IIACACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

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The 'top of house' issues facing the City of London: Recent observations from September ICSA meetings in London

HIGHLIGHTS:

The business of 5000 UK-based financial service firms will be severely disrupted if a "single market" or passporting regime cannot be achieved through negotiation.

Britain will likely require a "soft Brexit" approach on sovereignty of UK law and immigration control to strike an acceptable deal with the EU.

A transition arrangement beyond the Article 50 negotiating period is essential to avoid pre-emptive institutional structural adjustment or sudden dislocations in markets to meet new dealing conditions.

36 sell-side and buy-side firms in London are collaborating on detailed market standards and a compliance framework to improve conduct in FICC markets. This effort responds to successive scandals in market manipulation in debt and derivative markets.

The IIAC will review the newly developed FICC market standards, monitor ongoing progress on development and implementation, and consider the merits of a Canadian version of the FICC standards.

INTRODUCTION

Throughout the summer two issues dominated discussion and debate in the City of London – Brexit and implementation of the recommendations of the Fair and Effective Markets Review (FEMR). The financial services industry's success in tackling these issues will have an important bearing on the future of UK capital markets.

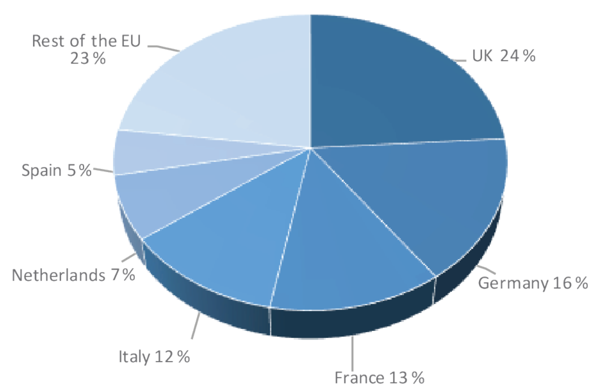
My meetings with the International Council of Securities Associations (ICSA) Board members, professionals in the City, and with the past Chair of the Fixed Income, Currency and Commodities (FICC) Markets Standards Board (FMSB), Elizabeth Corley, and its recently appointed Chair Mark Yallop, provided the opportunity to better understand the underlying themes, the implications of Brexit and the FMSB standard-setting exercise.

Since the Brexit vote on June 23, discussion among City professionals has focussed on the optimal approach and strategy of the UK government to negotiate a free trade deal, or an open market, with the European Union so UK-based companies retain their right to sell financial services across Europe. A successful outcome is vital. The UK financial sector accounts for almost one quarter of all EU financial services income and 40 percent of EU financial services exports.

It is recognized the UK government did not have a Plan B to roll out in anticipation of a Brexit vote. The May government is moving flat out to develop the plan. The challenge is daunting, as any trade deal will require some trade-off on UK sovereignty on immigration, and financial contributions to the EU budget, the precise features of the EU the majority of the British voted against.

The FEMR issued its Implementation Report in July 2016, announcing the formation of a FICC Market Standards Board to develop and implement a code of conduct and standards for dealing in the fixed income, currencies and commodities markets. These recommendations flow from the steady drumbeat of market scandals in recent years. The FMSB will rely on internal firm procedures and regulatory oversight for compliance with the standards. The Board has also recognized the standards must be adopted in some form across foreign jurisdictions, given the global dimension of the FICC markets and potential for regulatory arbitrage.

Share of EU Financial Services Activity
Gross Value Added



Data Source: Bank of England

THE THREAT OF BREXIT TO THE LONDON MARKETS

London's pre-eminence as a global financial centre evolved steadily over the past thirty years. The modern era for London markets began with the institutional streamlining and massive restructuring under "Big Bang" in the late 1980s as the existing framework was dismantled, and foreign institutions were permitted to build a presence in the London market, enabling the New York-based investment banks to build market share quickly. The UK's earlier entry into the European Economic Community (EEC) in 1973 facilitated London-based institutional business into Europe, particularly as trade was liberalized and capital barriers were removed across Europe. London quickly assumed its place as the financial centre of Europe. Foreign institutions moved aggressively into London followed by an expanding pool of multi-lingual and talented professionals, taking advantage of existing financial, legal and accounting infrastructure; and open access through a "passporting" regime, to retail and institutional clients across Europe.

Data Source: TheCityUK

The Brexit vote has now put all this at risk. UK withdrawal from membership in the EU will mean the loss of passporting rights for both institutions and professionals providing financial services to European institutional and retail investors, as well as corporate clients, from their London operations. It is not realistic to re-orient London from Europe to non-European markets, in an effort to compensate for the loss of the single European market, as suggested by Lord Nigel Lawson, former Chancellor of the Exchequer. The London-based global investment banks are already entrenched in other major global centres, such as New York City, Tokyo and Hong Kong. The loss of the single market will inevitably lead to re-location of businesses and the restructuring of existing operations to retain access to the European markets and serve existing clients. The result will be a concomitant net reduction in financial activity in London.

TIMING AND OUTCOME OF NEGOTIATIONS

Three questions are top of mind: i) what will be the approach and negotiating strategy of the new Conservative government to preserve the single market with Europe; ii) how quickly can negotiations be finalized, clarifying the landscape; iii) and what will be the extent of financial disruption for London-based institutions if negotiations drag out, remain unresolved or collapse?

The UK will signal early next year its intention to leave the EU by triggering Article 50. There will then be a two-year window to reach an agreement, at which time, if agreement is not reached and ratified by 29 EU governments, the UK is formally out of the EU with all the attendant consequences.

There is considerable uncertainty about the upcoming negotiations – such as, if the existing government or a new government (in the event of an intervening election) changes its position, can Article 50 be reversed? Further, there is the increasingly held view that the inevitable complexity of the negotiations will make it difficult to reach agreement in the two-year timeframe. It is conceivable no agreement is reached in the defined timeframe, meaning Britain would be out, and then possibly back in, if a final agreement is reached. A transitioning period beyond the two-year negotiating window will be required to avoid massive dislocations in the London and EU financial markets.

Four leading advocacy organizations for America's financial services industry wrote to U.S. Treasury Secretary Jacob Lew in mid-September underlining the importance of the UK markets for U.S. financial institutions. Over 40 percent of U.S. exports of financial services destined for Europe go through the UK. Most major U.S. financial institutions have a significant presence in London, where they rely upon the single passport to service customers and clients across the EU.

It is vital these trade flows are not disrupted. The U.S. financial industry has recommended that i) negotiations be conducted in a transparent manner; ii) stakeholders be fully consulted in these negotiations; iii) both sides embed arrangements for global standard setting; and iv) policymakers establish a timely provisional, transitional arrangement to assist financial services firms navigate and adapt to any institutional or legal changes underpinning the inter-EU/UK trade and investment relationships. There remains the likelihood that, in the short-term, business will hold back investment decisions until circumstances are clarified, or may relocate some operations outside London as a contingency, before negotiations are complete – decisions that would damage the London economy. The immediate financial impact of the Brexit vote was limited to sterling depreciation, with the financial shock well contained by actions taken by the Bank of England.

Data Source: TheCityUK

Over the near term, as negotiations get underway, Brexit will likely have a modest dampening effect on the economy and financial markets as business spending decisions are postponed. The real impact of Brexit on financial markets and domestic spending patterns, however, will only manifest itself once the course of the negotiations become clearer, the apparent ease or the intractability in reaching acceptable market access. In contemplating all this, it is useful to remember it took Canada seven years to reach a formal deal on free trade with the EU, talks are ongoing, and the pact has yet to be ratified.

Data Source: TheCityUK

The optimistic view is that negotiations between the UK and EU will move relatively quickly and constructively as it is in everyone's interest to do so. Moreover, the best result may be less than the status quo ante, as the UK had negotiated relatively favourable terms of EU membership.

DISRUPTION IN FINANCIAL FLOWS FROM LOSS OF A SINGLE MARKET

The uncertainties go beyond the timing and outcome of negotiations. The disruption to financial services firms as a result of losing the single market and passporting rights will differ, dependent on the nature of their business in the EU and the extent of business now driven through subsidiaries, affiliates and existing infrastructure operating in continental Europe. For example, a good part of clearing and settlement operations are now based in Ireland, and Paris and Frankfurt carry on significant subsidiary operations. It has been suggested that securities clearing and settlement are the most vulnerable and may have to relocate to continental Europe.

According to FCA data, the passporting provisions allow 5,476 UK-registered financial firms to operate freely across the European single market. Their ability to do business across the EU is threatened once the UK leaves the bloc. Some 8,000 financial firms based elsewhere in the EU also do business in the UK via passporting, and their rights are likewise threatened. "These figures give us an initial idea of the effects of losing full access to the Single Market in financial services," remarked Andrew Tyrie, Chairman of the Treasury Select Committee.

City firms would then need country-by-country approval for each financial service sold on the continent. Compliance with this patchwork of national licensing regimes in Europe would add significantly to costs. Alternatively, firms could re-locate to the continent and establish full operations through an EU passporting arrangement. This too would be costly. It is unclear whether the UK could negotiate some compromise arrangement, say some form of regulatory recognition, given the close correspondence between UK and EU regulations.

It is hard to believe any free trade arrangement with the EU—whether broadly-based trade in goods and services, or even a special carve-out for financial services—will be achievable without the UK relinquishing some sovereignty over laws and immigration controls. At this early stage of the negotiating process, however, the UK government has signalled the so-called "soft position" on sovereignty, and immigration is off the table. The former Swiss central bank governor Philipp Hildebrand gave a pessimistic assessment, referring to Switzerland's experience and frustration in reaching a deal on EU financial access after Swiss voters backed a referendum in February 2014 to limit immigration from EU countries—in direct contradiction with its agreement with the EU on the free movement of people. Switzerland has until 2020 to reach a deal, or forfeit access to the EU markets.

The UK has announced that Article 50 will not be triggered before year-end 2016 to give sufficient time to develop a negotiating strategy with the EU. The May government has created a new government department to manage the Brexit mandate, complementing likely significant involvement of other government departments and agencies.

Several things are clear:

First, the UK government has indicated a single market with Europe is a priority objective. It is an interesting irony that the City of London and metropolitan London have been enormous beneficiaries of EU immigration over the years, attracting a large pool of talented professionals from across Europe, turning London into a world-class cosmopolitan city.

At the same time the government will place emphasis on developing trade relationships with non-EU countries. For the financial sector, however, the upside from greater market access outside Europe is limited as the global banks in London with greatest weight are already well established in the New York, Tokyo and Hong Kong markets. The likelihood is that without direct market access to Europe the London-based institutions will pull operations back to continental Europe to serve their clientele.

Second, the dismantling of infrastructure in London, and related loss of efficiencies, will likely result in a higher cost of capital, and more expensive and less efficient financial services, at least in the near term. The benefits of the London market to continental European investors and companies provide an incentive for the EU to press for a satisfactory trade agreement.

It is also clear that joining the European Economic Area (following the example of Norway, Iceland and Liechtenstein) to retain the trade benefits is a non-starter as a negotiating model as access to a single European market hinges on three conditions: the free movement of people, the sovereignty of EU law and contribution to the EU budget.

The impending negotiations will be tough. For the UK government, the negotiations represent an opportunity to achieve a more efficient, less bureaucratic EU, more streamlined regulation and greater national autonomy over immigration flows. Indeed, the electorate impulses that drove the Brexit decision resonate in many EU countries.

ADDRESSING THE SCANDALS IN THE FICC MARKETS

The FEMR was launched in June 2014 by the Bank of England, HM Treasury and Financial Conduct Authority (FCA) to conduct a comprehensive and forward looking assessment on the way the wholesale Fixed Income, Currency and Commodities (FICC) markets operate in the wake of a number of scandals (e.g. Libor fixing) in both the UK and global financial markets. To tackle this project, the Review created a new FICC Markets Standards Board (FMSB). The outcome of the Fair and Effective Market Review was to establish the FICC Markets Standards Board to develop standards of conduct to improve the quality, clarity and market-wide understanding of wholesale FICC trading practices.

The FMSB has created a non-profit corporation funded by 36 member financial institutions (25 sell-side and 11 buy-side firms) and with a small full-time staff. The FMSB established six standing sub-committees, fixed income rates products, fixed income spread products, currencies, commodities, conduct and ethics, and codes and standards convergence (to address practices and standards across industry associations and regulators to avoid duplication). So far, the FMSB has published, for comment, transparency draft statements on 'Reference Price Transactions in Fixed Income Rates Markets' and 'Binary Options in Commodities Markets'. The FMSB also provided input to the work being undertaken to create a Global FX Code for currency dealing.

Mark Yallop, the new Chair of the FMSB, has indicated that the FMSB sub-committees are working on detailed standards in a range of other areas such as the new issue process in fixed income markets, formal wholesale FICC markets training programs, and market surveillance programs. The overall number of standards is unclear.

The Bank of England and Financial Services Act of 2016 extended the administration of the Senior Managers Regime to include authorized financial services firms, covering at least the firms active in the FICC wholesale markets. Thus, the Senior Managers Regime would be applicable to the FMSB standards, making senior managers responsible for compliance with these standards.

The extension of the Senior Managers Regime to the FMSB standards will drive internal compliance procedures within firms. Further, recognition by firms that failure to comply properly with the FICC market standards will lead to increased regulation of the marketplace. The European Securities and Markets Authority (ESMA) has already indicated its inclination to develop more detailed rules based on the UK guidelines. The FMSB will also rely on two external mechanisms for compliance discipline. First, the FCA will provide a compliance audit of the FICC market standards and, second, the buy-side clients who are aware of the standards and represented on the FMSB, will be expected to oversee conduct and conformity to the standards.

PAID IN TAXES IN 2015/2016
making the financial services sector
the UK's largest tax paying sector

Data Source: TheCityUK

The FMSB recognizes the FICC market standards must be adopted across international markets to be effective, otherwise dealings could shift to non-UK jurisdictions to avoid compliance with the standards. The FMSB plans various approaches to encourage adoption of the standards outside the UK. The FMSB will reach out to individual foreign jurisdictions to explain the evolution and importance of the standards, and will work with the FSB and the International Organization of Securities Commissions (IOSCO)—the global standard setter for securities markets regulation—to promote an international version of the standards. Perhaps most importantly, the FMSB will encourage international firms active in the London markets to extend the standards across their global trading operations to achieve cross-firm uniformity of conduct and drive operating efficiencies, and to project a high standard of market dealing to increase transactional flows and profitability.

Canadian investment dealers registered to deal in FICC markets in the UK, and their professional traders and managers, will be subject to the FMSB standards. The IIAC and its Debt Markets Committee will review in detail the newly developed FICC market standards, monitor ongoing progress on development and implementation, and consider the merits of a Canadian version of the FICC standards. This investigation will involve discussions with the Investment Industry Regulatory Organization of Canada (IIROC) staff, the Bank of Canada and the Canadian buy-side institutions that play a major role in domestic wholesale markets. Mark Yallop, Chair of the FMSB, and CEO Gerry Harvey, have accepted an IIAC invitation to give a presentation of their work and engage in an exchange of views later this autumn.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
September 2016