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GLOBALISATION AND FINANCIAL REGULATION: CHALLENGES AND TRENDS

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Since the financial crisis of 2008, there has been a major shift away from internationally agreed standards and principles, as regulators and policy makers have focused on national legislative and regulatory solutions to crisis management. This has coincided with the rise of populist and nationalist political movements across a growing number of countries, further eroding international solutions. However, despite this move towards deglobalisation, the growth of the global digital economy will require international cooperation.

In this report, Clifford Chance experts discuss these competing forces towards and against globalisation, focusing on five areas that are driving or challenging global approaches in financial regulation.

1. Implementation of financial crisis reforms

The 2008 global financial crisis introduced an avalanche of regulatory reforms to counter the perceived failures of the global financial system. While regulators have been ready (and eager) to collaborate on principles and standards, they have not always implemented these principles and standards in the same way.

We can see this in a number of areas including derivatives markets regulation. There is clear and overwhelming global acceptance of the G-20 standards on trading, clearing and margining of over-the-counter derivatives, which have the aim of making the market safer and more transparent. However, jurisdiction-specific implementation of these globally agreed standards differs in often small but significant ways, creating friction in cross-jurisdiction transactions and encouraging market fragmentation.

2. Crisis management measures

National and protectionist approaches are most clearly seen in crisis management measures. In the immediate aftermath of the 2008 financial crisis, it was decided that the response needed to be global. However, in reality, policy makers have often taken national and protectionist approaches to crisis management, focusing on financial stability and the impact on taxpayers, rather than the broader global economy. For example, reforms involving resolution, bail-in, capital buffers and intermediate holding company requirements are designed to ensure financial stability at the national level where losses will most likely be suffered, in an attempt to ensure that taxpayers will not be called upon in future to pay to prevent a failure of the financial sector. The result has been a marked increase in efforts to "ring-fence" international financial firms' capital and liquidity for the benefit of local creditors.

3. Market access and the Brexit legacy

De-globalisation of financial activity is often driven by national rules limiting market access. Recent political events such as the UK's decision to leave the European Union have exacerbated this trend. Depending on how Brexit is delivered (which remains uncertain), the UK is likely to relinquish free EU market access. Brexit will also involve the painful untangling of the UK from the integrated legal framework and structures of the EU.

However, maintaining access to EU financial markets and, indeed, access to global markets is essential for financial firms engaging in global capital transactions. Here, firms may need to resort to bespoke country by country solutions, creating friction for cross border business.

4. China's search for global capital

With protectionism and deglobalisation on the rise in Europe, the US and elsewhere, China, by contrast, is championing globalisation. Its financial system is still relatively closed to international access, but the Chinese government has recently taken steps to open up access to its financial markets to foreign investors, in order to seek global capital. Although it remains at a relatively early stage, legislative changes such as the new Foreign Investment Law and links to the global financial system including Shanghai-Hong Kong Stock Connect are already having an impact and China's influence in global financial markets may grow significantly if this trend continues.

5. The emergence of the digital economy

We expect to see major changes for the finance industry over the next decade, as the market and regulators adapt to an increasingly digital economy. Technological innovation in financial services (including use of artificial intelligence and machine learning, cryptoassets and blockchain technology) the rise of fintechs and entry of Big Tech companies into financial services are all driving this change.

Policy makers and regulators recognise the benefits of developing a consistent, global approach to the regulation of new market participants and products in this area, that addresses the emerging risks and challenges. Otherwise, regulatory arbitrage and consumer and market failures in this area will seem inevitable.

IMPLEMENTATION OF FINANCIAL CRISIS REFORMS

Differences in national implementation driving divergence

In the aftermath of the crisis, G20 policy makers agreed new global standards for financial markets to address what were seen as the causes of the crisis. These included the introduction of new regulation for derivatives markets, such as clearing, trading and risk mitigation requirements, and other prudential measures including the introduction of bank recovery and resolution regimes and enhanced capital and liquidity requirements under Basel III.

Because the post-crisis global standards tended to take the form of general frameworks, they left room for divergence in national and regional implementation. In some cases, differences in the scope, substance and timing of implementation across jurisdictions has left firms grappling with inconsistent and overlapping requirements.

In turn, this has been a contributing factor to market fragmentation, which can reduce or trap liquidity, limit firms' ability to diversify and manage risks across borders and impair financial stability. A fragmented approach to regulation also increases the compliance burden for firms as they may need to comply with multiple similar regulations which differ in small but significant ways.

International standard-setting bodies such as the BCBS, FSB and IOSCO do carry out reviews of how relevant standards have been implemented globally. However, more may be needed to promote consistent global application of these standards in a way that fosters and supports global financial markets.

Types of divergence that may drive fragmentation

We have seen differing implementation of global standards causing challenges for firms and driving market fragmentation in a number of ways.

Duplication

The extraterritorial application of derivatives clearing, trading and risk mitigation requirements leaves many firms subject to multiple rule sets. For example, firms entering into derivatives transactions via a branch may be subject to rules in both the jurisdictions of both their head office and the local branch. Issues can also arise where each of the counterparties in different jurisdictions are subject to different local requirements. These issues may be particularly acute in the case of the derivatives trading and clearing obligations, where parties may find they are unable to satisfy their different obligations on the same trading venues and CCPs. Equivalence and substituted compliance regimes go some way to ease these challenges, but they are not available across the board.

Discrepancies

There are various examples of discrepancies, where the detailed rules implementing global standards differ from jurisdiction to jurisdiction. For example, the content and format of derivatives transaction reports, as well as the scope of intragroup and other exemptions from derivatives clearing, trading and risk mitigation requirements, are not consistent across different jurisdictions. This means that firms subject to requirements in

"We need 'smarter globalisation' of financial regulations, an approach to differentiate the degree of expected cross-border consistency depending on the nature of the regulation.

We have designed and implemented international regulatory standards assuming global consistency is usually a good thing. Each regulatory area, however, has different reasons for cross-border consistency and different needs to be tailored to national specificities. There are many good and bad reasons for setting standards globally and also for tailoring regulations nationally."

Ryozo Himino, vice minister for international affairs, Financial Services Agency, Japan (October 2018) multiple jurisdictions may need to build different systems to comply with each set of requirements, increasing the implementation and compliance burden. Another important discrepancy arises from the inconsistent implementation of the Basel capital and liquidity standards, leading to global groups having to use one set of rules and models for the consolidated group and another for a subsidiary outside the home jurisdiction.

Competition

In some cases, policy makers and regulators have taken action to keep resources or activities local. This is often driven by concerns around the ability of regulators to effectively supervise offshore activity that may impact the stability of local financial markets. For example, some jurisdictions require certain derivatives transactions to be cleared at local CCPs (e.g. Japan in relation to yen-denominated trades executed in Japan). In the EU, EMIR 2.2 also introduces the possibility for ESMA to de-recognise non-EU CCPs in certain circumstances.

Desynchronisation

Finally, while global standards generally set out common implementation deadlines, different jurisdictions may implement requirements on different timescales. In many cases, new global standards require the introduction of new primary legislation which can also impact the timing of implementation. For example, the US introduced swap execution facilities under the Dodd-Frank Act several years before the EU introduced its derivatives trading obligation under MiFID2. Again, this can leave firms subject to different rulesets in different jurisdictions and temporarily upset the playing field.

Impact on financial markets and possible solutions

The Japanese G20 Presidency, FSB and IOSCO have been examining potential adverse effects of market fragmentation arising from regulation, and what actions could be taken to address them. In June 2019, the FSB[1] and IOSCO[2] published reports on their work in this area.

These reports recognise that market fragmentation can have both positive and negative drivers and consequences. For example, some types of market fragmentation may arise from measures to improve domestic resilience and in some cases may have a positive effect on financial stability, by reducing the risk of transmitting economic shocks between jurisdictions. There is a balance to be struck between enabling cross-border financial activity and market access on the one hand, and a need to tailor local regulatory frameworks to reflect domestic policy mandates, risks and responsibilities on the other. The reports therefore identify and focus on areas where reducing regulatory-driven market fragmentation may have a positive impact on financial stability or improve market efficiency without adversely impacting financial stability.

The FSB report focuses on trading and clearing of OTC derivatives, banks' cross-border management of capital and liquidity and the international sharing of data and other information. It identifies potential ways of enhancing international cooperation

1 FSB Report on Market Fragmentation published 4 June 2019 and available at https://www.fsb.org/wp-content/uploads/P040619-2.pdf

2 IOSCO Report on Market Fragmentation & Cross-border Regulation published 4 June 2019 and available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf

and helping to mitigate negative effects of market fragmentation in these areas on financial stability, including increased cross-border information sharing and communication among regulatory authorities via supervisory colleges and crisis management groups. The IOSCO report also considers the role of supervisory colleges in strengthening collaboration and cooperation between regulators and identifies this as an area for further work.

Both the FSB and IOSCO reports also examine existing approaches to cross-border regulation, including recognition and deference mechanisms, which may take various different forms such as exemptions, substituted compliance, equivalence and passporting. The IOSCO report recognises that deference may not be appropriate in all circumstances, but proposes that IOSCO could serve as a forum for exchanging information about approaches to cross-border regulation and good practices around deference tools. Similarly, the FSB proposes carrying out further work on exploring where and how to enhance the clarity of deference and recognition processes in OTC derivative markets.

At an international level, the Japanese G20 Presidency has identified market fragmentation as a critical issue affecting the global economy, and both the FSB and IOSCO are continuing their work on addressing market fragmentation. However, we still see various trends towards national policy makers and regulators pursuing a domestic agenda and financial stability at the national or regional level rather than prioritising cross-border financial activity.

CRISIS MANAGEMENT MEASURES

The post-crisis agenda: ending 'too big to fail'

In the immediate aftermath of the financial crisis, it was resolved that the response to the crisis needed to be global and that the concept of "too big to fail" no longer applied.

The G20 mandated the FSB to take the lead on a raft of post-crisis measures. The most important of these were the Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011, updated 2014) and the Total Loss Absorbing Capacity Principles and Termsheet (November 2015). These documents aimed at creating a mechanism whereby a global institution could be resolved in an orderly manner at the level of its ultimate holding company (the "Single Point of Entry" model).

Single Point of Entry and loss-absorbing capacity

The Single Point of Entry model aims to enable the resolution of global banking groups at the ultimate holding company level. However, local subsidiarisation and intermediate holding company requirements and restrictions on the deployment of loss-absorbing capacity across global groups point to a national or regional approach and could hamper the effectiveness of the Single Point of Entry model.

Although governments approved of the Single Point of Entry model for the resolution of global banking groups in principle, they soon became uncomfortable with it in practice. In particular, US regulators became concerned that foreign banks operating in the United States were accessing the US domestic dollar markets in order to fund their non-US business, resulting in significant "due from" balances on the books of foreign banks' US operations. As a result, they imposed an Intermediate Holding Company (IHC) rule, requiring foreign banks to maintain a single US holding company in respect of their US non-branch operations. The EU retaliated with the Intermediate Parent Undertaking (IPU) rule, which will require non-EU banks and investment firms to maintain a single EU holding company in respect of their EU subsidiaries.

"some national policymakers... fear that banks are still "national in death" and that they might have to carry the burden when a bank gets into trouble. In the absence of clear safeguards to protect domestic interests in bad times, policymakers thus feel the need to require the local entities of banks to maintain relatively high amounts of capital and liquidity, also in good times."

Speech by Andrea Enria, Chair of the Supervisory Board of the ECB on "Supervising banks – Principles and priorities" (7 March 2019)

Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011, updated 2014)

Total Loss Absorbing Capacity Principles and Termsheet (November 2015)

Effective resolution regimes

The FSB called on G20 jurisdictions to put in place effective resolution regimes giving resolution authorities a broad range of powers to resolve failing banks in an orderly manner, where losses are imposed on shareholders and investors – and not taxpayers. The Key Attributes document sets out twelve features that it identified as essential for an effective resolution regime.

TLAC

The TLAC requirements are designed to ensure that if a global systemically important bank (G-SIB) fails, it has sufficient loss-absorbing capacity available in resolution to implement an orderly resolution that minimises impacts on financial stability, ensures the continuity of critical functions and avoids exposing public funds to loss.

The effect of these requirements is to trap capital and liquidity in the newly-created subsidiaries, since such resources could only be used to meet losses elsewhere in the group with the consent of the local authorities. This undercuts the basis of the Single Point of Entry approach, which was designed to create the maximum degree of flexibility to deploy capital wherever needed.

The fragmentation effect of these geographic ring-fencing requirements was compounded by two other developments. One was ring-fencing of deposit-taking activities (most notably in the UK in the wake of the Vickers Commission report). Since the purpose of ring-fencing retail deposit-taking is to ensure that retail depositors receive a higher level of protection than other creditors, it is extremely unlikely that the capital held in a ring-fenced bank will ever be released, and is therefore lost to the rest of the group.

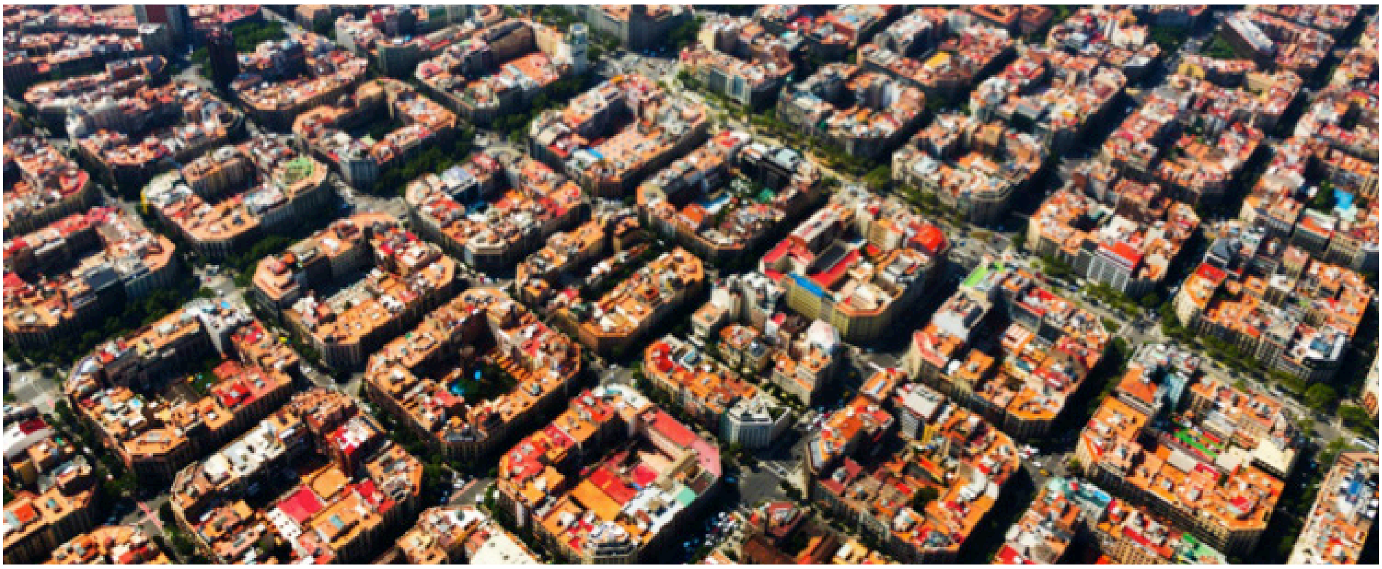
The other was the demand by local regulators for high levels of TLAC to be issued by local subsidiaries. The original FSB term sheet had provided for wholly-owned subsidiaries to require only 75% of the amount of TLAC which they would have required had they been independent. However national authorities have the power to increase this, and many have done so. Again, the effect of this is to trap loss-absorbing capacity in local subsidiaries, preventing them being used elsewhere in the group.

The consequence of this fragmentation of loss-absorbing capacity is that bank groups become "brittle". It is increasingly easy to imagine a loss in a relatively small subsidiary of a G-SIB group causing the collapse of that group, since although the group as a whole may have more than enough capacity to absorb the loss, the capacity may be incapable of being transferred to the part of the group where the loss has occurred.

The policy drivers behind this fragmentation of loss-absorbing capacity are broadly twofold. One is a lack of confidence by national governments and resolution authorities in each other – ring-fenced capital and liquidity pools may be regarded as insurance policies against the authorities in the home country seeking to renege on host country creditors and depositors. The other is a desire of host countries to grow their financial markets by domesticating activities. This latter driver can also be seen in measures such as local trading mandates, which prohibit firms from executing certain trades (derivatives and, in the EU, equities) outside the jurisdiction.

"The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation."

Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011)



MARKET ACCESS AND THE BREXIT LEGACY

Navigating market access: the issues

Regulating market access is a key way in which national policy makers and regulators seek to maintain oversight of and manage risks associated with the financial activity taking place in their jurisdiction. However, as discussed in the earlier section on market fragmentation, restrictive market access rules can have adverse consequences, such as reduced efficiency of cross-border investment, risk management and resource allocation.

When seeking to calibrate rules on market access and the extraterritorial impact of national regulation, policy makers and regulators generally seek to balance an appropriate level of oversight of what is taking place in their markets against the risk of unduly restricting access to global financial markets. Although there are concerns at an international level around the adverse consequences of market fragmentation, there is currently a trend a towards tightening up existing frameworks and mechanisms for allowing cross-border market access. In the EU, this trend may be attributed, at least in part, to Brexit, as the EU assesses the impact of the UK leaving the single market, whilst the size of UK financial markets means that they are likely to remain of systemic importance to the EU.

Licensing requirements

Licensing requirements are the main legal tools that jurisdictions use to regulate market access, although they are by no means the only legal tools that can restrict or limit cross-border market access in practice.

Licensing requirements restrict market entry for firms providing banking and investment services, ensuring that, at the national level, only firms which satisfy certain minimum conditions and comply with ongoing requirements are able to operate in the jurisdiction concerned. Approval conditions could include local presence, capital requirements, organisational requirements (including fitness of management, systems and controls) and the capability of being supervised.

Firms need to consider differing tests that trigger licensing requirements in different jurisdictions and for different activities and services. In some jurisdictions, there is a strong territorial-scope analysis and “characteristic performance” test such that, if the economic activity of the relevant service is actually performed outside of the jurisdiction then no licensing requirement is triggered (even if the services are being provided to persons located in the jurisdiction).

In other jurisdictions, any nexus to the jurisdiction, including the location of the recipient of the service, would bring the provision of the service into scope. In still other cases, the trigger for licensing is the targeted marketing or solicitation of local service recipients, so no licence may be required if it is possible to evidence client-initiated requests (reverse solicitation).

Even if a firm falls with the jurisdictional scope of a particular regime, there may be exemptions to licensing requirements, such as for cross-border activities with institutional counterparties. This country-by-country analysis can be complicated and impacts the viability of cross-border operating models, often pushing firms to establish a locally licensed presence.

National approaches to market access are the norm in Asia, Africa and North America. The one regional exception is the European Union where firms established and licensed in one Member State may exercise "passporting" rights to provide cross-border services or establish a branch in another Member State without obtaining a local licence. However, even in the European Union, market access for non-EU firms is determined at the Member State (national) level – with certain exceptions, for example where there is an equivalence or recognition mechanism for the EU to determine that the rules of the relevant third country are equivalent.

Other limitations on market access

Product regulation acts as a significant limit on market access. This includes marketing restrictions such as national prospectus requirements for public offerings and cross-border marketing of investment funds.

Eligibility requirements can also act as limitations to market access. These include requirements for locally licensed entities to take on specific roles such as depositaries of alternative investment funds or local registrations for money market funds or benchmarks.

Mandatory requirements for locally authorised firms to trade certain shares on locally authorised trading venues restrict firms from trading dual-listed shares outside of their jurisdiction.

Existing free trade agreements (FTAs) do not address these barriers to market access for financial services. For example, even the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada includes only limited provisions on financial services and crucially does not address local licensing requirements.

Navigating market access in Asia

Hong Kong

While Hong Kong adopts an open capital market approach, the local banking and securities regulatory regimes apply to various regulated activities and restrict market access on a cross-border basis from outside Hong Kong. For example, under the Securities and Futures Ordinance, an overseas person cannot actively market services to the Hong Kong public if such services would be regarded as a regulated activity. The Banking Ordinance also regulates deposit advertisement and money broker operations with extra-territorial restriction. Additionally, the concept of "carrying on business" in Hong Kong is likely to be interpreted widely, and very little activity is required to be undertaken in Hong Kong before a company could be treated as "carrying on business" in Hong Kong.

Offering of financial products to persons located in Hong Kong could also trigger regulatory licensing and product authorisation regimes unless an exemption or private placement safe-harbour applies.

Singapore

Market access requirements depend on the relevant activity being carried on as certain financial regulatory regimes apply to activity carried out on a cross-border basis from outside Singapore, but with Singapore persons. For example, Singapore's Securities and Futures Act, which regulates financial services relating to capital markets products including securities, exchange traded and OTC derivatives contracts, funds and foreign exchange trading has express extra-territorial application and applies to activity carried out on a cross-border basis. Caution should be taken even in cases where the regulatory regime applies only to activity carried on within the jurisdiction, as prohibitions against solicitation can nevertheless apply, for example under the Payment Services Act which is expected to come into force at the end of 2019 or the start of 2020.

Offering of products to persons in Singapore would typically trigger licensing and prospectus requirements unless exemptions or safe-harbours apply; capital markets product issuers (including those outside Singapore) are required to carry out classification of products and to notify relevant distributors unless restricted to certain offerees only.

Japan

Japan has similar licensing restrictions on market access. Activities including deposit-taking, lending, securities-dealing, derivatives, asset/fund management and insurance fall within the scope of Japanese financial services regulation. Entities conducting such activities in Japan or from outside Japan towards Japan residents are generally subject to the Japanese licensing requirements (and disclosure requirements in case of a securities offering). Certain exemptions may be available, such as for "cross-border activities with institutional counterparties," subject to case-by-case analysis.

Following the Japanese government's recent focus on opening the Japanese market to foreign institutions, the Japanese Financial Services Agency (FSA) has established a Financial Market Entry Consultation Desk, which welcomes inquiries from foreign institutions regarding registration procedures and provides a fast-entry route to doing business in the Japanese market.

The view from Europe – the European Commission's approach to equivalence

In the EU, equivalence mechanisms are used to reduce overlaps in regulatory and supervisory compliance and, in some cases, to facilitate market access. For example, equivalence is a prerequisite for recognition of non-EU central counterparties (CCPs) for the derivatives trading obligation and regulatory capital purposes; and the Markets in Financial Instruments Regulation (MiFIR) introduced an equivalence regime for cross-border provision of investment services to professional clients and eligible counterparties.

Nevertheless, the level of third country market access made possible via equivalence is relatively limited. It is no substitute for passporting rights enjoyed by EEA firms. For example, there is no equivalence mechanism in EU legislation allowing market access in respect of core banking services such as deposit taking and lending. In addition, the EU has recently agreed changes to the recognition regime for third country CCPs and the equivalence regime under MiFIR, which will grant EU supervisors greater powers to supervise or impose requirements on these non-EU CCPs and investment firms, even where the third country regime is deemed equivalent.

The European Commission's recent communication on its equivalence policy also indicates a tightening approach to equivalence and third country market access. For example, the Commission highlights that equivalence assessments involve a risk-management exercise and that it "*will expect stronger safeguards against risks when that third country's impact on the EU markets is high.*" The Commission also notes that equivalence empowerments in EU legislation are unilateral and discretionary, meaning that third countries do not have a right for their framework to be assessed or to receive a positive equivalence determination, even if the framework does, in fact, fulfil relevant criteria.

Finally, the Commission makes clear that it has the discretion to adopt, suspend or withdraw equivalence decisions as necessary, and the flexibility to grant time-limited or partial equivalence decisions. Alongside the communication, the Commission announced the withdrawal of some existing equivalence decisions under the Credit Ratings Agencies Regulation, where the local frameworks have not kept up with subsequent changes to the EU regime.

This policy may, therefore, give the Commission leeway to use the equivalence process as leverage to achieve unrelated political goals, such as in the case of the recognition of Swiss exchanges in the context of the negotiations with Switzerland on a new framework agreement for EU-Swiss trade. The Commission does not mention, in its communication, the GATS constraints on derogations from most-favoured nation treatment but these are, in any event, relatively weak.

The impact of Brexit

While the final outcome (even at this late stage) remains far from certain, at the time of writing, the policy of the UK Government is to leave the European Union and the single market on 31 October 2019. By withdrawing from the EU single market (leaving aside the possibility of some sort of future and/or transitional arrangement between the UK and the EU on market access), UK-based financial firms will lose the benefit of passporting rights to access EU markets and investors.

EEA firms will also be restricted in their access to UK financial markets, although the UK Government has introduced various temporary permissions and recognition regimes which seek to mitigate cliff-edge impacts of a no-deal Brexit and allow EEA firms to continue their current UK activities for up to three years after exit day. The loss of passporting rights will impact the provision of banking, broker/dealer and asset management services from the UK into the EU (and from the EU into the UK) as well as cross-border capital raisings and marketing by issuers and fund vehicles and trading on UK/EU trading venues.

The European Commission has made time-limited equivalence decisions in respect of central counterparties (CCPs) and central securities depositories (CSDs) to address contract continuity and financial stability risks in a no-deal Brexit scenario. However, the Commission has so far declined to make an equivalence decision in relation to UK trading venues, and the UK is similarly delaying a decision on equivalence of EU trading venues until there is reciprocity – despite calls from the financial services industry for these decisions to be made in time for Brexit. There is a risk that, if relations were to continue on an acrimonious path following a no-deal Brexit, both sides may be tempted to use unilateral measures such as withholding of equivalence as leverage for post-Brexit negotiations. As highlighted above, the Commission's policy on equivalence indicates that it may also require a more stringent assessment of UK regimes before granting equivalence, in light of the high impact on EU markets.

Structural solutions

In order to continue providing the range of services to their EEA client base (without looking at country-by-country or product-by-product solutions), UK-based firms will need structural solutions, such as establishing or expanding an EEA presence in order to access EEA clients. Likewise, EEA-based firms would likely need to establish or expand UK-based operations to continue to provide services to their UK clients. As a result, firms are moving businesses and people from the UK to locally licensed entities which can benefit from a single passport, creating new infrastructure and operations and splitting liquidity. As firms have different location choices, no single EEA jurisdiction has benefited at the UK's expense.

Maintaining legacy books

In certain limited circumstances, firms may be comfortable with retaining existing business on UK based entities, but activities in relation to maintaining the legacy book will be significantly impacted in order to ensure that what was being done does not trigger licensing requirements in EEA countries. For example, in general terms, performance of obligations under a derivative contract should not trigger national licensing requirements in the EEA countries if the single passport is lost, but material amendments to the contract terms and certain lifecycle events might do so. Provision of ongoing services, such as a bank account, may also require an ongoing licence if the account holder is in a particular EEA country. Accordingly, such business may need to be transferred to a locally licensed entity.

New business outside territorial scope

Some firms may wish to apply country-by-country or product-by-product solutions to continue using a UK based entity when facing EEA clients in certain circumstances. However, navigating national market access rules will result in patchwork, highly bespoke solutions which will limit marketing and service provision and, therefore, any UK platform seeking to grow EEA business. Some EEA jurisdictions have introduced new laws or regulations to mitigate cliff-edge impacts of a no-deal Brexit, such as rules allowing for contract continuity, transitional exemptions or licensing regimes. In other cases, firms will need to argue that their activities do not trigger local licensing requirements, or that an existing exemption is available on a country-by-country or product-by-product basis.

CHINA'S SEARCH FOR GLOBAL CAPITAL

China's growing role in the global financial system may act as a counterbalance to de-globalisation trends seen in Europe and elsewhere. While China's financial system is still relatively closed to international access, the Chinese government has recently taken steps to open up access to its financial markets to foreign investors, particularly in order to seek global capital. Although it remains at a relatively early stage, the impact of this opening up of China's financial system is already being felt globally. The sheer size of China's economy means that China's influence in global financial markets has potential to grow significantly if this trend continues.

Liberalisation of China's markets and opening up the financial sector

At the April 2018 Bo'ao Forum of the Asia Annual Conference, President Xi Jinping delivered a speech in which he highlighted the continuing liberalisation of China's domestic economy and financial markets and announced four liberalisation measures, namely:

- lifting market entry barriers;
- creating a more attractive investment environment;
- enhancing the protection of intellectual property rights; and
- increasing imports into China by reducing the import duty on cars and other products.

As a result, PRC regulators including the People's Bank of China (PBoC), the China Banking and Insurance Regulatory Commission (CBIRC), the China Securities Regulatory Commission (CSRC), the State Administration of Foreign Exchange (SAFE), the Ministry of Commerce (MOFCOM), and the National Development and Reform Commission (NDRC) have issued or amended various regulations to implement these measures.

Encouraging foreign direct investment

On 15 March 2019, the National People's Congress (the PRC legislator) passed the long-awaited Foreign Investment Law (FIL) which will come into force on 1 January 2020. The FIL will bring China's foreign investment regime into a new era by replacing and repealing the existing laws regulating foreign-invested entities. The FIL sets out rules to further encourage, promote and protect foreign investment. It therefore sends a signal that the Chinese government will continue encouraging foreign investment into China.

In particular, the FIL confirms that foreign investors investing in sectors outside the "negative list" of sectors, for which foreign investment is prohibited or restricted, will be entitled to "national treatment" at the time of making the investment. The FIL clarifies that "national treatment" means that the market access requirements applicable to foreign investors will be no less favourable than those applied to domestic investors. The number of sectors appearing on the latest Negative List for Foreign Investment, jointly promulgated by NDRC and MOFCOM on 28 June 2018, has also been greatly reduced from 63 to 48 sectors.

Since 2012, SAFE has also conducted a thorough reform of the foreign exchange (FX) administration regime of direct investment, to further streamline and optimise relevant FX procedures. Discretionary settlement of FX into RMB under capital accounts was implemented in 2015, and further facilitation on settlement and payment under capital accounts has been carried out since then to attract foreign investment.

Macro-prudential management for cross-border financing

Foreign Debt: PBoC introduced a pilot macro-prudential management system for cross-border financing in 2016, before expanding it nationwide. For PRC borrowers (including domestic corporates) seeking international commercial loans, prior approval is no longer required and the balance ceiling has been raised, allowing them to bring more money into the country. This also implies a broadening of investment channels for non-PRC lenders, who may therefore enjoy more discretion and flexibility when entering into financing transactions with PRC counterparties.

Cross-border Guarantee: SAFE released its Regulations on the Administration on Foreign Exchange for Cross-border Guarantee in May 2014, which reduce or eliminate approval and registration requirements for most types of cross-border guarantee and relax previous restrictions on the provision of cross-border guarantees. Again, the relaxation of these regulatory requirements greatly facilitates access to financing for PRC entities.

Raising/removing foreign ownership limits

Shortly after President Xi's speech in April 2018, Governor Yi Gang (head of PBoC) announced an ambitious plan to raise foreign ownership limits for PRC financial institutions, so that foreign investors would become entitled to hold controlling stakes in such institutions from 2018. In summary:

- There is no foreign ownership limit on financial asset investment companies or wealth management companies newly established by domestic commercial banks.
- Foreign ownership limits on domestic commercial banks and financial asset management companies have been completely removed.
- The cap on foreign shareholding in domestic securities companies, mutual fund managers, futures brokers has been increased to 51% and will be completely removed in 2021.
- The cap on foreign shareholding in life insurers is increasing from 49% to 51% and will be completely removed in 2021.

Access to securities markets

China has also taken steps to open up its capital markets towards foreign investors, and to broaden the scope of international investment opportunities through different regimes over the past decades. For example:

- QFII / RQFII Regime

  Following their introduction in 2002 and 2011 respectively, China's qualified foreign institutional investor (QFII) and Renminbi qualified foreign institutional investor

(RQFII) regimes have offered a way for overseas institutional investors to invest in China's financial markets. PRC regulators are now considering consolidating both regimes. Once finalised and agreed, the new rules would significantly alter the current regulatory landscape, and are expected to boost the domestic securities market in China.

- Stock Connect and Bond Connect initiatives

  June 2019 saw the launch of the Shanghai-London Stock Connect link, which allows overseas investors access to China A-shares via trading depositary receipts on the London Stock Exchange (LSE). It will also allow Chinese investors to trade in depositary receipts representing LSE-listed shares on the Shanghai Stock Exchange. Again, this can be seen as a signal that the Chinese government is keen to increase foreign access to its financial markets, and marks a significant opening up of Chinese capital markets to European investors.

  The Shanghai-London Stock Connect link follows a slightly different structure from the original Shanghai-Hong Kong Stock Connect scheme, launched in 2014, which enabled mainland Chinese resident investors to trade Hong Kong listed securities and vice versa. From 1 May 2018, the aggregate daily trading quotas on the Shanghai/Shenzhen-Hong Kong Stock Connect were quadrupled to RMB 94 billion. Similarly, trading volumes via the China-Hong Kong Bond Connect scheme have increased significantly during 2019, a trend which is expected to continue.

- The speed with which some of these regulatory changes are being introduced demonstrates the Chinese government's commitment to forge ahead with its policy of liberalising and opening up its financial markets. China is also in the process of reforming its financial regulatory system, with the aim of better serving the real economy and supporting the development of its domestic capital markets, which may also increase the attractiveness of China facilitating increased liberalisation of the financial markets.

A broader push towards economic globalisation?

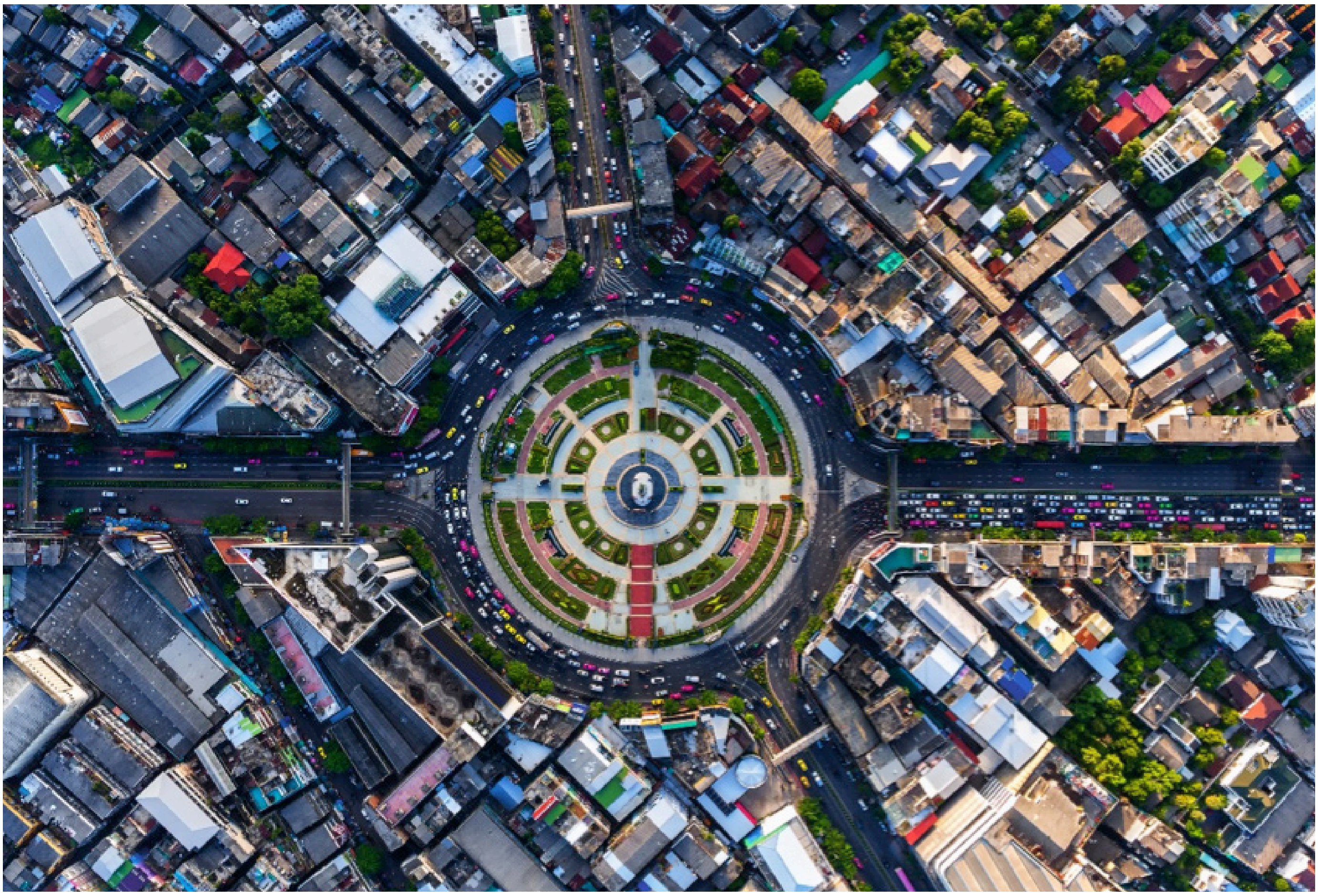
More broadly, the Chinese government has indicated that it is committed to safeguarding economic globalisation and will continue to promote opening up of its markets and fostering international economic cooperation and competition. The road ahead may not always be smooth, particularly in light of the ongoing US-China trade conflict. Nevertheless, we see this outward-looking perspective in China's search for global capital and investment, particularly in the following initiatives:

The Greater Bay Area and Free Trade Zone

China's national strategy to develop the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) aims to leverage the advantages of this region, facilitate in-depth integration and promote coordinated regional economic development. The Outline Development Plan for the GBA published in February 2019 includes various measures to expedite the development of financial industries throughout the GBA. In addition, greater autonomy will be granted to a pilot free trade zone (FTZ), to encourage innovation and test reforms, with the aim of leading to wider reforms and opening up of China's financial markets.

Belt and Road Initiative

China's Belt and Road Initiative (BRI), unveiled by President XI Jinping in 2013, is an ambitious development projects that aims to boost global trade between Asia, Europe and Africa, and create vibrant economies along its route, covering 74 countries. The huge scale of the BRI vision means that its funding will need international cooperation and innovative solutions; it seems clear that China cannot fund the entire initiative alone. Whilst current BRI initiatives are mostly being led by Chinese state-owned banks, policy banks and governmental bodies, we may start to see greater interest and opportunities for international fund managers and others to invest in BRI projects. There are challenges to attracting private capital and filling the current BRI funding gap, but we expect to see more collaboration between Chinese state-owned enterprises and foreign investors or sponsors to capitalise on the potential and opportunities arising from BRI.



THE NEW DIGITAL ECONOMY

Technological innovation, the rise of fintech firms and entry of big tech companies, such as Facebook, are all contributing towards the emergence of new financial services which reach consumers across multiple jurisdictions. This leads to difficult questions about the applicable law, but whilst policy makers and regulators recognise the need for a coordinated response to these developments, so far, their response has been largely limited to addressing money laundering and terrorist financing risks.

Fintech trends and developments

Fintech is leading to the emergence of new asset classes and services, which present both risks and opportunities. We also see challenges for policy makers and regulators in keeping up with the pace of change and in grappling with issues arising from the cross-border nature of these activities.

Cryptoassets and Distributed Ledger Technology

Cryptoassets are continuing to evolve as established financial players and big tech companies enter the market. For example, in February 2019, JP Morgan launched its own digital coin (JPM Coin), designed to make instant payments using distributed ledger technology (DLT) and in June 2019, Facebook announced plans to launch a new global digital currency called Libra that would enable users to transfer value on a peer-to-peer basis via digital wallets within Facebook applications.

Financial institutions have also been exploring how DLT could be used in financial services more generally to increase efficiency and enhance record keeping and data management. For example, we have seen DLT being used at various stages of capital markets transactions, including for market soundings, book building and allocations processes. For an overview of the current global regulatory response to cryptoassets see box on page 22.

Crowdfunding and P2P lending

Crowdfunding and peer-to-peer (P2P) lending has experienced rapid growth in recent years. This is one of the more mature fintech sub-sectors and some jurisdictions have already implemented specific regulatory frameworks for crowdfunding and P2P lending.

In the EU, the proposed Crowdfunding Regulation is expected to introduce a harmonised licensing and passporting regime for lending-based and investment-based P2P platforms across the EU, possibly from mid-2020. However, more generally, the approach to regulation of these activities differs across jurisdictions.

Open Banking, APIs and secure data sharing

Payment services have seen significant change in recent years, with the advent of internet and mobile banking and the growth of fintechs offering innovative payment services and solutions. At the same time, there has been a focus on the role of competition in payment services, with open banking initiatives in the UK and EU requiring payment account providers to open up access to customer's accounts in order to allow these new players to provide their services.

The UK Open Banking initiative requires payment account providers to provide this access via Application Programming Interfaces (APIs), with various other jurisdictions requiring or encouraging use of APIs for similar data sharing purposes. The UK government's Smart Data consultation, published in June 2019, also proposes extending Open Banking-style secure data sharing to other financial services.

Cloud computing

Cloud computing – where software, hardware and maintenance are offered as a service by the software vendor and delivered to the customer over the internet – is growing rapidly, with more than half of all business computing now taking place in the cloud. We have seen shifts in both financial institutions' and regulators' attitudes towards cloud computing over the past couple of years, as it has become increasingly common. Nevertheless, cloud computing continues to pose a number of regulatory challenges for financial services firms, including compliance with outsourcing and data protection requirements. The vast majority of cloud services are also provided by three major vendors, leading to regulatory concerns around concentration and lock-in risks.

AI and machine learning

Artificial intelligence (AI) and machine learning is playing an increasingly prominent role in financial services, and is used in areas as diverse as robo-advice, detecting fraud and market abuse, algorithmic trading, devising fund investment strategies and analysing customer behaviour for marketing purposes.

Financial regulators recognise the benefits of AI and machine learning for issues such as fraud monitoring, but are also alive to new risks. Ensuring effective human oversight and the 'explainability' of decisions made using AI will be crucial for firms as they seek to exploit this new technology. For example, using machine learning and AI does not absolve firms from assessing the suitability of products for their clients. The current focus in many jurisdictions on corporate culture and the responsibilities of senior management may also drive the need for boards to focus on oversight and ethical questions regarding their use of this technology.

Regtech

Regulators are also turning to technology to help them monitor and supervise the industry effectively. Regulators have more data available than ever before, in part due to recent regulatory changes, such as the enhanced transaction reporting requirements under MiFID2 in the EU. However, this is only useful to regulators if they can effectively analyse and interpret the data.

Advanced analytics and AI may also help regulators identify the most efficient way to use their scarce resources, or even allow them to identify and address potential issues before they arise.

Focus on cryptoassets

The market for cryptoassets and tokens issued in initial coin offerings (ICOs) has grown significantly over the past few years. This is a global phenomenon and the decentralised nature of (public) blockchain networks raises particular legal and regulatory challenges, such as the application of conflict of laws rules to assets held on the blockchain.

Market participants have faced uncertainty as to whether certain types of cryptoassets fall within the scope of existing regulations or how these regulations ought to apply in practice. Recent enforcement actions, notably in the US, have also illustrated the broad extra-territorial application of some national regulatory regimes. Therefore, market participants will often need to navigate multiple regulatory regimes in relation to cryptoasset activities.

At an international level, FATF has recommended that cryptoexchanges and wallet providers should be required to implement AML and CTF controls and should be licensed or registered and supervised or monitored by national authorities. The FSB and other international bodies also continue to monitor developments in cryptoasset markets. However, they have not proposed broader global standards for regulation of cryptoassets on the basis that they do not (yet) pose risks to financial stability. Nevertheless, recent developments such as Facebook's Libra announcement could change this assessment and catalyse the development of global standards for the regulation of cryptoassets.

At a national level, various regulators have published their assessments of when cryptoassets will fall within existing financial services regulatory frameworks. In some cases, they have also identified gaps in existing frameworks, potentially paving the way for future regulatory change. Some jurisdictions, such as France have gone a step further and have proposed new laws to regulate cryptoassets.

Regulators and lawmakers around the globe are grappling with many of the same issues and questions about how to apply existing laws and regulations to cryptoassets. These include:,

- Which types of cryptoassets fall within the scope of existing financial regulatory frameworks?
- What is the territorial reach of those existing frameworks and the extent of regulators' jurisdiction?
- How do existing rules on custody and settlement (including settlement finality rules) apply to holding and transferring cryptoassets via a DLT network?
- Which law(s) will apply to proprietary aspects of holding and transferring cryptoassets that are native to the blockchain (i.e. where there is no single account or record of legal title to the asset located in a particular jurisdiction)?

Due to the cross-border nature of cryptoasset activity, there is potential for conflict if policymakers in different jurisdictions arrive at different answers to these questions. In turn, this could lead to increased regulatory and legal risk for firms as they seek to comply with multiple different regimes or where it is unclear which set of rules would apply. It could also allow firms to engage in regulatory arbitrage, exploiting the differences between regimes. However, there are calls both from regulators and from industry to foster international cooperation and supervisory convergence in this area.

Given the decentralised, international nature of cryptoassets and related activities, we expect to see international collaboration around enforcement activity. Questions of jurisdiction and applicable law will feature prominently as courts struggle to apply existing precedent to public and private blockchains and their international participants.

Global regulatory responses

Global standard setting

To date, there has been limited global standard setting for cryptoassets and other fintech-related developments. The Financial Action Task Force (FATF) has issued international recommendations on extending AML and CTF measures to cryptoasset exchanges and wallet providers.

However, other international standard setting bodies have not yet issued recommendations or principles for regulation of cryptoassets, on the basis that they do not currently pose a material risk to global financial stability. The Financial Stability Board (FSB) continues to monitor fintech developments, including the competitive impact that big tech firms may have on financial markets and reliance by financial institutions on third-party data service providers (e.g. cloud service providers).

Regulatory collaboration: A global sandbox?

The Global Financial Innovation Network (GFIN) is an international network or financial regulators and related organisations, which launched in January 2019. It will provide firms with a sandbox environment in which to trial innovative products across multiple jurisdictions. It also seeks to create a framework for cooperation between financial services regulators on innovation-related topics.

However, not all regulators support a sandbox approach, (for example, the German BaFIN has indicated it does not), with some expressing concerns about the ethical implications of offering preferential regulatory treatment or waiving rules for a small number of hand-picked start-ups.

Will regulation act as brake on the globalisation of fintech?

Regulation can act as a brake on globalisation and lead to market fragmentation, particularly where duplicative or potentially conflicting rules have extraterritorial impacts. In particular, overarching data protection regulations and the expansion of the scope of existing anti money laundering (AML) regimes to capture cryptocurrency exchanges and wallet providers may hinder cross-border activity.

AML

In October 2018, FATF recommended that crypto exchanges and wallet providers should be required to implement AML and CTF controls and should be licensed or registered and supervised or monitored by national authorities. The EU had already committed to bringing many crypto changes and wallet providers within the scope of AML and CTF requirements through the fifth anti-money laundering directive (AMLD5), which Member States are due to implement by 10 January 2020.

When these rules come into effect they will require in-scope cryptocurrency exchanges and wallet providers to have in place policies and procedures to detect, prevent and report money laundering and terrorist financing, to the extent not already required to do so under national law. These entities will also become subject to registration or licensing requirements (if this was not already the case under national law) and persons that own or hold a management function in these entities will be subject to fitness and propriety requirements.

However, AMLD5 does not apply to crypto-to-crypto exchanges, which are within scope of the FATF recommendation. The UK government has therefore indicated that it intends to gold-plate AMLD5 by extending the same rules to crypto-to-crypto exchanges. Again, this is an example of how internationally agreed standards may be implemented in different ways.

Data protection

The ability to share and transfer data across borders is a significant issue for fintech firms, given the cross-border nature of much fintech activity and increasing reliance on third-party data service providers. However, the EU GDPR and similar regimes in jurisdictions such as China have introduced greater protections for personal data, bringing with them new challenges and barriers for data flows across borders. The extraterritorial application of some of these regimes may also pose particular challenges for firms with global business operations.

In its February 2019 Report on fintech and market structure in financial services, the FSB noted that restrictive data protection regimes may also hinder regulators' ability to supervise foreign firms operating in their jurisdiction, but that this issue "would be mitigated if data protection frameworks offer a mechanism that ensures that third-country authorities have access to the personal data needed to conduct their supervisory and enforcement activities."

LOOKING AHEAD

Since the Second World War, the accepted wisdom has been that economic interdependence and interaction are essential for the world to become both safer and wealthier. As financial markets became increasingly global, policy makers and regulators sought to develop internationally agreed regulatory standards and principles via bodies such as the Basel Committee, FSB and IOSCO.

In the aftermath of the 2008 financial crisis, G-20 policy makers agreed international regulatory reforms to counter the perceived failures contributing to the crisis. However, the strain on the global financial system during and since the crisis has acted as a major check on globalisation, as policy makers have focused on national legislative and regulatory solutions to crisis management alongside the rise of populist and nationalist political movements across a number of countries. Inconsistent national implementation of the globally agreed regulatory reforms has also contributed to market fragmentation in some areas.

Counter to these recent national trends, global regulatory solutions are still supported by other developments. For example, China is taking steps to open up and liberalise its financial markets and attract foreign investment. The game changer may be the emergence of the digital economy which by its nature disrupts national frameworks and will require international cooperation. Indeed, policy makers and regulators recognise the need to develop a consistent, global approach to the regulation of new market participants and products in this area and address the emerging risks and challenges.

We expect these competing influences for and against globalisation will continue to coexist. As a result we may see a more nuanced approach to the development of global standards for financial regulation emerging, which aims to find the right balance between setting global standards and allowing for national tailoring of regulations in a way that enhances rather than undermines global and national financial stability.

"There is a serious risk that unless a commitment to international cooperation and openness is restored, the world will retreat to one that is closed and fragmented, which history has shown time and again leads to instability and perverse economic outcomes"

Taro Aso, Minister of Finance and Deputy Prime Minister of Japan (Statement at the G20 FMCBG Meeting under the Japanese Presidency, January 2019)

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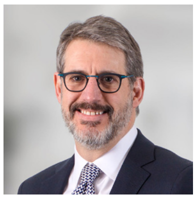

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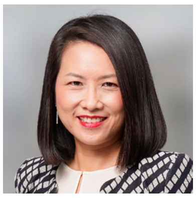

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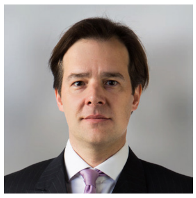

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