

Client Update

European Commission Explains Its Approach to “Equivalence” Decisions in Financial Services

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On 27 February 2017, the European Commission published a Staff Working Document¹ containing an assessment of EU equivalence decisions in financial services policy.² Equivalence decisions are a core element of the Commission’s international strategy for financial services and provide benefits for both EU- and third-country financial markets. If the Commission determines that a third country’s regulatory, supervisory and enforcement regime is “equivalent” to the corresponding EU framework in a particular market sector, that recognition usually makes it possible for authorities in the European Union to rely on supervised entities’ compliance with the equivalent foreign framework.

This reduces or eliminates overlaps between different regulatory regimes and provides EU firms and investors with a wider range of services, instruments and investment choices originating from third countries that can satisfy regulatory requirements in the European Union. In insurance, for instance, Solvency II allows third countries meeting certain standards to be declared to be “fully equivalent” for reinsurance, solvency capital and group supervision purposes, as well as “provisionally” or “temporarily” for particular purposes. Bermuda and Switzerland are the only two countries who have been determined to be fully equivalent, while the United States (among others) has been named provisionally equivalent when calculating solvency capital in certain limited circumstances. There is also provision for equivalence assessments to be made in the Prospectus Directive, the European Market Infrastructure Regulation (EMIR), the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR).

¹ Staff Working Documents (SWDs) are internal documents of the Commission. They are not always publicly available.

² EU equivalence decisions in financial services policy: an assessment (SWD(2017) 102 final).

However, not all EU legislation provides for equivalence assessments, and equivalence has different implications for market participants depending on the particular legislation in question.

The stated purpose of the Staff Working Document is:

- to provide a factual summary of third-country provisions in EU financial services legislation;
- to explain the process that culminates in an equivalence determination by the Commission; and
- to take stock of the Commission's experience with the equivalence framework.

The publication is timely; if the United Kingdom ceases to be a member of the EU single market in goods and services after Brexit, as the UK government indicated in the white paper published on February 2, 2017,³ the issue of equivalence will become critical for UK market participants who wish to have continued access to the European Union. UK market participants will no longer be able to rely on the various EU passports to market their services or establish branches in other EU Member States. An equivalence assessment in favour of the United Kingdom may, in some cases, enable cross-border access to the European Union to continue, albeit not on the same unrestricted terms as the EU passports provide.

There is an assumption that, since the United Kingdom has implemented EU financial services legislation rigorously since its accession to the European Union (in many cases 'gold-plating'—going further than strictly required by EU law), an equivalence determination in the United Kingdom's favour would be a foregone conclusion. This may be overly optimistic: equivalence is determined according to a range of factors and the Commission has a broad discretion in making a determination, involving a risk-based approach to assessments, and proportionality in the application of the equivalence criteria, as the Staff Working Document explains.

A Commission equivalence decision takes the form of an implementing act which can be adopted only after confirmation by representatives appointed by the Member States in a vote of a regulatory committee. When taking a decision on equivalence, the Commission ultimately exercises its discretion taking into account objectives stemming from the relevant EU legislation and from the

³ The United Kingdom's exit from and new partnership with the European Union (Cm 9417).

Treaty.⁴ These objectives may include, in particular, promoting the internal market for financial services and protecting financial stability or market integrity within the internal market.

In this context, factors such as the size of the relevant market, the importance of the functioning of the EU internal market, the interconnectedness between the markets of the third country and the European Union, or the risks of circumvention of EU rules may play a role. It is relevant that in many cases the size of the UK market is significant in relation to the size of the EU market as a whole. There is also a political overlay to any equivalence decision that must be borne in mind. For these reasons, it may not be acceptable to the remaining 27 EU members for the major providers of financial services in a particular sector to be located in a country that is not a Member State.

The Commission has so far adopted 212 equivalence decisions, and a total of 32 jurisdictions have been positively assessed for at least one area. Japan has had the most equivalence findings (17), closely followed by the United States and Canada (16 each), Australia (13), Brazil (12) and Singapore (11). The Commission states that overall experience with equivalence may be considered as broadly satisfactory, but that a few areas may require increased attention:

- Given the diverse structures of foreign jurisdictions and markets, the relevance an equivalence decision can have for the establishment and functioning of the internal market, financial stability or market integrity varies significantly. The Commission's focus on risks in this process implies that "high-impact" third countries for which an equivalence decision may be used intensively by market operators will feature a higher number of risks which the Commission will need to address in its assessment of the equivalence criteria and in the exercise of its discretion. It is likely that, in a number of areas, the United Kingdom would be considered a "high-impact" third country.
- Existing equivalence decisions are not always coherent as to the need to assess both the regulatory and the supervisory framework to the same degree. They also do not offer a coherent answer as to what role the three European Securities Authorities (ESMA, EIOPA and the EBA) should play in the equivalence assessment process.
- The Commission says that the recent approach of integrating into equivalence the monitoring and enforcement of third countries' ongoing

⁴ The Treaty on the Functioning of the European Union (TEFU).

compliance with the equivalence criteria in the relevant legislation has proved appropriate, and this approach is crucial in ensuring that the equivalence granted by the European Union sets sufficiently robust prerequisites for a given third country's supervision system and related enforcement, including enhanced supervisory cooperation with supervisors in the European Union, enabling on-site inspections and effective access to data in the third country. The Commission considers that the European Securities Authorities are well-placed to engage in specific monitoring tasks in their area of activity.

The Staff Working Document provides a timely analysis of the EU equivalence assessment process—a process with which the United Kingdom will need to become increasingly familiar as it moves towards leaving the European Union and, most likely, the EU single market. Given the relative size of the UK market in several financial services sectors, it is possible that the Commission will apply equivalence assessment criteria more rigorously in assessing the United Kingdom than in the case of “lower impact” jurisdictions, so a determination of equivalence in favour of the United Kingdom cannot be assumed.

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Please do not hesitate to contact us with any questions.