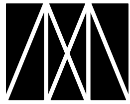

MERCATUS CENTER
George Mason University

POLICY BRIEF

Evaluating the Opportunity for US-UK Financial Services Trade Liberalization

Barnabas Reynolds

December 2020

The ongoing trade negotiations between the United States and the United Kingdom present a historic opportunity to liberalize trade in the financial services industry. The financial sector is already a leading area of trade between the two countries, which play host to the world's financial centers of New York and London. Each nation's businesses offer a wide range of products and services that differ, overlap, and complement each other in a myriad of ways. This brief examines how both countries would benefit from expanding consumer choice and drive further economic growth through an ambitious financial services trade deal—one based on mutual reliance on each other's regulations and regulators and on a shared common-law framework.

SUSTAINED PROFIT AND GROWTH: A VALUABLE PRIZE

Trade in financial services involves well-known industries such as banking, insurance, and mutual fund management as well as more niche products such as derivatives. Although the provision of certain financial services requires a charter (such as, for instance, for the carrying on of insurance business or the provision of local depositary services), a range of financial services can be provided across borders without the onerous requirement of a local charter. Two prominent examples are selling hedge fund interests as well as providing certain fintech services. An ambitious US-UK agreement on financial services would allow US-based providers to operate in the United Kingdom without tying up additional investment capital and collateral to deliver services to the UK market. It would also allow financial products to be developed and sold even more easily to the UK consumer base. Selling those services more freely to the United Kingdom should allow for easy access to the rest of the world from the City of London, whose working day straddles the US, European, and Asian time zones. In turn, the reciprocity of the agreement would open the US markets to the UK for the same range of financial services.

The views presented in this document do not represent official positions of the Mercatus Center or George Mason University.

At stake is expanded access to a key overseas market worth nearly $20 billion to US firms, which was the value of exported financial services from the United States to the United Kingdom in 2019.[1] A free trade agreement could also expand opportunities for US firms to sell more financial services through foreign direct investment. The United States is already the largest investor in the United Kingdom, with $758 billion in assets in the British market, representing a quarter of total US investment in Europe. US investment in the United Kingdom constitutes more than 12 percent of all US foreign direct investment worldwide.[2]

The benefits for US consumers and firms would include an expansion of the supply of financial services, leading to more robust competition and lower prices. Lowering regulatory barriers for the flow of British capital will only deepen its effect on the US economy. Already, US consumers import over $12 billion per year in financial services from the United Kingdom,[3] and UK companies invest over $500 billion in the United States, accounting for more than 15 percent of all inbound foreign direct investment.[4]

OBSTACLES AND BARRIERS: IDENTIFYING UNNECESSARY PROTECTIONS

Unlike other areas of trade, such as goods, financial services are typically not subject to tariffs. Trade barriers are instead mainly a matter of regulation. The extent to which restrictions can be lowered or removed depends on the ability of the two countries to rely upon the safety of the other's regulatory system. Without the recognition of each other's systems as sufficiently similar, each country defaults to imposing its own regulatory requirements at its border. Those requirements are designed to ensure that the countries' financial markets are kept safe and sound.

Yet for two trading partners, both with sophisticated regulatory regimes, this practice imposes unnecessary costs on businesses. It means that cross-border financial business into the United States is generally subject to US regulation, duplicating the requirements of the already-proven UK system. It can mean that non-US financial institutions entering the US market have to register with regulators, establish a branch, subsidiary, or other legal presence in the United States, and maintain a separate amount of minimum capital. In addition, financial services in the United States may be subject to federal and state law and also several different statutes, rules, and regulations that vary by product and jurisdiction (geographic market), and the enforcers afford different levels of deference to non-US regulators. Obtaining all relevant local licenses and authorizations is costly and time consuming.

Although to some degree similar costs also exist for services entering British markets, the United Kingdom's financial regime includes the overseas persons exclusion that authorizes many cross-border financial services without imposing UK regulation on US providers. This is probably the most permissive and open regime in the world. Nevertheless, there are UK restrictions that could be liberalized, most notably the requirements that require capital and collateral in the UK subsidiaries of US (and other) financial institutions.

A mutual recognition by both regulatory systems of both countries should streamline the ability of firms to provide certain services across borders, though other services would have to be left out of the trade agreement. It should be clarified that in the United States, the trade agreement could relax federal government requirements for UK firms, but it can neither automatically relax statutory obligations (particularly for independent regulatory agencies such as the Securities Exchange Commission [SEC]) nor relax state-specific laws and regulations. The executive branch will need to work with Congress to amend and align relevant laws to the terms of the agreement, and it will need to work with states' governors and legislatures to encourage the respective alignment. States will have an incentive to fast-track authorizations for UK firms as they begin to observe the economic benefits from liberalization.

This recognition would require a determination by each country that the other's system is sufficiently similar, a requirement that should be relatively easy to satisfy. There are of course some important differences between US and UK regulation, some of which are even philosophical. For instance, US investment banking regulation has a different focus than that of the UK regime with regard to regulatory capital. Under the US broker-dealer regime, regulatory capital rules exist primarily to protect customer deposits and credit balances,[5] and they exist only secondarily to evaluate and regulate the safety, soundness, or liquidity of US broker-dealers.[6] Thus, US capital and other regulatory requirements for broker-dealers are focused on ensuring that fully paid customer assets (and free cash balances) are segregated from use by the broker-dealer and available for return to the customer in the event of failure of the broker-dealer.

In the United Kingdom, safety and soundness concerns are addressed by the regulatory capital rules. Segregation is addressed through client money and client asset regulations and through the use of the law of trusts. However, despite these differences, the objectives of the two systems are broadly the same. To the extent that regulators in the United States and United Kingdom are broadly aligned in their overall approach to financial regulation, it should be possible to fit the two systems together despite schematic differences between the two.

When the United Kingdom was within the European Union, the European Union insisted that any trade deals had to be done with the whole of the European Union. The continental civil law systems are quite different from the US and UK common-law systems. The philosophies applied to financial regulation floating on top of those systems is also very different and is far more controlling of commercial interests. With Brexit, the opportunity arises for a more integrated approach between the United States and United Kingdom for the benefit of competition, consumer choice, and business in both markets.

OPENING BANKING, INSURANCE, AND DERIVATIVES TO MORE COMPETITION

In the United States, a trade agreement should take immediate effect over many rules and regulations within the jurisdiction of the executive branch; that is, the public administration. However, to

function, the agreement will need additional action from Congress to amend US laws with specific requirements for foreign financial institutions, particularly the laws and the norms of independent agencies (such as the SEC). Further action will be needed from state legislatures and governors who wish to align their states to the federal relaxations and waivers provided by the trade agreement. Any services liberalized for cross-border provision will need to satisfy law-specific and state-specific requirements or secure a waiver from the enforcers of those requirements. This is particularly true for banking, insurance, and to some extent derivatives markets as well.

For banking in the United States, extensive federal and state licensing regimes restrict foreign banks and financial services businesses from engaging in a range of banking-related activities without prior regulatory approvals. In branching, deposit taking, money transmission services, and consumer lending, federal and state banking agencies enforce significant statutory barriers to free entry. These barriers are intended to ensure that financial services providers are subject to the full protective panoply consumer and prudential regulations at the state and federal levels.

Insurance regulation in the United States is also restrictive. Each of the 50 states has its own regulatory licensing regime, which means that there are significant barriers to entry for non-US companies providing insurance services across the United States. There is no single federal regulator of insurance providers nor any federal entity with the power to recognize foreign providers. The oversight activities of state insurance regulators may differ, but all regulators oversee the safety and solvency of insurance companies through key phases, including chartering and change in ownership approvals, lengthy regulatory obligations, routine financial analyses, and periodic on-site examinations.

For derivatives,[7] cross-border access is complicated by the fact that there are multiple US regulatory regimes, each with different regulators, depending on the particular product. These products include swaps, security-based swaps, options, and futures. Economically similar or related products can be subject to substantially different requirements depending on technical legal distinctions. Furthermore, these regimes generally take a different approach, even for institutional business, from the one adopted by the SEC for securities—except for certain options and swaps that themselves constitute securities.

In each of these three important areas, a US-UK trade agreement could introduce more competition through the mutual recognition of each country's regulatory supervisory standards. As explained later, financial service providers could operate under different standards as long as the regulatory regimes seek equivalent results.

US BROKER-DEALER REGULATION: THE CLOSEST TO A LIBERAL REGIME

The United States has a reasonably sophisticated and robust broker-dealer regime that permits non-US financial institutions to conduct institutional business directly with the US markets. This

regime identifies circumstances that permit direct contact, solicitation, order taking, execution, clearing, and settlement by non-US financial institutions, but in many cases it continues to require the involvement of US-registered broker-dealers at specified points in the transaction cycle.[8]

Similarly, with regard to the regulation of securities offerings and trading, SEC regulation S grants limited but meaningful recognition to certain non-US securities offerings, permitting those transactions to qualify as "non-US" transactions for the purposes of that rule.

For securities exchanges, the SEC has never moved beyond conceptual discussions and high-level proposals regarding mutual recognition. Whereas important competition and regional protection issues underlie some of this history, increased automation and the value of access to liquidity already makes exchange recognition an achievable goal. A US-UK trade agreement should establish mutual recognition while selectively relaxing the requirement that US-registered broker-dealers be required for all transactions, though state-specific regulations would remain mandatory for UK firms until the states themselves allow a similar relaxation of their requirements.

BARRIERS IN FUNDS: PROTECTING US CONSUMERS OR RESTRICTING CHOICE?

The US mutual fund industry is likewise subject to national restrictions. US funds that are widely distributed (namely, retail funds) must be registered with the SEC and are highly regulated under the Investment Company Act of 1940, also known as the 1940 Act. Regardless of how extensively regulated they are in their home country, non-US funds may not make any public offering in the United States unless they register the investment company and the securities with the SEC. To address investment company registration, they need a special SEC exemptive order under section 7(d) of the 1940 Act, none of which has been issued in nearly 50 years. In 1983, the SEC published a release suggesting that any non-US fund sponsor seeking US retail distribution should form a parallel vehicle organized in the United States rather than seeking to do so on a cross-border basis. A US-UK trade agreement could revisit the possibility of SEC exemptions to allow British investment companies to increase their participation in the US market. Beyond the jurisdiction of the agreement, UK investment firms would need to meet state-specific regulations or seek relief from the states.

SHAPING THE IDEAL US-UK FINANCIAL SERVICES TRADE DEAL

All of these difficulties can be overcome with sufficient political will. The best starting place would be to make a joint commitment to open the US and UK financial services markets, implemented through the mutual recognition of regulatory standards and supervision, so long as those standards seek to achieve equivalent outcomes.[9] Those outcomes must be based on the objective international standards for market infrastructure that already underpin the two country's financial sectors, such as those set by the Basel Committee on Banking Supervision, the Committee on

Payment and Settlement Systems, and the International Organization of Securities Commissions. Where no such standards exist, or where they are insufficiently developed, as is the case for brokerage and funds, the outcomes desired would be agreed upon specifically between the United States and the United Kingdom. These high-level outcomes would keep each market safe from systemic risk and ensure consumer protection while recognizing that each country will adopt its own regulatory approach.

Businesses in one country could then operate in the other on the basis of the authorization in their home country, eliminating the costs and complications associated with complying with two sets of regulations and being supervised twice. This would mean that the United States and United Kingdom would accept each other's standards and regulators. However, both countries would legislate and regulate for safety and soundness in their own manner while ensuring that they do not discriminate against incoming firms, services, and capital.[10] The mutual recognition would of course be granted to firms as long as they keep a clean track record of compliance with their home regulators, are willing to report details of their activities on foreign soil to foreign regulators, and subject themselves to foreign courts to resolve disputes arising from those activities.

In order to ensure unnecessary barriers are relaxed, the deal should specify that neither country will impose new restrictions on businesses providing cross-border services from the other country (in the United States, the trade agreement should refer to federal authority but not states' authority). To the extent permitted by law, the trade agreement should entail no limits on the number of suppliers or employees permitted to provide cross-border services, no limits on the value of cross-border transactions, and no restrictions on participation in the other's capital raisings and similar opportunities. There should also be no restriction on the types of legal entities that can provide services.

The agreement should also include information sharing. For example, if a US-based mutual fund complex sold products only into the United Kingdom, UK authorities should provide information to US regulators about the business's operations, such as treatment of customers, in the United Kingdom. Should anything occur that might threaten the stability, competitiveness, or smooth operation of either the United States or United Kingdom's economies or financial sectors, there should be a comprehensive and agreed-upon process for consultation and mutually agreed-upon action.

In addition, the United States could consider an exclusion of the requirement for authorization entirely for financial institutions solely conducting cross-border wholesale financial services business with no permanent place of business established in the United States. The United Kingdom already allows US financial institutions to access its markets this way through its overseas persons exclusion, which it intends to maintain. The United States could adopt a similar framework, with appropriate limitations. The framework would build on and be broader than the existing US regime for wholesale broker-dealer business, mentioned above.

The US and UK approaches to litigation and regulatory enforcement, though far from identical in their particulars, are fundamentally compatible and thus should not present a significant obstacle to the new arrangement. Both systems recognize limits on the extraterritorial application of their laws as well as limits on their jurisdiction over foreign persons, consistent with traditional common-law principles. Both systems maintain robust frameworks for investor protection—particularly for retail investors—and, in the wholesale markets, generally apply the principle of caveat emptor (the seller is not responsible for losses incurred by the buyer on an investment, as long as it was properly described). The principal commitment from each country would be to enforce its rules appropriately to address conduct and effects within its borders, with a spirit of mutual deference, to ensure a fair market.

Other topics could also be addressed alongside this liberalization. Calibrating data privacy obligations is a vexed question on both sides of the pond. The European Union's General Data Protection Regulation represents one end of the spectrum, taking a civil law, prescriptive, top-down approach to data protection. The United States has a much less structured vision for data standards, in keeping with its legal tradition—and in fact consistent with the common law as well as Scots law traditions in the United Kingdom. The topic is subject to ongoing legislative consideration. The text in the trade agreement could be a starting point for this mutual recognition of regulatory standards. The United Kingdom can take the opportunity to create a new, focused regime more akin to that of the United States, which can be fostered and supported as part of a US-UK free trade system.

Similarly, were opportunities to arise for UK financial technology businesses, the proposed UK digital services tax could be revised or repealed on the basis that the deal provides offsetting opportunities for UK fintech and other financial businesses in the United States. There may need to be an on-ramp transition to such an environment, but the result would benefit producers and consumers in both countries. Such a change could then set the standard for the rest of the world in financial services.

CONCLUSION

A bilateral US-UK financial services agreement would be of benefit to corporations and consumers in both countries. The global financial services markets hosted by the United States and United Kingdom will flourish in a regulatory environment that encourages innovation while curbing misconduct. An agreement to fully open these two markets to each other will have net benefits for investors and firms in both countries, yielding greater growth, deeper liquidity, better pricing, and a more extensive offering of financial services as a result of a dynamic, combined marketplace based on a shared and trusted legal and regulatory methodology.

ACKNOWLEDGMENT

I thank Oliver Linch for his help in writing an initial draft of this brief. I am grateful to Thomas Donegan, Adam Hakki, Russell Sacks, Geoffrey Goldman, Reena Sahni, Mark Chorazak, Jennifer Morton, Paul Schreiber, and Danforth Newcomb for their comments on an earlier draft. All faults that remain and the views expressed are my own.

ABOUT THE AUTHOR

Barnabas Reynolds is head of the Financial Institutions Group at Shearman & Sterling LLP. He is the author of a number of publications relevant to the financial services trade negotiations between the United States and the United Kingdom, including the financial services annex of the *The Ideal U.S.-U.K. Free Trade Agreement: A Free Trader's Perspective* (Washington, DC: Cato Institute, 2018), produced by 11 US and UK think tanks and university-based research centers, including the Mercatus Center at George Mason University, and *Free Trade in UK-EU Financial Services: How Best to Structure a Brexit Free Trade Deal* (London: Politeia, 2018).

NOTES

1. The United States exported $18.86 billion in financial services trade with the United Kingdom in 2019. "International Data," Bureau of Economic Analysis, accessed October 30, 2020, https://apps.bea.gov/iTable/iTable.cfm?reqid=62&step=9&isuri=1&6210=4#reqid=62&step=9&isuri=1&6210=4.
2. Daniel S. Hamilton and Joseph P. Quinlan, *The Transatlantic Economy 2019: Annual Survey of Jobs, Trade and Investment between the United States and Europe* (Washington, DC: Foreign Policy Institute, 2029).
3. "International Data," Bureau of Economic Analysis.
4. Hamilton and Quinlan, *The Transatlantic Economy*.
5. Rule 15c3-3, commonly known as the "customer protection rule," is intended to protect customer funds held by broker-dealers and to prohibit broker-dealers from using customer funds and securities to finance any part of their business that is unrelated to servicing customers. One of the main goals of the customer protection rule is to ensure that, in the event of the broker-dealer's insolvency, all of a customer's fully paid and excess margin securities are available for return to the customer, along with all of the customer's "free credit balances" (e.g., cash) held by the broker-dealer. 17 C.F.R. § 240.15c3-3 (2002).
6. Rule 15c3-1, commonly known as the "net capital rule," is the principal rule governing regulatory capital requirements for US-registered broker-dealers. The net capital rule requires US broker-dealers to maintain net capital (as defined in the rule) in specified amounts that are determined by the types of business conducted by the broker-dealer. The rule is designed to ensure the ready availability of funds and securities in the event that a broker-dealer must liquidate and promptly return such funds and securities to creditors and customers in order to prevent losses to those creditors and customers. 17 C.F.R. § 240.15c3-1 (2020); Financial Industry Regulatory Authority, *Net Capital Requirements for Brokers or Dealers: SEA Rule 15c3-1*, 2014.
7. Derivatives are financial securities that derive their value from an underlying asset or group of assets, such as stocks, bonds, commodities, and currencies. A derivative itself is a contract between two or more parties that derives its price from fluctuations in the underlying assets.
8. Rule 15a-6 provides an exemption from broker-dealer registration requirements, provided that the firm's broker-dealer activities come within one of the four exemptions set forth in the rule. Following the adoption of rule 15a-6 in 1989, the

SEC has issued key guidance expanding the scope of the rule's exemptions and answering certain questions regarding the same. 17 C.F.R. § 240.15a-6 (1989); Securities and Exchange Commission, *Transactions in Foreign Securities by Foreign Brokers or Dealers with Accounts of Certain Foreign Persons Managed or Advised by U.S. Resident Fiduciaries*, January 30, 1996; Securities and Exchange Commission, *Securities Activities of U.S.-Affiliated Foreign Dealers*, April 9, 1997; Securities and Exchange Commission, *Request for No-Action Relief from Section 15(a) of the Exchange Act by LiquidityHub Limited*, November 28, 2007.

9. I drafted a proposal in 2018 in the context of an exercise of mock negotiations conducted by 11 US and UK think tanks and university-based research centers, including the Mercatus Center at George Mason University. Daniel Ikenson, Simon Lester, and Daniel Hannan, ed., *The Ideal U.S.-U.K. Free Trade Agreement: A Free Trader's Perspective* (Washington, DC: Cato Institute, 2018).

10. In the last financial crisis, non-US financial institutions were able to borrow from the Federal Reserve and take that funding out of the US to their home countries without constraint. That led to a new, intermediate holding company requirement for large non-US financial institutions to hold capital locally, and it led to supervisory constraints on US branches. In this proposal, there would be arrangements for cross-border US dollar—and sterling—business between the Federal Reserve and the Bank of England to ensure that the cost of liquidity provision fell on the central bank where those needing it are located.