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Brexit: Is Equivalence a Solution for Financial Services?

8 October 2020

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Background

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Alongside the continuing challenges of COVID-19 for businesses and communities globally, as the deadline for reaching an agreement on the EU-UK future relationship draws closer, Brexit has returned prominently to the headlines in recent weeks. With the chief negotiators continuing to report little progress on the key issues in the negotiations, it appears increasingly likely that there will be no agreement in respect of financial services by the end of this year. In the absence of any form of agreement, reliance may be placed on the existing EU equivalence framework in seeking to minimise disruption to EU-UK trade in financial services.

In this context, as part of Matheson's thought leadership on Brexit, partners from across our financial services teams have come together to produce this paper on how the existing EU equivalence framework operates - and whether or not it offers a solution to the many challenges for financial services arising from the UK's withdrawal from the EU. Our partners have also created individual papers summarising the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: investment funds, insurance, derivatives, banking, MiFID firms, fintech and payments; together with an analysis of equivalence as a viable or relevant mechanism in each case. These individual papers may be accessed through the links provided below in section 4, under the heading 'Sectoral Analysis'.

Should you wish to discuss any of the information in this document or to review your Brexit plans, please contact myself or any one of my colleagues whose details are provided at the end of this paper.

Sharon Daly
Head of Matheson Brexit Advisory Group

1. Progress of the Trade Negotiations and Current Outlook

It is October. On 31 December 2020, the transition period agreed under the withdrawal agreement ("WA") between the European Union ("EU") and the United Kingdom ("UK") will end. It is widely accepted that, in order for a comprehensive free trade agreement ("FTA") to be in place by the end of the transition period, the FTA would have to be agreed upon in October or early November to allow time for translation into the official languages of the EU and ratification by the European Parliament. The European Council is due to meet on 15 and 16 October, which UK Prime Minister Boris Johnson has set as a deadline for reaching an agreement. The EU has stated that a deal must be sealed by the end of October or early November. Any extension to the transition period has been ruled out by the UK.

This timetable makes it very difficult to envisage a comprehensive FTA being agreed before the end of the transition period. Despite Prime Minister Johnson's insistence in June, following a high-level meeting between Mr Johnson and EU institutional leaders, that the outline of a deal could be sealed by the end of July based on an accelerated work programme, both the EU and UK statements following the latest negotiating round (29 September to 2 October 2020) continue to confirm the limited nature of the progress made and the familiar differences which persist. The European Commission's ("Commission") **statement** of 2 October 2020 highlighted the lack of progress on important matters such as the protection of personal data, climate change commitments and carbon pricing, alongside the continuing "serious divergences on matters of major importance for the European Union". The UK **statement** of 2 October 2020 also noted that significant gaps remained, notably but not only in the areas of fisheries, the level playing field and governance. Following negotiations in August, the Commission had concluded, "Today, at this stage, an agreement between the United Kingdom and the European Union seems unlikely." While brinksmanship may have been a consistent feature of the Brexit negotiations over the past four years, it appears ever more likely that the clock will stop before a comprehensive FTA has been reached.

There is the possibility that, rather than a comprehensive FTA being put in place, a series of agreements addressing different sectors may be negotiated, with some areas being prioritised before the end of the transition period. It is noteworthy that the political declaration agreed in October 2019 states that the UK and EU intend to develop in good faith “agreements” (plural) giving effect to the future EU-UK relationship. The UK’s **written statement** of February 2020 outlined that the UK envisages a suite of agreements, the main elements of which would comprise a comprehensive FTA. On the other hand, the EU’s consistent, publicly stated preference is for a single, comprehensive FTA rather than separate agreements. This, combined with the EU’s frustration with the UK’s approach to negotiations and its perceived failure to engage on key issues¹, means that in the absence of a single FTA, the risk of no agreement is arguably higher now than it has ever been.

Even if a deal in principle could be reached in time between the two sides, with further details to be agreed at a later date - possibly on a sector by sector basis - whether an agreement could be reached in respect of financial services before year end may nonetheless be regarded as unlikely in light of the significant number and the complexity of the issues to be agreed upon. The alternative is a “no-deal” or “hard” exit (an outcome still favoured by some in the UK Conservative Party), with the future EU-UK relationship to be governed by World Trade Organisation (“WTO”) rules and reliance being placed, where possible, on the EU equivalence framework.

Focus on Financial Services

Despite the role of the City of London as a global financial hub and the high degree of interconnectedness of the EU and UK financial markets, there has been surprise in some quarters at the manner in which other sectors or issues have been given at least as much priority as financial services when, on the face of it at least, the value of financial services to both sides is arguably more significant than some of those other sectors or issues. In March 2018, Donald Tusk, then European Council President, highlighted the difficulties involved in including detailed rules on financial services in an FTA:

“In the FTA we can offer trade in goods, with the aim of covering all sectors, subject to zero tariffs and no quantitative restrictions. But services are not about tariffs. Services are about common rules, common supervision, and common enforcement. To ensure a level playing field. To ensure the integrity of the Single Market. And ultimately also to ensure financial stability. This is why we cannot offer the same in services as we can offer in goods. And it’s also why FTAs don’t have detailed rules for financial services.”²

The **draft FTA** prepared by the UK in May 2020 contains specific provisions on financial services in Chapter 17 and the draft text is significantly more detailed than the equivalent provisions in the EU draft **text** of March 2020. The EU has given no indication that it is prepared to include any provisions on financial services in an FTA that would go beyond the financial services chapter set out in previous EU FTAs. The EU draft FTA published in March 2020 largely reflects the provisions in the Annex on Financial Services in the General Agreement on Trade in Services (GATS) in the WTO rules, which would also apply in the event of no agreement being reached. These rules do not create a reliable mechanism for service providers to gain access to foreign markets, rather a framework within which governments operate when determining what access rights they are prepared to allow to foreign service providers.

¹ Keynote address by Michel Barnier at the Institute of International and European Affairs 2 September 2020. Available [here](#).

² Remarks by President Donald Tusk after his meeting with then Taoiseach Leo Varadkar. Available [here](#).

The Equivalence Question

In the absence of a comprehensive FTA incorporating detailed provisions on financial services, or a specific agreement on financial services as one element of a suite of agreements before the end of the transition period (both outcomes appearing increasingly unlikely as time ticks on), UK financial market participants may be left to rely on existing third country regimes – or the equivalence framework – set out in EU financial services legislation to ensure continued access to the EU financial markets. The most fundamental impact for UK financial market participants arising from the UK exiting the EU is the loss of passporting rights, that is the right available to a financial institution authorised in a European Economic Area (“EEA”) member state (the home state) to carry on certain activities covered by EU legislation in another EEA member state (the host state) on the basis of its home state authorisation or licence. Passporting rights continue during the transition period but will end on 31 December 2020. Accepting the loss of passporting rights as an unfortunate but necessary consequence of leaving the Single Market, the question then arises as to whether the equivalence framework offers a satisfactory basis for the future EU-UK relationship in the area of financial services.

2. What is Equivalence?

Equivalence is the concept that the regulatory or supervisory regime of one jurisdiction relating to a particular financial services sector is of an equivalent standard to that which applies in another jurisdiction, allowing the authorities in one jurisdiction to rely on supervised entities' compliance with equivalent rules in another jurisdiction.

The first point to clarify is that it is not the case that the Commission can make an over-arching equivalence determination that would deem the UK financial services regulatory and supervisory regime equivalent to the EU regime as at the end of the transition period. Some, but not all, EU legislative acts contain mechanisms which allow financial institutions based in third countries to gain access to EU markets. The availability of this access is conditional upon a determination by the Commission that the third country's regulatory regime in the specific context covered by the legislation is equivalent to that of the EU, involving an assessment of the comparability of the two regulatory regimes to determine how financial services firms can interact within those regimes, and typically based on advice given by one of the European Supervisory Authorities. We have included below a series of links to sectoral specific analyses of equivalence in areas including banking, derivatives clearing, insurance, investment funds, MiFID firms and fintech and payment services. The EU equivalence framework allows supervisors to make a range of judgments about risk and risk management. In the financial services context, the types of risks to be considered in any equivalence determination will relate to financial stability and market integrity, investor and consumer protection and fair competition. "High impact" third countries, where there is a large degree of interconnectedness of the assessed market with EU markets (as will be the case with respect to the UK financial services market), will present a more significant set of risks to be assessed by the Commission.³ Therefore, it is not simply a case of assessing whether the legislative, regulatory and supervisory regimes in the two jurisdictions

³ The European Commission Communication on Equivalence in the Area of Financial Services 29 July 2019 refers to high-impact areas or third countries as having a high impact on the EU in terms of financial stability, market activity and investor protection. Available [here](#).

are very similar or identical; other factors may be taken into account by the Commission in assessing the risks involved in granting market access or equivalent rights to the third country firms.

In its **communication** on equivalence published in July 2019, the Commission stated that the equivalence regime is outcomes-focused and that third country regimes do not need to be identical to the EU framework. The Commission will consider the treatment the third country affords to the EU regulatory framework, to the supervisory work of the EU authorities and the local presence of EU market participants, including the treatment of EU players active in third countries and subject to local rules and supervision.⁴

There are, however, a number of difficulties with relying upon the current equivalence framework as the basis for the future financial services relationship, which are considered further in the following paragraphs.

No Single Equivalence Framework

The reality is that the majority of EU financial services legislation does not contain equivalence regimes relating to access rights (the Alternative Investment Fund Managers Directive ("AIFMD") and the Markets in Financial Instruments Directive ("MiFID") are notable examples of access-related equivalence regimes). Unless there are significant changes to EU financial services legislation, equivalence in the context of access to markets will not be relevant to a large proportion of the UK's financial services sector. For example, equivalence regimes are not available for deposit-taking, lending, mortgage lending, insurance mediation and activities relating to UCITS. It should also be borne in mind that even where equivalence regimes are available, they will not provide identical market access rights to passporting arrangements and may not be available for certain activities or clients. This lack of a comprehensive framework of equivalence regimes means that, even if the UK were to achieve the best possible outcomes under the existing regimes contained in EU legislation, UK firms would still not be in a position to offer the full range of financial products and services that they can offer today in the EU.

Circumstances in which an Equivalence Decision can be Made

There is also a significant element of unpredictability regarding whether and when an equivalence determination may be made by the Commission. There is no established EU template or standard approach for equivalence judgments. In its July 2019 **communication** on equivalence, the Commission stated that third countries do not have a right to have the equivalence of their regulatory frameworks assessed or to receive an equivalence determination, even if the third countries can demonstrate that their framework fulfils the relevant criteria.

In theory, as at the end of the transition period, it should be a straightforward procedure for the UK regulatory regime to be considered equivalent to the EU regime as the UK has already implemented EU financial services legislation. However, the practical reality is that, in light of the risk management basis of equivalence decisions and the UK's status as a "high impact" third country, the process is likely to be lengthy and potentially subject to political considerations. It is worth noting that Michel Barnier, the

⁴ It is worth noting that, while prior to withdrawal the EU had the power to make equivalence decisions which were binding on the UK as an EU member state, at the end of the transition period (in the absence of an agreement on financial services) the UK will gain the power to make its own equivalence decisions with respect to access to UK markets. In this regard, the Equivalence Determinations for Financial Services (Amendment etc) (EU Exit) Regulations 2020 (SI 2020/1055) were published on 30 September 2020. The regulations concern the UK future regime for equivalence.

EU's chief negotiator, has recently **stated** that the EU will only grant equivalence determinations in those areas where it is clearly in the interest of the EU, its financial stability and its investors and consumers. Furthermore, the debate concerning the UK's proposed Internal Markets Bill has no doubt heightened EU concerns that the UK may deviate from EU standards and may significantly impact the approach of the EU when looking at equivalence determinations.

Unilateral Right of Withdrawal of Equivalence Decision

The Commission may also unilaterally withdraw an equivalence decision at relatively short notice. For many in the UK government, the point of exiting the EU is to acquire and exercise the ability to diverge from EU rules and standards and it is unclear at present whether the UK would be willing to align its regulatory regime in the long term as closely with that of the EU as the concept of equivalence would require. This alignment presents particular difficulties as the UK will no longer be involved in the EU legislative process and makes reliance on the equivalence regime an unattractive option from the UK perspective. The UK's publicly stated intention to diverge from EU rules in some areas after 1 January 2021, combined with the Commission's ability to unilaterally withdraw an equivalence determination, undermine the stability of equivalence as the foundation of the future relationship.

Our View

It is clear that the existing equivalence framework does not provide an acceptable, long-term, sustainable solution for the UK-based industry as a whole to access EU markets. Predictability, stability and transparency are key for financial services firms to implement their distribution, marketing and growth planning in the medium to long-term and the existing regime does not offer any of these benefits.



3. Could there be a Modified Equivalence Framework?

While the UK's earlier proposals for a form of "enhanced equivalence" based on mutual recognition were rejected by the EU, there have been some efforts during the negotiations to propose modifications to the current equivalence framework to improve its stability and predictability as a basis for cross-border financial services between the EU and UK. Under the political declaration, it was agreed that the EU and UK would start assessing the equivalence of each other's regulatory and supervisory regimes as soon as possible after the UK left the EU, endeavouring to conclude equivalence assessments by the end of June 2020. Mr Barnier noted in a **speech** on 30 June 2020 that the Commission has sent questionnaires to the UK covering 28 areas where equivalence assessments are possible, of which the UK had at that time answered only four. The political declaration also stated that cooperation on regulatory and supervisory matters should include transparency and appropriate consultation on the process of adoption, suspension and withdrawal of equivalence decisions.

The UK's position is that equivalence determinations should be based on an assessment of the equivalence of outcomes. As the UK cannot outsource regulation to another jurisdiction, the relationship cannot be built on the textual alignment of the EU and UK regulatory frameworks.⁵ In its February 2020 **policy paper** on its approach to negotiations on the future UK-EU relationship, the UK government called for appropriate consultation and a structured process for the withdrawal of equivalence findings.

The EU has underlined its need to maintain its regulatory and decision making autonomy and has stated that the EU's autonomy on equivalence should not be restricted by any FTA.⁶ The Commission's view is that the higher the possible impact on EU markets and interests, the more granular the assessment required. In a **speech** delivered in June 2020, Mr Barnier stated the UK's proposals on equivalence were

⁵ Bank of England Speech given by Sir Jon Cunliffe 11 February 2020. Available [here](#).

⁶ Slides for Internal EU27 preparatory discussions on the future relation: "Personal data protection (adequacy decisions); Cooperation and equivalence in financial services" January 2020: available [here](#).

unacceptable as they would severely limit the EU's regulatory and decision-taking autonomy and make it easy to continue to run EU businesses from the UK, with minimal operations and staff in EU member states. In an earlier [speech](#) in February 2020, Mr Barnier warned that equivalence decisions would never be global or permanent and that they were, and would remain, unilateral decisions. He rejected the idea that these determinations would be subject to joint management with the UK.

There are, therefore, two possible scenarios where equivalence determinations may need to be made. Firstly, in the event of no deal being agreed, the EU may make determinations under the existing equivalence framework. Secondly, in the event of a limited agreement being reached, that agreement may include a modified equivalence framework, which might involve consultation on the withdrawal of equivalence determinations and thereby afford due consideration to the needs of business and customers for sufficient time to adapt to change. In either scenario, there is a need for equivalence determinations to be in place by the end of the transition period or for temporary arrangements to be put in place while they are finalised after exit. In the absence of final determinations or temporary arrangements, there is a "hiatus risk" whereby both UK and EU-based firms may find themselves subject to highly disruptive lapses in capital and regulatory reliefs, new regulatory requirements or lost cross-border rights.



4. Sectoral Analysis

In light of the increasing possibility of no agreement being reached in respect of financial services before the end of the transition period, and the fact that the equivalence framework is not comprehensive and will impact different sectors in different ways, our partners have examined in the below papers the relevance of equivalence and the potential impacts on various sectors of no deal or a limited deal.

Click on the links below to access our sectoral papers summarising the expected legal impacts on the various sectors in the event that there is no agreement on financial services by year end.

[Banking](#)

[Derivatives
Clearing](#)

[Fintech and
Payments](#)

[Insurance](#)

[Investment
Firms](#)

[Investment
Funds](#)

To discuss any of the information in these notes in further detail, please get in touch with any of the partners listed in the sectoral papers and at the end of this paper.

From an Irish perspective, cognisant of the need to protect the €85 billion worth of trade between Ireland and the UK, various government departments have been tasked with examining what legislation needs to be passed before the end of the transition period. A new Brexit Omnibus Bill, supplementing legislation published in February 2019, is being drafted to address the potential consequences of the UK leaving without an agreement and to minimise insofar as possible disruption in various sectors including financial services. The Irish Government published its Brexit Readiness **Action Plan** on 9 September 2020, noting in relation to financial services:

“The risks to financial stability, the financial services sector, and consumers of financial services are considered to be relatively low as a result of extensive preparations already undertaken. Some level of market disruption will be unavoidable, but the financial system as a whole is expected to be sufficiently resilient to withstand it.”

It is perhaps too early to say whether any potential reliance on the EU equivalence framework or modified equivalence agreement could bring positive, negative or neutral consequences from an Irish perspective. Many firms have already moved to establish or expand their presence in Ireland as a means of ensuring continued access to EU markets and this trend may continue as the outcome of the negotiations becomes clearer and as shortcomings in any equivalence regime become manifest. Ireland presents an attractive relocation or expansion location, offering a similar cultural and economic landscape to the UK and being one of the only English-speaking members of the EU. Although conjectural at present, possible future disruptions to the ability to outsource or delegate to third countries in some sectors may impact on the ability of Irish entities outsourcing to UK operations, with the EU insisting on more activity taking place physically within the EU. The flipside is that increased substance requirements within the EU could mean more jobs for Ireland, which certainly has the highly educated workforce to meet any potential demand.

Since the Brexit referendum in June 2016, the recurring mantra for businesses has been “hope for the best, prepare for the worst”. It could not have been anticipated that businesses would also be in the midst of handling the challenges of a global pandemic when the time would come. With less than three months to the expiration of the transition period and the negotiators repeatedly reporting “little progress”, our view continues to be that while the best outcome for all businesses continues to be for a deal to be reached, the risk of a no-deal Brexit on 1 January 2021 remains high and preparation for this scenario continues to be advised. Preparations should account for the fact that equivalence will not offer a solution to cover all aspects of a financial services firm’s business.

If you would like to discuss or review your current Brexit plans, or indeed to follow up on any of the matters discussed in this paper, please contact one of our partners listed below.

8 October 2020

Further Brexit-related updates, articles and briefing notes may be accessed on our **Brexit Forum**.

5. Looking Ahead: Our View

At the time of writing, it would appear that there may be three possible outcomes to the negotiations, with varying prospects of materialising: a full FTA incorporating financial services provisions; an agreement in principle (possibly even on a sector by sector basis) with further details to be agreed; or no agreement necessitating reliance on WTO rules and the current equivalence framework. Equivalence may play a role in the latter two scenarios with respect to certain aspects of EU-UK financial services, although possibly a modified form of equivalence in the event that a limited agreement is reached.

However, for the reasons outlined above, equivalence as it currently operates does not offer a sustainable, stable, long-term basis for the future financial services relationship. Indeed, while the Commission recently granted temporary equivalence to UK central counterparties for a period of 18 months post-transition in the interests of financial stability, the Commission has already confirmed that it will not adopt an equivalence decision in respect of MiFID in the “short or medium term”.⁷ As noted by EU Commissioner-designate for Financial Services and Stability, Mairead McGuinness, at her recent European Parliament confirmation hearing, “Under all circumstances, deal or no deal, trading in financial services will be different and less fluid as of the first of January next year”. Financial services firms need to revisit their “hard Brexit” contingency plans and ensure that they have measures in place to address the loss of access to EU markets arising from the UK’s withdrawal. Firms should consider the Commission’s over 100 sector-specific stakeholder **readiness notices** setting out what various sectors need to be aware of in preparation for the end of the transition period.

⁷ Getting ready for changes Communication on readiness at the end of the transition period between the European Union and the United Kingdom: available [here](#).

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About Matheson

Matheson's primary focus is on serving the Irish legal needs of internationally focused companies and financial institutions doing business in and from Ireland. Our clients include the majority of the Fortune 100 companies. We also advise over half of the world's 50 largest banks and 7 of the world's largest asset managers. We are headquartered in Dublin and also have offices in Cork, London, New York, San Francisco and Palo Alto. More than 740 people work across our six offices, including 96 partners and tax principals and over 515 legal and tax professionals.

Our expertise is spread across more than 30 practice groups, including Finance and Capital Markets, Corporate, International Business, Mergers and Acquisitions, Technology and Innovation, Digital Services, Intellectual Property, Insolvency and Corporate Restructuring, EU and Competition, Asset Management and Investment Funds, Employment, Pensions and Benefits, Commercial Real Estate, Litigation and Dispute Resolution, Healthcare, Insurance, Tax, Private Client, Energy and Infrastructure, FinTech and Life Sciences. We work collaboratively across all areas, reinforcing a client first ethos among our people, and our broad and interconnected spread of industry and sectoral expertise allows us to provide the full range of legal advice and services to our clients.

Matheson and Financial Services

At Matheson, we work with many of the world's leading financial institutions, including the leading global insurers and almost one third of Irish domiciled investment funds.

We are ideally placed to advise your business, whatever the challenge. Financial institutions operate in a dynamic and rapidly-changing environment. Our team can help guide you through an increasingly complex regulatory landscape. To keep pace, financial institutions need timely and accurate legal advice from a broad range of dedicated experts. Our Financial Services team has extensive industry sector knowledge and so can offer the best value for clients.

The size of our firm and quality of our lawyers allows our team to consider issues across a number of key areas, helping businesses approach issues in a commercial and effective manner. The Financial Services team draws on the expertise of a number of key practice groups throughout the firm including asset management, finance and capital markets, fintech, insurance, mergers and acquisitions, regulatory investigations, risk management, tax and technology. The wide ranging experience on offer at Matheson means our clients are provided with end-to-end solutions for their commercial needs. [Read more.](#)

Our Brexit Forum

We have extensive experience advising clients on their Brexit preparedness. You can contact our Brexit Advisory Group [here](#). You can also access current news and insights across a variety of sectors on our [Brexit Forum](#), which features webinars, blogs and briefing notes addressing the implications of the UK's withdrawal from the EU for our clients.

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