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LETTER FROM THE PRESIDENT

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Brexit and what it portends for UK-EU and global capital markets

HIGHLIGHTS:

The Brexit negotiations will go down to the wire with the eventual outcome difficult to predict. The market dislocations could be modest given regulatory reliance on mutual recognition or national treatment, or substantive if trade execution and clearing are forced into EU markets.

There is a need for an overarching structure to promote regulatory cooperation for efficient cross-border capital flows. The Financial Stability Board (FSB) may be the best possible vehicle to take on responsibility for a regional or global collaborative framework for regulatory coordination of rules and mechanisms.

Brexit and the ongoing negotiations between the UK and European Union (EU), and likely outcome and implications for European and global capital markets, dominate the financial headlines, especially in Europe. These negotiations coincide with the "big bang" of EU regulation (MiFID II), the phasing out of the London Interbank Offered Rate (LIBOR) and transition to alternative reference rates, American disengagement from multilateralism, and continued sluggish growth in the global economy. These developments have implications for the global economy, and financial institutions and Canadian businesses operating in the European and global markets.

The consensus is the Brexit process has been mishandled from the start. The UK has failed to define its core objectives and its negotiating strategy. Moreover, the governing coalition, the Conservative Party, with its mix of Remain MPs and Brexiteers, has complicated formation and execution of strategy.

MEANDERING BREXIT NEGOTIATIONS

The government is now nearly half-way through the defined negotiating period, having triggered Article 50 last March, and negotiations on a trade deal have not yet begun. It has become clear a decision on a financial settlement is a pre-condition for starting negotiations on both the transition period and final trade arrangement. In her Florence speech in September, Prime Minister May put forward a proposed £20 billion package, 'the divorce bill', with the EU signaling it was insufficient. This financial package has now been upped to £40 billion to break the deadlock in Brexit talks. However, at this stage, it is not even clear whether the final agreement on money depends on a specific dollar amount or an agreed methodology to calculate the settlement amount.

Some argue an agreed upon financial settlement will be a sufficient, or close to sufficient condition for the UK to retain access to a single market in Europe and gain concessions on control over EU immigration and recognized sovereignty of UK law. While the UK has not yet articulated its formal position on immigration and sovereignty, the UK Brexit Minister has opined publicly on permitting open immigration to the UK financial sector, and the UK Parliament has passed second reading of the EU (withdrawal) bill, bringing EU legislation and regulations into domestic law.

On the other hand, many argue an agreed upon financial settlement simply opens up further intense negotiation on a free-trade deal or single market access, and concessions on EU immigration/sovereignty. The talked-about models for the UK are i) the Norway ETA agreement, providing access to the single market, attornment to EU law, and agreement to unfettered movement of EU citizens; and ii) the Canada-European Union Comprehensive Economic and Trade Agreement (CETA). The problem with the Canadian trade deal is that it does not include financial services. Whether or not the UK can negotiate improvement over the aforementioned models, the fact remains the negotiating period will have to be extended beyond the March 2019 deadline, raising further political problems for the UK and making the transition arrangements an even higher priority.

As the negotiations bog down, the transition arrangements loom as increasingly important to enable business to restructure to the new regime and avoid disruption. The UK and EU governments have not signaled anything on this front. However, European business associations met recently with the UK government to indicate their intentions to begin moving operations from the UK, unless transition is clarified by December this year. U.S. banks operating in London are reportedly re-organizing back-office operations of their European investment banking business to place them within a London branch of the European subsidiary. It is not clear that such a structure will be acceptable to the EU authorities.

MERGING OF GERMAN AND FRENCH INTERESTS MAY NOT BE AS STRAIGHTFORWARD AS THOUGHT

A strong EU voice is critical for constructive dialogue on the ongoing Brexit negotiations, not just until UK withdrawal from the EU, but more importantly in the post-Brexit period. A more stable political climate, and picture of improving EU economic growth, as well as a more Euro-centric view from France (reflecting the Macron election and related convergence in economic thinking and strategy between France and Germany) increase the prospects for a more unified voice and bargaining geared to a more market-oriented approach.

However, the risks of a less coherent position from Europe remain significant. First, financial and economic shocks remain a possibility given a shaky banking system and high debt loads in Southern Europe. Second, the anticipated strengthening in the French-German alliance may be overstated as Macron encounters problems managing his ambitious comprehensive policy agenda-- not just labour, tax and fiscal reforms in the country-- but major policy initiatives in technology, sustainability and immigration. Finally, the Merkel government may find it a complicated task to pull together a coalition government, strongly tied to France. The EU Summit has been postponed from December 2017 to March 2018, reflecting difficulties forming a government.

THE EVOLVING REGULATORY LANDSCAPE IN EUROPE AND THE UK

The negotiating process for transition arrangements and a trade deal are interesting developments in their own right, but in the context of the financial sector, it is perhaps more insightful to consider the post-Brexit environment, notably potential interference to cross-border flows from re-alignment of regulatory regimes and related impact on financial business. While there is much uncertainty about the final outcome of the negotiations, the likely result will be either a 'hard' or 'soft' Brexit, in either case resulting in a potential divergence in regulatory regime.

In thinking about the regulatory regime, it is useful to separate the institutional or wholesale financial businesses from the retail businesses. First, the UK wholesale market is a critical source of liquidity and funding for EU corporate and government bonds. The European banks have become even less capable of meeting European financing requirements, given the troubles at Deutsche Bank and the parlous state of Italian banks, while the French and Spanish banks are in modestly better shape. Further, the indigenous European capital markets are under-developed. This suggests the EU approach to regulating European-directed financings and institutional trading will be reasonable. €1.3 trillion in European assets are held in UK-based banks, testifying to the breadth and depth of the London market.

The retail advice/product distribution business is spread right across Europe and regulated by national governments. The European Securities Markets Authority (ESMA) is moving to a single rulebook and EU supervisory oversight, with a similar initiative underway with the so-called Banking Union. Much of the cross-border retail business is in managed fund products, mutual funds, ETFs, etc., as it is in Canada and the U.S. Subsidiaries of the asset-managers are already established in Luxembourg and Brussels. These administrative offices obtain EU approval to delegate fund managers based in the U.S. and UK. There are indications in a post-Brexit regime the EU could make approval of offshore managers more difficult. This hard-ball play might affect UK-based funds more because of the longstanding precedent for approving U.S.-based managers. The regulatory impact would not appear overly onerous and, indeed, unlikely, as forcing asset managers to relocate to Europe would not improve investor protection, nor would it have much economic impact as such a move if directed at the UK could simply result in a shift of managers in the U.S..

The starting point for post-Brexit, whether institutional or retail, is rule equivalence, as the UK comes out of the Brexit negotiations with the EU rulebook. The logical approach is mutual recognition between the UK and EU27 for financial institutions and advisory and dealing activity, publicly offered securities, and clearing.

The alternative could be a national treatment regime, similar to the Canadian-U.S. relationship. Either regulatory model would be easily adaptable. The third hard option is that the EU could force the UK dealing banks to conduct trading and clearing business with European clients within the EU, requiring the shift of trading and clearing operations to Europe through EU-based infrastructure. However, this is a high stakes option and difficult in the short run, as existing infrastructure in Europe is inadequate and resources insufficient for effective regulation of trading and clearing. Indeed, British regulators provide key oversight and perspective on the boards of ESMA and the EBA (European Banking Authority), and the Governor of the Bank of England is on the board of the European Systemic Risk Board. Finally, heavy reliance on funding from UK markets and related increased costs and dislocations thrown up by this regulatory option make it unlikely. That said, it cannot be assumed decisions in Brussels will be driven by economic rationale, and not politics.

IS THERE A CHANCE FOR MORE FORMAL REGIONAL AND GLOBAL REGULATORY COORDINATION?

As we move forward in a post-Brexit world, the divergence in rulebook between the EU and UK will widen. One force driving divergence would be efforts to dismantle parts of the highly prescriptive MiFID II rule framework. The UK is likely to streamline these rules to achieve better balance between market efficiency and investor protection, and improve the competitiveness of its capital markets. Over time, this rule disharmony will increase compliance costs of cross-border trade, and could upset the balance of regulatory cooperation with the EU. Further, the UK will be looking to establish greater rule convergence and regulatory cooperation, such as mutual recognition and passporting, with the U.S. authorities. The effort will be difficult, both because of natural intransigence of the U.S. regulators, and as well put in jeopardy regulatory arrangements with the EU.

It is clear that post-Brexit, the UK and the EU need a model of regulatory cooperation. A more ambitious model would includes the U.S. and Japan. In a recent opinion piece in the *Financial Times* (October 31, 2017), Sir Howard Davies (Chairman of the Royal Bank of Scotland) identified the need for an overarching structure for EU and UK capital market regulatory cooperation. He notes that much EU regulation is derived from international codes and rules; the rough similarity in rulebooks and market structure in the U.S., UK, Japan, Australia and Canada; and capital rules based on the Basel Accords. He suggests the formation of a group of 'Wise People' to advise on the structure of enhanced regulatory cooperation, drawn from Europe and the UK – similar to the efforts of Alexandre Lamfalussy in the early 2000s and Jacques Larosière de Champfeu in 2009 that brought recommendations for approving directives and creating new regulatory authorities in Europe.

SUMMARY

The need for greater cross-border coordination in securities regulation was evident well before Brexit, manifest in the disjunctive rule-making in the G20 reforms of the OTC derivatives market and the completion of the MiFID II rule package. The Financial Stability Board (FSB) may be the best possible vehicle to take on responsibility for a regional or global collaborative framework for regulatory coordination of rules, and mechanisms to address differences in cross-border regulation. While the FSB does not have binding authority over individual jurisdictions, similarly, neither does the BIS over national banking systems. Yet the BIS has demonstrated over the years strong and effective influence coordinating capital and liquidity standards for the global banking system. Perhaps a similar influence can be wielded in securities regulation. The FSB would need to work closely with individual securities regulators and their governments, perhaps beginning with the larger jurisdictions such as the EU and UK, to define a mandate and structure for regulatory coordination. The recommendations of the 2015 IOSCO Task Force on Cross-Border Regulation offer an effective place to start.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
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