

Fragmentation & Complexity of UK/EU Regulatory Divergence in Asset Management

Despite what some may think, UK and EU regulators are fully aware of the challenges posed by regulatory divergence in the asset management space following the UK's departure from the EU and have been taking various measures to address these issues. The challenge is that divergence both in the rules themselves, and the timeframes for implementation will cause additional burden to asset managers running cross-border operations. At present, this is most evident between the EU and the UK, but it should be noted that even within the EU SFDR framework, there are individual NCAs who are expressing concern on the constraints of the article 8/9 system of classifying products and suggesting alternatives. **So, is even more fragmented regulatory divergence a possibility?**

Regulatory authorities in the EU and the UK do not operate in ivory towers. They do engage in ongoing dialogue to address their respective regulatory challenges and promote cooperation where possible. This regular communication helps regulators understand each other's perspectives, discuss potential solutions, and work towards maintaining an effective regulatory framework for the asset management industry. However, it is only natural that an individual regulator works in the best interests of their own jurisdictions, practices, and consumers. This means that there can be disharmony, and therefore additional divergence. In addition, some regulators may wish to "gold-plate" their regulatory regimes in ways which other authorities may determine to be over-zealous, and not entirely necessary.

But do not assume that regulators are blindly ignoring the wants and needs of those in a different jurisdiction. They recognise the issues and are striving to strike the balance between what is necessary from a regulatory perspective, but which also allows the industry to flourish and prosper with integrity both within their own jurisdiction, and from a wider regional perspective. What this all means is that some degree of divergence is inevitable and unavoidable. Within the EU, the ESG framework is well-defined, and even if some individual member states harbour concerns, they are (at least for now) bound by the framework because of their political unity. Therefore, the key known concern is that of divergence between the UK and the EU.

Equivalence is a word that is often bandied about in regulatory circles. Equivalence decisions aim to recognise that the regulatory regimes in the EU and the UK achieve similar outcomes, reducing the need for duplicative compliance efforts by asset managers. Quite recently the FCA has issued a consultation on the Overseas Fund Regime and has broadly acknowledged certain aspects of "equivalence" for Overseas Funds seeking to be sold and distributed in the UK. Whilst this doesn't provide carte-blanche for every aspect of Overseas Funds being treated the same as UK funds, it does attempt to recognise that the intended outcomes of Overseas Funds are broadly the same as for UK funds, and that it is only right that UK investors have access to investment in Overseas Funds. However, it is notable that the EU classifies the UK as a third country, and therefore equivalence in that direction is somewhat closed off.

But without doubt, there is a fear from asset managers that over time, the rules by which they must abide in the UK, will increasingly differ to those in the EU. If regulatory deadlines apply at different times for essentially the same regulation, this further complicates their regulatory change programmes. Already we have seen some divergence in rules and timeframes for SDR, and SFDR.

Of course, there is the wider picture too, where global asset managers operating in multiple jurisdictions already know they have different rules to consider outside the UK and the EU. Jurisdictions such as those in North America, Asia, and other financial centres already represent different challenges. Very few of the regulators in these jurisdictions share the same exact views, so regulatory divergence is something that already exists, and for some, the UK/EU divergence is just one more that now needs to be accommodated. **So where does this leave asset managers going forward?**

At ISC, we have a tendency to split regulation into two separate areas: -

1. Markets & Infrastructure
2. ESG

Note: *We acknowledge that there can be crossover between the two, so some regulation (e.g. Consumer Duty) can have a foot in both camps.*

The reason we split these in this way is because we find so many asset managers wanting to talk specifically about ESG regulation. Essentially, we have treated ESG as a carve-out from everything else. Everything that falls into Markets and Infrastructure is a bucket for all regulation that does not include ESG.

Despite whatever anyone claims, ESG is a relatively new global investment theme concept, and therefore the rules governing it are also relatively new. We believe that lessons are still to be learnt along the way, by asset managers, by investors, and by the regulators themselves. This means that what ESG regulation looks like today, could be very different to what ESG looks like in 10 years' time. And in that time, and as ESG regulation matures, it could either diverge more, or actually begin to converge again. If the world is ever able to buy in to a single consolidated vision of sustainability in the future, **why wouldn't those ESG rules become more harmonised?**

Within Markets and Infrastructure, we know that some of the legacy EU regulations will be rolled back in the UK, and we also know that some of the UK's future regulation will move away from the direction that the EU will take. Such regulation has slowly evolved over the years and has been deliberate in solving many of the traditional issues surrounding market practice. It has dealt with long-established weaknesses and strengthened them. Enhanced technology and improved data availability have assisted regulators in being able to define new rules to stamp out poor (or even criminal) practices. Markets and Infrastructure regulation now in place has led to a cleaner and more transparent asset management industry than we have ever seen before. Future regulation in this space will either build on what has already been put in place, or will address rules around new and emergent issues in the industry (e.g. the use of AI, tokenisation, etc.)

In conclusion, it is our belief that the UK and the EU will continue to diverge in a regulatory sense. We believe that regulators in all jurisdictions will continue to talk with, and learn from each other, but will always defend the interests of their own jurisdictions ahead of agreeing to compromise with another regulator. We believe that (at least in the short term) there will be more divergence in the ESG space, than in regulation around Markets & Infrastructure.



However, we do wonder if in the long-term, (and as ESG matures further), that a global view of ESG eventually becomes more accepted and may even lead into a convergence of regulation as pressure around the world on every nation to buy in to a global sustainable view increases. But don't hold your breath... this might be a long way into the future.

Contact us reg-change@iscltd.com