Post EU Referendum: Impact on UK Investment Firms and Financial Regulation

The UK's financial industry is the economy's most productive sector, its biggest exporter and highest tax payer. As such, the principle of EU "passporting", allowing UK-based firms to operate in EU markets and attract overseas investment will remain critical for the economy's health post-Brexit. Given the global nature of financial markets and London's status as a global financial centre, UK financial regulation will continue to rely on cross-border recognition after Brexit, both within the EU and internationally. The efficient functioning of both the UK's and the EU's financial market infrastructure will require existing EU and UK regulation continuity and seamless implementation. Notwithstanding the outcome of future UK bilateral negotiations with EU member states, UK firms would indeed need to continue to comply with EU regulatory transaction reporting requirements (MiFID II, EMIR rewrite and SFTR) in order to continue cross-border trading with counterparties in the rest of the EU. Thus, reporting requirements are to remain in force and will require implementation in a post-Brexit, EU-equivalent, legal regime for UK financial services.

Lena Komileva, Managing Director and Chief Economist, G+ Economics
Sponsored by Abide Financial

AbideFinancial
Regulatory Reporting Solutions

Brexit: You cannot predict. But you can prepare.

After the UK's historic vote to leave the EU, UK investment firms face unprecedented uncertainty over the UK's future access to the single market and the true economic consequences of Brexit in the long run. This has taken its toll on confidence in the City and contingency planning has emerged as a top priority for financial institutions. The need to maintain equivalent regulatory standards in order to access European capital markets after Brexit means little will change for UK institutions with respect to EU regulation and international standards, including the new MiFID II transaction reporting requirements coming into effect from January 2018. The prospect of prolonged economic uncertainty during a lengthy period of complex UK-EU exit negotiations ahead, however, adds a layer of complexity to firms' operations in the UK, raising the bar for compliance readiness, operational flexibility, technology risk management and strategic cost control.

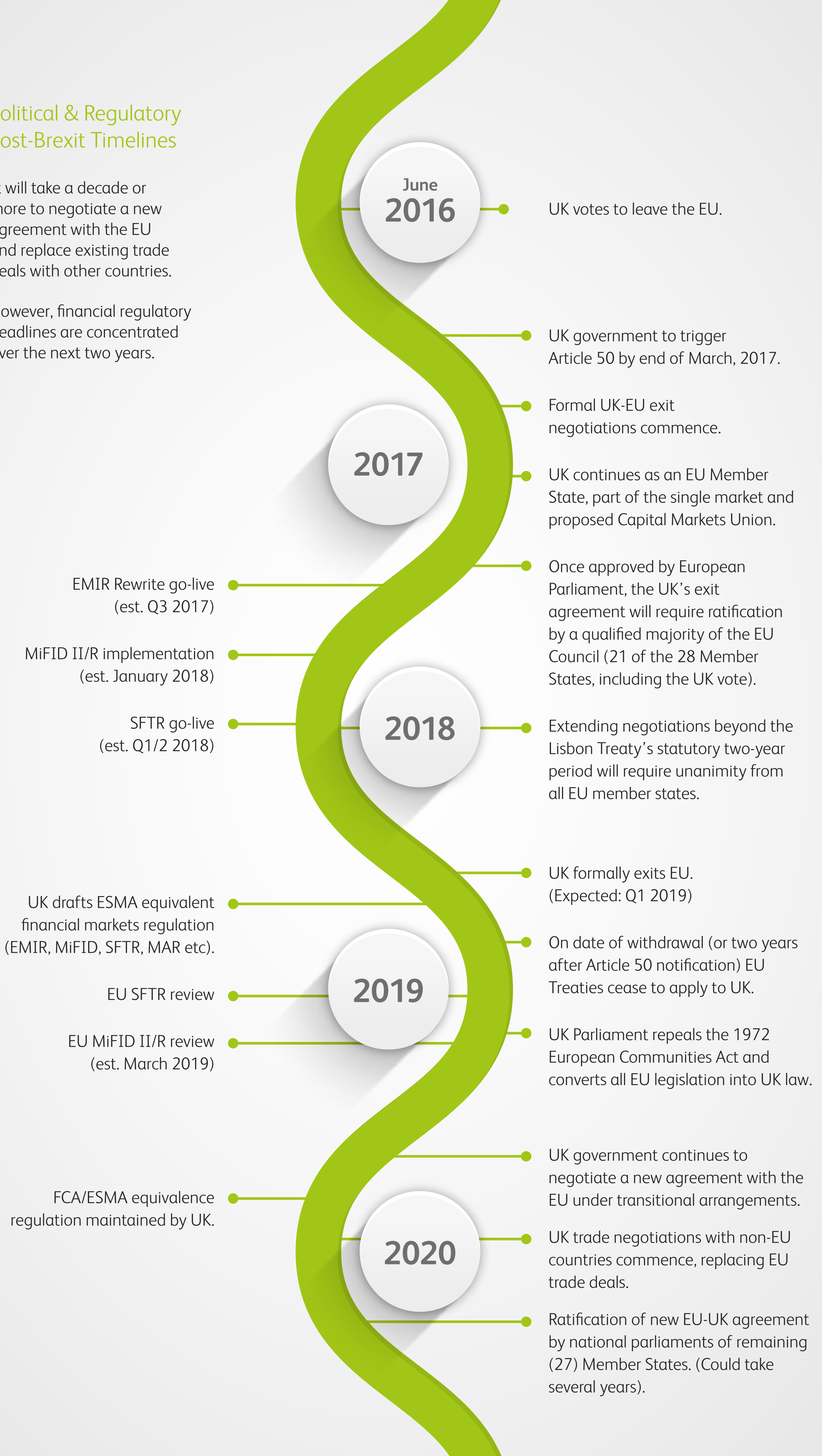
How Brexit Will Affect UK-Based Financial Firms Operating in EU Markets

- The UK government has announced that it will begin the formal EU exit process by triggering Article 50 of the Lisbon Treaty, by the end of March 2017. This implies that the UK's membership of the EU will likely cease in Q1 2019. The government's negotiation strategy over the next two years will determine what form Brexit and a future UK-EU relationship eventually take. This will have significant consequences for the UK's economy and financial infrastructure.
- Preserving the UK's status as a global financial hub in a highly globalised international financial industry will require maintaining regulatory equivalence with ESMA and consistency with international standards in global markets. As such, little is likely to change for UK institutions subject currently to EU regulation, including MiFID II transaction reporting requirements due to take effect in January 2018.
- Likely transitional arrangements between the UK government and EU Council during the Brexit negotiations would also seek to ensure that not much changes over the next four years in respect of capital transfers and payment operations, in order to minimise any short-term disruptions to the operations of EU firms operating in the UK.
- In the short to medium term, economic uncertainty will remain. The government's long-term vision for the UK outside the EU is shrouded in unprecedented constitutional uncertainty and international legal complexity and will require a difficult trade-off between domestic political priorities and economic safeguards in a new post-Brexit EU political climate.
- The prospect of prolonged UK/EU exit negotiations and potential timing issues linked to future bilateral trade and service provision agreements creates commercial and operational uncertainty and additional managerial complexity for UK-based firms.

Political & Regulatory Post-Brexit Timelines

It will take a decade or more to negotiate a new agreement with the EU and replace existing trade deals with other countries.

However, financial regulatory deadlines are concentrated over the next two years.



Brexit and Single Market Membership

The EU Referendum on 23 June posed the serious question of whether the UK will remain in the EU, but it did not determine the model for exit, including the all-important issue for UK businesses of single market membership. The difficult political compromises involved for all EU member states including the UK, following the Leave vote, mean that the precise terms of Brexit and the negotiated post-Brexit model for the UK will remain a matter of significant uncertainty for quite some time.

There is no precedent for a member state leaving the EU. This creates political, legal and economic uncertainty with respect to the UK's ongoing relationship with the EU as part of the withdrawal process, including the issue of single market membership. Following on existing models for the EU's relationships with non-member states, there are a range of arrangements, from the "EU-light" precedent of fairly complete single market membership provided by Norway, with its EEA and EFTA memberships, through to a Swiss-style FTA (Free Trade Agreement) negotiated option of partial access, to the extreme case of UK "going it alone" on the basis of WTO (World Trade Organisation) rules .

Notwithstanding the various degrees of economic cooperation and integration with the EU offered by various Brexit options, there is a fairly clear correlation between the level of access that non-Member States have to the EU's single market and the extent to which they are required to accept EU rules, including single-market legislation and the four freedoms of people, goods, capital and services, as well as make a financial contribution to the EU budget. As such, UK's continuing access to the European single market post Brexit remains a highly uncertain proposition.

What Model will the UK Follow: Hard Brexit or Soft Brexit?

For the UK financial services sector, Brexit highlights the importance of compliance readiness, operational flexibility, rigorous IT risk management and strategic cost control

The scale of the UK government's task in respect of delivering a post-Brexit model that will be agreed by the UK Parliament, EU Parliament and a majority of individual EU Member States, is daunting. The fixed two-year time frame envisaged in Article 50(2) of the Treaty on European Union creates the risk that the UK government may run out of time to agree a coherent and conclusive model for the UK's relationship with the EU post-Brexit.

Out of EU, but within EEA: Soft Brexit

One option for the UK government to consider is an 'off the shelf' third country arrangement as the starting point for withdrawal negotiations with the EU.

If the government follows the Norwegian model, the UK leaves the EU but remains part of the European Economic Area (EEA) and re-joins the EFTA (European Free Trade Association). Single market membership means accepting free movement of people, paying into the EU budget and accepting EU rules with no say. Being part of EFTA also prevents the UK from signing unilateral deals with third countries. The result would be to diminish the UK's sovereignty relative to EU membership. It remains doubtful, therefore, that EEA membership could be politically acceptable in the UK in light of the EU referendum 'leave' result.

EEA Membership - Norway Model

PROS

- Continuing EU single market participation as member of EEA
- Passporting rights within EEA
- Free trade within EU/EEA per EFTA
- Free movement of labour (in business and financial services)
- (Limited) right to refuse to implement new EU laws (Guillotine clause)

CONS

- Acceptance of all EU regulation, competition policy and all other single market 'rules'
- Subject to EU rules but no voice to influence
- Required to contribute to EU coffers (Norway pays around EUR96 per capita per annum, roughly equivalent to the UK's contribution)
- Free movement of labour (political opposition in light of 'Leave' vote)
- National sovereignty diminished relative to EU membership

Europe 'à la carte': Hard Brexit

If the UK government were to reject the Norwegian model as a poor alternative to EU membership and one that is unpopular among the Brexit camp, it could model its post-Brexit approach on Switzerland, and opt for a so-called "Brexit heavy" approach. Switzerland's arrangement with the EU is governed by over 100 bilateral agreements which enable the Swiss Confederation to adopt some provisions of EU law in order to have partial access to the single market. The UK would have to enter into bilateral agreements in specific sectors with each EU Member State in which it wished to do business. A bespoke body of agreements, such as the Swiss model, may prove enormously complex and lengthy to negotiate. Moreover, there appears to be little appetite for negotiating such a deal with the UK, particularly in respect of an exemption on freedom of movement. Partial access to the single market also comes with economic costs costs associated with growth, scale and jobs. In addition to having to comply with multiple regulatory regimes, UK firms may also have to carry the cost of establishing EU-domiciled subsidiaries; The fact that Switzerland's significant framework of bilateral agreements does not cover financial services means that Swiss banks operate in the EU via subsidiaries, presently located in the City of London.

Non-EEA Membership - Switzerland Model

PROS

- Customised bilateral agreements, not automatically subject to EU legislation
- Selective adoption of EU directives and regulations; EU influence limited to ten agreed areas
- (Limited) right to refuse application of new EU laws (Guillotine clause)
- Free trade (EFTA)
- Prevailing sovereignty, not bound by ECJ or EFTA Court judgements
- Free movement of people*
- Limited financial contribution to EU (est. EUR53 per capita per annum)

CONS

- Complex negotiation and implementation of interdependent bilateral treaties
- On-going implementation of agreements obliges Switzerland to take over relevant Community legislation for EU market access
- High national costs of continued regulatory equivalence surveillance; EU-Switzerland bilateral agreements managed by more than 15 joint committees
- No automatic passporting rights; need to set up subsidiaries within EU jurisdictions to access the single market
- Free movement of people*
- Limited financial contribution from EU

*Note: In February 2014, a referendum to limit the freedom of movement of foreign citizens to Switzerland was won by a narrow margin. Implementation of this mandate, which requires the introduction of a quota system by 2017, could trigger the 'Guillotine clause' resulting in the renunciation of all other bilateral agreements with the EU.

Brexit and ‘Passporting’ Rights

What does this mean for UK financial services? Under current EU passporting rules, including MiFID and EMIR reporting requirements, a financial services firm in one member state can sell services cross-border across the EU, while being regulated by authorities in its home country. This “single passport” means that a UK firm can grow its business on an EU-wide scale from its UK base, without the need to seek local regulatory authorisation in other EU states, or having to establish a local branch. It also means that a Swiss or a Chinese or an American bank can currently do the same from a branch or subsidiary established and regulated in the UK.

As such, it is particularly important that UK investment firms prepare for and implement EMIR changes and MiFID II requirements throughout the Brexit transition over the next couple of years. Passporting is also a key component of the UCITS regime, allowing fund promoters and managers to market funds in other EU member states without additional authorisation (per UCITS IV Directive). Unlike MiFID II, however, under UCITS firms must appoint a local ‘facilities agent’ and pay a regulatory fee in each applicable Member State.

Full MiFID II compliance will act as an interim risk neutraliser for UK firms facing uncertainty over access to the EU single market post Brexit.

The Principle of Regulatory Equivalence Post-Brexit

Any new UK-EU deal will take at least four years and possibly over a decade to negotiate (it took Switzerland 10 years; Canada’s deal took over seven years and is yet to be implemented).

Regardless of the nature of the final deal, regulatory equivalence would help to address the need for UK-registered firms to maintain access to the EU single market. It would also give the UK the best starting point for ensuing negotiations on future EU market access and terms of trade.

Post-Brexit, the principle of regulatory equivalence for maintaining access to the single market is paramount.

EU financial services directives and regulations, including MiFIDII/R (Markets in Financial Instruments Regulation/ Markets in Financial Instruments Directive II), AIFM (Alternative Investment Fund Managers Directive) and EMIR (European Market Infrastructure Regulation) each make provision for a "third country" regime.

Under "third country" provisions, the UK would need to achieve regulatory equivalence with the EU and satisfy the European Commission that FCA supervisory levels match those currently imposed by ESMA. While regulatory equivalence may allow non-EEA countries to sell services into the EU it does not confer passporting rights allowing firms to set up shop within the single market. Without passporting and equivalence, "third country" rules stipulate that a firm can only do business with an EU country where the national regulator agrees and the firm is subject to the local regulatory regime. For UK firms, access to the single market will continue to be dependent on applicable regulatory equivalence and some form of cooperation agreement between the UK and the EU.

The UK's leading role in drafting MiFID legislation makes the principle of equivalence relatively straightforward to satisfy. As the regulator of the EU's biggest financial centre, the City of London, it is highly unlikely that the FCA would substantially deviate from the EU and G20 initiatives that it has helped spearhead since the global financial crisis. Indeed, FCA Chief Executive, Andrew Bailey, has affirmed that he expects "no great bonfire of regulation" after Brexit, clarifying that the FCA would want to include the safeguards within MiFID II in equivalent regulation.

The issues surrounding UK equivalency post-Brexit relate more to timing and economic impact. A key economic aspect is that regulatory equivalence will not necessarily be sufficient to grant full passporting rights. Unlike passporting, equivalence can allow non-EEA countries to sell services into the EU, but it does not let their firms set up in the European market. Without passporting and equivalence, "third country" rules stipulate that a firm can only do business with an EU country if the host regulator agrees and the firm complies with the national regulatory regime. Moreover, even if the impact of Brexit is softened by transitional arrangements between the UK and the EU, lengthy negotiations at macro level and adherence to evolving regulatory requirements – like the EMIR Rewrite and other evolving initiatives such as Securities Financing Transactions Regulation (SFTR) - will inevitably be required to access the EU single market.

Conclusion

Post referendum uncertainty about a new UK-EU agreement after Brexit has added a considerable layer of operational complexity to UK investment firms planning and managing impending UK and EU regulatory implementations including MiFID II/R and the EMIR Rewrite, the upcoming SFTR and international regimes.

"If you fail to plan, you are planning to fail" (Benjamin Franklin)

While formal Brexit negotiations will likely take at least four years, and will probably go well into the next decade, EU rules, including MiFID and EMIR reporting requirements, will remain in force for UK firms at least for the duration of transitional UK-arrangements. The need to preserve passporting arrangements with the EU thereafter means that UK firms will need to prepare for and implement EMIR changes in late 2017 and MiFID II reporting requirements in January 2018.

The starting point of every Abide engagement is a no-obligation consultation with a transaction reporting specialist and free 'regulatory health check'. Contact us now for an in depth conversation about preparing for MiFID II, EMIR and other regulatory reporting challenges.

E: advice@abide-financial.com
T: +44 20 7148 0971

Abide Financial London
2nd Floor
St. Mary Le Bow House
54 Bow Lane
London
EC4M 9DJ

@Abide_Financial
www.abide-financial.com

AbideFinancial
Regulatory Reporting Solutions