KEY POINTS
- There is no single harmonised approach towards third country access.
- Even where equivalence is available, it is not always accompanied by passporting rights.
- A number of key directives do not currently contain any provisions for equivalence.

Spotlight

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Equivalence: panacea or Pandora's box?

In this article, Saima Hanif considers whether the concept of third country "equivalence" could be a satisfactory substitute for passporting.

Act in haste, repent at leisure – or so the saying goes. This could not be more true than when surveying the consequences of the UK's decision to leave the EU. As the ramifications of the decision to leave the EU continue to unfold, the one consistent message emerging from Brussels is that access to the single market will be contingent on accepting the four fundamental freedoms,[1] and in particular, free movement of persons. As this is unlikely to be politically unacceptable to the UK government, it creates a serious dilemma for the financial services sector.

One of the undisputed benefits of EU membership for the financial services industry, has been the ability to "passport" services into Europe, without the need to be separately regulated or otherwise located in an EU member state. Indeed, it is the reason why many non-EU financial institutions chose to locate themselves in London (as demonstrated by the recent plea by the Japanese banks for a "soft mode" Brexit). If the UK is unwilling to accept free movement of persons, it seems likely that the right of passporting will not be preserved following the UK's exit from the EU.[2]

Without the ability to passport their services into Europe, there is a fear that financial institutions based in London will be forced to relocate some or all of their operations to a country within the EU. In response to this, some commentators have alighted upon the concept of third country "equivalence". However, upon closer examination, it is clear that equivalence in its current form is not a satisfactory substitute for passporting. Realistically therefore, the only hope is that in the negotiation process, in respect of financial services, the UK is able to agree a bespoke arrangement that successfully mitigates the lack of passporting.

THIRD COUNTRY "EQUIVALENCE"

Third country equivalence arises where the regulatory regime of a third country relating to a particular sector is recognised by the EU as being of an equivalent standard to that which applies under EU law. The fact that the EU has been willing to embrace such a concept is heartening in so much as it demonstrates that, at least in principle, the EU is not protectionist in its mind set, but is willing to open its markets to third parties.

However, it is in the application of the principle that difficulties arise. First, there is no single harmonised approach towards third country access. Hence, when seeking to understand what equivalence means for a particular sector in the industry, one has to turn to the provisions in the specific directive. This "patchwork" approach is far removed from the relative simplicity of passporting.

Second, even where equivalence is available, it is not always accompanied by passporting rights – accordingly if an investment firm is permitted to sell its services into a member state following a determination of equivalence, that would not automatically allow that firm to also provide cross-border services into the entire EU.

Third, a number of key directives do not currently contain any provisions for equivalence, UCITS being one such example. For these sectors therefore, equivalence does not address the problems associated with the lack of a passport.

EQUIVALENCE DETERMINATIONS: THE PROCESS

Typically, equivalence provisions require verifying in an assessment that a third-country framework demonstrates equivalence with the EU regime when it comes to:

- having legally binding requirements;
- having effective supervision by authorities;
- achieving the same results as the EU corresponding provisions and supervision (outcome-based analysis).

The process by which a determination of equivalence is arrived at, is a two stage process:

- a technical assessment carried out by a relevant EU agency. In financial services, the assessment is typically by one of the European Supervisory Authorities, that is, ESMA, EIOPA and the EBA. That advice is provided to the European Commission (DG FISMA). In essence the technical advice will deal with the extent to which the laws and regulation of that country are equivalent to the arrangements in the EU. Assessments will typically involve some dialogue with authorities of the third country the framework of which is under assessment. There are no timelines for completing such an assessment, and there is very little public guidance as to exactly how the assessments are carried out;
- once the assessment is complete and all technical criteria are satisfied, the equivalence determination is formally decided by the Commission. The Commission then puts its proposed decision to the vote of EU member states. The Commission decision can be vetoed by the European Parliament or Council.

A decision on equivalence may take the form of an implementing or delegated act, in accordance with what is envisaged in the corresponding equivalence provision. The latter may stipulate whether such decision can be granted in full or partially, for an indefinite period or with a time limit. Sometimes, equivalence decisions may apply to the entire framework of a third country or to some of its authorities only. Some equivalence decisions may be subject to specific conditions being satisfied.

The process to achieve equivalence is therefore far from straightforward. Not only is there a degree of opacity in the machinations of the technical agencies and the Commission, but it is apparent from the foregoing that it has the potential to be a lengthy and drawn-out process. By way of example, the negotiations between the US and the EU in respect of CCPs under EMIR took over three years to negotiate. Over that period, there were protracted debates about the extent of the divergence between the US and the EU regimes.

There is also a concern that at the stage where the Commission is required to make a determination, it is in fact a highly politicised

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determination. As the former European Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill remarked: '… Competitive pressures and political reality influence how people think about the equivalence process …' Obtaining equivalence is therefore a far from easy process. This sentiment was also echoed by Professor Sir Charles Bean, who gave evidence to the Financial Affairs Sub-Committee that: '…By definition, we are equivalent at the moment since we are part of the single market, but in practice, proving equivalence and maintaining it is quite challenging…' If the EU were in the future to introduce regulations that the UK did not agree with, the UK would be faced with a dilemma that a failure to adopt the regulation(s) could potentially lead to a withdrawal of the equivalence determination. Finally, a further concern is that the Commission can unilaterally withdraw (or alter) an equivalence determination at will.

EQUIVALENCE PROVISIONS

The limitations of relying on equivalence as a means of accessing the single market is evident even from a cursory review of the directives where there are such provisions.

For example, whilst MiFID II/MiFIR has a specific third country regime (see Arts 46–49) the equivalence provisions only apply with respect to the provisions of investment services to *per se* professional clients and eligible counterparties: it does not cover retail investors or elective professional clients. (Article 46 of MiFIR provides that a third country firm may provide investment services to eligible counterparties and professional clients in all member states without the establishment of a branch provided that, *inter alia*, the Commission has issued an equivalence decision and the firm is included in a register of third country firms kept by ESMA.) It is also important to note that MiFIR does not cover the services and activities that are currently covered by the CRD passport and that fall outside the scope of the MiFID II passport, eg deposit-taking, lending, credit etc.

Similarly, the AIFMD, which the UK has implemented, whilst it has equivalence provisions, it is also not without problems. Non-EU AIFMS are not permitted to market the funds in the EU, or manage EU AIFs. The consequence of this is that UK fund managers will only be able to market the funds to EU investors under national private placement regimes (see Arts 36 and 42). The only other options are to set up a subsidiary in the EU or to use an existing authorised AIFM platform in the EU. If a marketing passport for non-EU AIFM is eventually introduced (this is expected in 2017) then this should benefit UK AIFMs, as it would permit the marketing of UK funds to professional clients in the EU. However, extension of the marketing passport to the UK depends on the adoption of a delegated act by the Commission (which must not be vetoed by the European Council and Parliament), which, is likely to be highly politicised. In any event even if the UK was granted full equivalence under AIFMD, there would still be additional costs for UK AIFMS, as they would still need to appoint an EU-based depositary and legal representative. It is also as well to remember that there have, as yet, been no equivalence decisions under AIFMD, and MiFID II has yet to be implemented – hence this is unchartered territory. In respect of the insurance sector, the Solvency II Directive permits insurers from third party countries to establish branches in member states. However, such branches are subject to onerous capital and supervisory arrangements and do not themselves have passporting rights into other member states.

NO EQUIVALENCE PROVISIONS

Even more problematic is the fact that there are specific areas, where currently there are no third party regimes. There are no equivalence provisions in the payments sector, for example. Nor is there currently a third country regime in respect of UCITS. This means that if the UK were to become a third country, UK UCITS would lose their status as UCITS and UK management companies would no longer be able to use their passport to manage UCITS in other member states. A UK-domiciled UCITS may therefore have to establish a branch in each EU member state that it wishes to enter, or may have to delegate the management of the fund to an EU company (as with US UCITS.) Of equal concern is the fact that the CRD IV Directive does not contain any equivalence provisions in respect of activities such as deposit-taking and lending.

CONCLUSION

In short, equivalence is not a panacea for the problems caused by a lack of passporting rights. It is at best, a piecemeal approach, limited in its application and which has yet to be tested in key areas. The very fact that there are key sectors where equivalence is not even available is a further complication. The predicament is further compounded by the fact that a determination on equivalence is essentially a political judgment, which creates huge uncertainty for businesses.

That equivalence is so limited should not come as a surprise, as it was never intended to be a suitable alternative to passporting; but the focus on equivalence post-Brexit is a reflection of the fact that the UK is in an unprecedented position. What is therefore required is an unprecedented solution, namely a bespoke agreement that can remedy problems of the sort that are identified in this article. Whether such an agreement will be forthcoming remains to be seen, but at present, it is the only credible means by which to secure access to the single market. ■

1 In response to a recent comment from Boris Johnson that there was no "automatic trade-off" between future British access to the EU's single market and the UK's acceptance of free movement of goods, services, capital and labour, the French Finance Minister, Michel Spain, reiterated that the freedoms are "indivisible". The President of the European Council Donald Tusk has also said very recently that "…Our task will be to protect the interests of the EU as a whole…and also to stick unconditionally to the treaty rules and fundamental values. By this I mean, *inter alia*, the conditions for access to the single market with all four freedoms. There will be no compromises in this regard."

2 Although there has been some suggestion that organisations may be able to rely upon 'acquired rights' it is unlikely that this will provide a reliable and certain basis upon which passporting rights will be preserved.

Further Reading:

- MiFID II and the AIFMD: is an onshore model for third country asset managers inevitable? [2014] 8 JIBFL 497.
- "Third country" issues in current EU financial services regulation [2012] 5 JIBFL 287.
- LexisNexis Financial Services blog: What might Brexit mean for financial services lawyers?