UK post-Brexit financial regulation: the status quo on equivalence

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Abstract Given the extraordinary circumstances the world currently faces due to the COVID-19 outbreak, the energy and focus of the UK and the EU have shifted to dealing with the global pandemic and progress in reaching an arrangement on equivalence post-Brexit appear to have stalled. The purpose of this article is to summarise the status quo on this topic before the interruption began.

Keywords Brexit · Equivalence · Third-country regime · Financial regulation · Free trade agreements

1 Introduction

On 31 January 2020, the United Kingdom (UK) left the European Union (EU). Until 31 December 2020, the likely end of the transition period, we do not expect to see major changes in terms of financial services regulation. As for what will happen after this period, beginning 1 January 2021, it is difficult to predict the exact circumstances the UK will be in. This depends on the progress and outcome of the negotiations with the EU as well as the free trade agreements (FTAs) the UK is currently negotiating with other states. Currently, the UK is pursuing an FTA with the US with provisions for exporting financial services.¹ UK regulators have also entered into a number of Memoranda of Understanding in 2019 with regulators in Asia and Europe.

Given the extraordinary circumstances the world currently faces due to the COVID-19 outbreak, the energy and focus of the UK, the EU and most other states

¹ <https://www.ft.com/content/064c36d0-5e2a-11ea-b0ab-339c2307bcd4>.

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have shifted to dealing with the global pandemic and progress in reaching an arrangement appear to have stalled. The face-to-face Brexit talks between the UK and EU scheduled for March have been postponed although Boris Johnson, the Prime Minister of the UK, insists that this will not result in the end of the transition period being extended.

This leaves the UK's financial services sector in deep uncertainty, particularly in relation to the possibility and scope of a wide-reaching equivalence decision to permit UK firms to continue conducting business in the EU. However, more time is perhaps something that could be useful given the current state of negotiations in regard to the financial services industry. The UK currently appears to find itself subject to a choice of closely aligning its regulatory regime with the EU's regime to maintain the best possible chance of obtaining equivalence and of diverging and deregulating its regulatory regime to maintain its autonomy and status as a thriving financial centre.

Divergence from EU legislation has already been hinted at by Mr. Johnson, and Andrew Bailey, then the Chief Executive of the Financial Conduct Authority (FCA) and now the Governor of the Bank of England. Mr. Bailey has already suggested a "same outcome, lower burden" approach and advocated for an 'outcomes-based' equivalence rather than a 'rules-based' equivalence assessment.² The UK's desire for a more flexible and pragmatic regulatory environment can be said to stem from the criticism of EU financial regulation, which is often seen as being excessive, unwieldy and at times, beyond the comprehension of the average human mind. Further, the situation seems to be abated by the reluctance of the EU to expand the equivalence regime as well as the recent legislation it passed which makes the equivalence process more difficult than before.

In any case, the financial services industry will likely have a large impact on the UK's negotiation position and whichever path it chooses, there will be both benefits and disadvantages. This article will discuss and provide a briefing on the current state of agreements and negotiations on the UK's post-transition period financial regulation with a focus on equivalence. It will also provide a brief overview on the recent actions taken by the EU and the UK which could impact the negotiations and the future financial regulation of the UK.

2 Equivalence

Once the transition period ends, the UK will be a "third country" for the purposes of EU legislation unless special arrangements are otherwise agreed to. In this case, the UK's regulatory requirements need to be deemed 'equivalent' to gain access to EEA markets as 'passporting' rights will no longer be available to UK firms after 31 December 2020. Passports facilitate access on a cross-border basis without the need for local entities to be set up or local regulatory licenses to be obtained. By issuing an equivalence decision, certain services, products or activities of non-EU or third country firms will be deemed acceptable for regulatory purposes by the EU, provided that the firms are in compliance with the 'equivalent' rules of their home state. To

²<https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation>.

date, the European Commission has issued over 280 equivalence decisions for over 30 countries.³

2.1 Assessment of equivalence

In order for an equivalence decision to be made, an assessment of the third country's regime will need to be completed and this process can be slow and complex. A third country's regime need not be identical to the EU framework but needs to fully ensure the outcomes set out in the relevant EU legislative framework. The Commission may also grant a time-limited equivalence or set conditions or limitations to equivalence decisions. For instance, it may grant equivalence in part, or grant equivalence to the entire framework of a third country for specific covered entities, products or services or to categories of products or services, or to some of its competent authorities only.

The Commission aims to apply assessment criteria in a proportional manner and takes a 'risk-sensitive' approach. However, the 'outcomes-based' approach will likely no longer be emphasised as the EU has recently approved reforms (see section below) making third country access more difficult to obtain and maintain. The reforms were part of the reviews of the European market infrastructure regulation, of the European supervisory authorities and the investment firm review. Steven Maijoor, the chair of ESMA, during a speech in June 2019, stated that "it is important to underline that focusing only on high-level outcomes may sometimes result in ineffective cross-border arrangements as it would allow regulatory and supervisory differences to persist" and that "in some areas and in some cases, more ambition is needed, and we should strive to further remove differences." Instead, the Commission will be undertaking a "detailed and granular assessment" when determining whether a third country regulatory environment is equivalent.⁴

In terms of the UK's situation, the UK and the EU committed, through a Political Declaration in October 2019, to making their 'best endeavours' to carry out and finalise equivalence assessments for each of their jurisdictions by June 2020.⁵ It is to be emphasised that the equivalence assessments and the decisions shall be made at the complete discretion of each party and will not be open to negotiation. However, the parties shall respect each other's autonomy to make equivalence decisions in their own interest. Commentators have suggested that there will likely be no form of review after decisions have been made.⁶

The desire of the UK to diverge from EU regulations appear to have made equivalence talks more tense. In March 2020, the EU rejected the UK chancellor Rishi Sunak's letter and request for a swift decision on equivalence based on the fact that the UK currently has an identical regulatory framework to the EU.⁷ In his letter, Mr.

³https://ec.europa.eu/commission/presscorner/detail/en/IP_19_4309.

⁴https://www.esma.europa.eu/sites/default/files/library/esma71-319-120_fese_dinner_address_dublin_june_2019_steven_maijoor.pdf.

⁵https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/840231/Revised_Political_Declaration.pdf.

⁶<https://www.shearman.com/perspectives/2020/01/eu-uk-future-eu-announces-timetable-for-cross-border-equivalence-in-financial-services-brexit>.

⁷https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/869535/Chancellor_letter_to_Dombrovskis.pdf.

Sunak had also called for “consultation and structured processes for the withdrawal of equivalence findings, to facilitate the enduring confidence which underpins trade in financial services” in a bid to increase the stability of the equivalence regime. Mr. Sunak further stated that his team was ready “to begin working with your team in a structured way so that we can both progress our assessments of each other.” Given the importance of financial regulation in the parties’ negotiations, it likely represents a significant form of leverage for the EU.

In response to Mr Sunak’s letter, Valdis Dombrovskis, one of the European Commission’s executive vice-presidents, rejected Mr Sunak’s request to speed things up and insisted that the June 2020 deadline refers to finalising the respective equivalence assessments and not the issuance of any final equivalence decisions. Mr. Dombrovskis further stated that the EU’s equivalence assessment of the UK’s regulatory environment “will have to be forward-looking” and would take into account “overall developments, including any divergences of UK rules from EU rules”.⁸ Accordingly, it seems unlikely that the two parties will reach a decision on equivalence by the end of June 2020 and provide certainty to the sector as per Mr. Sunak’s request. In addition, the response from the European Commission highlights that any steps taken by the UK towards divergence and deregulation may adversely affect the equivalence assessment carried out by the EU.

2.2 Scope of equivalence

Currently, the equivalence regime remains the main way in which UK firms will be able to carry out business in the EU after the transition period. A bespoke agreement providing for a wider equivalence regime between the UK and EU has already been rejected by the EU and it has been made clear that a future EU-UK FTA will not contain any common regulatory framework provisions.⁹ In areas where equivalence has not been agreed, it is likely the UK will have to trade on WTO terms.

Given that UK regulation is currently fully compatible with EU law, it could be said that they have the best chance of being considered equivalent where an equivalence decision is made. However, the main challenge as of today is whether the UK’s rules being deemed equivalent will be sufficient for UK firms to continue their business in the EU after the transition period. It should be noted that the majority of EU financial legislation does not provide for equivalence in the context of access to markets. Equivalence currently applies in respect of around 40 areas which are subject to ‘third country’ provisions and the specific conditions for equivalence depend on each act.¹⁰

Important activities that do not have equivalence regimes include deposit taking, lending, payment services, mortgage lending and insurance mediation and distribution. These are all crucial areas for the UK financial services sector which could be adversely affected even if an equivalence decision is made. There is still uncertainty

⁸https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200313-letter-evp-dombrovskis-uk-chancellor-sunak.pdf.

⁹https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_179.

¹⁰https://ec.europa.eu/commission/presscorner/detail/en/IP_19_4309.

as to what options firms carrying out these activities will have. It is also not possible to grant a wide sweeping or ‘enhanced’ equivalence decision covering all applicable areas and a decision for each area will likely need to be obtained individually. The EU has made it clear that the UK will be subject to the same equivalence assessment process as all other third countries. As mentioned previously, the process is long and complex and there is currently no jurisdiction which has obtained all possible equivalence decisions.

However, the negotiations are yet to be finalised and the UK may still have options. It may be possible for the UK and the EU to agree for both parties to develop a more comprehensive equivalence approach that remedies the above limitations. This can include broadening the range of financial services for which equivalency can be established and to increase the transparency of the process for determining equivalence and in which circumstances such determinations could be withdrawn.

2.3 Withdrawal of equivalence

Another concern with equivalence is the fact that the equivalence decision can be withdrawn with as little as one month’s notice or after an agreed transition period. The Commission also has discretion to issue equivalence decisions fully or partially and/or subject to a time limit. For example, the Commission did not renew its time-limited equivalence decision in relation to Switzerland’s stock exchanges.¹¹

In July 2019, the Commission set out its equivalence policy with non-EU countries including the ongoing monitoring and review of equivalence decisions.¹² In its policy, the Commission referred to the review of equivalence as being a review which “examines all equivalence criteria and specific conditions contained in an equivalence decision, so as to ascertain that they continue to be respected” which may be “pursued on an ad-hoc or regular basis and may result in the Commission unilaterally withdrawing equivalence.” However, the relevant third country will still have the opportunity to “demonstrate that their regime delivers the outcomes as set out in the corresponding EU framework.” The Commission also noted that one of its priorities for 2019–2020 will be to look back at previous equivalence decisions in light of the new legislative changes in relation to equivalence and repeal existing decisions where necessary.

2.4 The EU’s recent reform of equivalence

In July 2019, the Commission set out its equivalence policy with non-EU countries which reflected recent reforms of the equivalence rules.¹³ The reforms were part of the reviews of the European market infrastructure regulation, of the European supervisory authorities and the investment firm review.

¹¹<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018D2047&qid=1545401795538&from=EN>.

¹²https://ec.europa.eu/info/publications/190729-equivalence-decisions_en,
<https://www.ft.com/content/a8f46a2c-b111-11e9-8cb2-799a3a8cf37b>.

¹³https://ec.europa.eu/info/publications/190729-equivalence-decisions_en,
<https://www.ft.com/content/a8f46a2c-b111-11e9-8cb2-799a3a8cf37b>.

Relevant updates include the fact that the Commission plans to take greater care when assessing the equivalence of “high-impact” third countries i.e. countries for which a grant of equivalence will likely be used on a wider scale. It is likely that the UK will be categorised as a “high-impact” country. The Commission also emphasised the need for “mutually accommodating outcomes” which can affect whether an equivalence decision is granted.¹⁴

Various commentators and discussions in the reports published by the FSB and the IOSCO¹⁵ have alluded that the reforms could result the fragmentation of global financial markets. The FSB report highlighted areas such as the cross-border trading and clearing of OTC derivatives, banks’ management of capital and liquidity and the reporting and sharing of data and information as areas of high importance.¹⁶

In November 2019, the EU also effected legislative changes to narrow the MiFID II third country regime which will take effect from June 2021.¹⁷ These changes provide for the undertaking of a “detailed and granular assessment” when assessing equivalence, in contrast to the outcomes-based assessment. The Commission can also attach ‘specific operational conditions’ to an equivalence decision, such as requiring firms to comply with MiFID transaction reporting requirements.¹⁸ As stipulated in the Commission’s equivalence policy, ESMA will now be empowered to undertake ongoing monitoring of existing equivalence decisions and report its findings to the Commission annually. The exemption of reverse solicitation has also been narrowed.

3 Recent actions taken by the UK

3.1 Treasury Committee inquiry

Prior to the general election on 12 December 2019, the Treasury Committee had set up an inquiry on the future of the UK’s financial services.¹⁹ The inquiry was to look into issues such as the Government’s financial services priorities be when it negotiates its future trading relationship with the EU and how can the UK financial services sector take advantage of the UK’s new trading environment with the rest of the world. Due to the general election, this inquiry has been closed but if an inquiry is opened on this subject in the future, the evidence gathered may be used. It is not clear if a new inquiry will be established any time soon.

¹⁴https://eur-lex.europa.eu/resource.html?uri=cellar:989ca6f3-b1de-11e9-9d01-01aa75ed71a1.0001.02/DOC_1&format=PDF.

¹⁵<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf>.

¹⁶<https://www.fsb.org/wp-content/uploads/P040619-2.pdf>.

¹⁷<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2033&from=EN>.

¹⁸<https://www.lw.com/thoughtLeadership/third-country-firms-operating-cross-border-into-the-eu-upcoming-reform>.

¹⁹<https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries/parliament-2017/the-future-of-the-uks-financial-services-17-19/>.

3.2 HM Treasury review

In July 2019, the HM Treasury begun the Financial Services Future Regulatory Framework Review which aims to examine the long-term effectiveness of the UK regulatory regime and consider where change might be necessary, especially in relation to Brexit. The first phase focuses on a call for evidence for regulatory coordination.²⁰ The call for evidence is the first phase in a number of planned interventions by the Treasury to determine the long-term effectiveness of the regulatory regime. It will look at whether more can be done to better coordinate the work of each regulator and limit unnecessary burden. The wider review will take stock of the overall approach to regulation of the financial services sector, including how the regulatory framework may need to adapt in the future, particularly in relation to Brexit.

The outcome of the consultation was published in March 2020. The Government is of the view that the institutional architecture for UK financial services regulation remains appropriate. In addition, the Government also set out plans for the ‘Regulatory Initiatives Grid’, to be launched over summer 2020, and will provide an indicative two-year forward look of major upcoming regulatory initiatives affecting the financial services sector. The Grid will be published twice a year and include all publicly announced supervisory or policy initiatives that will, or may, have a significant operational impact on firms and will set out an indicative timetable for each regulatory initiative.

The second phase of the Review will look at how financial services policy and regulation are made in the UK, including how stakeholders are involved in the process. The Government’s forthcoming White Paper on Financial Services will set out how the Review fits within the Government’s vision for the future of financial services.

3.3 The UK’s Budget

As part of the UK’s 2020 Budget, the first budget since the general election, was the announcement of a new consultation aimed at making the UK’s funds regime more attractive to investors.²¹ Areas to be covered by the consultation include the tax treatment of asset holding companies in alternative fund structures, VAT on management fees, regulation and other parts of existing regulation. The Government has also confirmed that it will consult on the way the UK should implement new prudential rules for investment firms and launched a ‘Reforming Regulation Initiative’, inviting ideas that will help to ensure that the UK’s regulation is “sensible and proportionate”.²²

3.4 The Financial Services Bill

The Financial Services Bill is one of the key pieces of legislation that must be passed by Parliament before the UK leaves the EU.²³ A new Financial Services Bill was announced with the Queen’s Speech in October 2019 to replace the previous Financial

²⁰<https://www.gov.uk/government/consultations/financial-services-future-regulatory-framework-review>.

²¹https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871767/200227_M8580_Condoc_Asset_Holding_Companies_Final_Condoc.pdf.

²²<https://www.gov.uk/government/consultations/reforming-regulation-initiative>.

²³<https://www.gov.uk/government/collections/financial-services-bill-consultations>.

Services Bill which was pulled in March 2019. The new bill is intended to ensure that the UK maintains its ‘world-leading regulatory standards’ and remains open to international markets after Brexit. Interestingly, the bill did not indicate intentions to closely align the UK financial regulatory regime with the EU’s regime.²⁴

3.5 The regulators’ approach

The consultation and initiative launched by the Government appear to be in line with the statements made by the heads of regulators including Mr. Bailey, now the Governor of the Bank of England, who spoke about a “same outcome, lower burden” approach.²⁵ This would involve “exercising flexibility” in relation to EU rules that are not working efficiently or effectively.²⁶ It is predicted that leaving the EU may enable the UK authorities to “switch off” provisions under different single market directives that have proved burdensome and run counter to UK policy.²⁷ Examples include aspects of the Alternative Investment Funds Directive (AIFMD) and remuneration policy for banks. It is also possible that post-Brexit, the UK authorities would seek to develop parallel EU and non-EU compliant frameworks to maximise the flexibility of the UK as a financial centre.²⁸

In terms of preparations, an MoU between the FCA, Bank of England, HM Treasury and the PRA was established in October 2019 setting out how they will coordinate their functions in relation to equivalences and exemptions.²⁹ The FCA also concluded new cooperation agreements or MoUs with the EU markets, insurance and banking authorities which will take effect in a no-deal outcome. These MoUs provide a framework for the sharing of confidential information, which will assist the FCA in carrying out its functions. They allow UK or EU based firms to delegate or outsource certain activities to firms based in the other jurisdiction and support future market access and equivalence decisions.³⁰

In addition to the risk assessment and monitoring of the industry preparations, the EBA has also been active in the preparations for post-Brexit cooperation agreements, where the focus has been three-fold:

- o cooperation among supervisors;
- o cooperation among resolution authorities; and
- o cooperation between the EBA and the UK authorities.

²⁴<https://www.lw.com/thoughtLeadership/10-key-regulatory-focus-areas-uk-european-wholesale-markets-2020>.

²⁵<https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation>.

²⁶<https://www.fca.org.uk/news/speeches/future-financial-services-regulation-uk>.

²⁷<http://www.allenoverly.com/publications/en-gb/lrrfs/uk/Pages/Financial-services-regulation—what-impact-will-Brexit-have-on-regulated-firms.aspx>.

²⁸<https://www.irsg.co.uk/assets/IRSG-Full-report-The-EUs-third-country-regimes-and-alternatives-to-passporting.pdf>.

²⁹<https://www.fca.org.uk/publication/mou/hm-treasury-fca-pra-equivalence-mou.pdf>.

³⁰https://www.fca.org.uk/news/press-releases/updates-fcas-directions-under-temporary-transitional-power?utm_source=POLITICO.EU&utm_campaign=c99b0dd1ef-

In all three areas, the EBA has developed MoUs which were concluded with UK authorities in spring 2019. All of these MoUs are considered as cliff-edge MoUs to be set in place in case a cliff-edge scenario materialises and ensuring that the supervisory and resolution cooperation between the EU and the UK is proportionate to the integration of both financial sectors.³¹

4 Conclusion

The focus of the UK and EU has currently shifted to other pressing matters. However, the future of financial regulation and reaching a satisfactory arrangement with the EU remains crucial to maintaining the UK's status as a global financial centre and providing much needed certainty to UK firms. During this time where talks and meetings have been postponed, the UK is likely taking time to reflect on the tough choices that will have to be made. Whether it will involve aligning its regulatory regime and pressing on for equivalence, persuading the EU to expand and enhance the existing equivalence process or diverging from EU rules altogether, it is not clear. What is clear is that the EU has since made the equivalence process more challenging for the UK and other third countries to obtain and maintain. Moreover, the EU appears unwilling to give in to any of the UK's demands and has signalled that it is keeping a close eye on any divergences from EU rules. Regardless, the UK has already begun making efforts to reform its financial regulation towards a more simplified and proportionate approach. In any case, it is unlikely that we will see any substantial developments until the equivalence assessments by the UK and EU are completed by June 2020 at the earliest. For now, firms will need to be pragmatic and take steps to plan for the worst-case scenario.

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³¹https://www.esma.europa.eu/sites/default/files/library/jc_2019_54_jc_autumn_2019_risk_report.pdf.