Brexit, Financial Services, and Equivalence

John Armour
University of Oxford
john.armour@law.ox.ac.uk
UK and EU financial services

Overall: 35% of wholesale financial services

Sources: ECB, PRA, The CityUK
UK as wholesale market hub

“The bringing together of investment banking with asset management is the core of the concentration of activity we have in the UK.”

Katharine Braddick, Director of Financial Services, HM Treasury, evidence to HL SCEU Financial Affairs Sub-Committee, 19 Oct 2016

Why?

- UK financial system traditionally more market-oriented (Carlin and Mayer, 2003; Rajan and Zingales, 2003)
- Agglomeration effects (human capital, netting, regulatory capacity)

Importance for the EU27?

- EU27 are ‘over-banked’ (Langfield and Pagano, 2015)
- Flagship Capital Markets Union programme seeks to develop EU capital markets (European Commission, 2015)
EU financial services ‘passport’

- Single rule-book
  - Written by European Supervisory Authorities, Enforced nationally
- Approval only necessary once, at “home” jurisdiction
  ⇒ “passport” to provide services throughout EU
Third country (3C) financial services: basic position

- Decentralisation: every country for itself
  - No EU financial services passport
  - WTO GATS carve-out for domestic financial regulation

⇒ Firms must seek authorisation in each state where want to do business
  - MS must not discriminate in favour of 3C firms (authorisation threshold must be ≥ EU rules)
  - But nothing stops MS discriminating against 3C firms
Post-crisis regulation

• Post-crisis, intensity of financial regulation ↑
  • Compliance costs of decentralised regime increasing
  • Concerns about systemic risk, reciprocity

• G20 coordination – Financial Stability Board (FSB)
  • Push to convergence in international financial regulation
  • Implementation monitoring by FSB

EU ‘3C equivalence’ concept

• Response to increased *intensity* and reduced *variation* in financial regulation
  ⇒ Centralised ‘equivalence’ assessment is easier to implement and of greater utility than before
  ⇒ Trend has been to build in ‘3C equivalence’ frameworks to EU finreg since c 2009

• Three general points
  1. Not a general framework, a lattice of specifics
  2. Scope, goals, determination process differ *inter se*
  3. A moving target....
| Source: European Commission (updated 29.09.2016) |
**3CE: scope**

- Many 3CE regimes are about *supervisory coordination*
  - Recognising 3C supervisors as part of a supervisory college
  - Facilitate oversight and reduction of systemic risk in SIFIs

- Others are about *market access*
  - Prudential equivalence: EU firms may use 3CE firm’s services consistently with EU prudential regulation (eg CCPs)
  - 3C passport: 3C-authorised firms may passport local authorisation into EU
### 3CE: scope (2)

<table>
<thead>
<tr>
<th>Sub-sector</th>
<th>Legislation</th>
<th>Supervisory coordination</th>
<th>Market access</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>Prospectus Directive, UCITS V, MiFID II, etc</td>
<td>No</td>
<td>Some (Prospectuses)**</td>
</tr>
<tr>
<td>Insurance</td>
<td>Solvency II</td>
<td>Yes</td>
<td>Some (reinsurance)</td>
</tr>
<tr>
<td>Commercial Banking</td>
<td>CRD IV</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Asset Management (professional clients)</td>
<td>AIFMD*</td>
<td>Yes</td>
<td>(Yes)</td>
</tr>
<tr>
<td>Wholesale markets</td>
<td>MiFIR*, EMIR, CSDR*, SFTR*, Benchmarks*, CRAs</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Not yet in force or no determinations yet made

** New regime to be introduced under revised Prospectus Directive
## MiFIR: 3C Passport Scope

<table>
<thead>
<tr>
<th>Activity</th>
<th>Covered</th>
<th>Not covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brokerage</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Prime brokerage lending (ancillary)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Underwriting</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Market making</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Structured finance</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>M&amp;A advisory</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Proprietary trading</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Commercial lending</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>M&amp;A lending (not ancillary)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>M&amp;A securities</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
3CE: process

Country-level requirements

- Commission: ‘equivalence’ determination
- Cooperation agreement: NCAs / ESAs

Firm-level requirements
**3CE: process**

**Commission** must determine

1. Equivalent **substantive rules** (likely advised by ESAs)
2. Effective **supervisory framework**
3. (in some cases) **Compliance**
4. (in a few cases) **Reciprocity**

(In many cases) must also be **cooperation** agreement between ESA and 3C NCA.

**Discretionary:** No right to a determination

**Reversible:** Determination can be revoked
Which countries are equivalent?

**Banking**
- Japan
- South Korea
- Switzerland
- China
- India
- Australia
- Brazil
- Canada
- USA

**Insurance**
- Canada
- Japan
- Mexico
- Switzerland
- USA

**Wholesale mkts**
- Saudi Arabia
- South Africa
- Korea
- China
- Switzerland
- USA
# 3CE process: key considerations

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Issues</th>
</tr>
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<tbody>
<tr>
<td>Politicisation</td>
<td>Much discussed, likely overblown. Commission (advised by ESMA) makes decision, not Parliament. Technocratic decision-making is what the EU stands for. Long list of existing determinations makes it hard to find UK not equivalent.</td>
</tr>
<tr>
<td>Delay</td>
<td>Less discussed, but more serious. Time to <em>first</em> EMIR determination from implementation: 2 years. Commission’s discretion when to start (3C has no entitlement). MiFIR not implemented until 1 Jan 2018...</td>
</tr>
<tr>
<td>Dynamism</td>
<td>Need to ensure continued equivalence. Some mechanism for automatic implementation of EU measures. Twin track regime?</td>
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<tr>
<td>Reversability</td>
<td>Credibility of UK’s dynamic commitment to equivalence is key, or firms will not be willing to invest.</td>
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## Outlook

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
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<tbody>
<tr>
<td>3CE frameworks ‘fit’ UK’s comparative strength (EU27’s comparative weakness) in wholesale markets</td>
<td>Banking is not covered. US banks likely to have limited rationale for UK base</td>
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<tr>
<td>EU will struggle to replicate UK contribution quickly (agglomeration effects)</td>
<td>US may seek to compete directly as 3C. (Would need adjustment to US rules to permit reciprocity)</td>
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<td>UK will be equivalent on exit</td>
<td>Need to maintain dynamic equivalence</td>
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<td>3CE determination is technocratic</td>
<td>Hard to complete by 2019</td>
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<td>FSB provides opportunities to maintain influence on finreg agenda</td>
<td>Trump regime hostile to FSB</td>
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