IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

Linklaters

The architecture for regulating finance after Brexit:

Phase II

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CITY OF LONDON

TheCityUK THE FIRST 10 YEARS

About the IRSG

The International Regulatory Strategy Group (IRSG) is a practitioner-led group comprising senior leaders from across the UK-based financial and related professional services industry. It is one of the leading cross-sectoral groups in Europe for the industry to discuss and act upon regulatory developments.

With an overall goal of promoting sustainable economic growth, the IRSG seeks to identify opportunities for engagement with governments, regulators and European and international institutions to advocate for an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing views.

About Linklaters

As one of the leading global law firms, Linklaters supports clients in achieving their objectives by solving their most complex and important legal issues. Our expertise and resources help clients to pursue opportunities and manage risk around the world.

We build lasting relationships with our clients, and we are committed to supporting them at all times, as they adjust to changes in their markets and regulatory landscape – whether we are working with them on a deal, dispute or regulatory issue, or to help them establish operational sustainability. Our focus is on consistently delivering integrated, global solutions, built on our strong local capabilities in different jurisdictions and deep specialist expertise across many sectors and product areas. Linklaters has been at the forefront of analysing and shaping the impact and options arising from the UK's vote to leave the EU since before the referendum. Our experts across all disciplines and sectors – including financial regulation, trade law, employment, data, tax, governance, risk, corporate restructuring and M&A – in the UK, across the EU and globally are working together with clients to help them navigate the risks and spot the opportunities that Brexit offers, and to plan and adapt in line with the changing environment.

TheCityUK and the City of London Corporation co-sponsor the IRSG.

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FOREWORD

The UK-based financial services sector is an engine for growth right across the country, helping people to start a business, plan for retirement, buy a home, save for the future, insure their belongings and buy goods or services. It also helps provide the capital that businesses need to grow and the support services which enable job creation and allow new ideas to flourish.

The regulation and supervision of the financial services sector has a significant impact on the ability of firms to meet the needs of their customers. It also makes a major contribution to the UK's position as the leading global financial centre. Both the sector and its regulators face an increasingly dynamic landscape of socio-economic and geopolitical change. Brexit is one facet of that change and has provided a catalyst for the UK to reconsider its future role and competitive positioning in the world.

Whatever the relationship between the UK and the EU in the post-Brexit environment, UK-based financial services firms and regulators will no longer sit within the European regulatory and supervisory architecture. This has clear domestic implications. New thinking will be required about the respective roles of firms, regulators and government, particularly in rulemaking.

The IRSG set out its initial thinking on the post-Brexit regulatory landscape in our December 2017 report 'The architecture for regulating finance after Brexit'. This was the first report of its kind and helped to foster a debate around the future of financial regulation in the UK by setting out the principles of an effective regulatory framework and recommendations on how to strike the balance between competing regulatory objectives and ongoing consideration of broader public policy objectives.

We believe these principles remain the right way to assess the effectiveness of the regulatory framework. While the future UK-EU relationship has not yet been agreed a number of significant developments have made it appropriate to update the original report. The process of onshoring EU law has provided clarity on the transfer of powers post-Brexit. Interventions on the future of financial regulation from regulators, Parliamentarians and government show that there is a willingness to engage with the issues that we have identified.

It is clear that there will be a different focus on financial regulation policy in the years ahead and potential choices for targeted reform. Given the wider scope and powers that regulators could have post-Brexit, there is a need to ensure that the development, implementation and supervision of financial regulation are appropriately scrutinised. We propose mechanisms – among other things – to bolster that scrutiny, including the establishment of a Financial Services Regulatory Policy Committee with specialist knowledge to ensure that the way these powers are used is subject to observation and examination by outside bodies.

We believe that effective regulation underpins the UK's position as the leading global financial centre as well as the sector's ability to meet the needs of customers. Brexit creates a timely opportunity to review the structure and processes of financial regulation to ensure it maintains effectiveness at a time of domestic and international change.

Taken together, this report's recommendations will ensure that regulation of the UK-based financial services sector remains globally leading, enhances the UK's position as an international financial centre and delivers the best possible outcomes for customers and clients while enabling the sector to play its role in addressing the UK's competitiveness and productivity challenges.

Mark Hoban
Chair, IRSG

EXECUTIVE SUMMARY

This is the IRSG's second report on the framework for regulating finance after Brexit. A key element of the first report, published in December 2017, was to propose principles for assessing the effectiveness of the regulatory framework including regulatory independence, regulatory accountability, coherence, flexibility, and clear and appropriate regulatory objectives. These were used to develop recommendations which analysed how to strike the balance between competing regulatory objectives and ensure ongoing consideration of broader public policy objectives.

Since December 2017, there have been some significant Brexit-related developments, including:

- The passing of onshoring legislation which established the approach to identifying which UK bodies would mirror the various EU institutions, and transferring powers to those bodies accordingly.

- Changing expectations about the future UK-EU relationship, with the Political Declaration noting that a future agreement would reflect the UK's and the EU's regulatory and decision making autonomy.

Other changes since the first report which add impetus to this second report include:

- A renewed focus on the UK's regulatory architecture with various actors in the public sector having spoken about the future of financial regulation in the UK.

- The broader social and economic context in which financial services operate has evolved, with an increasing focus on financial services' role in promoting sustainable business and on technological innovations in the delivery of financial services. These require a regulatory framework which enables a flexible, innovative and agile response from those involved in the development of public policy and financial regulation.

Against that backdrop, the IRSG continues to view the principles it set out in the original report as the right ones to guide thinking about the future regulation of finance in the UK. Likewise, many of the original recommendations remain valid. Nevertheless, the IRSG considered that it was appropriate to refresh the original report and bring it up to date to reflect current circumstances. This report therefore reviews and updates both the principles and the recommendations based on those principles and sets them in the current context.

PRINCIPLES OF AN EFFECTIVE REGULATORY FRAMEWORK

The UK's current regulatory framework does not have the same level of resource, specialist mechanisms or scrutiny as exist within the European system.

To ensure the UK regulatory system is effective, robust and capable of taking a flexible and innovative approach to rulemaking while striking the right balance between different public policy considerations, we must develop a framework that appropriately balances:

Regulatory independence

Our regulators must be independent and free from undue political and business influence. They must act in the pursuance of their publicly stated roles and objectives. This provides certainty which is crucial for the UK's role as an international financial centre, encouraging investment into the UK and assuring firms they are competing on a level playing field. Where financial regulation is given a role in pursuing broader social objectives, there must be transparency about this mandate. In responding to the opportunities and challenges of innovation, regulators should maintain impartiality between business models.

Flexibility

Regulators will need to respond to market developments and innovations swiftly. Along with responding to technological and ethical challenges, regulators will need to consider their objectives in the context of consumer and political demands. Flexibility will also be needed to tailor regulation to a specific market. Flexibility in this sense should be distinguished from regulatory or legislative churn and principles-based regulation as it can also be compatible with detailed rulemaking. Consideration of how the UK might exercise flexibility must also include recognition and scrutiny of approaches to broader international regulatory alignment (including with the EU). To ensure appropriate flexibility, it is necessary to reassess the post-onshoring division of powers in the UK regulatory architecture.

Accountability

Regulators must be accountable and subject to appropriate levels of scrutiny. Accountability involves regulators being subject to defined standards and there being mechanisms to ensure there are appropriate remedies if they do not adhere to these standards. Scrutiny involves the regulators being subject to observation and examination from outside bodies. In applying these, it is important to note that accountability and scrutiny are relevant in relation to both the exercise by regulators of policymaking powers and their supervision of firms and individuals. Post-Brexit, additional domestic mechanisms and controls will be needed to ensure government and regulators' policymaking decisions are subject to scrutiny and are held accountable.

Coherence

The respective competencies of the UK regulators should be clearly demarcated to avoid regulatory overlap, a lack of consistency in how they balance competing objectives and critically, facilitate regulatory coordination. To maintain the UK's pre-eminent position as an international financial centre, it must ensure its domestic framework is consistent with international standards. On leaving the EU, the responsibility for maintaining a coherent regulatory system will rest entirely with UK policymakers. The ongoing development of the division of responsibilities for legislation following the onshoring process will require a carefully articulated and transparent process. Coherence should also be a principle governing the textual sources and format of financial rules, which have been complicated by the Brexit onshoring process.

Appropriate regulatory objectives

UK regulators should continue to be guided by a small number of clear and appropriate objectives that produce intended outcomes, are coherent and comprehensive and, when considered together, flexible enough to adapt in light of technological or market developments. If regulators are to have additional public policy objectives within their remit they must consciously and transparently balance those against the rest of their remit. Sustaining and promoting an environment where financial services can flourish in their global context should be made a secondary regulatory objective. This would ensure the UK financial sector is not disadvantaged compared to the rest of the world and that customers of that sector (including domestic consumers) can access the best financial services in the world and realise the full benefits of innovation.

SUMMARY OF RECOMMENDATIONS

The recommendations set out below are intended as a menu of possible changes to be considered as part of the UK's post-Brexit regulatory architecture.

Powers and resources of the regulators

Redistribute powers to amend onshored regulation to achieve consistency in the UK's existing regulatory architecture.

- Following the onshoring process, the UK should assess the allocation of powers in its architecture based on existing institutional arrangements to ensure consistency between onshored regulations and the existing rule book. The overarching principles, broad parameters, powers and constraints should be set in primary legislation and, once established, resources should be allocated accordingly to make the most of rulemaking expertise and ensure flexibility of the regulatory system.

Framing the responsibilities of the regulators

Provide a formal role for international financial standards within the regulatory architecture.

- Given the growing importance of global standards for financial regulation and the UK's desire to help shape and spread those standards into the future, it may be appropriate to refer to them in a new regulatory principle under Financial Services and Markets Act 2000 (FSMA).
- Regulators would need to take into account, where appropriate, international standards that have been developed by consensus when discharging their regulatory functions, and to actively promote their adoption on the international stage. This would ensure a continued focus by the UK regulators on maintaining their leading role in shaping these standards and encourage other desirable outcomes, such as continued structured cooperation with both EU and other regulators.

Clarify roles and responsibilities in meeting public policy objectives.

- Enhanced roles for Her Majesty's Treasury (HMT) and Parliament in coordinating public policy objectives with the financial regulators would ensure that financial regulation is integrated into a wider public policy context.

Reflect the need to maintain and enhance the financial services ecosystem in regulatory objectives.

- Sustaining and promoting an environment where financial services can flourish in their global context should be made a secondary regulatory objective. This should be distinguished from a drive for lower standards which could allow excessive risk to develop within the financial system. The sector does not want a regulatory race to the bottom but attaches importance to promoting the competitiveness of the UK.

General accountability and scrutiny of the regulators

Strengthen mechanisms for scrutinising and holding regulators and HMT to account.

- Due to the loss of the need to comply with EU law and peer review from other EU financial regulators and the European Supervisory Authorities (ESAs), we recommend the establishment of a Parliamentary committee with a mandate specifically focused on the regulators and with formal mechanisms to ensure regulators regularly report to it on the exercise of their functions, and to allow systematic and constructive scrutiny of their activities. This should be appropriately staffed and resourced.

Increase transparency of decision making by HMT and the regulators to improve scrutiny.

- To ensure appropriate scrutiny, decision making by HMT and the regulators must be sufficiently transparent. Transparency mechanisms should therefore be reconsidered as part of the UK's post-Brexit regulatory architecture.

Enhance engagement with and the role of the Law Commission and other legal expert groups.

- HMT and the regulators should more actively engage with the Law Commission to consider legal issues such as the appropriate review and consolidation of financial services legislation and related common law. This will help address the need for additional scrutiny of the regulator's legislative functions.

Strengthen the role and visibility of statutory panels.

- We recommend the PRA and FCA actively consider whether their statutory panels could be strengthened and made more prominent in ensuring appropriate scrutiny of the regulators.

Legislative and regulatory processes

Consolidate financial regulation to improve accessibility.

- A consolidation exercise should be considered to improve the accessibility of the law and lower compliance costs, by making it easier to locate specific regulatory requirements within the legal framework.

Establish mechanisms to track regulatory developments which could affect trade negotiations.

- Mechanisms should be put in place to track domestic and international regulatory developments which may jeopardise market access, as well as tracking measures that may jeopardise equivalence with the EU. The impact of regulatory developments on trade negotiations should also be considered.

Make review mechanisms mandatory.

- A formalised process should be put in place to review new rules or legislation within a set time frame to ensure they are relevant and appropriate for their desired outcomes.

Establish a Financial Regulatory Policy Committee.

- We recommend the establishment of a Financial Regulatory Policy Committee with specialist sub-committees and representatives of the full range of stakeholder interests to scrutinise regulatory cost-benefit analyses. It should also review the content of regulatory proposals with the potential for a role in any legislative review mechanism.

Establish a Joint Regulatory Committee.

- When the UK leaves the EU, it will no longer be subject to the ESAs' Joint Regulatory Committee, and there is currently no UK domestic equivalent. We recommend the establishment of a permanent committee of relevant UK regulators tasked with ensuring regulatory coordination and coherence.

1 WHERE WE ARE NOW – THE NEED FOR AN UPDATED REPORT

In December 2017, the IRSG published ‘The architecture for regulating finance after Brexit’ (the first Architecture report). This report made several recommendations aimed at ensuring that the design and implementation of financial regulation policy functions appropriately when the UK is no longer a member of the EU.

The first Architecture report helped to foster a debate about the future of financial services regulation in the UK. Since its publication, there have been some significant developments and hence new analysis and reconsideration of the recommendations found in the first Architecture report are required.

1.1 Onshoring legislation has been passed

In preparation for the possibility of leaving the EU without a Withdrawal Agreement, the UK passed the European Union (Withdrawal) Act 2018 (EUWA) and statutory instruments (SIs) under it to maintain, to the greatest practicable extent, legal continuity on exit. The European Union (Withdrawal Agreement) Bill (WAB) maintains its approach to ensuring legal continuity following the end of the envisaged implementation period.

The first Architecture report made recommendations about where, in the context of financial services regulation, the power to amend retained EU law should lie in the future, with a view to ensuring flexibility and coherence. These recommendations have been overtaken by the passage of the EUWA and legislation made under it (the onshoring process), and the continuation of this approach under the WAB. We are now able to review the effects and suitability of the approach that has been taken. A detailed discussion of the onshoring process can be found in the Annex to this report. The remainder of this Section describes how powers and responsibilities in respect of onshored legislation have been allocated.

Onshoring means that there will be a fundamental transfer of powers post-Brexit, from EU institutions to domestic UK ones. An important part of the onshoring approach has been to identify the UK equivalent to the various relevant EU institutions and to transfer powers to them. The authority of the European Parliament and Council of the European Union to make and amend Level 1 legislation has been equated to the power of Parliament to enact primary legislation. Therefore, Level 1 directly applicable EU legislation has been onshored in a manner that makes it broadly equivalent to primary UK legislation. It may only be amended by Parliament or those to whom Parliament has delegated power. Level 1 directives that have already been implemented in the UK by various legal means will continue to be implemented in the UK as currently. Some Level 1 directives are implemented via the regulators’ rulebooks. Those rulebooks will remain under the control of the regulators post-Brexit, but they will not have powers to amend UK implementing legislation. Without such powers, keeping legislation up to date to reflect market developments may require primary legislation.

Broadly, responsibilities previously allocated to the European Commission will now be allocated to HMT under retained EU law. This includes the powers to make Level 2 delegated acts and equivalence and exemption determinations. These functions will be exercised by SIs. Depending on the power in question, HMT's ability to make SIs will be subject to differing levels of parliamentary oversight. For example, under the onshored UK version of the Markets in Financial Instruments Regulation (MiFIR), SIs made by HMT will be made under the negative procedure except for those that affect the regulatory perimeter (which will be subject to the positive procedure).[1]

Similarly, the responsibilities previously allocated to the ESAs will now be allocated to the UK regulators. These range from administrative matters, such as the maintenance of certain registers, to more significant responsibilities for the purposes of the regulatory regime. These include:

1.1.1 **Direct supervisory powers:** In the limited areas where ESAs have direct supervisory powers (e.g. with respect to credit ratings agencies), such powers are being transferred to the UK regulators.

1.1.2 **Binding technical standards:** The ability to make and amend binding technical standards has been granted to the UK regulators. This sort of delegation of powers over onshored legislation was recommended in the first Architecture report. Just as the European Commission needs to adopt draft binding technical standards produced by the ESAs, so too will HMT need to approve draft binding technical standards produced by the regulators. However, unlike the European Commission in the Lamfalussy process, HMT will only be able to refuse to approve the making and amending of binding technical standards in specific circumstances (namely, that they have implications for public funds or prejudice international negotiations or obligations).

1.1.3 **Guidance:** The power to make Level 3 guidance has also been allocated to the UK regulators. Given they are also responsible for enforcement, this may be of substantial practical significance as the actual application of regulations to firms (and therefore the scope for enforcement) is sometimes only made clear by guidance.

A natural consequence of the UK's financial regulatory system becoming independent from that of the EU is that there will be no equivalent to the coordination or oversight roles exercised by the ESAs over National Competent Authorities. Broadly, such oversight and coordination roles have been removed from onshored financial services legislation, allowing the UK regulators to act without this additional layer of scrutiny in certain areas. For example, the product intervention powers exercised by the FCA under MiFIR will no longer be subject to coordination and analysis by the European Securities and Markets Authority and no UK body is assuming an equivalent oversight role going forward.

It is worth noting that, alongside the transfer of power in relation to financial regulation itself, there will also be a broader transfer of powers exercised by EU institutions in areas of law and policy that have a significant impact on financial services. For example, in relation to data protection, power to make adequacy assessments in relation to third

1 Under the negative procedure, either House of Parliament may vote to annul the proposed SI within a limited time period. Under the positive procedure, both Houses of Parliament must vote in favour of the proposed SI. However, in practice the differing procedures are unlikely to lead to significantly different outcomes as SIs (either positive or negative) are very rarely rejected by Parliament.

countries will pass from the European Commission to the Secretary of State for the Department for Digital, Culture, Media and Sport.
The Information Commissioner's Office will also receive additional powers in this area.

One final point to note about the onshoring process is that provisions that require the future review of the functioning of legislation by the European Commission and ESAs with a view to making improvements were not generally retained.

A renewed focus on regulatory architecture

Various actors in the public sector have made public their views about the future of financial regulation in the UK.

In January 2018, shortly after the first Architecture report was published, the House of Lords EU Financial Affairs Sub-Committee published its report Brexit: the future of financial regulation and supervision.

Andrew Bailey, CEO, the Financial Conduct Authority (FCA), and Sam Woods, CEO, Prudential Regulation Authority (PRA) have made important speeches (in April and May 2019) setting out fresh ideas. Mr. Woods, for example, has called for a move towards stylish regulation, which would involve a more principles-based approach than at present.

The former Chancellor of the Exchequer Philip Hammond announced during the annual Mansion House speech plans for HMT to proceed with a two-stage consultation on financial services, covering in the first instance 'air traffic control', i.e. increased coordination between the regulators (principally, the FCA, the PRA, Bank of England, the Payment Systems Regulator and the Competition and Markets Authority) on their respective regulatory pipelines.

The House of Commons Treasury Committee's recent report on the work of the FCA in the regulatory perimeter made a number of recommendations about the remit and powers of the FCA and emphasised the more active role HMT should take if those recommendations are not followed.

1.2 Expectations about the future relationship have changed

Expectations as to the future relationship between the UK and the EU have changed. Although the first Architecture report did not make assumptions about what the final economic partnership between the UK and the EU would be, it had in mind the proposed model contained in another IRSG report, 'A New Basis for Access to EU/UK Financial Services Post-Brexit' dating from September 2017. In brief, this proposed that the UK and the EU should offer mutual recognition of financial regulations on the strength of alignment assessed on an outcomes basis, overseen by a Forum for Regulatory Alignment. Since then, the likelihood of such an approach being adopted has diminished, and a more detailed analysis of the specific implications of this can be found in Section 2.2.3. The UK now has the opportunity to explore a variety of other approaches to its post-Brexit regulatory regime.

The current common ground between the UK and the EU over the future relationship is set out in the 'Political Declaration Setting Out the Framework for the Future Relationship between the European Union and the United Kingdom' agreed in October 2019 (the Political Declaration). This indicates that, in financial services, a future agreement would "[respect] the Parties' regulatory and decision making autonomy". It notes that "both Parties will have equivalence frameworks in place that allow them to declare a third country's regulatory and supervisory regimes equivalent for relevant purposes" and commits them to keeping the equivalence frameworks under review.

The meaning of equivalence

According to the European Commission, there are approximately 40 different equivalence provisions in 17 pieces of EU financial services law, although not all of these have been used. Equivalence provisions empower the European Commission to make determinations that specified aspects of financial regulation and supervision in third countries provide for the same outcomes as those of the EU, providing various advantages. Some equivalence regimes entail a grant of market access such as enabling third country central counterparties to provide services to EU clients. Others have different effects: for example, equivalence decisions relevant to the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) change the risk weightings to be applied to credit exposures in the third country by EU institutions.

It is unclear the extent to which the EU's approach to and framework for equivalence for the UK within the future relationship might differ from that currently applicable to other third countries. In the Political Declaration the UK and the EU have said they will seek "close and structured cooperation on regulatory and supervisory matters". This will involve "transparency and appropriate consultation" in respect of equivalence decisions as well as both political and technical information exchange and consultation on regulatory initiatives.

Even if the implementation period expires without the UK and EU agreeing their future economic partnership, the UK could still benefit from recognition under the current equivalence regimes. However, the use of equivalence as a political tool by the EU in its recent relations with Switzerland casts doubt on whether and how quickly equivalence decisions would be forthcoming if relations between the EU and the UK were to be strained by such an occurrence.

The relative value of the current equivalence regimes has been covered by other IRSG publications, such as 'The EU's Third Country Regimes and Alternatives to Passporting', dating from January 2017. While the European Commission has accepted the need for reflection on the performance and reform of specific equivalence regimes, including greater transparency over the making of decisions, not all of the changes it could make will involve greater liberalisation. For example, the European Commission communication 'Equivalence in the Area of Financial Services' of 29 July 2019 signals that "high-impact areas or third countries" will receive greater scrutiny in the context of ongoing monitoring after equivalence has been granted. This focus on high-impact areas also made its way into the most recently drafted or redrafted equivalence regimes. For example, the 'risk-sensitive and proportionate approach' for foreign central counterparties in the European Market Infrastructure Regulation (as amended) may mean a more relaxed approach to equivalence decisions for some third countries, but a much more rigorous one for countries like the UK on whose financial infrastructure the EU relies heavily. The EU has also recently repealed certain equivalence decisions (or allowed them to lapse). These changes suggest that the EU is taking a more proactive and critical role in assessing the benefits and risks of making equivalence determinations and in subsequently monitoring them.

1.3 The broader context for financial services has changed

Society is placing new demands on the financial services sector at an increasing pace. Technological innovations are frequently enabling faster, more secure and more convenient access to financial products, as well as disintermediation and disruption of existing business models. Data has become ever more important to financial markets and the provision of financial services more generally.

This presents great opportunities for the UK's burgeoning FinTech sector. The regulatory response needs to be agile and to deal with increased challenges in areas such as data privacy and the ethics of artificial intelligence. The need for an appropriate regulatory response has been recognised in the UK by the House of Commons Treasury Select Committee expanding the scope of its Future of Financial Services Inquiry to include the role of regulators and government policy in facilitating the emergence of FinTech. In a similar manner, European Commission President Ursula von der Leyen used a recent speech to emphasise the importance of a unified approach to artificial intelligence.

In addition, there are calls for the financial sector to play a greater role in many areas of public concern such as the fight against climate change and environmental degradation, promotion of social welfare at home and abroad, encouragement of financial inclusion and support for industrial strategies to ensure balanced and sustainable economic growth. This report aims to take account of these ongoing developments for the future of the financial regulatory system after Brexit.

2 A RETURN TO THE PRINCIPLES OF AN EFFECTIVE REGULATORY FRAMEWORK

At the heart of the first Architecture report was the argument that anyone assessing the robustness and effectiveness of a regulatory framework needs to consider five principles: regulatory independence, regulatory accountability, coherence, flexibility and appropriateness of regulatory objectives. The IRSG continues to view these as the correct principles for thinking about the future of regulating finance in the UK.

This Section reviews the principles of an effective regulatory framework in light of the developments discussed in Section 1 and considers how the balance between them may have changed. Our recommendations in Section 3, updated from the first Architecture report, are based on these considerations.

2.1 Regulatory independence

2.1.1 **The importance of regulatory independence:** Regulatory independence is a central feature of the UK system for financial regulation. Market participants need to know that regulators are impartial and free from undue political and business influence. They must be acting, and be seen to be acting, solely in pursuance of their publicly stated objectives and roles whether in the context of setting rules or monitoring compliance with them. This enables market participants to have certainty about the regulatory environment they face and assures them that they are competing on a level playing field – something particularly crucial for an international financial centre. Such an environment is essential to encouraging investment in the UK.

However, regulatory independence does not mean that regulators should be unconstrained in formulating policy. Their objectives are set through political processes and they must operate within the broad parameters set out in legislation. In this broad sense, the regulators are directed by the priorities of wider society even though they pursue their objectives independently.

2.1.2 **Pressures on the financial regulatory system to promote wider public policy objectives:** It is possible that growing calls from the public and politicians alike for the financial sector to contribute visibly towards public social and financial inclusion goals, such as addressing intergenerational differences or supporting the transition to a carbon-neutral economy, could eventually pose a challenge to regulatory independence. Informally pressuring regulators to perform broader social functions, rather than making any role they perform part of a formal framework, can create a number of problems. For instance, a lack of transparency as to how those broader social functions are balanced with other regulatory objectives.

In principle, there are three different possible responses to such pressures.

The first is to draw and maintain a distinct line between financial regulation objectives and other public policy objectives. Parliament and government would then rely exclusively on other policy levers to fulfil those latter objectives. The second is to permit government interaction with, and even management of, the regulators to promote the public policy objectives in question, accepting a reduction in regulatory independence and its consequences as a necessary cost. The third is to find some way of placing the relevant public policy objectives within the remit of the regulators but respecting the primacy of their core financial regulation objectives.

Of the three approaches, the IRSG considers the third preferable. This approach would essentially involve the government and/or Parliament either:

i. amending the financial regulators' objectives

ii. directly legislating on certain areas to be overseen by the financial regulators.

Point ii could be achieved for example, by a specific mandate from Parliament for the appropriate regulator to make and enforce rules governing a particular issue (rather than Parliament making detailed rules itself).

While there are good arguments for separating financial regulation and other public policy objectives, this is only sustainable to the extent that it remains acceptable to politicians and the public. It is precisely the growing calls from both to consider anew the purpose of the financial sector which requires some response. Moreover, it is reasonable for financial regulators to act on specific public policy goals linked to the financial sector. Further, unlike the second approach, the third approach could bolster regulatory independence by internalising political and social pressures in the form of subsidiary statutory objectives or some other legislative requirement.

Under this approach, interactions between politicians and regulators would then be based on proper and transparent accountability. Interactions would involve scrutiny of whether the regulators are acting consistently with their objectives and legislation, rather than opaque or informal pressure to act.

2.1.3 **Impartiality between business models:** It is also important that the regulators maintain independence in the sense of impartiality to specific business models. This is key to ensuring they remain open to innovation in the financial sector and avoid the risk of bias in favour of established financial services firms and against new entrants such as challenger banks and other FinTechs.

The UK regulators have been at the forefront of global efforts to encourage FinTech and foster innovation in the financial sector. As a result, they have also historically committed to tech-neutrality. However, there are indications that this approach may be under pressure. For example, Nick Cook, Director of Innovation, FCA in his speech 'From Innovation Hub to Innovation Culture' on 5 June 2019[2] questioned whether the FCA is able to remain technology-neutral in a world where technology is so embedded in the delivery of financial services, and so fundamental as a driver of consumer outcomes. While it is undoubtedly true that technology is important in driving consumer outcomes, mandating particular technological approaches and moving away from tech-neutrality could also risk stifling innovation and competition.

2 Nick Cook, 'From innovation Hub to Innovation Culture', (June 2019), available at: https://www.fca.org.uk/news/speeches/innovation-hub-innovation-culture

2.2 Flexibility

2.2.1 **The importance of flexibility:** The pace and extent of change in financial services highlights the need for regulators to anticipate and respond to market developments and innovations swiftly. Along with keeping pace with new disruptive technological and ethical challenges posed by developments in FinTech and elsewhere, regulators need to consider how best they can meet their objectives in the context of evolving consumer and political demands, such as the move to sustainable/green finance. For example, any sustainability taxonomy will need to evolve as metrics for the environmental and social impact of specific technologies and industries develop. Flexibility will also be needed to tailor regulation to the specific market (for example, recognising the different prudential and conduct risks posed by domestic small and medium-sized enterprise (SME) financial providers in comparison with larger international financial providers), rather than taking a one-size-fits-all approach. We do not expect the pace of change and the consequent need for flexibility to diminish over time. It should remain an important structuring principle for the UK system.

Flexibility, when considered as the ability to respond in a timely fashion to changing circumstances, should be distinguished from regulatory or legislative churn. Market participants need certainty and predictability in the regulatory regimes to which they are subject. Constant change is a disincentive to investment and a drain on business resources. Taking the regulatory initiative when required does not necessarily require continual regulatory change. Similarly, flexibility in this sense should be distinguished from principles-based regulation – the style of regulation that grants regulators increased discretion when assessing compliance. Flexibility can be compatible with detailed rulemaking, for example, by including the technical details of regulatory requirements in rules which can be easily updated, rather than primary legislation.

Flexibility will be particularly important in the post-Brexit context, as the UK will need to adapt its financial regulatory system (including onshored EU legislation discussed below) to reflect the new circumstances in which the UK finds itself.

2.2.2 **Onshored legislation:** Flexibility requires dedicated, streamlined regulatory processes and high levels of expertise. It was for these reasons that the first Architecture report recommended that the regulators should generally be able to amend the relevant onshored EU law instead of requiring any changes to be made through primary legislation by Parliament.

As matters stand, this will not be the case post-Brexit. As discussed in Section 1, the UK regulators have only been transferred powers currently exercisable by the ESAs. Among other things, this means that only Parliament will be able to amend onshored Level 1 directly applicable EU legislation (unless it delegates powers to make such amendments). Such onshored law includes detailed rules, the making and amendment of which Parliament has traditionally delegated to the UK regulators. Similarly, the Level 2 powers granted to HMT mean that HMT will be newly responsible for drafting the kind of detailed rules that have previously rested within the competence of the EU or been delegated by Parliament to the UK regulators.[3] Moreover, Level 2 rulemaking will be formally subject to parliamentary oversight because of the need to operate through SIs.

3 This is not entirely unprecedented, as some detailed regulatory rules have historically been set out in HMT SIs rather than in the regulators' rulebooks (e.g. those relating to payment services). However, the scope of detailed regulatory rules for which HMT will be responsible will have been significantly expanded.

The relative inflexibility that will come with the need to coordinate regulatory changes across Parliament, HMT and the regulators contrasts not only with standard practice in the UK for developing and maintaining its purely domestic financial regulatory regimes, but also from the relative flexibility of the regulators to amend financial regulatory regimes derived from Level 1 directives. The directives will not be incorporated into UK law but the implementing legislation, consisting of both SIs (generally where they concern the powers of the regulators or questions of the scope of the regime) and elements of the regulators' rulebooks (with respect to more detailed requirements), may often be open to ongoing amendment by HMT and the regulators respectively under their general powers. It is unclear why legislative origin (EU or domestic) and form (regulation or directive) should be more decisive in determining how financial regulation can be amended than other considerations such as the location of relevant expertise. The post-onshoring division of powers should therefore be approached as a temporary situation that should be reassessed in a timely manner to ensure an effective regulatory architecture.

If the regulators are not given powers in relation to requirements deriving from onshored Level 1 directly applicable legislation (in the manner they currently have in relation to requirements deriving from many Level 1 directives), then parliamentarians will need greater resourcing and expert support to engage effectively and in a timely manner with the detail of a large volume of financial regulation. Greater resourcing and expert support for parliamentarians would, of course, be welcome under any circumstances. It would promote effective scrutiny and accountability of the regulators and HMT and assist Parliament in setting targeted legislative mandates to the regulators where appropriate.

2.2.3 **The trade-off between alignment and flexibility:** Another aspect of flexibility to note, beyond speed and efficiency as discussed above, is flexibility in the sense of policymaking autonomy. As noted in Section 1, the UK and the EU are not currently seeking a system of comprehensive mutual recognition for financial services. In theory, this considerably enhances the UK's choices and allows greater flexibility for the UK regulators in setting policy within the UK system.

However, just because greater flexibility might be exercised this does not mean that the UK should always diverge from the EU (or other major jurisdictions) in its financial regulatory approach. The issue of equivalence with the EU in specific areas should be considered, as should broader international regulatory alignment.

If the UK wishes to obtain and maintain specific equivalence determinations from the EU after its withdrawal, or more generally maintain regulatory alignment with major jurisdictions, it will need to carefully consider whether the benefits in a particular case outweigh the cost to flexibility.

- **Benefits:** There are several examples of equivalence decisions which have enabled significant trade volumes, such that opportunities to attain equivalence should be seriously considered. Government and the regulators will require input from the industry to assess the expected benefits associated with obtaining equivalence determinations in specific areas.

  Even outside specific areas of equivalence, the maintenance of some regulatory alignment between the UK and EU (or other major jurisdictions), could reduce costs for firms and potentially their customers, and increase the incentives to offer cross-border services. There are also broader areas of policy which impact on financial services but do not squarely fall within financial regulation (such as data protection), where maintaining international alignment could present benefits for the UK financial sector. These potential benefits should not be overlooked.

- **Costs:** As noted in the IRSG report 'The EU's Third Country Regimes and Alternatives to Passporting', reliance on the EU's ordinary equivalence regimes may be unsatisfactory for some UK providers of financial services, and in any case less satisfactory than a system for mutual recognition such as that considered in the first Architecture report.

  The main reasons for this are well known. Equivalence decisions can be withdrawn at short notice without right of appeal. While seemingly technocratic exercises, decisions concerning equivalence can be politicised or otherwise linked to extraneous factors. This has been demonstrated most clearly by the EU's recent approach in withdrawing equivalence from Swiss exchanges. These aspects of legal uncertainty associated with equivalence regimes mean they are not necessarily as effective in promoting cross-border trade in financial services as they might seem.

  Where equivalence is available, equivalence determinations can vary widely in their basis for assessment and scope. While traditionally intended to be driven by outcomes, in practice determinations can depend upon line-by-line comparisons of legislation. The European Commission has explicitly stated that adherence to international standards is not in itself sufficient. Hence, maintaining equivalence with the EU in certain areas could lead to a form of indirect rule taking by the UK to maintain alignment with the specifics of EU financial regulation. Conversely, equivalence could be based on a more general impression of the UK and its broad intentions to either maintain regulatory alignment or diverge from the EU. Therefore, the overall perception of the policy direction of the UK could equally play a role in determining whether equivalence is granted in respect of seemingly discrete areas of financial regulation.

- **A dynamic trade-off:** The weighing and balancing of benefits and costs could change if equivalence regimes were enhanced to focus more on outcomes (permitting greater flexibility in how the UK achieves outcomes) and to provide a greater degree of legal certainty to businesses (increasing the expected benefits of equivalence). In performing this analysis, the UK will also need to bear in mind that the potential benefits of flexibility will be different for different areas related to each equivalence regime. Where it is unlikely newfound flexibility would be used, there would be a greater case for maintaining alignment.

  As part of this trade-off, the UK will also need to consider whether it takes the approach of seeking equivalence from the EU before modifying its regulatory regime, and then making desired amendments or reforms, or vice versa. These differing approaches will require different approaches to flexibility over time.

2.3 Accountability

2.3.1 **Accountability and scrutiny:** As noted in Section 2.2, the UK system is based on the delegation by Parliament of extensive powers to regulators. The flexibility inherent within these powers, combined with the principle of regulatory independence, give the regulators substantial freedom to pursue their statutory objectives as they see fit within the parameters set in legislation.

However, the regulators clearly must be subject to both accountability and scrutiny in the exercise of their powers. Otherwise there is a risk that their powers could be misapplied whether through overreach or neglect. It is important that the two concepts of accountability and scrutiny are distinguished:

- Accountability involves the regulators being subject to defined standards and there being mechanisms to ensure there is a remedy where they do not adhere to these standards. Such remedies can range from court interventions resulting from legal challenges, to softer remedies, such as simple embarrassment when regulators are required to explain actions in public. Such remedies are a powerful incentive for regulators to act having taken all – and only – the relevant considerations into account when exercising their powers. At the extreme, a complete lack of accountability would reduce faith in the system and tend to invite the prioritisation of the expedient over the public interest.

- Scrutiny involves the regulators being subject to observation and examination by outside bodies. Ultimately, scrutiny may feed into accountability by comparing the regulators' actions to the standards to which they are held. However, scrutiny does not need to result in specific remedies to be beneficial. Merely ensuring that others are paying attention to the actions of the regulators can be enough to encourage a higher standard of behaviour. Scrutiny of the regulators can also lead to greater public buy-in to the system of financial regulation. Where the actions of the regulators are not examined and understood, their important role in the economy and wider society will be obscured.

In applying both accountability and scrutiny, it is important to understand that both apply to the two distinct areas where regulators have:

- the power to set policy via rulemaking, guidance and other mechanisms

- the power to undertake supervision of, and enforcement against, firms and individuals.

In the area of policymaking, it is worth noting that HMT (in its roles in the sphere of financial regulation, for example producing SIs) should also be subject to appropriate scrutiny and accountability.

2.3.2 **The current context – accountability:** At the highest level, regulators are accountable to their statutory objectives and requirements. They report on these to HMT through their statutory obligation to provide HMT with their certified accounts and their annual reports explaining (among other things) how they have discharged their functions, advanced their statutory objectives and taken into account the statutory regulatory principles. HMT must lay these before Parliament.

There are also several mechanisms aimed at ensuring the regulators are accountable under the law to those who are or could be affected by their actions. Judicial review allows market participants to challenge a regulator which has acted unlawfully in the way that it has come to a decision. This would cover both the way in which it created rules or how it has interpreted and enforced existing rules. The regulators are also required by law to operate a complaints scheme, although the importance of the scheme is limited, as the independent Complaints Commissioner who can hear unsuccessful complaints under the scheme is only empowered to make recommendations.

However, the practical application of these accountability mechanisms is limited. The relative lack in practical use of accountability mechanisms above leads to a deficit in regulatory accountability, particularly when it comes to issues such as how the regulators interpret the law and their own rules.

For market participants, the close oversight of financial institutions by regulators, regular contact (particularly for larger institutions), and the significant number of formal or informal approvals such institutions must seek from the regulators, means financial institutions take great care to ensure that they maintain effective engagement with the regulators.

Judicial review is relatively little used against the financial regulators (particularly by larger firms), due in part to the time, cost and uncertainty involved, but mainly due to the risk firms feel they may face to their relationship with the regulators should they pursue a judicial challenge. While it would not be desirable for the financial regulators to be subject to constant judicial review, there is a notable contrast between the relative infrequency of judicial review of the financial regulators, and the relative frequency with which firms in other industries judicially review decisions by other regulators (for example, Ofcom in the telecommunications industry).

Parliament does not have structured mechanisms – or indeed, the resources – to consistently exercise even soft remedies against the regulators where they have either overreached, or not taken sufficient action, in accordance with their role defined by legislation. In many ways, this mirrors some of the issues faced by Parliament in even holding HMT to account in its financial regulatory policy making role. While there are well established mechanisms for Parliament to scrutinise and reject SIs produced by the government (including HMT), in practice Parliament has limited resources to undertake meaningful scrutiny of SIs, and extremely rarely rejects them (with the House of Commons not rejecting an SI since the 1970s).

2.3.3 **The current context – scrutiny:** In recent years, the role of scrutinising the financial regulators has increasingly been performed by the Treasury Select Committee of the House of Commons, which summons senior personnel and others to appear before it. However, the Treasury Select Committee has a broad remit, and scrutiny of the financial regulators is not its main focus.

It is vital that Parliament has sufficient oversight of the regulators to provide meaningful scrutiny. It should be able to satisfy itself that the powers it has conferred are being used as intended, and that the regulators are operating within the parameters set out in primary legislation, and in accordance with the principles of better regulation, a topic which has received insufficient attention.

An important element in enabling this scrutiny is transparency in regulatory activities and deliberations (although, as acknowledged in the first Architecture report, there are times when there is an overriding public interest in privacy). Currently, the activities of the regulators are not always transparent, and are therefore difficult for Parliament to scrutinise. Indeed, the decision making and activities of HMT in the financial regulatory sphere are also not fully transparent, and therefore scrutiny of HMT is subject to similar constraints.

To provide scrutiny, Parliament needs sufficient resources and to be provided with the support and expertise to meaningfully track and assess the activities of the financial regulators. These additional resources could also be used to enable more detailed oversight of the role of HMT within the financial regulatory system as well (by enabling more detailed examined of SIs drafted by HMT).

2.3.4 **Implications of Brexit and onshoring:** Brexit will result in UK regulators no longer falling within a system of EU law which subjects them to a number of accountability and scrutiny mechanisms. Most importantly, EU-wide single market rules are arrived at through a defined political process, which includes input from, and scrutiny by, democratic elements such as the European Parliament and national governments. Under this process, limited discretion is granted to National Competent Authorities, and legal accountability to single market rules limits the ability of the UK regulators to act independently in setting their rules. Following Brexit, this limitation on the UK regulators will no longer apply. Similarly, ESAs will no longer exercise the various scrutiny and coordination roles that they currently exercise in relation to the UK regulators.

Some of the constraints mentioned above are clearly unnecessary in the UK post-Brexit. However, others could have been replicated in the UK but have not been. For example, as noted in Section 1, whilst the UK regulators have assumed the role of the ESAs in drafting binding technical standards, HMT has not received the same powers to reject or amend such drafting of binding technical standards (both, accountability mechanisms) that the Commission currently enjoys in relation to the ESAs.

These changes mean that a careful examination of the domestic mechanisms for the scrutiny and accountability of the regulators is even more important in a post-Brexit context.

The question of whether greater domestic accountability and scrutiny is required in a post-Brexit context is not just relevant to the regulators. Under the onshoring process, HMT has itself received new powers due to effectively having the powers currently exercised by the European Commission transferred to it. Perhaps most consequential is the power to make equivalence determinations via SIs. These SIs are subject to annulment by Parliament and therefore they are nominally subject to Parliamentary oversight. However, in practice, SIs are rarely annulled by Parliament, and it is not clear that Parliament currently has the resources to scrutinise effectively HMT's use of its powers in the sphere of financial regulation. Given equivalence decisions can have major consequences (for example, in relation to trading relations with other countries), it seems unsatisfactory that they should be subject to such limited accountability and scrutiny.

Equivalence decisions by the UK in the post-Brexit context could also raise a number of difficult questions. For instance, what if the EU deems another country to be equivalent under its framework immediately post-Brexit but the UK does not (despite having substantively similar rules)? Or indeed, what if the situation was reversed? This would obviously raise questions about how HMT was using its powers, but it is not clear whether there is sufficient capacity or expertise in place to scrutinise HMT, or the mechanisms to hold it to account on this point.

2.3.5 **The implications of no general system of mutual recognition:** While UK regulators would have had some flexibility in designing regulations under the mutual recognition model, both the UK and the EU would need to have retained the confidence of the other in the quality of their regulatory outcomes. In view of the importance of European markets for the UK industry, we argued in the first Architecture report that special mechanisms would be needed to prevent divergence from EU law without appropriate political authorisation where this could jeopardise favourable treatment. In other words, the increased powers of the regulators to alter the UK's relationship with its biggest trading partner would be matched by an additional layer of oversight.

As it is now envisaged that the future UK-EU relationship in financial services will be based on the current third country equivalence regimes, this specific kind of additional accountability is less important, since a smaller volume of financial regulation will warrant special treatment. Nevertheless, some mechanism would still be desirable to protect against inadvertent divergence from the EU that could jeopardise equivalence.

The reduced need for such special checks and balances relating to favourable EU treatment does not mean that the rationale for greater general accountability in the regulation of UK financial services after Brexit has diminished since the Architecture was published. In fact, the opposite is the case. The situation where UK regulators do not need political authorisation for matters potentially causing divergence with the EU is a situation where the regulators hold more power. Other more general forms of regulatory accountability, building off the first Architecture report and discussed in Section 3, should be strengthened in this case.

2.3.6 **New thinking about regulatory approaches:** Sam Woods' speech on stylish regulation makes the case for more principles-based regulation and for a greater degree of regulatory discretion than is provided for under the EU system. The IRSG notes that there are always trade-offs between principles-based and rules-based approaches. The balance between them depends in part upon the area of financial regulation concerned. In situations where a more principles-based approach is used, the relevant parameters for the use of discretion must be very carefully bounded.

While there may be a good case to consider a more principles-based approach in some areas of financial regulation, any such move would further increase the power of the regulators both in respect of creation and implementation of policy. It may also complicate the process for obtaining equivalence under specific EU regimes. If principles-based regulation is to be the direction of travel in the coming years, it will be important that accountability and scrutiny mechanisms should be appropriately recalibrated, both in relation to policy towards rulemaking and the application of those policies to firms and individuals.

2.3.7 **Loss of peer review and benchmarking in respect of good regulatory practice:** One effect of being within the EU framework has been the largely shared consensus on both financial regulatory priorities and 'what good looks like' for the purposes of determining the effectiveness of regulators and their mission statements. There is both express and implicit benchmarking against other EU regulators, with shared identification of key supervisory objectives and methods for ensuring delivery that indirectly moderates regulatory behaviours. Obviously, there will still be interactions between the UK regulators and EU regulators following Brexit and cooperation on many fronts including through formal international forums. However, the UK regulators will no longer be fully embedded in the EU framework.

When this environment no longer exists, other domestic controls will be needed to ensure accountability. These should combine the regulatory objectives set by

Parliament in primary legislation with a control environment to ensure effective oversight. These should apply at the commencement of any new regulatory initiative and on a continuing basis and should include a system that ensures appropriate balancing between competing objectives, particularly when those objectives are split between regulators. This should, in turn, be supported by an infrastructure of reporting frameworks to ensure that there are:

- formalised duties to explain
- proper exposure to scrutiny
- meaningful possibility of independent review.

Existing examples of the duty to explain include the obligation imposed on the PRA to report to Parliament on its ongoing supervision of the ring-fenced bank system and the integrity of the boundaries. Examples of internal scrutiny include the operations of the Bank of England's Independent Evaluation Office, which reports on material regulatory processes and their effectiveness to the Court of the Bank. These precedents can be considered, together with the current EU 'Better Regulation' principles (even though these principles are not always applied effectively), and further elaborated upon.

2.4 Coherence

2.4.1 **The importance of coherence:** With multiple sources of regulation comes the challenge of ensuring coherence. At the most basic level, the respective competencies of the regulators should be clearly demarcated to avoid regulations cutting across each other. At another level, regulators with broad remits must ensure consistency in how they balance competing objectives across their policy teams. Statutory hierarchies and principles such as those set out in the FSMA are very useful in this regard. However, even where such hierarchies do exist, appropriate mechanisms are needed to ensure that there is consistency in their interpretation and application and that the weighing and balancing process is transparent and accessible to market participants.

A more sophisticated understanding of regulatory coherence would cover what has been termed 'air traffic control'. The years since the global financial crisis have seen extensive regulatory developments at both the UK and the supranational level which have made the financial system more resilient and boosted confidence in market integrity and consumer outcomes. However, the pace of change has been very high, and some market participants have faced practical and logistical difficulties in adapting to a large number of new requirements in short order. A system of 'air traffic control' would involve better coordination between the financial services regulators to ensure that the combined regulatory policy pipeline is smooth. It would also consider the effect of other regulations that, while not specifically targeted at the financial sector, would involve significant in-house adjustments for market participants or other impacts on the financial sector – good recent examples being the General Data Protection Regulation and changes in International Accounting Standards.

Coherence is also necessary at the international level. The UK thrives as an international centre for finance and related professional business. To maintain its pre-eminent position in financial services, the UK will need, as a minimum, to ensure that its domestic framework is coherent with international regulatory frameworks. Continued compatibility with international standards (including in areas that impact on financial services, such as data protection), and the development and promotion of those standards abroad, promotes confidence in the UK financial services industry and minimises the risk of regulatory arbitrage.

2.4.2 **The impact of leaving the EU:** After the UK leaves the EU, UK policymakers will be entirely responsible for the coherence of the regulatory regime. The European Commission, European Parliament and Council of the European Union would no longer be involved in developing financial regulation directly applicable to the UK, which currently sits alongside but is separate from purely domestic aspects of the regime. A reduction in the number of sources of regulation (even when all of those sources are themselves coordinated and coherent) inherently makes it easier to coordinate between and to ensure coherence across those sources. The more limited reach of equivalence regimes (as opposed to a full system of mutual recognition) would reduce the general need to maintain broad alignment. The opportunities these changes present to enhance the coherence of UK regulation should be embraced.

2.4.3 **Onshoring and the division of responsibilities for legislation:** One challenge posed to coherence by the onshoring process comes from the way that it has fragmented responsibility for packages of related legislation. For example, the Markets in Financial Instruments Directive II (MiFID II) package consists of a Level 1 directive, a Level 1 regulation, several delegated acts (taking the form of either regulations or directives) and a large number of binding technical standards. In the post-Brexit UK MiFID II regime, Parliament will control the amendment of the onshored Level 1 regulation (MiFIR), HMT (and Parliament) the amendment of the delegated acts, and the UK regulators not just the binding technical standards but also much of the UK version of the Level 1 directive (which is mostly implemented in the regulators' rulebooks). The practicalities of managing this division of powers going forward, and coordinating any rule changes, needs to be clearly articulated and transparent. A rationalisation of responsibilities (even if no policy changes to the rules themselves are made) should be a focus post-Brexit.

2.4.4 **Onshoring and the comprehensibility of financial regulation:** As well as raising issues concerning the allocation of powers, onshoring has added significant complexity to the UK regulatory framework. Notably, the comprehensibility and coherence of the UK regulatory framework has been somewhat diminished by the legal details of onshoring. References to EU law in UK law can be counterintuitive and complex, as no distinct naming system has been put in place for onshored EU legislation. Relevant obligations can be found scattered across the regulators' rulebooks, onshored EU legislation and domestic legislation, and overlaid by various transitional provisions. This means multiple sources with complex interactions must be referred to in order to interpret regulation. While there were very good reasons for putting in place transitional measures, their interactions with the post-Brexit versions of UK regulatory rules add significant complexity to any attempts to identify, still more interpret, which rules apply following Brexit. Improving the accessibility of financial regulation should be a focus post-Brexit.

2.5 Appropriate regulatory objectives

2.5.1 **The importance of appropriate regulatory objectives:** As noted in the first Architecture report, the extensive powers and independence of the regulators mean that they need to be guided by a small number of clear and appropriate objectives. Objectives must be chosen carefully to produce the intended outcomes, must be coherent and comprehensive when considered together and must be flexible enough to be applied in light of technological and market developments.

The core structure of regulatory objectives is capable of being qualified and nuanced through the use of hierarchies of objectives, as well as through principles to which the regulators must have regard in pursuit of their objectives.

2.5.2 **Pressures on the financial regulatory system to promote public policy objectives:** As discussed at Section 2.1.2 above, there is value in placing certain public policy objectives within the regulators' remit. Under this approach, regulators would be required to consciously and transparently balance those public policy objectives against the rest of their remit. Candidates might include such matters as the promotion of green technologies and industries or of intergenerational justice.

Precisely what secondary objectives or regulatory principles would be appropriate would need to be the subject of a broad and open political discussion about the various ways in which the financial sector and the regulators can promote the public good. This would avoid such considerations being left to the informal interpretation of the regulators themselves. This should not be controversial as the regulators have rightly emphasised the importance of their role being closely tethered to the objectives given to them by Parliament (for example, as noted by Andrew Bailey in the FCA's 2017 Mission Statement).

2.5.3 **Recognition of the international context:** The first Architecture report recommended that "sustaining and promoting an environment where financial services can flourish in their global context should be made a secondary regulatory objective". The suggested formulation was intended to promote the latter without implying a pathway to reduced standards. Any suggestion of making competitiveness an objective promotes lively debate between those who see it as an invitation to lower standards, and those who see promotion of the UK's financial services sector and maintaining the attractiveness of the UK market as a centre for international business as a worthy national objective given the importance of the sector to the national economy.

In the context of this debate, it is important to remember that competitiveness is not just about ensuring the UK financial sector is not disadvantaged compared to the rest of the world. It is also about ensuring that customers of that sector (including domestic consumers) are able to access the best financial services in the world and realise the full benefits of innovation.

The tendency of regulators is usually to press for narrower and more circumscribed objectives. Regulators naturally tend to be cautious, and this is reinforced by the incentive structure in regulation, in which typically failures are public, and successes are private. Having varied and complex objectives might make an already difficult job more onerous. Including a competitiveness objective on regulators might be seen as an unnecessary complication, particularly at a time when financial services themselves are changing rapidly, becoming more complex and harder to manage.

Regulators as well as government officials and parliamentarians have argued that having a competitiveness objective, while an attractive idea in theory, was one of the many factors which in practice contributed to the 2008 global financial crisis.

There is an inescapable – and present – tension between different regulatory objectives. The UK in a post-Brexit world will also need to assess how to trade-off policymaking autonomy against the requirements for international market access, a focus on domestic competition with a focus on global competitiveness, or a focus on growth and global competitiveness with the overriding need for financial stability and protection of consumers. It would be better to have these trade-offs managed transparently: either combined within regulators' objectives, or else more clearly in the interaction between the regulators and HMT. The regulators already have an obligation under FSMA to consider the government's economic strategy when exercising their functions, and this may therefore already lead to them at least considering competitiveness. However, how the regulators take into account this statutory obligation is not entirely transparent.

Regulators in other countries manage these trade-offs, without undermining their focus on stability. Relevant financial regulators in Australia, Singapore and Hong Kong all have competitiveness/growth as a regulatory objective. As do Japan and Malaysia. Canada's is formulated as protecting the interests of consumers while having due regard to competitiveness. Many of these countries have adjusted their regulatory objectives and their implementation since the financial crisis, but without abandoning competitiveness altogether. There is no reason the UK could not follow this approach.

Some ways the regulators could integrate competitiveness into their processes would be relatively straightforward, for example including the competitive impact of rules in impact assessments. Of course, the introduction of a competitiveness remit may not be enough to shift behaviour by itself, but it would give HMT and Parliament a clearer standard to hold the regulators to account for the extent to which their actions support or impede wider public policy.

3 RECOMMENDATIONS

The recommendations set out below are intended as a menu of possible changes to be considered as part of the UK's post-Brexit regulatory architecture.

3.1 Powers and resources of the regulators

3.1.1 **Redistribute powers to amend onshored regulation to achieve consistency in the UK's regulatory architecture:** Following onshoring, the UK has the opportunity to consider carefully and systematically how powers should be allocated between Parliament, HMT and the regulators in the post-Brexit context. As discussed in Section 1, the allocation of powers following the onshoring of EU legislation has broadly followed allocation of powers under the EU system, but this is unsatisfactory for a number of reasons (for example, due to its impact on flexibility discussed in Section 2.2.2). The UK should not simply continue to the approach resulting from the onshoring process. Instead, the UK should assess the allocation of powers within its regulatory architecture on the basis of its own institutional arrangements and ensure that it is consistent between EU-derived regulation and other financial regulation.

As the UK's institutional arrangements traditionally provide significant discretion to the regulators, ensuring consistency in this way would have benefits for the flexibility of the regulatory system and make the most of the concentration of rulemaking expertise within the regulators. The overarching principles, broad parameters, powers and constraints, will still need to be set in primary legislation. Accountability and scrutiny will also need to be strengthened, as discussed in Section 3.3.1.

Once a permanent allocation of powers and responsibilities has been established post-Brexit, resources will need to be allocated accordingly. If, for example, Parliament is to play an enhanced role in relation to the scrutiny of financial services regulation in specific areas, it will need appropriate support and expertise to perform that role in a meaningful and effective manner. Similarly, if HMT is to undertake third country equivalence assessments, it will need the appropriate resources to do so.

3.2 Framing the responsibilities of the regulators

3.2.1 **Provide a formal role for international financial standards within the regulatory architecture:** Given the growing importance of global standards for financial regulation and other policy areas that impact on financial services (such as data protection) and the UK's desire to help shape and spread those standards into the future, it may be appropriate to refer to them in a new regulatory principle under FSMA. Regulators would need to take into account, where appropriate, international standards that have been developed by consensus when discharging their regulatory functions, and to actively promote their adoption on the international stage.

Such a principle would mean that the regulators would need to consider their actions, including changes to their rules, against the background of global standards where appropriate. It would give those tasked with scrutiny and accountability, such as the appropriate Parliamentary committees, an additional benchmark to assess the regulators against. Such a principle would not establish a hard obligation for the regulators to adhere to international standards in all circumstances (except as required, for example, by primary legislation), as there may be occasions where it is appropriate or desirable for the UK to diverge from those standards. Nevertheless, the regulators could at least be obliged to reflect upon international standards when exercising their rulemaking powers to ensure costs that come from complying with a multiplicity of standards are not imposed on international market participants unnecessarily.

A formal role for international standards within the regulatory architecture would also ensure a continued focus by the UK regulators on maintaining their leading role in shaping these standards, and encourage other desirable outcomes, such as continued structured cooperation with EU regulators and ESAs. Obviously, these activities would require appropriate resources.

3.2.2 **Clarify roles and responsibilities in meeting public policy objectives:** Setting policy direction and making politically sensitive trade-offs in determining objectives requires democratic legitimacy and accountability and is clearly the role of Parliament. Government and Parliament should not avoid making these difficult policy decisions or pass them to regulators to determine. By contrast, the regulators should carry out the detailed application of regulation independently of Parliament or the government, given this confers significant benefits in terms of the stability and predictability of regulation and the concentration of regulatory expertise.

As discussed in Section 2.1.2, this balance can be achieved by Parliament setting secondary objectives or principles that the regulators have the discretion to balance against their other objectives. An obligation on HMT to indicate public policy considerations more frequently to the regulators or introducing greater formal scrutiny by HMT in certain areas of rulemaking may also be an effective way to ensure regulators act in line with public policy objectives whilst keeping detailed rulemaking powers with the regulators. HMT and Parliament will also continue to be able to adjust primary or secondary legislation if these mechanisms fail. These enhanced roles for HMT and Parliament in coordinating public policy objectives with the financial regulators, would ensure that the financial regulation is integrated into a wider public policy context.

3.2.3 **The need to maintain and enhance the financial services ecosystem should be reflected in regulatory objectives:** We would recommend that sustaining and promoting an environment where financial services can flourish in their global context should be made a secondary regulatory objective. This should be distinguished from a drive for lower standards which could allow excessive risk to develop within the financial system. Industry does not want a regulatory race to the bottom but attaches importance to promoting the competitiveness of the UK.

Adding this secondary objective would meet the concern that if the regulators are only able to use a wider set of powers in furtherance of regulatory objectives which are protective and conservative in nature, the cumulative impact of regulation on the ecosystem will be increasingly negative. Its inclusion would empower the regulators to work with stakeholders, where appropriate, to make the UK a better place to do business (including as a home market for international providers of financial services) and more attractive for international consumers of financial services. This would also encourage the regulators to stay focussed on maintaining the UK's position as a centre of innovation in financial services, and not to be wedded to existing business models (a risk discussed in Section 2.1.3).

If this objective was not introduced, at a minimum we would recommend the reinstatement of the former requirement to have regard to the international character of financial services and the desirability of competitiveness as one of the regulatory principles. This could also be supplemented by other measures, such as those discussed in Section 2.5.3 regarding assessing the competitive impact of rulemaking.

3.3 General accountability and scrutiny of the regulators

3.3.1 **Strengthen mechanisms for scrutinising and holding regulators and HMT to account:** The loss of the constraining factor of the need to comply with EU law and of peer review from other EU financial regulators and the ESAs needs to be carefully thought through when considering the breadth and depth of scrutiny and accountability mechanisms. Additionally, if the regulators are granted increased powers in relation to onshored regulation as suggested above, this should be matched with heightened scrutiny and accountability to ensure they are operating within the broad parameters set by legislation.

As a result, we recommend that there should be a parliamentary committee with a mandate specifically focused on the regulators and with formal mechanisms to ensure regulators regularly report to it on the exercise of their functions (for example, a sub-committee of the Treasury Select Committee). It should have sufficient expert staff and resources to ensure that the full range of financial regulatory activities are subject to meaningful scrutiny. This body would supplement the existing ways in which the Treasury Select Committee exercises oversight by creating more time for systematic and constructive scrutiny of how existing regulation is working and of regulatory proposals. This would include not just scrutiny of the regulators, but also of HMT's exercise of its functions in this area (e.g. through the drafting of SIs).

While the constraints on the use of judicial review discussed in Section 2.3.1 may not be easily overcome, it would be helpful to consider, at the very least, whether the process of judicially reviewing the exercise of regulatory powers can be made more accessible from a speed and cost perspective.

3.3.2 **Increase transparency of decision making by HMT and the regulators to improve scrutiny:** As discussed in Section 2.3.3, in order to ensure appropriate scrutiny, it is important that decision making by HMT and the regulators is sufficiently transparent. Clearly, there are a number of existing transparency mechanisms (for example consultations on proposed rule changes), but the issue should be reconsidered as part of the UK's post-Brexit regulatory architecture. Examples of areas where we believe transparency could be improved include:

- Publishing minutes of the Prudential Regulation Committee insofar as these concern their general policy discussions (rather than discussion of individual firms and cases).

- The holding of annual public meetings by the PRA, like the FCA.

- Publishing clear and stable frameworks setting out which consultation mechanisms will be used in which circumstances.
- Publishing individual responses to consultations.

3.3.3 **Enhance engagement with and role for the Law Commission and other legal expert groups:** HMT and the regulators should more actively engage with the Law Commission and other bodies, such as the Financial Markets Law Committee. This engagement should be to consider legal issues such as the appropriate review and consolidation of financial services legislation and related common law, and to review relevant legislation thematically rather than on a piece-by-piece basis.

This would help to address concerns in the industry, discussed in Section 2.3, that there may be insufficient scrutiny of the regulators' legislative functions and of their interpretations, particularly when the ESAs no longer provides oversight. The role of legal expert groups in scrutinising the regulators' interpretation of rules and legislation could therefore be enhanced, for example, through formal mechanisms to provide input on the regulators' interpretation of rules and legislation. It would also be helpful if such legal expert groups had structured mechanisms to receive submissions from firms in this regard, so their scrutiny of the regulators is informed by the practical experience of firms.

3.3.4 **Strengthen the role and visibility of statutory panels:** The PRA and FCA statutory panels each have the same formal remit – to consult over the extent to which the relevant regulator's general policies and practices are consistent with its general duties. They serve an important role in the current UK system of financial regulation and will remain important going forward in ensuring appropriate scrutiny of the regulators.

The FCA panels are particularly active. They are independent of the FCA but have close working relationships with it and amongst themselves. They are publicly committed to standards of good governance and act transparently. The latest annual report of the FCA Consumer Panel indicates that it submits numerous consultation responses, publishes position and discussion papers and takes a proactive approach in canvassing public opinion. The practitioner panels tend to be less involved in these types of activities since their constituents are more likely to respond directly and make their own voices heard.

While the PRA Practitioner Panel (the PRA's sole external panel) provides valuable early input into the PRA policy formation process, its terms of reference indicate that it has a more circumscribed remit for scrutinising and publishing its findings than its FCA counterparts (including its direct analogue, the FCA Practitioner Panel). We recommend FCA and the PRA actively consider whether its panel could be strengthened and made more prominent. Another feature of the PRA Practitioner Panel which may be worth reviewing is its broad composition, which may prevent adequate representation of a full range of views within particular PRA-regulated sectors. Establishing additional panels for the PRA could address this.

3.4 Legislative and regulatory processes

3.4.1 **Consolidate financial regulation to improve accessibility:** The UK regulators' rulebooks are not a one stop shop for detailed regulatory requirements, because much regulation is set at the EU level with no UK implementation required. After onshoring, the location of specific regulatory requirements within the legal framework will remain complex (as discussed in Section 2.4.4) and it is unlikely that the situation would be improved simply by the reallocation of powers recommended above. There may still be little correspondence between the form and location of specific regulatory requirements and the regulator or other body (whether HMT or Parliament) responsible for those requirements. Consideration should thus be given to a consolidation exercise to improve accessibility of the law and lower compliance costs.

3.4.2 **Establish mechanisms to track regulatory developments which could affect trade negotiations:** HMT and the regulators should put in place mechanisms to track domestic and international regulatory developments which might jeopardise foreign market access. Such mechanisms should not be limited to simply tracking measures that may jeopardise equivalence decisions that have been or could be made by the EU. As discussed in Section 2.2.3, tracking the benefits and costs of divergence in relation to areas of potential or actual equivalence will be an important task and HMT should have the ability, where it thinks appropriate, to constrain the power of regulators to change rules in those areas. The impact of regulatory developments on trade negotiations should also be considered as part of the allocation of powers in the UK regulatory architecture, to ensure appropriate oversight is exercised in this area.

3.4.3 **Make review mechanisms mandatory:** Formalising requirements to review new rules or legislation within an appropriate period would provide the opportunity to improve regulatory outcomes. This is to ensure financial services law remains relevant and adapts to broader changes in society, as well ensuring that regulatory rules are not retained where they do not achieve their desired objectives. This is important for both the flexibility and the coherence of the UK regulatory system discussed in Sections 2.2 and 2.4 respectively. Review requirements should follow an appropriate period of reflection (to avoid unnecessary regulatory churn) and be approached with the recognition that even where rules are not perfect, there may be merits in retaining them.

3.4.4 **Establish a Financial Regulatory Policy Committee:** The regulators are normally required to conduct a cost-benefit analysis when making a regulatory proposal. Cost-benefit analyses improve the transparency and quality of decision making by making a regulator set out reasoned arguments about the impact of their rules and policies. However, their effectiveness depends in part upon the degree to which they are subject to scrutiny, especially given the inherent risk that regulators may underestimate costs – particularly negative externalities – and overstate benefits where they have already settled on a course of action.

The UK's existing Regulatory Policy Committee (RPC) is an independent public body that scrutinises impact assessments from government and regulators including the FCA, challenging assumptions and omissions, and rejecting inadequate analysis. However, the RPC does not have specialist expertise in financial regulation and is often engaged late in the policymaking process. We recommend that Parliament and the government should consider whether a body specific to, and with greater links to, the financial regulators would be appropriate. A Financial Regulatory Policy Committee, with specialist sub-committees and representatives of the full range of stakeholder interests, could not only scrutinise regulatory cost-benefit analysis with the benefit of background knowledge but also review the content of regulatory proposals themselves (including, for example, from the perspective of internal and external regulatory coherence and the broader better regulation agenda). It might also find a role in any legislative review mechanism. Such a committee would need to be independent and could report to HMT and the sub-committee recommended in Section 3.3.1. This should hopefully help to mitigate the potential deficit in scrutiny of and accountability in regulatory rulemaking discussed in Section 2.3.

3.4.5 **Establish a Joint Regulatory Committee:** While the ESAs work together in a Joint Regulatory Committee, there is no equivalent for the PRA, FCA, Bank of England, Payment Systems Regulator, and other regulators with an influence on financial services (such as the Information Commissioner's Office) in the UK. While the regulators have statutory duties to consult each other, maintain memoranda of understanding and benefit from some institutionalised overlap in governing personnel, there is a case for more institutionalised coordination to ensure the type of 'air traffic control' discussed in Section 2.4.1. We recommend the establishment of a permanent committee, with senior representatives of the main regulators, tasked with ensuring coherence in regulation and supervisory approach and with public minutes.

CONCLUSION

The UK's regulatory architecture is a key component of the successful financial and related professional services ecosystem in the UK. While moving towards a new relationship with the EU, and a new position in the global economy, the UK must continue to review the structure and processes it has in place to ensure an effective, well-scrutinised framework. This will enable the UK to remain globally leading, providing the best outcomes for customers and building the UK's position as an international financial centre.

The context in which financial services operate continues to evolve and our regulatory system must be able to keep pace with the changes and respond effectively. It will need to balance competing regulatory objectives with broader public policy objectives. The recommendations in this report aim to ensure that the UK framework remains world-leading and collaboration between industry, regulators and government will be key to its continuing success.

ANNEX: ANALYSIS OF ONSHORING

1 The fundamentals of onshoring

The onshoring of EU legislation is based on sections 1, 2 and 3 of the EUWA. The WAB modifies the approach of these sections of the EUWA during the implementation period but does not change the fundamental mechanisms. Financial services legislation is treated no differently from any other legislation under either the EUWA or WAB.

Section 1 EUWA repeals the European Communities Act 1972 (ECA) on exit day. The ECA is the Act that gives effect to the UK's membership of the EU in UK law and so, for example, ensures that directly applicable EU legislation (i.e. EU legislation that does not require implementation by the UK) is recognised in UK law. The WAB inserts a new Section 1A into the EUWA that preserves many of the effects of the ECA until the end of the implementation period, notwithstanding its repeal, to ensure the continued operation of EU law in the UK.

Section 2 EUWA provides that EU-derived domestic legislation, as it has effect in UK law pre-exit day, will continue to have effect after exit day. EU-derived domestic legislation is broadly defined to encompass UK legislation implementing EU law or relating to the EU or EEA. This effectively saves UK legislation that might otherwise be affected by the repeal of the ECA under section one. The WAB modifies the effect of this section so it will apply from 'IP completion day' (the end of the implementation period), and insert a similar provision as a new section 1B to the EUWA to ensure EU-derived domestic legislation is saved during the implementation period.

Section 3 EUWA provides that direct EU legislation, so far as operative immediately before exit day, will form part of domestic law after exit day. The WAB amends this section so that the term 'exit day' is substituted by 'IP completion day'. Direct EU legislation is defined to include directly applicable EU legislation and certain aspects of the European Economic Area Agreement. In general, retained direct EU legislation will constitute a special category of UK legislation, with rules for its modification set out in section 7 EUWA. Broadly, section 7 EUWA splits retained direct EU legislation into principal and minor categories, with the minor category essentially covering tertiary direct EU legislation. The government's ability to modify the principal legislation via subordinate legislation is more restricted than for the minor legislation. For example, where amending powers that preceded the passing of the EUWA are being used, the amendment or repeal of the principal retained direct EU legislation will be subject to similar procedures as those that apply to modification of UK primary legislation.

The meaning of operative immediately before exit day requires special explanation.[4]

4 As previously noted, the WAB substitutes the term exit day in this phrase with IP completion day.

The EUWA explains that direct EU legislation is operative immediately before exit day if it is not just in force on exit day but also applies. Whether or not EU legislation is in force is effectively a formality and is usually expressed to occur shortly after the text of the final legislation is published in the Official Journal of the European Union. However, just because a piece of EU legislation is in force does not mean it actually applies from that point as well. In many cases, EU legislation will have a relatively long period before it applies. For example, in the financial services area MiFIR was published in the Official Journal in June 2014 and came into force in July 2014 but did not generally substantively apply until January 2018. In addition, EU legislation is often drafted so that individual provisions of a given piece of legislation (e.g. individual articles of a given regulation) apply from different points in time, even though they all come into force at the same time (e.g. to provide for a phasing in of legal requirements).

This aspect of onshoring complicates the post-Brexit UK regulatory framework, as it means that the UK can potentially only partially onshore any financial services regimes which have individual provisions applying both before and the end of the implementation period.

2 Amending retained EU law for deficiencies

Section 8 EUWA provides the mechanism by which retained EU law can be amended to reflect the UK's exit from the EU, by providing the government with the power to make SIs.[5] The power granted to the government under Section 8 EUWA is broadly defined, allowing a minister to "make such provisions as the Minister considers appropriate to prevent, remedy or mitigate (a) any failure of any failure of retained EU law to operate effectively, or (b) any other deficiency in retained EU law, arising from the withdrawal of the United Kingdom from the EU".

In respect of financial services, the government has sub-delegated the power to amend certain retained EU legislation to the relevant UK regulators (FCA, PRA and Bank of England).[6] This sub-delegation covers EU binding technical standards and EU-derived aspects of the regulators' rulebooks. Amendments made by the UK regulators must be approved by HMT.

The EUWA put in place procedures by which the SIs would be passed by either the affirmative or negative procedure and thereby subjected to greater or lesser (but in all cases limited) scrutiny by Parliament.[7] Under the negative procedure an SI is subject to annulment by either House of Parliament within 40 days, and under the affirmative procedure an SI requires active approval by both Houses of Parliament (generally through delegated legislation committees). In practice, approval of SIs is effectively a formality, and annulment almost never happens. In any case, Parliament was faced with hundreds of SIs and insufficient resources in relation to the onshoring process, so parliamentary scrutiny of the SIs made under the EUWA did not have a significant impact on the process of amending retained EU law.

The government's approach to amending retained EU law (and the regulators' approach to amending their rulebooks) was not to make policy changes, but to instead make essentially technical changes, such as reflecting the EU's status as a third country in relation to the UK post-Brexit, transferring regulatory powers from European authorities to UK ones and amending cross references to EU legislation where appropriate. While

5 This power is supplemented by other powers under the EUWA, for instance under paragraph 21 Schedule 7 EUWA. The WAB modifies this power so it applies to the end of the implementation period rather than when the UK leaves the EU.

6 Using the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018.

7 The EUWA provides for scrutiny through sifting committees to check whether the affirmative or negative procedure is appropriate.

these changes appear to be minor when considered in the abstract, they have led to significant compliance challenges for financial services firms – for example, affecting their ability to use EEA trading venues to trade shares and derivatives as a result of changes in scope of the mandatory trading obligations under MiFIR. It is also worth noting that a number of less technical changes have been made using the government's powers under the EUWA, such as transitional measures.

3 References to retained EU law and EU law

In the onshoring process, the UK has not put in place a specific naming scheme for retained EU law. For example, the UK retained version of MiFIR is referred to in a manner which at first glance makes it indistinguishable from the EU version of MiFIR.

Instead of implementing a unique naming scheme, the EUWA and certain SIs under it put in place interpretation provisions (in some cases through amendments to the Interpretation Act 1978) to address references to EU law in UK legislation (including retained EU law) post-Brexit. How a reference to EU law should be interpreted as a result of these provisions depends, in summary, on whether:

a. the reference exists immediately before onshoring

b. the reference is ambulatory or non-ambulatory

c. the EU law is a form of direct retained EU legislation

d. EU law has been amended in such a way to alter the effect of the reference.

While this approach avoided the need for the government to update every reference to EU law in the corpus of UK legislation and retained EU legislation, it does mean that interpreting such references is now potentially counterintuitive, and subject to complex interpretation provisions across multiple pieces of legislation. The absence of a clear scheme established by legislation for distinguishing between the UK and EU versions of EU regulation means that private legal documents may use different formulations, increasing the risk of confusion and adding to legal costs of adapting to the post-Brexit legal framework.

4 Transitional measures

The government recognised that it would be difficult for financial services firms to immediately adapt to the changes being made to the UK regulatory regime as a result of a no-deal Brexit. As a result, as part of the onshoring process many transitional measures were put in place using the government's powers under the EUWA, and by the UK regulators in the exercise of their powers, in order to address this possibility. The WAB will ensure that these transitional measures are also in place for the end of the implementation period, although it is not clear at this stage whether a political decision may be made to remove them.

These transitional measures can be summarised as falling into three key buckets:

i. **Temporary licensing relief for EEA firms:** Over 8,000 EEA firms currently use passporting rights to provide financial services in the UK (either on a branch or cross-border basis). The government and regulators recognised that a no-deal Brexit would create a licensing cliff edge for such firms, and in any case, it would not be possible for the UK regulators to process licence applications from all of these firms prior to Brexit. Hence, the government used its powers under the EUWA to establish a temporary permissions regime (TPR) (which would allow passported firms to continue to operate in accordance with their passported permissions for up to three years whilst awaiting full authorisation) and a financial services contracts regime (FSCR) (which would allow passported firms to benefit from temporary licensing relief in relation to financial services contracts entered into prior to Brexit). Several other temporary regimes facilitating EEA firms access to the UK were also put in place in specific areas.

The UK regulators have put in place specific regulatory rules that apply to these firms. Notably, such firms would, if treated like any other third country firms, often have to switch from complying with home state rules in their home EEA country to UK ones after Brexit. The FCA provided extensive transitional relief by allowing these firms to rely on substituted compliance (i.e. complying with their home state rules to satisfy UK requirements), whereas the PRA provided much more limited temporary relief for firms it supervises.

ii. **General transitional relief:** The government used its powers under the EUWA to make the Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019. Among other things, this SI granted the UK regulators the power to make temporary transitional directions. This power enables them (subject to limitations) to temporarily waive or modify regulatory obligations for UK-supervised persons where those obligations have changed or apply for the first time due to the onshoring of EU legislation because of Brexit. The UK regulators intended to use these powers to put in place a temporary standstill of all onshoring changes in the case of a no-deal Brexit. However, the regulators put in place a number of limitations on this relief, namely (i) only applying the relief in the absence of specific transitional relief (discussed below); (ii) not applying the transitional relief in respect of changes to the regulatory perimeter; (iii) generally not applying transitional relief where the issue could be solved by an equivalence determination with respect to the EEA; and (iv) putting in place specific exceptions to transition relief in certain key areas (e.g. MiFIR transaction reporting).

iii. **Specific transitional relief:** As well as the more general pieces of transitional relief discussed above, the government used its powers under the EUWA to put in place large numbers of other transitional regimes in specific areas. For example, under the Benchmarks Regulation regime, the government put in place mechanisms to allow UK firms to continue to use benchmarks they use prior to Brexit, post-Brexit.

5 Post-Brexit onshoring

It is worth noting that onshoring of EU financial services legislation will not necessarily stop at the end of the implementation period. As discussed above, since only operative directly applicable EU legislation will be onshored by the EUWA, the UK in some cases will only onshore parts of regulatory regimes. Similarly, the UK has been supportive of several pieces of EU financial services legislation that are not expected to fully apply even by the end of the implementation period (for example, the Investment Firms Review and Sustainable Finance Package), and so may want to find ways to onshore or replicate such legislation in the UK in future.

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