ALERT MEMORANDUM

The UK's Post-Brexit Financial Services Regulatory Framework – Details Emerge

June 26, 2020

On June 23, 2020, HM Treasury announced the first concrete "details on the UK's continued commitment to high regulatory standards for the financial services sector post-EU withdrawal", in respect of prudential and markets regulation.[1]

These policy announcements[2] demonstrate the government's willingness to depart from some of the least industry-friendly EU rules and its desire to preserve the openness of the UK financial centre. However, it remains to be seen whether the UK Parliament will approve HM Treasury's key proposals to delegate the design and implementation of micro-prudential regulation to the expert, independent financial services regulators, and how the regulators will fulfil this role in practice and balance safety, soundness and consumer protection concerns, on the one hand, and considerations as to the competitive position of the UK's financial markets, on the other hand, in a post-financial crisis, post-pandemic ("COVID-19") and post-Brexit context.

The announcements also included HM Treasury's proposed solution for tackling the 'tough legacy' of contracts which reference the London Interbank Offered Rate ("LIBOR") and do not have robust reference rate fallbacks and which cannot be amended ahead of LIBOR discontinuation at the end of 2021.

Implementation of regulatory reforms – HM Treasury's general approach

— The government intends to implement immediate reforms in line with the approach of the EU and other international authorities, where relevant. However, there will be some areas where it would deviate to account for the specificities of the relevant UK sector.

— In particular, HM Treasury is considering the implementation of aspects of EU regulations that do not apply until after the end of the Brexit transition period (*i.e.*, December 31, 2020)[3]. It notes that "*it is right that the UK exercises its discretion when implementing these files*".

Financial Services Future Regulatory Framework Review

— In July 2019, HM Treasury launched its Financial Services Future Regulatory Framework Review to consider how the UK's regulatory framework needs to adapt over the coming years to be fit for the future.[4] HM Treasury intends to use the review to explore the role of government and Parliament in deciding how public policy issues should be addressed in key areas of financial services regulation post-Brexit, and how the FCA and Bank of England can take the lead on designing and implementing specific regulations while ensuring there is appropriate democratic policy input.

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[1] *See* https://www.gov.uk/government/news/regulatory-reforms-in-financial-services?utm_source=e542de87-0eb8-42e5-b587-01edbbb84951&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

[2] These announcements are incorporated in a set of ministerial statements, a policy statement and a consultation document, in addition to related statements by the FCA.

[3] Such regulations will therefore not be "onshored" under the European Union (Withdrawal) Act 2018.

[4] *See* https://www.gov.uk/government/consultations/financial-services-future-regulatory-framework-review#history.

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— The next phase of the review will look at how financial services policy and regulation are made in the UK. HM Treasury will consult on its approach to the next phase of the review in the second half of this year.[5]

Equivalence

— The government continues to believe that comprehensive mutual equivalence is in the best interests of both the UK and EU.[6]

— HM Treasury intends to amend the onshored Markets in Financial Instruments Regulation ("MiFIR") to update the equivalence provisions for third country investment firms under Title VIII (Provision of services and performance of activities by third-country firms following an equivalence decision with or without a branch).[7]

Prudential requirements – general approach

— The government notes that "rules designed as a compromise for 28 countries cannot be expected in every respect to be the right approach for a large and complex international financial sector such as the UK".

— HM Treasury has identified four "*overarching principles*" in legislating prudential standards in the planned Financial Services Bill:[8]

- financial stability and the implementation of international standards, in particular the Basel III and 3.1 standards;
- supporting the government's wider objectives on growth, competition, and competitiveness;
- a central role for the financial services regulators in designing and implementing the detailed and technical requirements that will apply to firms; and
- a flexible and proportionate approach, enabling the UK to both maintain a strong future partnership with the EU and other major economies, and to account for specificities in the UK financial services market.[9]

— As a result, the vast majority of prudential requirements for banks and investment firms will be implemented in the regulators' rulebooks.[10]

— In exercising these rule-making powers, the regulators will be subject to an "*enhanced accountability framework*" that will:

[5] The first phase of the review considered the issue of coordination between UK regulatory bodies with responsibility for financial services regulation, with the aim of improving the effectiveness of coordination in the future. The government published a call for evidence, which closed in October 2019. A summary of the responses to the call for evidence was published in March 2020.
[6] The Political declaration setting out the framework for the future relationship between the European Union and the United Kingdom envisages that the key mechanism the UK and EU will use to regulate interactions between their financial systems will be their respective equivalence frameworks. It provides that "*the Parties should start assessing equivalence with respect to each other under these frameworks as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020*". In our view, none of the areas of divergence from the EU framework announced by HM Treasury should, in principle, affect the EU's assessment of the equivalence of the UK's regulatory frameworks.
[7] This is likely to carry across changes to the EU MiFIR Title VIII introduced by the Investment Firms Regulation ("IFR") with effect from June 26, 2021.
[8] In the Queen's Speech on December 19, 2019, the government announced its intention to bring forward a Financial Services Bill in order to *(i)* deliver the government's commitment for long-term market access between the UK and Gibraltar for financial services firms; *(ii)* simplify the process which allows overseas investment funds to be sold in the UK; and *(iii)* enable the UK to implement the Basel standards.
[9] It seems not unlikely that these principles would also be made to apply in other areas of regulation.
[10] Reflecting the position before the coming into effect of the Capital Requirements Regulation ("CRR").

- enable greater scrutiny of the regulators' decision-making by Parliament and industry; and
- ensure that the regulators consider UK competitiveness, international developments in prudential regulation and the UK's relationships with other jurisdictions, such as financial services equivalence, when setting these prudential rules. This will require that the regulators:
  - set out how these matters have been taken into account, balanced and traded-off, when consulting on new rules; and
  - explain how these new rule-making requirements have influenced the design of the regime once the rules are finalised.

— HM Treasury intends to specify the additional requirements of the enhanced accountability framework "*at the level of regulatory principles or equivalent*". This would mean that the PRA's primary and secondary objectives, and the FCA's strategic and operational objectives, will keep the same status as they currently have.[11]

Second Capital Requirements Regulation ("CRR II"), Fifth Capital Requirements Directive ("CRD V") and Basel 3.1

— The government and the regulators propose to introduce updated rules for banks such that they achieve similar intended outcomes as those in CRR II. The UK will endeavour to introduce the new rules by Summer 2021, broadly consistent with the application date of the majority of the CRR II requirements (*i.e.*, June 28, 2021).[12] However, the specific timing of introduction of these rules will be dependent on the Financial Services Bill's passage through Parliament.

— The UK is also bound to transpose CRD V, given that the transposition deadline of December 28, 2020, falls within the Brexit transition period. A consultation on the UK's transposition of CRD V will take place in July 2020.

— The government and regulators intend to implement "*targeted deviations*" from the EU regime to reflect the number, size and nature of investment firms and credit institutions within the UK, and the structure and operation of the UK market. However, they have not yet identified the relevant aspects of CRR II. The Financial Services Bill will delete articles of the onshored CRR, where appropriate, and provide HM Treasury with the power to make further deletions. The PRA will publish further details on how it will tailor the regime to the UK in due course.

— HM Treasury remains "*committed to the full, timely and consistent implementation of the Basel 3.1 standards*" and plans to work towards a UK implementation timetable that is consistent with the one-year implementation delay announced by the Basel Committee on Banking Supervision on March 27, 2020 to provide operational capacity for banks and supervisors to respond to COVID-19.[13]

— The PRA will also need to ensure that the impact on sustainable lending to the UK economy is sufficiently considered.

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[11] HM Treasury seems to have in mind the approach which applied to the FCA's predecessor, the Financial Services Authority (the "FSA"): the FSA was obliged to meet its statutory objectives in ways consistent with certain "principles of good regulation", including taking into account the international character of financial services and market, and the desirability of maintaining the competitive position of the UK.

[12] Certain measures (including total loss-absorbing capacity ("TLAC") requirements for global systemically important institutions) began to apply on June 27, 2019.

[13] *See* https://www.bis.org/press/p200327.htm.

IFR and Investment Firms Directive ("IFD")

— The government and the regulators also intend to introduce a new prudential regime for investment firms ("IFPR") with similar intended outcomes as those in the IFD and IFR and ideally the same effective date as the IFD and IFR (*i.e.*, June 26, 2021).

— HM Treasury intends to include additional detail in the legislation which will specify the IFPR's ultimate objectives. This additional detail will prescribe that the new regime should address the potential harm that investment firms pose to their clients, the risks they may pose to markets and should capture, where relevant, the specific vulnerabilities and risks inherent to investment firms.

— However, HM Treasury and the regulators do not intend to require PRA-designated investment firms to re-authorise as credit institutions, unlike the EU regime. HM Treasury and the regulators consider that the existing PRA designation framework achieves the same outcomes sought by the IFD and IFR.

— CRR II and CRD V, as well as any subsequent updates to the banking regime, should not apply to solo-regulated investment firms:

- HM Treasury intends to amend onshored CRR to disapply it for solo-regulated investment firms.
- In addition, the government does not intend to require FCA-regulated investment firms to comply with the requirements of CRD V in the period until the IFPR applies.

— The FCA has published a discussion paper on implementing the IFPR. The deadline for comments is September 25, 2020. The discussion paper highlights the key impacts of the IFD and IFR and the FCA's initial views on the intention and implication of the regime, with the intention of soliciting views on the approach the FCA could take in the UK under domestic legislation. This includes that:

- all investment firms would be subject for the first time to liquidity requirements;
- the levels of initial capital required for authorisation would be updated and there would be changes to the rules on the definition of capital;
- there would be a brand new methodology for calculating capital requirements (*i.e.*, the "K-factor" approach);
- there would be new rules on prudential consolidation, group risk and concentration risk;
- there would be new remuneration and disclosure requirements; and
- if the UK were to adopt a similar approach under the domestic IFPR as in the IFD and IFR, the FCA would no longer apply the range of existing prudential categories such as "full scope IFPRU", "BIPRU" and "exempt-CAD". All firms would simply be known as "investment firms", of which the (typically) smaller firms would be termed "small and non-interconnected investment firms".

Second Bank Recovery and Resolution Directive ("BRRD II")

— HM Treasury intends to transpose most of BRRD II.

— However it does not intend to transpose the requirements that do not need to be complied with by firms until after the end of the Brexit transition period, in particular the revisions to the Minimum Requirements for Own Funds and Eligible Liabilities ("MREL") framework. The UK already has in place a MREL framework in line with international standards (*i.e.*, the Financial Stability Board's TLAC standards).

— In considering the transposition of BRRD II, the government will look to build upon the UK's current resolution regime under the Banking Act 2009.

Solvency II

— The government plans to bring forward a review of certain features of Solvency II that were the subject of long-standing discussions when the UK was an EU Member State, to ensure that the regime is properly tailored to take account of the structural features of the UK insurance sector. These include:

- risk margin;
- matching adjustment; and
- operation of internal models and reporting requirements for insurers.

— The government expects to publish a call for evidence in Autumn 2020.

Central Securities Depositories Regulation ("CSDR") settlement discipline

— The UK will not implement the EU CSDR settlement discipline regime, which is due to apply in February 2021.[14]

— UK firms should instead continue to apply the existing industry-led framework.[15]

— The government will consider the future approach to the UK's settlement discipline framework. HM Treasury has promised that any future legislative changes will be developed through dialogue with the financial services industry, and sufficient time will be provided to prepare for the implementation of any future regime.

Securities Financing Transactions Regulation ("SFTR") reporting

— The UK will not take action to incorporate into UK law the reporting obligation of the EU's SFTR for non-financial counterparties ("NFCs"), which is due to apply in the EU from January 2021. The government considers that systemically important NFC trading activity will be captured sufficiently through the other reporting obligations that are due to apply to financial counterparties.

Market Abuse Regulation ("MAR")

— HM Treasury intends to amend onshored MAR to confirm and clarify that both issuers and those acting on their behalf must maintain their own insider lists.

— HM Treasury also intends to change the timeline issuers have to comply with when disclosing certain transactions undertaken by persons discharging managerial responsibilities.[16]

European Market Infrastructure Regulation ("EMIR")

— HM Treasury intends to introduce legislation to complete the implementation of the EMIR "REFIT" to improve trade repository data and ensure that smaller firms are able to access clearing on fair and reasonable terms.

[14] This includes measures aimed at improving settlement efficiency, such as cash penalties for fails and mandatory buy-in requirements.
[15] Of course, UK firms would be subject to the EU's CSDR in respect of transactions which are settled in EU central securities depositories.
[16] These changes will presumably incorporate the changes to EU MAR made by Regulation (EU) 2019/2115 as regards the promotion of the use of SME growth markets, which will apply from January 1, 2021 (and therefore after the end of the Brexit transition period). It is not clear whether the other changes in Article 1 of Regulation (EU) 2019/2115 would also be adopted.

Packaged Retail Investment and Insurance Products ("PRIIPS") Regulation

— HM Treasury wants to improve the functioning of the PRIIPs regime in the UK and address potential risks of consumer harm, in response to industry and regulator feedback. It intends to publish a policy statement in this respect in July 2020.

Benchmark Regulation ("BMR") and LIBOR

— HM Treasury intends to provide continued market access to third-country benchmarks until end-2025.[17] HM Treasury intends to publish a policy statement in this respect in July 2020.

— HM Treasury plans to make amendments to the onshored BMR which aim to give the FCA enhanced powers to manage an orderly transition from LIBOR to help deal with tough legacy contracts that cannot transition from LIBOR before the end of 2021. The proposed new powers will be available where the FCA has found that a "critical benchmark" (as defined under the onshored BMR; see the Q&A section below) is not representative of the market it seeks to measure and representativeness will not be restored. The FCA would be able to direct the administrator to change the methodology used to compile the benchmark if doing so would protect consumers and market integrity. Although this would not make the benchmark representative again, it would allow the FCA to stabilise certain LIBOR rates during a wind-down period so that limited use in legacy contracts could continue, if suitable robust inputs to support such a methodology change are available. The FCA considers that this approach is consistent with the "*synthetic methodology*" solution put forward by the Sterling Risk Free Rate Working Group ("RFRWG") in its *Paper on the identification of Tough Legacy issues* in May 2020.[18] It will publish statements of policy on its approach to potential use of these powers following further engagement with stakeholders in the UK and internationally.

— HM Treasury will also seek to strengthen the BMR framework to prohibit use of an individual critical benchmark where its representativeness will not be restored, whilst giving the regulator the ability to specify limited continued use in legacy contracts.

Do the proposals mean that transitioning from LIBOR is no longer necessary?

No. These powers are intended to provide a potential way of resolving recognised issues around a "*narrow pool*" of tough legacy LIBOR contracts.

The RFRWG, the FCA and the Bank of England published joint statements on March 25, 2020[19] and April 29, 2020[20] relating to LIBOR transition. These statements reiterated the need for firms to continue to migrate away from LIBOR and that firms cannot rely on the benchmark's continued publication after 2021. The proposals recognise that, as already acknowledged by the regulators, the interim timetable for transition has been slowed by COVID-19 but indicate that the market must continue transitioning away from LIBOR.

Furthermore, as a practical matter, and as pointed out by HM Treasury and the FCA, regulatory action to change the LIBOR methodology may not be feasible in all circumstances or for all LIBOR currencies. Even if feasible, parties who rely on such action will not have control over the economic terms of that action. Any methodology change may also be unable to replicate exactly the preferred structures expected to prevail in the new markets based on the alternative risk-free rates. Accordingly, transitioning away from

[17] The transition in the BMR ends December 31, 2021.
[18] *See* https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/paper-on-the-identification-of-tough-legacy-issues.pdf?la=en&hash=0E8CA18F27F75352B0A0573DCBBC93D903077B6E.
[19] *See* https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans.
[20] *See* https://www.fca.org.uk/news/statements/further-statement-rfrwg-impact-coronavirus-timeline-firms-libor-transition-plans

LIBOR as far as possible may be the only way for parties to have certainty and control over their contractual terms when LIBOR ceases or is deemed to be no longer representative.

Would the proposed legislation only apply to LIBOR?

No. As noted above, the proposed legislative changes are anticipated to apply to "critical" benchmarks as defined under the onshored BMR.[21]

How do the proposals fit with BMR's prohibition of an ongoing market in a non-representative benchmarks?

The BMR requires that, where an administrator considers that the input data does not represent the market or economic reality that a benchmark is intended to measure, the administrator must, "within a reasonable time period", either change the input data, the contributors, or the methodology in order to ensure that the input data does represent such market or economic reality, or else cease to provide that benchmark.[22] The FCA considers that a methodology change might be appropriate to sustain the rate if reliance on its current methodology became inappropriate or not feasible before the end of the reasonable time period as determined to be appropriate for the orderly wind-down of the benchmark.

Would the proposals to prohibit use of a benchmark where representativeness will not be restored apply only to new contracts, or also to legacy contracts?

The changes will make clear that, in principle, where a benchmark loses representativeness and its representativeness will not be restored, use of the benchmark must cease. However, the intention is to protect consumers and market integrity where there are legacy contracts that [are less likely to] be amended. Accordingly, when using its powers to operationalise this principle, the FCA will seek to do so in a manner that prevents market disruption. In addition, the FCA will have the power to permit continued use in legacy contracts, where it considers this appropriate.

Is it recommended to include a pre-cessation trigger in contracts?

Yes. Fallbacks which come into effect at the point a benchmark becomes non-representative provide another route to ensure that contracts move away from LIBOR before it becomes non-representative, and before any prohibition on use comes into effect.

Would LIBOR's methodology necessarily change?

No. The legislation does not mean that LIBOR's methodology will be changed. The FCA acknowledges that market participants may prefer that publication of some LIBOR currency tenor pairs ceases, rather than there being a change to the methodology. In other circumstances, methodological change may be desired but not feasible. The FCA's planned policy statements should provide more information on these matters.

Would it have been better to directly impose legislative changes on LIBOR-referencing contracts that are governed by the laws of England and Wales, Scotland, or Northern Ireland, like the proposal for legislative relief under New York law put forward by the Alternative Reference Rates Committee ("AARC")?

Adopting a similar approach for contracts governed by UK law would, if the ARRC approach is adopted, help to bring about international consistency in the treatment of tough legacy contracts. However, it remains

[21] *I.e.*, a benchmark listed in *(a)* Commission Implementing Regulation (EU) 2016/1368 establishing a list of critical benchmarks used in financial markets pursuant to the BMR; or *(b)* regulations made by HM Treasury under paragraph 5 or 6 of Article A20 or paragraph 5 of Article 20 (of the onshored BMR).

[22] Article 11(4) BMR.

to be seen whether the AARC proposals would be adopted. Accordingly, HM Treasury's proposals are a pragmatic solution which has the advantage of using the existing BMR framework.

Do the proposals increase the conduct risk for regulated firms?

No. They should not increase conduct risk as long as firms do not respond to the proposals by relaxing their LIBOR transition plans including amending existing LIBOR-referencing contracts. We do not think that these proposals heighten concerns firms may have about the fairness or reasonableness of seeking to amend contracts but firms would need to effectively communicate the proposals and any changes to their approach to the transition as a result.

The proposals are intended to create additional options to manage the wind-down of LIBOR (or other critical benchmarks) during a pre-cessation period and thereby reduce disruption for themselves and their clients.

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