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The future regulatory framework principles and process

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This paper discusses the way forward for the UK as it moves out of the legislative orbit of the EU and commences the wider regulatory reform programme proposed by the UK government.

Introduction: what's going on?

Six years on from the Brexit vote, the UK is still at an early stage in getting to grips with its place outside the EU. From a legal and regulatory perspective, very little has changed: EU-derived law (the EU *acquis*) still predominates in the UK regulatory environment. The UK needs a domestic framework, rather than one comprising legacy EU law, and the Financial Services and Markets Bill (FSM Bill), currently before Parliament, initiates that process.

Brexit has presented headwinds to the UK's predominance as a regional and global financial centre: the key question under discussion is then how far, and how fast, regulatory reform should be used as a tool to reposition the sector for growth. Recent governmental announcements suggesting a Big Bang 2.0 indicate a desire to achieve tangible improvements to the competitiveness of the sector that goes well beyond the status quo.

Out with the old – disposing of the EU *acquis*

The EU Withdrawal Act 2018 (as amended) (the EUWA) repealed the European Communities Act 1972 and brought to an end the jurisdiction of the Court of Justice of the EU in the UK on 31 December 2020. But the legacy of European law hangs heavy over the UK legal system, and particularly on the UK financial services regulatory framework. EU legislative change dominated the reform of financial markets following the global financial crisis, leaving the UK with an alphabet soup of regulations and directives which overwhelmingly set the substantive requirements of UK firms.

As the repeal of all of that EU regulation without any successor rules would have left the UK legal system in disarray, the Government chose to perpetuate EU legislation by 'onshoring' it – converting EU law as it stood when the UK left the single market into domestic law. The effect of this has been to leave the UK with a domesticated version of the EU rulebook.

While much of this is sensible, uncontroversial and should be retained, in a number of respects it is no longer fit for purpose. Some provisions are obscure and/or duplicative of pre-existing UK law. Some are now inappropriate to the position of the UK outside the single market, reflecting the needs of EU, not UK, markets and including a number of areas in which the UK's policy objectives diverge from those of the EU. It is also inflexible, being largely based in legislation, not rules.

Unfinished business

This situation was only ever intended to be temporary. Following a consultation on the optimal structure for UK financial services post-Brexit, the FSM Bill is intended to create the legislative and institutional architecture to support a move away from onshored EU legislation towards the historic approach taken under the Financial Services and Markets Act 2000 (FSMA). Under this model, primary responsibility for regulation is delegated to the UK regulatory authorities, subject to the oversight of Parliament. Structurally, this model would migrate the *acquis* into rules.

The job ahead

The scale of reform necessary to move away from the EU legacy is intimidating. The government's own retained EU law dashboard indicates that there are 365 pieces of onshored EU law in existence which are relevant to financial services. To review all the legislation, identify the policy changes that should be made, create new rules in place of the legislation, consult on them and permit the regulated sector time to implement will take a number of years. That said, recent governmental announcements seem to contemplate accelerating this timeline considerably.

The process will require significant resources within the Government, the regulators and industry. Ensuring that the regulators are appropriately staffed to take on their new mandates under the FSM Bill will be crucial to the success of the anticipated new framework.

In with the new – how far should the replacement for the EU acquis diverge from the existing position?

Objective of the future regulatory framework?

The intended destination of this journey – a thriving international financial centre post-Brexit – is clear. Brexit provides the ability to reshape the UK regulatory framework with the aim of improving the competitive position of the UK financial services industry without weakening the regulatory protections that are a key selling point. But assessing where and how to make changes to the *acquis* (and indeed elsewhere) to improve competitiveness is complex – not least as change inevitably carries transitional costs, which can be heavy, and can have knock-on effects outside the UK.

Key principles

If the objective is clear, what principles should guide the review process?

We start from the proposition that the UK exists in a global market. Firms succeed if they can achieve the best outcomes for their clients, and for themselves, in that global market. To succeed, the UK therefore needs UK market participants to be able to access global financial markets with minimal regulatory duplication, and at the lowest price.

This proposition drives the following principles:

1. **The UK needs to be open to the world** – the UK needs to facilitate inbound business, including capital flows, data flows, and personnel. The UK Government and regulators should remove domestic hindrances to efficient participation by foreign organisations in UK markets, including by deference (recognition of foreign regulatory requirements on an outcomes basis) to meet domestic requirements.
2. **The UK needs to maximise access to world markets** – the UK needs to ensure, to the maximum extent possible, that the world/global markets are open to London. The UK Government and regulators should remove domestic hindrances to efficient participation by UK organisations in foreign markets, in part by ensuring the good standing of the UK for purposes of foreign access regimes (e.g. equivalence in the EU). Reconciling the needs of foreign access requirements with local streamlining may in some cases require twin-track regulation (i.e. to require a baseline regulatory standard and permit a higher regulatory standard where necessary to enable access). Bilateral arrangements (such as the forthcoming mutual recognition agreement with Switzerland) also have a role to play here.
3. **Change for efficiency's sake, not for change's sake** – while divergence from EU standards may be in line with the political drive to "take back control", change should be made only where there are gains that exceed the transitional costs of change. Change should impose the minimum cost possible on firms – for example changes to reduce reporting requirements should accommodate existing reporting arrangements, rather than require changes to them. Many firms operate common platforms across the UK and the EU.
4. **Recognising the global stage** – international consistency of standards benefits many market participants. Having to consult and comply with multiple, duplicative regulatory frameworks increases the friction and costs of doing business cross-border. The UK should recognise that regulation can be a source of competitive advantage, as well as disadvantage; continue to uphold (and set) international standards; and look to the markets with which it competes to assess where opportunities may lie. Going forward, when developing new standards in emerging areas, consideration should be given to other initiatives in other jurisdictions to minimise frictions while preserving the integrity of the UK markets.
5. **Promoting competition** should be a keystone – the reform process is to benefit future entrants to the market as well as incumbents and changes should facilitate competition. Equally, the impacts of reform on the competitiveness of international financial institutions participating in the UK markets should also be taken into account: protectionism in wholesale markets disincentivises investment and drives liquidity elsewhere.
6. **Innovation** – the framework must allow for and encourage innovation. Technological developments are a necessary ingredient to the success of the UK markets.
7. **Clarity** – the UK regime needs to be streamlined, comprehensible and proportionate. We have accumulated nearly 20 years of intensive EU rulemaking, in many cases layered onto pre-existing domestic regimes. This complex web of legislation needs review, consolidation and simplification.

The *acquis*, and indeed the wider UK regulatory framework, need review against these principles to identify where change is justified.

What should not change?

The UK has taken a leadership role in the development of a number of areas of regulation. Compliance with internationally agreed standards is a hallmark of a well-regulated regime. Where the *acquis* reflects those standards, the UK should not diverge from it. Examples include the Basel prudential rules; the FSB recovery and resolution framework; and the G20 commitments on the regulation of OTC derivatives following the global financial crisis.

Possible approaches: radical, or incremental?

One (radical) way of thinking about the process is to undertake a little regulatory "archaeology". The *acquis* comprises a large number of reforms, largely made following the global financial crisis. Looking back at each of these, one can assess whether they were made:

(a) as part of a commitment to international standards; or

(b) as a response to an observable market failure which occurred in the UK markets (regardless of whether it occurred elsewhere in the EU).

If they were not, then the starting position is that they should be removed. The result of this analysis would arguably put large swathes of the *acquis* up for sunset. This is particularly true of wholesale markets, in which the historic free market approach of the UK system has been highly permissive, based on principles of *caveat emptor* backstopped by high standards of disclosure to found rights for misselling. This may not be appropriate for all cases, however, where continued compliance with standards equivalent to those in the EU might ensure access to those markets is maintained.

A more incremental approach would be to follow an "if it ain't broke, don't fix it" approach: prioritising continuity over change except in those areas where there are identifiable failures in the *acquis*.

Recent publications from the Government have indicated a willingness to be radical in approaching the exercise.

What else could change?

The EU *acquis* is not, of course, the end of the story. The current environment merits review of the wider UK legal and regulatory framework, and in some areas (particularly capital markets and fintech) significant work is already underway.

The mechanics of change

The journey is almost as important as the destination

The process of revoking EU legislation is fundamental to, and inextricably linked with, the creation of the future regulatory framework. How that task is performed will be critical to the future regulatory framework's success. Industry participants are keen to understand how they will be able to, and indeed will *have to*, engage in this new wave of regulatory change.

Big Bang 2.0 or a drip feed of piecemeal change?

HM Treasury (HMT) and the regulators have confirmed that they are already working together on the potential prioritisation for the repeal of retained EU law.
As discussed above, the magnitude of the task means that the process will likely take a number of years but there is a clear political drive to move quickly.

In September of this year, the Government introduced the Retained EU Law (Revocation and Reform) Bill (the Brexit Freedoms Bill) to Parliament. It came with an announcement that all retained EU laws will be "sunset" on 31 December 2023. However, if the FSM Bill "subsists" by the end of 2023 (currently it appears likely to be passed by April/May 2023), the Brexit Freedoms Bill will not require the financial services legislation listed in Schedule 1 to the FSM Bill to be revoked by the end of December 2023. Neither does the deadline to revoke apply to any rules of the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA), the Bank of England or to any PSR generally applicable requirements or directions of general application.

Complex process

As a technical matter, the rewrite of the acquis into UK rules will be complex, with a high risk of unintended consequences. A staggered review will have to cater for the intricate web of cross references and interdependencies across the onshored EU acquis.
Take, for example, the requirement in prudential regulation for credit assessments to be mapped to corresponding risk weights where the process for mapping is set out in separate legislation. If the process is not in place, the regulation cannot operate. Reviewers will have to ensure that they focus on the detail and the wider framework.

Transparency

The government and both regulators each undertake to provide as much clarity as possible to stakeholders on forward plans. The government expects to set out further information on the programme of work "in due course". The FCA intends to publish a dedicated space on its website, "in the autumn", tracking its work in response to the future regulatory framework (FRF) and associated consultations and to outline the likely timetables for the FRF file transfer.

It is also imperative that the policy changes intended through the process are clearly, and exhaustively, articulated to market participants so that they understand all expectations of them.

Regulators' autonomy?

Understanding the timetable and purpose of change is one thing, being able to engage and to help shape policy is yet another area of concern for the industry.

In line with the FSMA model of regulation, where financial services regulation is centralised in the regulators' rulebooks, the FSM Bill gives the UK's financial services regulators greater rule-making powers. The focus then centres on the accountability of the regulators. The regulators will be required to respond to HMT recommendations and to keep their rules under review. The Bill also enables HMT to place obligations on the regulators to review their rules or to make rules in relation to specific matters or to specified descriptions of people. The content, form and outcome of those rules will remain for the regulators to determine.

Shaping policy

When deciding what rules to make, the regulators will need to follow their usual process, including considering their statutory objectives, regulatory principles and any additional "have regards" set by HMT. The FSMA also requires the regulators to consult publicly on rule changes, and to conduct a cost benefit analysis on the impact the rules will have. However, the FSM Bill enables HMT to exempt the regulators from the requirement to conduct a consultation and cost benefit analysis to the extent that the proposed rules make restatement provisions without material modification. The relevant regulator is responsible for assessing whether any changes are material. This could rob the industry of the ability to set out its case for divergence in a particular area, unless the Government can be persuaded that it falls within the public interest arena. Certainly, any policy change should be the subject of consultation, regardless of the regulator's perception of materiality.

What now?

The Bill had its **second reading in the House of Commons** on 7 September. The Public Bill Committee is now scrutinising the Bill and is scheduled to report by Tuesday 25 October. After the report stage, the FSM Bill will then have its third reading in the House of Commons before passing to the House of Lords.

Ultimately, we will have to wait until after the FSM Bill receives royal assent before we get any clarity on the regulators' policy approaches. The PRA intends to publish a consultation paper to follow up on its September **Discussion Paper** considering their approach to policy making. Responses to that consultation will then inform the PRA's final Policy Approach document, which it intends to be the policy equivalent of the PRA's Approach to Supervision publications. We would also expect the anticipated information from the Government on the programme of work at this stage, together with an update from the FCA on the anticipated timetable for the FRF file transfer.

Industry will want to engage with the substance of the reforms and to influence the process. There is understandable concern that any rush to revoke retained EU law could cause problems for the financial services markets at least in terms of resources, and also in terms of likely errors.

Change is coming. The market needs to work with the public sector to ensure that the future regulatory framework positions the UK to remain a thriving and competitive international financial centre.

We at Allen & Overy have given considerable thought to possible options for reform and would be delighted discuss them with you. Please reach out to your usual A&O contact or any of our Financial Services experts listed below.

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