set of rules (e.g. the UK rules), that would be likely to act as a disincentive to firms from outside the UK to seek to do business with UK firms and counterparties. Instead, the UK should apply a looser test which focusses more on outcomes.

10 IRSG Report on The EU's Third Country Regimes and Alternative to Passporting. (23 January 2017). https://www.irsg.co.uk/resources-and-commentary/irsg-report-on-the-eu-s-third-country-regimes-and-alternatives-to-passporting/

The IRSG has long advocated that a policy of mutual regulatory "deference" is central to well-functioning cross-border regulatory regimes.[11] While the UK authorities require appropriate powers to supervise UK firms, the distinction between UK firms and overseas firms is critical. 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[12] 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). 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 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.

11 See, e.g., IRSG Report on Mutual Recognition – A Basis for Market Access after Brexit (April 2017). https://www.irsg.co.uk/resources-and-commentary/irsg-report-on-mutual-recognition-a-basis-for-market-access-after-brexit/

12 See Financial Stability Oversight Council 2019 Annual Report., supra note 3 at 116. https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf

"The IRSG has long advocated that a policy of mutual regulatory "deference" is central to well-functioning cross-border regulatory regimes."

An approach based on deference is consistent with the direction of travel at a global level. We note, for example, that IOSCO recently published a report on Good Practices on Processes for Deference[13] which includes practices that regulators could consider to make deference determinations more efficient.

A recent example of a deference approach involving the UK is the joint statement issued by the UK and Switzerland on 30 June 2020 declaring their ambition to conclude a Mutual Recognition Agreement. The aims of this cooperation are to:

a. work towards mutual recognition of each other's regulatory and supervisory regimes in the fields of insurance, banking, asset management and capital markets;

b. reiterate both countries' commitment to an outcomes-based approach to mutual recognition;

c. on the basis of recognition, reciprocity and enhanced regulatory and supervisory cooperation, seek to improve access for the cross-border provision of financial services for wholesale and sophisticated clients as well as to reduce or remove ongoing frictions applying to cross-border activity between the two jurisdictions; and

d. avoid market fragmentation and build an open global financial system, with both countries noting their willingness to defer to each other's national regimes and supervisory practices where they achieve comparable overall outcomes with regard to market integrity, financial stability and the protection of consumers and investors.

The UK and Switzerland will seek to deepen their cooperation in international fora, by cooperating on both the design and implementation of robust international standards, as well as on innovation and the role of technology in financial services. The UK and Switzerland also announced their intention to create a clear, transparent and managed process in the event that recognition is withdrawn in the future or re-established after a withdrawal. Members of the Working Group have noted that there is a natural tendency for the regulators who are responsible for making equivalence assessments to err on the side of seeking detailed comparisons. Better guidance should be available to the regulators and their staff to assist them in making genuinely outcomes-based assessments.

Any decisions on deference should take into account any appropriate international standards – including (as discussed in Part 3 of this Report) the Basel Standards, the FSB Principles, certain IOSCO standards, the FATF Recommendations and the Insurance Core Principles of the International Association of Insurance Supervisors. This would assist in delivering greater harmonisation at an international level. The power to set the applicable standards may be reserved to HM Treasury, to provide flexibility as well as accountability.

"An approach based on deference is consistent with the direction of travel at a global level. We note, for example, that IOSCO recently published a report on Good Practices on Processes for Deference which includes practices that regulators could consider to make deference determinations more efficient."

13 IOSCO report on Good Practices on Processes for Deference. (June 2020). https://www.iosco.org/library/pubdocs/pdf/IOSCOPD659.pdf

Insofar as the Onshored TCRs, with their equivalence-based tests, continue to be part of the UK law, the UK should be considering the following issues:

a. To what services should they apply? The Onshored TCRs only apply to a limited subset of financial services. It is likely that any extension of the UK approach towards deference will take place gradually, in relation to specific areas of financial services. The Working Group felt that any extension of the Onshored TCRs should be considered 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.

b. What steps can be taken to improve those regimes? The Working Group is in favour of the UK taking steps to address the known shortcomings in the Onshored TCRs – in particular, the lack of procedural protections. In particular, the UK should:

i. publish clear criteria for allowing access – both at the level of agreeing a deference arrangement with the relevant third country and (if applicable) for the approval of individual firms from that country;

ii. have a mechanism for communicating with other countries for whom an equivalence determination has been made, including to discuss future regulatory changes and the possibility that the respective regimes may cease to be equivalent;

iii. have a clear, predictable process for termination of the arrangement (either at a national level or for individual firms), with objective criteria and with the ability for affected countries and firms to make representations and/or to make changes to their legal and regulatory regimes in order to prevent an equivalence determination being withdrawn;

iv. commit to having an adequate notice period for withdrawal of the arrangement, so that affected firms have the opportunity to make alternative arrangements; and

v. establish an independent tribunal or technical advisory panel to determine whether the criteria are satisfied.

c. What arrangements can the UK be putting in place with third countries to strengthen the equivalence regime? As part of the UK/EU trade agreement, the parties have agreed to try and codify the framework for regulatory co-operation in a Memorandum of Understanding. The Memorandum of Understanding covers governance arrangements for regular dialogue, notification of proposed changes to the law, the exchange of information and the role of international standards. An arrangement such as this could strengthen a particular relationship and make equivalence a more robust method of allowing cross-border access.

"An approach based on deference is consistent with the direction of travel at a global level. We note, for example, that IOSCO recently published a report on Good Practices on Processes for Deference which includes practices that regulators could consider to make deference determinations more efficient."

The IRSG has noted that the UK regulators are already taking steps which are consistent with an outcomes-based approach to equivalence. In particular, in its Guidance Document on the UK's Equivalence Framework[14], HM Treasury has set out the principles that the UK intends to follow in relation to its equivalence framework. These include the following principles:

a. Equivalence should facilitate the benefits of maintaining an open and globally integrated financial system in a way that ensures and supports financial stability, market integrity and consumer protection.

b. Equivalence will be judged on outcomes. Assessments of outcomes will be underpinned by compliance with internationally agreed standards and through different combinations of rules and supervisory practices, if these practices provide an equivalent outcome to the corresponding UK legal framework. Recognising this, the UK's equivalence framework will be flexible enough to allow for both jurisdictions to change and adapt their rules and for the UK to still consider the overseas jurisdiction equivalent, provided the cumulative effect of such changes does not lead to a material divergence that no longer achieves equivalent outcomes.

c. Equivalence is a transparent process – to which end, HM Treasury will endeavour to engage with interested parties as part of the process and will seek to provide Parliament with appropriate scrutiny over the operation of the equivalence framework.

d. Equivalence is an evidence-based process ensuring analysis based on regulatory advice and available evidence is at the core of decision making.

e. Equivalence – in its establishment and thereafter – should be a cooperative process.

f. Equivalence is intended to be a stable and reliable arrangement. Equivalence determinations will be terminated when the cumulative effect of regulatory changes lead to the other jurisdiction's framework's no longer delivering equivalent outcomes; with appropriate steps taken to mitigate any disruption.

g. Equivalence decisions are compatible with the UK's policy priorities, including those relating to the rule of law, international sanctions, human rights and efforts to combat money laundering.

14 Guidance Document for the UK's Equivalence Framework for Financial Services https://www.gov.uk/government/publications/guidance-document-for-the-uks-equivalence-framework-for-financial-services

These principles address many of the concerns outlined in the last paragraph on page 43. Nevertheless, there are still questions to be considered. In particular:

a. Should an equivalence-based approach should be pursued on a reciprocal basis only?

While there is a positive case for the UK to grant equivalence to other jurisdictions without necessarily requiring a quid-pro-quo response, such an approach may not be sustainable in all areas.

In cases relating to bilateral business, the ability of UK firms to find the best commercial partner either in the UK or another country with equivalent measures would be enhanced if the UK offered access on a non-reciprocal basis. However, for multi-lateral business and network-based infrastructures (such as trading venues, markets, CCPs and CSDs), granting access on a non-equivalent basis creates the risk that these infrastructures, through lack of access to clients in such a non-reciprocating jurisdiction, could be encouraged to move/set-up there (rather than in the UK) so as to access the broadest possible client base.

The IRSG recommends that, while there should be a presumption of openness, a case-by-case approach will need to be taken.

b. Should there be an ability to impose additional requirements?

HM Treasury's proposals for its Overseas Funds Regime[15] include two new, outcomes-based, equivalence regimes – under which HM Treasury explicitly says that overseas funds may not have to be subject to exactly the same regulation as funds in the UK but that the comparison will be based on HM Treasury's overall view of the other country's regulatory regime. This is consistent with the HM Treasury approach expressed above. However, the proposed Overseas Funds Regime does have one feature that is not part of the existing Onshored TCRs – namely, a power for HM Treasury to specify additional requirements for a category of funds, even where the regulation of funds in a country already meets the standard of equivalent investor protection.

This ability to impose additional requirements shows how the equivalence model might evolve in the future but it does introduce an element of further uncertainty about how the regime will operate and is another area where transparency and predictability will be important.

15 HMT: Overseas funds regime: Summary of responses (November 2020). https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933879/_FINAL__OFR_Consultation_Response.pdf

c. How should an equivalence-based regime interact with other means of access?

As noted in Part 2 of this Report, UK law currently provides that overseas firms that are within the scope of the Onshored TCR under MiFIR (i.e. because an equivalence determination has been made in relation to their country) cannot rely on the OPE. The Onshored TCR effectively "trumps" the OPE.

Overseas firms from countries where an equivalence determination has been made are in a worse position than overseas firms from other countries where no such determination has been made, even though the former are likely to be subject to more similar regulation to the UK that the latter. In order to redress this balance, the UK should consider removing the rule that disapplies the OPE and allowing all overseas firms to rely on the OPE in the same way even if an equivalence determination has been made in respect of their home state. In addition, insofar as the UK decides to broaden its equivalence-based regimes to cover areas of financial services where they are not currently used, the UK should ensure that such a regime does not encroach upon the areas covered by the OPE. Such regimes should only apply insofar as the OPE does not apply.

We note that HM Treasury's Call for Evidence in relation to the Overseas Framework[16] has specifically asked for comments on the overlap between the Onshored TCR for MiFIR and the OPE, and in particular on whether the issuing of an equivalence decision by the UK might affect overseas firms' decisions to undertake the activity in the UK. HM Treasury's focus on this question is welcome and the UK should be considering whether the OPE should take precedent for those firms that can use it – even where that might mean changing the OPE.

This issue also highlights the need to address the more fundamental question of how the different means of access for overseas firms should interact with each other.

"Overseas firms from countries where an equivalence determination has been made are in a worse position than overseas firms from other countries where no such determination has been made, even though the former are likely to be subject to more similar regulation to the UK that the latter. In order to redress this balance, the UK should consider removing the rule that disapplies the OPE and allowing all overseas firms to rely on the OPE in the same way even if an equivalence determination has been made in respect of their home state."

16 HMT call for evidence on the Overseas Framework, 15 December 2020. https://www.gov.uk/government/publications/call-for-evidence-on-the-overseas-framework

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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