Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

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The Rt Hon Andrew Tyrie MP
Chairman
Treasury Committee
House of Commons
14 Tothill Street
London
SW1H 9NB

Dear Andrew

As promised in my letter of 17 August, I am writing with further details on the questions raised at the 20 July TSC hearing.

You asked me to cover a number of issues, including an assessment of the regulatory landscape for financial services if the UK were to be considered a "third country" by the continuing European Union ("EU27"), with access rules essentially governed by WTO protocols. You also asked about the role of "passporting", the main elements of what an optimal future framework would look like, and the potential advantages of removing "passporting" requirements. Finally you asked for an assessment of the practicalities of improving global standards of regulation.

The General Agreement on Trade in Services (GATS)

I will start by offering some broader thoughts on cross-border trade in financial services. Generally, bilateral or multilateral trade agreements deal with issues of market access and non-discrimination, providing an overarching framework which governs firms' access to international markets.

The multilateral General Agreement on Trade in Services (GATS) under the World Trade Organisation (WTO) is in this mould. Two of the main principles within GATS are "most favoured nation" treatment: broadly, a WTO member granting favourable market access to another member must grant the same treatment to all other WTO members; and "national treatment", whereby once a service enters a market, members must treat that service no less favourably than domestic equivalents. These apply except where member countries of the WTO draw up regional Free Trade Agreements (FTAs), which allow for particular arrangements that liberalise trade in services between the signatories only. Such an agreement must satisfy the conditions specified within Article V of the GATS.

Under GATS the degree of market access is limited by the schedules of specific commitments and limitations for each member. In reality in order to operate in a particular market there may be specific requirements in place that an entity (foreign or domestic) will need to fulfil.

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The EU's schedule of market access contains limitations in respect of certain areas of financial services (I explain further the limitations in respect of asset management below). The GATS also contains discretions which permit signatories to take prudential measures where required, allowing national regulators to discriminate against foreign suppliers if this is deemed necessary for prudential security (known as the "prudential carve out" and aimed at ensuring the integrity and stability of the financial system).

One of the key distinguishing features of financial services is that the provision of most services is subject to authorisation by a statutory regulator. Requirements on authorisation are not, in and of themselves, prohibited under the GATS. Firms would, in many cases, therefore require authorisation from the regulator of the jurisdiction into which they seek market entry.

The role of "passporting"

For many activities, the EU single market obviates the need for firms to seek authorisation in another EU Member State[1] by establishing the passport mechanism, through which firms may exercise their right to provide services cross-border or their right to establishment. A passport is itself an instance of the rights of establishment and the freedom to provide services under the Treaty on the Functioning of the European Union (TFEU).[2] With a passport, an entity's authorisation to do business in one EU Member State is recognised by others as an authorisation to do business in their territory as well, and no further authorisation requirements are imposed.

It should be noted that there is no single passport available across all financial services sectors. Rather, firms need to seek specific permissions to provide cross-border financial services (directly cross-border or via a branch) as detailed in the relevant single market legislation. In addition, certain types of financial services activity do not have an option to passport written into the legislation, for example there is no specific consumer credit passport. This means that firms wishing to offer services or establish branches in relation to this type of activity may either choose to seek authorisation in the Member State in which they wish to do business, or rely on their direct rights under the TFEU to operate on a cross-border basis from the UK. There are also some activities which do not require authorisation (for example spot FX trading in the UK). Absent the option of a passport, entry requirements for a firm in relation to a particular activity will be determined by the regulatory regime of the individual EU Member State for which it seeks market access.

Both the UK and the EU are WTO members. As such, if the UK were to leave the single market completely and no FTA with the EU was in place, its financial services sector would 'default' to access governed by WTO protocols and firms would no longer have access to the passport mechanism allowing the supply of services or establishment of branches on the basis of a single authorisation.

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[1] "Passporting" is also available to firms with an authorisation from an EEA regulator where the relevant legislation is covered by the EEA Agreement.

[2] The rights under the TFEU mean that even where EU financial services legislation does not provide a specific passport, firms are in principle able to operate on a cross-border basis, although historically financial services firms have tended not to rely on this route.

This process would clearly be subject to WTO process and procedure, as for example the existing Financial Services Schedule does not cover the UK as a country outside the EU. In the absence of "passporting" rights, UK firms would need either to seek access under "equivalence" frameworks where possible, to use "third country" passports where available under specific pieces of legislation, or alternatively to seek authorisation from each regulator of the jurisdiction into which they aim to do business.

The implications of a potential loss of passporting rights will vary in their impact across different sectors – and firms within sectors – according to a number of factors, including business models, corporate structures and location of clients. Furthermore, in a complex landscape analyses should be based upon an understanding of the links and dependencies across and between these factors, whereby the withdrawal of passporting rights under one directive may have associated effects in other areas.

Equivalence frameworks for third countries

Turning to equivalence frameworks within the EU, these are permitted under various pieces of EU financial services legislation and result in different treatment for a third country whose regulatory system has been determined as "equivalent" to the EU regime. A determination of equivalence results, in some cases, in the ability to access the single market for firms from that third country. Equivalence is not established until there has been a decision typically in the form of a legal act by the European Commission. The specific process leading to that act can take some time to work though. For example, it took over three years to reach an agreement which recognises of the US Commodities and Futures Trading Commission's (CFTC) regulation of US Central Counter Parties (CCPs) as equivalent to EU arrangements under EMIR.

The requirements for determining equivalence vary across the different pieces of EU legislation, but often rest upon a demonstration that the regime has legally binding requirements, provides effective supervision by authorities, and achieves the same results or outcomes as the EU's corresponding provisions and supervision. Decisions may also require that the third country can provide an effective reciprocal mechanism offering access to EU entities and for cooperation arrangements to be in place with the third country.

The following pieces of EU legislation or standards contain some form of third country equivalence framework:

- Solvency II
- MiFIR and MiFID II
- Short Selling Regulation (SSR)
- Securities Financing Transactions Regulation (SFTR)
- Central Securities Depositories Regulation (CSDR)
- Credit Ratings Agencies Regulation (CRAR)
- Accounting Directive
- AIFMD
- Statutory Audit Directive
- Accounting Standards for Consolidated Reporting
- Accounting Standards for Prospectus
- Prospectus Directive

- European Market Infrastructure Regulation (EMIR)
- Benchmark Regulation
- Transparency Directive
- Capital Requirements Regulation and Capital Requirements Directive (CRD IV)

MiFID II and the AIFMD also allow access referred to as "third country passporting", as they permit the provision of some services on a wider cross-border basis. To date, 33 third countries have been granted at least one equivalence determination by the EU under certain of the pieces of legislation listed above. Details of specific equivalence determinations under specific pieces of legislation and their scope are set out in the annex.

Whilst equivalence frameworks may allow for some access to the EU single market in financial services in specific areas, they do not generally provide for the same level of access as either "passporting" or the right to establishment or freedom to provide services under the TFEU. These agreements can also be withdrawn under certain circumstances. For example under CRD IV equivalence determinations affect, amongst other things, the treatment (for capital purposes) of certain third country exposures and the supervision of groups with a third country parent undertaking. Unlike other third country regimes such as that under EMIR, a CRD IV equivalence determination does not provide a mechanism for access to the single market. By contrast the proposed equivalence framework for MiFID II does provide access by third country firms on a cross-border services basis, but only for investment services for certain types of clients. For example marketing to retail investors on an EU cross-border services basis is not permitted.

In the absence of an equivalence determination or third country passport, third country firms can still seek to gain EU market access through applying for authorisation from the relevant competent authority of the Member State in which they wish to do business, subject to that Member State's requirements.

The WTO and EU frameworks for asset management

You asked more precisely for an estimate of what asset management looks like under the WTO framework. As explained above the framework for market access in financial services in GATS is supplemented by schedules of commitments which set out what treatment WTO members offer to others in terms of access or limitation.

Within the GATS there is a specific restriction in a schedule of commitments in relation to managers and depositaries of UCITS funds, which reflects the position under the UCITS Directive requiring that a UCITS is managed by an EU manager and has an EU depositary (this depositary is also required to be established in the Member State of the UCITS). There are no specific restrictions in relation to alternative investment funds (AIFs).

In practice this means that under the UCITS Directive, a UCITS fund must be established in the EU, be managed by a management company established in the EU and have a depositary in the Member State of the UCITS. These provisions are extended to the EEA States that are not in the EU (i.e. Norway, Iceland and Liechtenstein) as a result of the UCITS Directive being annexed to the EEA Agreement. Under AIFMD, "passporting" rights are currently limited to EU alternative investment fund managers (AIFMs) with an authorisation from an EU regulator.

These types of AIFM are able to manage EU AIFs established in another Member State either by establishing a branch in that Member State or on a services basis. They also have the right to market the EU AIFs they manage to professional investors in other Member States.

Asset management and third country passporting

For managers and funds outside the EU, the AIFMD offers the prospect of a third country passport. Although these specific provisions of the legislation are not yet in force and therefore have not yet been tested, in principle they allow for the marketing of non-EU AIFs to professional investors in the EU in certain cases, and for non-EU AIFMs to manage EU AIFs and market them to professional investors within the EU, if the non-EU AIFM is authorised in an EU 'Member State of reference'. The process for switching on these provisions has started, but it is not yet clear when the "third country passporting" regime will start. The European Securities and Markets Authority (ESMA) published its advice on "third country passporting" under AIFMD in July 2016. This advice is now being considered by the European Commission, European Parliament and Council of the EU.[3]

In the absence of the AIFMD "third country passporting" regime, currently for managers and funds outside of the EU marketing is through a National Private Placement Regime (NPPR). This allows Member States to permit EU AIFMs managing non-EU AIFs and non-EU AIFMs managing EU and non-EU AIFs to market these AIFs within a specific EU Member State on the basis of that member state's NPPR. The regimes are subject to certain minimum standards set out in AIFMD and vary across Member States in terms of the conditions they set for access; some regimes are more restrictive than others, and some Member States do not operate an NPPR at all.

Supporting FCA objectives through an "optimal framework"

Turning to the further information I undertook to provide, you also asked for an overview of the main features of an "ideal outcome" for financial services from EU exit negotiations. Those negotiations and the eventual shape of the UK's future relationship with the EU will, of course, be a matter for Government, and the FCA will cooperate closely with Government as the situation evolves.

In arriving at what is, at this stage, necessarily initial FCA thinking on an "optimal framework", we are mindful of our statutory objectives and therefore seek an arrangement that maximises competition in the interests of consumers, while preserving and deepening market integrity and retaining high conduct standards and protecting consumers across all relevant financial markets. The points I outline below are motivated with regard to those objectives.

Given the scope, scale and nature of the UK's financial services sector, a framework based upon five broad principles would help achieve this:

[3] https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries

1. **Cross-border market access.** As is clear from the "passporting" figures set out in my letter of 17 August, in particular with regard to wholesale and insurance business, UK and other EU firms operate cross-border into European and global markets as a matter of course. Open markets are an important enabler of healthy competition, supporting FCA objectives.
2. **Support for the principle of consistent global standards where markets are also global.** With so many sectors of financial markets truly international in their cross-border activity, it is important that – where relevant – regulatory standards are globally consistent. This means in certain areas, particularly wholesale financial markets, having standards that are consistent across regions and jurisdictions in order to minimise the risks of regulatory arbitrage and fragmented markets. It also means regulators working effectively together through international standard setting organisations as well as regionally.
3. **Cooperation between regulatory authorities.** Where business is being done involving firms, customers and markets across different jurisdictions, close contact and collaboration between competent authorities is essential to ensure that regulatory standards and outcomes are met and enforced. The FCA benefits greatly from cooperation with regulators in Europe and more widely – we can share information, intelligence and best practice, and our interactions provide a platform for consistent and effective supervision. A robust framework which provides for continued cooperation will be fundamental in enabling us to meet our objectives.
4. **Influence over standards.** Where UK firms and consumers have access to cross border markets, they are affected by the common standards governing these markets. In order to ensure that consumers are protected and markets are competitive and well-functioning, the UK authorities should have influence over the standards that structure these markets.
5. **Opportunity to recruit and maintain a skilled workforce.** The health of the UK's financial sector relies, in part, upon it being able to recruit and maintain the right people with the right mix of skills. A diverse workforce with varied experience and the requisite expertise is a key ingredient in ensuring the UK's markets and firms are well run and remain competitive, protecting consumers.

Potential advantages

Finally, you also requested some information on the potential advantages for the UK of operating outside of the EU, citing for example an ability to block products from other Member States that regulatory authorities believe may pose particular risks to consumers.

The FCA has powers of intervention with respect to incoming "passporting" firms which it can use independently or, in some cases, in cooperation with an EEA firm's home state regulator and the European Supervisory Authorities (ESAs).

That said, in the UK we have experienced some issues around inadequately vetted and capitalised EU firms being able to provide services directly to UK consumers on a passport. We are not alone in facing such issues. One particular example might be firms selling "contracts for difference" (CFDs), where although there are similar regulatory regimes in place across the EU we have seen firms based in some jurisdictions adopt aggressive marketing practices and increased numbers of complaints from retail consumers. We have sought to use the cooperation mechanisms we have in place with other home Member State regulators and also to work through the European Securities and Markets Authority (ESMA) to resolve these issues.[4]

Broadly speaking, countries outside the EU regulatory framework may find that they have greater flexibility to set rules that are specifically tailored to domestic markets and consumers – potentially of benefit in areas of financial services where there is little cross border activity. EU rules instead are by their very nature the product of a negotiation between Member States, and as such imply some degree of compromise between actors. Of course, even within the EU individual Member States are afforded some flexibility to tailor legislative implementation to their markets, for example where they are implementing directives, or where they benefit from specific derogations.

This potential flexibility in the regulatory environment outside the EU is, for certain countries and certain products or services, also tempered by their need to adhere to shared international standards (for example those set by the Basel Committee on Banking Supervision). In addition, for those countries wishing to be determined as equivalent with the EU, their ability to set their own standards and diverge from elements of the EU framework can be limited yet further.

Improving global standards

Given the UK's status as a world-leading financial centre the FCA considers participating in global-level regulatory dialogue as an important responsibility. We have a strong voice at a range of international authorities including the International Organisation of Securities Commissions (IOSCO), the Financial Stability Board (FSB), and the International Association of Insurance Supervisors (IAIS), among others. The UK, like many other jurisdictions, is also subject to periodic assessments and peer reviews by global-level bodies including the International Monetary Fund and Financial Action Task Force, which use accepted international standards as the benchmark for their assessments. Our desire to remain actively involved in discussions to develop regulatory standards at global level is therefore not in question.

Through our participation in various global level organisations such as IOSCO we are able to shape and develop global standards and contribute to efforts to promote global consistency and cooperation between regulatory authorities. Whilst the UK has a strong presence in these fora, the practicalities of developing and improving global standards are affected by the need for the various global bodies to build consensus among their memberships and ensure standards are applicable across a breadth of legal and regulatory regimes.

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[4] ESMA issued a warning on CFDs, binary options and other speculative products in July 2016 (ESMA/2016/1166), which details actions taken by National Competent Authorities to address issues arising in relation to a number of Cyprus-based investment firms offering CFDs.

Global standards are also not legally binding and can lack consequences in the form of sanctions or penalties for non-compliance. Therefore building strong relationships with our overseas counterparts on a bi-lateral basis is also seen as an important component of the FCA's ability to improve global standards and cooperation between regulatory regimes.

Yours Sincerely

Andrew Bailey
Chief Executive

Annex – Equivalence decisions taken by the European Commission (as at 18.04.2016). *Source: European Commission*

		Abu Dhabi	Argentina	Australia	Bermuda	Brazil	Canada	Caymans	China	Dubai	Egypt	Guernsey	Hong Kong	India	Indonesia	Isle of Man	Israel	Japan	Jersey	South Korea	Malaysia	Mauritius	Mexico	Monaco	N. Zealand	Russia	Saudi Arabia	Singapore	South Africa	Switzerland	Thailand	Taiwan	Turkey	US
Accounting Standards for Prospectus	Art. 35						Y		Y					Y				Y		Y														Y
Accounting Standards for Consolidated Reporting	Art. 1						Y		Y					Y				Y		Y														Y
Accounting Directive	Art. 46																																	
Credit Rating Agencies	Art. 5(6)		Y	Y		Y	Y						Y					Y					Y					Y						Y
Statutory Audit	Art. 47(3)			Y			Y											Y												Y				Y
	Art. 46(2)	Y		Y		Y	Y		Y	Y		Y			Y	Y		Y	Y	Y	Y							Y	Y	Y	Y	Y		Y
	Art. 46(2)				Y			Y			Y											Y			Y	Y							Y	
EMIR	Art. 13																																	
	Art. 25(6)			Y			Y						Y					Y		Y			Y					Y	Y	Y				Y
	Art. 75																																	
CSDR	Art. 25(9)																																	
SFTR	Art. 2(4)																																	
	Art.19																																	
	Art.21																																	
MiFID	Art. 19(6)																																	
Short Selling	Art. 17(2)																																	
MiFIR/ MiFID II	Art. 23 & 28																																	
	Art. 33																																	
	Art. 38(1)																																	
	Art. 38(2)(3)																																	
	Art. 47																																	
	Art. 25(4)																																	
CRR	Art. 107(4)			Y		Y	Y		Y			Y	Y	Y		Y		Y	Y				Y	Y			Y	Y	Y	Y				Y
	Art. 107(4)			Y		Y	Y		Y				Y		Y			Y		Y			Y				Y	Y	Y					Y
	Art. 107(4)			Y		Y	Y		Y					Y	Y			Y		Y			Y				Y	Y	Y					Y
	Art. 114-116			Y		Y	Y		Y			Y	Y	Y		Y		Y	Y				Y	Y			Y	Y	Y	Y				Y
	Art. 142			Y		Y	Y		Y			Y	Y	Y		Y		Y	Y				Y	Y			Y	Y	Y	Y				Y
	Art. 142			Y		Y	Y		Y				Y		Y			Y		Y			Y				Y	Y	Y					Y
Solvency II	Art. 172				Y													Y												Y				
	Art. 277			Y	Y	Y	Y											Y					Y							Y				Y
	Art. 260				Y																									Y				