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Memorandum of understanding on financial services: A stepping stone to ensuring equivalence?

The current negotiations on financial services regulation between the UK and the EU is the talk of the town on both sides of the Channel. A 'memorandum of understanding' (MoU) due to be agreed by the end of March has been met with some excitement. However, it seems it may be worth tempering expectations of what this may achieve in terms of widening EU access for UK firms, certainly as far as any immediate equivalence determinations go.

As of 1 January 2021, UK financial services firms are no longer able to provide their services on a cross-border basis in reliance on EU passporting mechanisms. In anticipation of this, most larger firms reorganised their operations in a manner enabling them to continue to service both their EU and UK clients relatively seamlessly. Nevertheless, significant efficiencies for clients and market participants may be gained by allowing a more open provision of services and trading to take place on the basis of equivalence.

The MoU may be a stepping stone in the direction of equivalence, but no concrete proposals as to specific equivalence determinations will result from it.

So what will the MoU actually achieve?

Further to a Joint Declaration on Financial Services Regulatory Cooperation[1] between the EU and the UK, the parties agreed *'to establish structured regulatory cooperation on financial services, with the aim of establishing a durable and stable relationship between autonomous jurisdictions'*. The intention is to preserve financial stability, market integrity and the protection of investors and consumers.

The arrangements will include bilateral exchanges of views and analysis on regulatory initiatives; transparency and dialogue in the process of adoption, suspension and withdrawal of equivalence decisions; and enhanced cooperation and coordination. The MoU should establish ***a framework for cooperation*** and allow the parties to discuss how to move forward with equivalence, but any actual equivalence determinations (and withdrawals) will only result from separate unilateral and autonomous decision-making processes on each side.

Little is, therefore, expected in the way of tangible outcomes for investment firms and market participants, and any arrangements provided by the MoU would likely be informal in nature and not carry any strict legal obligations.

In addition, it is worth noting that whilst some commentators in mainstream media appear to think of equivalence as a complete solution to allowing the UK access to EU markets and investors, and vice versa, on an ongoing basis, this is of course not entirely correct. The EU's equivalence regime is a patchwork covering a number of different regulatory requirements, but it does not cover all areas. Nevertheless, it would certainly be helpful in some.

What is holding up the equivalence determinations?

On the basis that the UK has largely 'onshored' EU financial services regulation, it would be appropriate to say that no other jurisdiction in the world has a more equivalent regime to that of the EU than the UK currently does.

EU legislation speaks of the need for a 'comparable level of protection to clients in the Union receiving services by third-country firms' and the requirement to 'monitor any significant changes to the regulatory and supervisory framework of the third country and review the equivalence decisions where appropriate'.

[1] https://ec.europa.eu/info/sites/info/files/brexit_files/info_site/com_2020_855_final_annexe3_v1.pdf

In line with this, the EU has deemed comparability sufficient in relation to jurisdictions including Australia, Brazil, Canada, Singapore and the US. However, EU concerns relating to the UK seem to go well beyond questions of technical equivalence or comparability, with ***political motivations playing a significant part***.

The EU has asked for information on the UK's intentions for future financial services regulation and has argued it must better understand how the UK intends to make changes going forward before they will make decisions on equivalence. This is causing concern in UK quarters – surely the EU would not expect the UK's rules to remain the same indefinitely?

The Governor of the Bank of England, Andrew Bailey, has noted that *'[t]his is a standard that the EU holds no other country to and would, I suspect, not agree to be held to itself'*[2]. He accepts that one interpretation of the EU's position is indeed that the rules should not change in the future, and that any change would be unwelcome. However, Bailey was quick to dismiss this argument as unrealistic, dangerous and inconsistent with practice, as clearly regulation must change to accommodate changes in the world around us. Bailey also noted a second argument that UK rules should not change independently of those in the EU, but *'that is rule-taking pure and simple'* which he would not consider acceptable in a UK context and, indeed, has not been the test up to now to assess equivalence.

In January, Bailey told a Treasury committee[3] that a sensible reason for the request may be that *'…both of us will change our rules when it is sensible to do so. We are both transparent about it, but obviously we would be transparent at the time. We are transparent to everybody; that is nothing unique. That seems a sensible basis to me, and that is the basis for judging equivalence.'*

However sensible that approach might be, it seems the EU is leaning more towards a 'rule taking' regime at this stage of the negotiations. The key question is whether the parties can eventually arrive together at a place where they are comfortable that they will have sufficient notice and understanding of any upcoming rule changes to be able to reassess equivalence whenever necessary in future, together with reassurance as to the parties' intention to stay in line with global developments.

The latter has already been dealt with, as the parties agreed to *'make their best endeavours to ensure that internationally agreed standards in the financial services sector for regulation and supervision, for the fight against money laundering and terrorist financing and for the fight against tax evasion and avoidance, are implemented and applied in their territory'* as part of the EU-UK Trade and Cooperation Agreement[4].

An approach combining this 'best endeavours' standard with enhanced transparency and cooperation under the MoU would go beyond what the EU already finds appropriate when dealing with equivalence determinations in other jurisdictions. No one is expecting the EU to do the UK any favours, but political motivations, protectionist policies and geographical proximity would seem to make decisions related to the EU's closest financial market and powerful competitor particularly difficult at this stage.

Impacts of the lack of equivalence

Recently we have seen some specific headlines detailing the effect of a lack of equivalence determinations on UK and EU markets and investors, such as Amsterdam overtaking London as Europe's top share trading centre, although the impact would in practice seem mostly symbolic. Whilst some trading has moved to the EU, and EU clients are to a greater extent being served directly from an EU base, most traders, investment managers and brokers are still at their desks in London.

Another example of the impact of a lack of equivalence is the (presumably) unintended effect of shifting parts of the interest rate swaps market away from both London and the EU to US swap execution facilities (SEFs) regarded as equivalent under both the EU and the UK regimes.

Further equivalence considerations are set out in more detail below.

Equivalence in the context of share trading

The EU Markets in Financial Instruments Regulation (MiFIR) requires investment firms trading in shares admitted to trading or traded on an EU trading venue to undertake trades on EU trading venues, or through an EU systematic internaliser, or on a third-country venue determined to be equivalent. There are certain, limited, exemptions from this rule - in particular, if trading is non-systematic, ad hoc, irregular and infrequent.

[2] The case for an open financial system - speech by Andrew Bailey: https://www.bankofengland.co.uk/speech/2021/february/andrew-bailey-mansion-house
[3] Treasury Committee, 6 January 2021: https://committees.parliament.uk/oralevidence/1473/pdf/
[4] Article SERVIN.5.41: International standards: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/948119/EU-UK_Trade_and_Cooperation_Agreement_24.12.2020.pdf

Post-Brexit, UK venues are no longer capable of fulfilling the EU requirement in euro denominated shares pending an equivalence decision. This means that anyone subject to the EU rules would be unable to access liquidity in such shares directly on UK venues.

UK investment firms are subject to a share trading obligation almost identical to the one under the EU regime under the UK onshored version of MiFIR, with a couple of important differences:

- it applies to shares admitted to trading or traded on a UK trading venue; and
- to comply with the obligation, transactions must be undertaken on a UK trading venue or through a UK systematic internaliser or, alternatively on a third-country trading venue assessed as equivalent by the European Commission before exit day (i.e. Australia, Hong Kong and the US) or by HM Treasury on or after exit day.

However, the UK Financial Conduct Authority (FCA) has used its Temporary Transitional Power to allow firms to continue to trade all shares on EU trading venues and systematic internalisers where the regulatory status of those venues and systematic internalisers permits the activity[5].

This is intended to preserve UK firms' ability to execute trades at the venues where they get the best outcomes for themselves and their clients. UK participants can, therefore, continue to access EU venues for share trading, provided the venue has the relevant permissions under either the UK's overseas access regime or the temporary permissions regime (TPR).

Unfortunately, this position has not been reciprocated on an EU level. The EU's approach to minimising overlapping UK and EU share trading obligations is rather more complex with the European Securities and Markets Authority (ESMA) taking the following approach[6]:

- assuming as a starting point that all EEA shares, i.e., ISINs starting with a country code corresponding to an EEA Member State, are within the scope of the EU share trading obligation;
- providing for GB ISINs to be outside the scope of the EU share trading obligation; and
- providing that EEA shares traded on UK trading venues in GBP will not be subject to the share trading obligation.

The final point is aimed at addressing the specific situation of a small number of EU issuers whose shares are primarily traded on UK trading venues in GBP, which ESMA regards as non-systematic, ad-hoc, irregular and infrequent.

The FCA has been openly critical of this approach, maintaining that neither the ISIN nor the currency should determine the scope of the share trading obligation.

> The FCA stated that: *'Any restriction on the trading of shares based on currency does not reflect the multicurrency nature of global capital markets and limits the ability of firms to determine how best to use global capital markets to support economic activity. It will cause disruption to investors, issuers and other market participants, leading to fragmentation of markets and liquidity in both the EU and UK.'*

Clearly, the UK view is that equivalence would be the right approach on both sides of the Channel, as evident in the words of Nausicaa Delfas, Executive Director of International at the FCA when she stated that: *'At the end of the transition period, the UK's and EU's regimes will be the most equivalent in the world, but as it stands this has not been recognised by the EU.'*[7]

However, despite arguments that a lack of equivalence is likely to damage market liquidity in affected shares to no good end, the EU so far seem unconvinced of the need for it and may instead prefer to see liquidity being created within the EU.

Equivalence in the context of derivatives trading

EU MiFIR imposes a ***derivatives trading obligation***, which applies to financial counterparties and non-financial counterparties over certain clearing thresholds (NFC+), as well as transactions between such counterparties and third-country financial institutions or other entities that would be subject to the clearing obligation if they were established in the EU. Such counterparties must trade derivatives subject to the trading obligation only on EU trading venues or third-country venues determined to be equivalent.

A similar obligation applies under the onshored UK MiFIR, with the key difference being that trading must take place on a UK trading venue or a third-country trading venue assessed as equivalent by the European Commission before exit day (i.e. Singapore and the US) or by HM Treasury on or after exit day.

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[5] FCA transitional direction for the share trading obligation: https://www.fca.org.uk/publication/handbook/sto-transitional-direction-dec20.pdf
[6] ESMA's Public Statement: https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-final-position-share-trading-obligation-0
[7] FCA sets out its approach to the share trading obligation: https://www.fca.org.uk/news/press-releases/fca-sets-out-its-approach-share-trading-obligation

The obligations under the two regimes are essentially equivalent, so there would not seem to be any technical reasons for withholding equivalence. However, the EU has so far been unwilling to grant equivalence.

Without mutual equivalence, some firms are caught in a conflict between the EU and UK requirements. In the UK, the FCA has used its Temporary Transitional Power[8] to modify the application of the UK derivatives trading obligation so that where firms subject to the UK requirement trade with, or on behalf of, EU clients subject to the EU requirement, they will be able to transact or execute those trades on EU venues provided that:

- they take reasonable steps to be satisfied the client does not have arrangements in place to execute the trade on a trading venue to which both the UK and EU have granted equivalence; and
- the EU venue has the necessary regulatory status to do business in the UK.

This relief applies to UK firms, EU firms using the TPR, and branches of overseas firms in the UK, but does not extend to trades with non-EU clients, proprietary trading (e.g. conducted to hedge a firm's own risk exposure) or trades between UK branches of EU firms.

Although the approach is aimed at supporting firms based in the UK to continue to do a range of international business and serve their global clients, the relief is narrow in scope and parties cannot rely on it where they are able to trade on a US SEF instead. The FCA has noted that it will consider by 31 March 2021 whether market or regulatory developments warrant a review of the approach.

The EU has so far not granted equivalence, with ESMA considering that the continued application of the EU derivatives trading obligation would not create risks to the stability of the financial system and stating that it '*acknowledges that this approach creates challenges for some EU counterparties particularly UK branches of EU investment firms. However, ESMA considers that EU counterparties can meet their obligations under the DTO by trading on EU trading venues or eligible trading venues in third countries*'[9].

In addition, the absence of an ***EU equivalence determination for UK regulated markets*** under Article 2a of the EU European Market Infrastructure Regulation (EMIR) is impacting EU market participants' ability to access liquid UK markets for investment and risk mitigation purposes.

A wide range of exchange-traded derivatives (ETDs) used for risk-management purposes by investors and corporate end-users are traded on UK regulated markets. In many cases, there may be no direct substitute or sufficient liquidity on EU or third-country markets.

Without equivalence, derivatives traded on third-country markets are treated as "OTC derivatives" under EU EMIR, which now includes derivatives traded on UK regulated markets. This could impact the regulatory classification of counterparties, with small financial counterparties and non-financial counterparties trading on UK markets becoming more likely to exceed the clearing threshold and thereby becoming financial counterparties or NFC+s.

A reclassification as an NFC+ carries material consequences under EMIR for an affected counterparty, including transactions being subject to mandatory clearing, stringent risk mitigation requirements for OTC transactions (such as bilateral margin requirements) and an inability to rely on financial counterparties for the reporting of OTC derivatives transactions. A reclassification as a financial counterparty would also result in transactions becoming subject to mandatory clearing.

In addition, trading with third-country counterparties is affected, as EU parties must consider which obligations apply to a contract based on the classification of their third-country counterparties as if they were established in the EU. The need for dual classifications and different calculations under the UK and EU frameworks may deter such parties from trading with each other.

The costs and regulatory burdens associated with a reclassification may translate into some entities needing to restrict their trading on UK regulated markets, potentially placing them at a disadvantage with respect to their ability to hedge their risks in the most cost-effective manner. Any impact on corporate end-users could in turn impact the real economy, such as costs of gas or power.

[8] FCA Transitional direction for the derivatives trading obligation: https://www.fca.org.uk/publication/handbook/direction-derivatives-trading-obligation.pdf
[9] https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-its-final-view-derivatives-trading-obligation-dto

In the UK, HM Treasury has granted equivalence for the purposes of Article 2a of the onshored UK EMIR, which enables UK firms to continue to treat derivatives traded on EEA regulated markets as ETDs rather than OTC derivatives and minimises the disruption they would otherwise experience[10]. Market participants are keen to ensure similar treatment under EU EMIR.

Equivalence in the context of clearing

Clearing and access to central counterparties (CCPs) is one area where equivalence and CCP recognition decisions have been forthcoming from both sides of the Channel.

ESMA published a time-limited equivalence decision in respect of the UK's legal and regulatory supervision regime of UK CCPs in September 2020[11], which was followed by the announcement that it would grant temporary third-country recognition to three UK CCPs from 1 January 2021[12] under EMIR. The recognition of these CCPs (ICE Clear Europe Limited, LCH Limited and LME Clear Limited) means that EU clearing members can continue to access their services, whilst the CCPs can continue to provide their services in the EU. The temporary equivalence and recognition decisions expire on 30 June 2022.

In the UK, HM Treasury has granted equivalence to CCPs established in EEA states, and a Temporary Recognition Regime (TRR) came into effect at the end of the transition period lasting, initially, three years[13]. It allows eligible non-UK CCPs to continue to provide clearing services in the UK before recognition is granted, provided they continue to be eligible for the TRR. In addition, a 'CCP run-off regime' allows certain non-UK CCPs time-limited recognition to continue to offer clearing services, giving UK firms time to close out contracts in an orderly manner in the event that an eligible non-UK CCP did not enter the TRR. The Bank of England can also determine a run-off period for non-UK CCPs that entered the TRR, but then exit it without being granted recognition.

However, despite these arrangements, there are concerns that the EU's decisions are simply intended to allow clearing members enough time to move positions from the UK to the EU. In particular, Brussels seems to be moving towards a position where ***euro-denominated derivatives clearing may be required to take place within the eurozone***.

Andrew Bailey has spoken recently about the pressures on EU banks to shift clearing of euro-denominated derivatives from London to the EU. In particular, he believes that the EU should not be targeting clearing of positions that are not held by EU counterparties, which would go well beyond the equivalence debate, and that the answer to EU concerns about financial services being provided outside the EU should be '*competition not protectionism*'. Whilst it remains to be seen whether the EU can be convinced of that approach, Bailey has labelled the suggestions relating to the wholescale move of euro clearing to the EU pursuant to a 'location policy' '*highly controversial and … something we would have to and want to resist very firmly*'[14].

Overall equivalence considerations

This briefing has only touched on a few areas relevant to equivalence decisions, whilst recognising that there are many more. However, the overall theme emerging is that politics will play a significant part in any equivalence determination and that the parties are coming to the negotiation table with widely different views.

The MoU seems unlikely to provide more than a framework for further discussion and cooperation, whilst wider agendas continue to distract from technical assessments of equivalence.

This leads to an unpredictability which may mean that, rather than hold out for equivalence, markets will need to continue to adapt. The question may then become whether there comes a point where equivalence no longer becomes essential or even desirable.

[10] Policy paper, HM Treasury equivalence decisions for the EEA States – 9 November 2020: https://www.gov.uk/government/publications/hm-treasury-equivalence-decisions-for-the-eea-states-9-november-2020/hm-treasury-equivalence-decisions-for-the-eea-states-9-november-2020
[11] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020D1308&from=EN
[12] https://www.esma.europa.eu/press-news/esma-news/esma-recognise-three-uk-ccps-1-january-2021
[13] Policy paper, HM Treasury equivalence decisions for the EEA States – 9 November 2020 (see footnote 9)
[14] Treasury Committee, 24 February 2021: https://parliamentlive.tv/event/index/5bd1da84-6a3b-456e-81cb-dd4d946173ed

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