The Equivalence Decisions Framework of the EU and UK – Brexit and beyond

December 28, 2020

With the UK and EU having announced the breakthrough on its Trade and Cooperation Agreement (**TCA**) the next steps for financial services firms will be if policymakers will turn to granting a decision on equivalence for a "third country". From January 1, 2021, the UK will, following the end of the Brexit-transition period and the TCA, be treated by the EU as a "third country". The EU has been reluctant to indicate whether it would grant an equivalence decision irrespective of the UK having implemented EU financial services legislation but having stated it would diverge in defined areas going forward.

EU legislation refers to those jurisdictions that are not part of the European Economic Area (**EEA**) as third countries. EU financial services legislation and rulemaking instruments contain measures allowing some (but not all) financial services firms based in third countries to gain access to EEA markets if such countries have been assessed by the European Commission as having a regulatory regime that is deemed to be equivalent to that of the EU.

Following the assessment by the EU, the European Commission grants a decision within its regulatory framework. In July 2019, the EU clarified[1] that third countries have no right to have the equivalence of their regulatory/supervisory regime to be assessed or to receive an equivalence decision even if such third country can demonstrate that its regulatory/supervisory regime fulfils relevant criteria.

This position is echoed in the text of the TCA, where it is made clear that the EU has a unilateral right to grant an equivalence decision for the UK and the UK in respect of the EU-27. Both the EU and the UK have frameworks for granting equivalence decisions and the EU has, at December 2020, granted the UK temporary and limited equivalence for central counterparty clearing and for settlement of Irish securities.

The UK has in turn decided to on-shore EU equivalence decisions into its own framework as well as set out similar (almost equivalent) guidance on its own new framework for UK equivalence determinations. The UK has already approved prospective equivalence determinations during the EU-UK transition period that will apply from January 1, 2021.

The EU's equivalence decision framework

The EU's equivalence decision framework was last reformed in July 2019. In summary it is a multi-stage process, whereby the European Commission, on the advice of one or more of the European Supervisory Authorities (European Banking Authority (**EBA**), European Securities and Markets Authority (**ESMA**) or the European Insurance and Occupational Pensions Authority (**EIOPA**)), assesses whether the third country's regulatory/supervisory regime for a particular area is equivalent to that of EU law.

Equivalence assessments can only be conducted and granted where the legislative or rulemaking instrument permits such a decision to be taken. If no such provision exists as a matter of EU law, then no such assessment and decision can be taken. Following the conclusion of the assessment the European Commission, a financial services firm that complies with those rules may be supervised by the EU and national level authorities on that basis. Equivalence decisions are no substitute for the EU's passporting regime nor necessarily a sustainable alternative to setting-up a suitably permissioned vehicle in the EU-27 (as an alternative, a third country branch – which may however not access the passporting regime).

The majority of EU financial services legislative and rulemaking instruments do not contain measures that cover equivalence decisions or third country market access rights. Moreover what constitutes equivalence can mean different things in different pieces of legislation. The European Commission periodically publishes an overview of what equivalence decisions it has granted.[2]

The EU's July 2019 reforms to equivalence assessment methodology stated that it would:

1. aim to take a proportionate approach on the risks indicated and/or implied in the third country frameworks being reviewed. The idea is to start with those that are more important to the EU-27 and its market(s). Those third countries that are considered "high-impact" include those with a large degree of interconnectedness of the assessed market with EU markets given that these present a more significant set of risks to be reviewed and assessed by the European Commission. The higher the possible impact – the more granular the assessment that is to be conducted;
2. review and study the intended outcomes of the third country regulation and supervision rather than focus just on the content of the rules/supervisory framework. In summary, the third country regulatory/supervisory framework's rules need not be identical, but the outcomes need to be aligned with those of the EU's framework;
3. assess the extent and nature of any obstacles relating to systemic risk, market disruption, competition and investor protection as well as compliance with EU priority policy areas, including international sanctions, anti-money laundering, terrorist financing and financial crime prevention (collectively **AML**); and
4. consider the risks to EU financial markets as well as the benefits for EU financial market participants if an equivalence decision were to be granted to a third country and third country firms that would then have access to the EU-27 and what this would mean for EU-27 markets and participants and whether these can be managed in a prudentially sound manner as well as an assessment of how such third country treats EU market participants in that third country.

The European Commission and the European Supervisory Authorities (as well as in many instances the European Central Bank and the Single Resolution Board in their Banking Union supervisory and/or financial stability oversight roles) monitor the ongoing status of equivalence decisions with a view to protecting the EU's own interests. As part of this monitoring, the relevant framework is assessed on whether it:

A. continues to fulfil the EU objectives for which it was taken – including as a result of changes in the regulatory framework of the third country;

B. the continued equivalence decision continues to comply with the EU's priorities on financial stability, market integrity or investor protection and whether the third country firms benefiting from the equivalence decision continue to respect the integrity of the EU's Single Market for financial services and the level playing field in the EU;

C. is affected by the third country being listed on the EU lists of non-cooperative tax jurisdictions or high-risk third countries with strategic deficiencies in their AML regimes.
The European Commission may at any time (and at short notice) choose to withdraw an equivalence decision either through repeal of the decision or by failing to review and extend an existing decision. [3] A third country (nor third country firms) cannot appeal the withdrawal of an equivalence decision.

Following the expiry of the June 2020 target time limit for conclusion of a stated equivalence assessment and in the lead up to and following the announcement of the conclusion of the TCA, the European Commission stated that it was not in any rush to grant the UK an equivalence decision. Even if it would, such decision would not cover all areas of financial markets activity.

The UK's equivalence determinations framework

The UK has introduced its own equivalence determinations framework. This is independent of that of the EU – thus if the EU were to find one jurisdiction the UK would not need to follow and vice versa. That being said, under the UK's new framework, HM Treasury (as the financial services regulatory and legislative policymaker) is empowered to review, assess and confirm other countries' regulatory or supervisory regimes with that of the regime in the UK, including such EU financial services legislation that has been "onshored" i.e., retained by the UK following January 1, 2021. Under the UK's new regime, it was decided that those equivalence decisions that were concluded during the time that the UK was a member of the EU, would be inherited by and form part of the UK's new regime.

Under the new UK equivalence regime, the territories of the EU and outside the EU and the UK will be referred to as third countries as well. HM Treasury's assessment, similar to the European Commission's role in the EU equivalence framework, will be completed by relying on advice from the UK financial regulatory authorities, namely, the Bank of England (**BoE**), the Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**), who have signed a joint memorandum of understanding. The approach that the UK will apply is set out in a Guidance Document from HM Treasury published in November 2020[4] as well as a table[5] detailing the UK equivalence decisions taken to date and which would apply from January 1, 2021.
In a similar (almost equivalent) approach to that taken by the EU, the UK equivalence framework aims to:

1. facilitate the benefits of maintaining an "…open and globally integrated financial system", which supports financial stability, market integrity and consumer protection;
2. be "outcomes based" and assessed with compliance with internationally agreed standards and supervisory practices;

While there are certainly a number of similarities between the proposed UK and EU regime, the UK's guidance on its approach reinforces that it will:

3. aim to establish a cooperative process that builds an understanding of different jurisdictions' approaches and engage in early supervisory dialogue; and
4. UK equivalence determinations will be "…terminated when the cumulative effect of regulatory changes" no longer satisfy, following remedial action, the equivalent outcomes.

HM Treasury, upon recommendation of any of the BoE, PRA or FCA may commence a new equivalence assessment but, in contrast to the EU, HM Treasury's Guidance is much more direct that it will consider requests from industry. Emphasis is also placed in the Guidance Document on HM Treasury engaging in dialogue with UK viewed third country authorities and discussion on how "their" relevant supervisory and regulatory frameworks meet the UK regime's own outcomes. Similar to the EU, once HM Treasury has concluded a positive equivalence determination, it will be made by way of legislative instrument i.e., a statutory instrument and an accompanying explanatory memorandum detailing the justification for the determination. The regulators may publish additional supporting material, including summary advice, as may be deemed necessary or desirable in respect of the equivalence determination.

In keeping with the EU regime, HM Treasury (on recommendation from the UK regulators) will review determinations and may remove or also decide not to review any equivalence determination. In contrast, HM Treasury's statements are more definitive that a withdrawal of an equivalence determination is one of last resort. The basis for a withdrawal decision are the same as the EU's approach but the UK also make an explicit referral in the Guidance Document to compliance with rule of law and human rights by the third country as considerations that may influence a decision. Equally, the Guidance Document (more detailed than the EU's wording) states that the withdrawal of an equivalence determination will seek, where possible to minimize adverse impacts of the removal, including market disruption and financial stability, including the introduction of an "adaptation period" if circumstances warrant it.

Outlook and next steps

In the absence of an EU-UK mutual equivalence decision/determination, financial services firms on both sides may need to consider other market access measures, including:

i. conducting business on the basis of reverse solicitation (which is subject to national rules as opposed to EU-27 wide harmonized rules) – although we note that the supervisory expectations including the EU-27's Supervisory Principles on Relocations (**SPoRs**)[6] are rather critical of this as the basis of a sustainable target operating model over the longer term; or
ii. setting-up a third country branch – although this may be limited in what the branch can do with whom and where; or
iii. establishing a fully authorized and permissioned subsidiary in the respective jurisdiction that is treated no less favorably than any other domestic firm.

It should be noted that due to pending changes in the EU's regulatory regime certain financial services firms (notably banks) that are headquartered outside of the EEA, will from the second half of 2021, provided they meet certain quantitative and qualitative threshold require an intermediate parent undertaking (**IPU**) to be set up in the EU-27, either as a financial holding company (FHC) or a mixed-financial holding company (MFHC). Both of these IPU entity types will require authorization and a license from the European Central Bank, if operating in the EU's Banking Union, or national competent authorities, if operating in non-Banking Union EU Member States. For further details see here.

Moreover, going forward, some third country jurisdictions may thus be equivalent for UK purposes but not necessarily for EU-27 purposes and vice versa. Consequently, as this will change over time, financial services firms will want to work with counsel to ensure they have a map as to what is equivalent for whom and with respect to which activity (as well as for how long and with what degree of confidence). Such a review is likely to gain importance as the existence and nature of equivalence (even if it is possibly never granted between the UK and EU) may impact both market access decisions but also more strategic concerns across a breadth of asset classes and transaction types.

If you would like to discuss any of the items mentioned above, in particular how to forward-plan any impacts the above or how it may affect your business or your clients more generally, please contact our Eurozone Hub, other Brexit Board members or the listed key contacts.

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1. Available here.↩
2. See most recent version available here.↩
3. Which it has already done in respect of certain jurisdictions and equivalence with the EU's Credit Rating Agencies Regulation or failing to extend a decision in respect of Swiss stock exchanges and the EU's Commission Implementing Decision (EU) 2018/2047 see coverage here.↩
4. Available here.↩
5. Available here.↩
6. See full breadth of coverage available here.↩

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