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Brexit, the EU and Its Investment Banker: Rethinking 'Equivalence' for the EU Capital Market

Niamh Moloney*

Abstract: The EU/UK negotiations on Brexit are now imminent following the formal notification by Prime Minister May of the UK's intention to leave the EU in the 'Article 50 letter' delivered to European Council President Tusk on 29 March 2017. The treatment of financial services will be a critical element of these negotiations. Prime Minister May had previously indicated in her 17 January 2017 speech on the UK's negotiating objectives that the UK is to leave the single market and confirmed this position in the Article 50 letter. Under current EU financial law the UK will accordingly become a 'third country' on Brexit. UK financial firms and actors will lose the ability to 'passport' into the single market in financial services from the UK – unless passporting rights are preserved under any new EU/UK arrangement, an outcome which is highly unlikely. This paper considers the risks to the EU from its oft-described 'investment banker' becoming a third country and explores the regulatory remedies which may be available and the preferences which may shape these remedies.

The paper adopts a legal-institutionalist perspective, which draws on the insights of comparative/international political economy, to examine the implications of the UK's future status as a 'third country' for the EU capital market and for its current flagship Capital Markets Union (CMU) agenda. The extent to which EU regulation is transformative is contested in relation to the development of the EU capital market. But the EU regulatory regime which governs third country access to the EU capital market is likely to be a significant determinant of the strength of the EU's capacity to absorb the loss of the UK from the single EU capital market and to contain related stability, liquidity, and efficiency risks. Drawing on international experience with access arrangements and on EU preferences and incentives, the paper considers the likely future of the current third country regime and how it might be re-configured so that third country access is based on a more secure footing.

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1. INTRODUCTION: CAPITAL MARKETS UNION, REGULATION, AND THIRD COUNTRIES

The passage through the UK Parliament of the Withdrawal from the European Union (Article 50) Bill 2016-17 on 13 March 2017 opened the way to the formal notification by the UK of its intention to withdraw from the EU under Article 50 of the Treaty on European Union. This notification followed on 29 March 2017 with Prime Minister May's 'Article 50 letter' to European Council President Tusk. After a period of intense discussion and speculation on the potential treatment of financial services,[1] an area of acute importance to the UK and to the EU 27, negotiations can get underway. But although the 23 June 2016 Brexit decision is already having an impact on the City of London and on UK financial regulation policy,[2] details on how a new EU/UK settlement on financial services might be configured are in short supply. Prime Minister May's 17 January 2017 speech on the UK's negotiating objectives[3] clarified that the UK will not seek membership of the single market or the European Economic Area. Since then, the government's 2 February 2017 White Paper on Brexit called for 'the freest possible trade in financial services between the UK and EU Member States.'[4] But the speech and the White Paper were very short on specifics. Prime Minister May's speech referred generally to seeking the 'greatest possible access' to the single market through a new Free Trade Agreement which could, in certain areas including financial services, 'take in elements of current single market arrangements.' The Prime Minister also noted the possibility of a 'phased implementation period', suggesting that a transitional arrangement of some form was likely to be sought. The White Paper relegated financial services to four short paragraphs which set out vague aspirations as to continued market access and cooperation. The 29 March Article 50 letter, while economical, is more revealing. Reflecting earlier indications, it confirms that the UK

[1] From the many reports see, for an EU perspective, European Parliament, Economic and Monetary Affairs Committee, Potential Concepts for the Future EU-UK Relationship in Financial Services, Study for the ECON Committee by C Gortsos (IP/A/ECON-2016-20) (2017) and, for a UK perspective, House of Lords, European Union Committee, 9th Report of Session 2016 2017, Brexit: Financial Services (2016).

[2] One early casualty of the Brexit decision has been the proposed merger between the London Stock Exchange Group and Deutsche Börse. The deal came close to collapse in February 2017 following a request from the Commission that the London Stock Exchange divest one its trading platforms, but Brexit-related opposition in Germany and the UK has also been associated with the difficulties: P Stafford, R Toplensky, and J Shotter, 'LSE Blamed as Deutsche Börse Tie-up Hits Rocks,' Financial Times, 28 February 2017. The deal was subsequently blocked by the Commission. From a policy perspective, the February 2017 review by the UK Financial Conduct Authority of the rules which apply to initial public offerings (FCA, Reforming the Availability of Information in the UK Equity IPO Process, Consultation Paper 17/5 (2017)) has been associated with efforts to reinforce the attractiveness of the UK capital market.

[3] 'The Government's Negotiating Objectives for Exiting the EU', 17 January 2017, available via https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech.

[4] Department for Exiting the EU, The United Kingdom's Exit From and New Partnership with the European Union (Cm 9417), February 2017, para 8.25.

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is to leave the single market and proposes implementation periods (generally). But it expressly references financial services, one of the few industries to be specified in the letter, and calls for financial services to be covered in a 'bold and ambitious' Free Trade Agreement. Most significantly, it notes that the UK and the EU have regulatory frameworks (generally) that already match and that the negotiations should accordingly prioritise how the evolution of regulatory frameworks is to be managed and how disputes are to be resolved. The letter accordingly identifies two key issues for financial services access which have been debated since the Brexit referendum: dispute resolution and the role of the Court of Justice; and how, given the likelihood of future regulatory divergence between the UK and the EU, market access can be managed and mutual recognition of regulation assured - whether under a Free Trade Agreement which covers financial services access or in relation to the EU's current 'equivalence rules' which govern access to the EU financial market.

Whether or not the UK will succeed in negotiating a Free Trade Agreement with a bespoke financial market access arrangement which addresses these two pivotal and complex issues is not, given the different EU and UK incentives and preferences engaged, clear. It is, however, clear that, under current EU law, the UK will have 'third country' status in relation to the EU financial market when it leaves the EU. The 'equivalence' device, the regulatory technique which the EU uses to manage third country access to the EU financial market and to manage the extra-territorial application of EU financial regulation has therefore come to dominate the policy discourse; the importance of regulatory equivalence to market access arrangements is also implied in the Article 50 letter reference to the need to manage regulatory divergence in the proposed Free Trade Agreement. One leading UK regulator, Andrew Bailey – chief executive of the UK Financial Conduct Authority – has called for market access to be based on a new equivalence arrangement,[5] 'TheCityUk', a leading City lobbying group, has supported an equivalence-based access arrangement,[6] and a call has been made for an international consensus on the interpretation and measurement of equivalence.[7] An arcane regulatory device embedded in the entrails of EU financial legislation has come centre stage, as have potential functional substitutes for the current equivalence regime which could be used in a bespoke arrangement contained in a Free Trade Agreement. The equivalence issue, and the related management of UK access to the EU financial

[5] Speech by A Bailey, FCA Chief Executive, 'Free Trade in Financial Services and Global Regulatory Standards: friends not rivals', Economic Council Financial Markets Policy Conference, 26 January 2017.

[6] TheCityUK, Brexit and UK-based Financial and Related Professional Services (2017). The Financial Times has taken a similar position: Editorial, 'The City Sets Plausible Goals for Life after Brexit,' *Financial Times*, 14 January, 2017 and Editorial, 'Equivalence Makes Sense for the City and Europe', *Financial Times*, 28 February 2017.

[7] Financial Services Negotiation Forum and Norton Rose Fulbright, Examining Regulatory Equivalence, 12 January 2017 (2017 FSNF/Norton Rose Report).

market, is not solely of interest to the UK as it moves to third country status.[8] It is of signal importance to the EU and, in particular, to its current Capital Markets Union (CMU) agenda, as discussed below. Similarly, it is a bellwether of EU intentions in regard to the Brexit negotiations on capital market access. The late February 2017 publication by the Commission of a 'working document' which is designed somewhat modestly to 'provide a factual overview of third-country provisions,' but which can be read as signalling a potentially tough approach to UK/EU market access discussions, underlines the current political salience of the third country rules.[9] It is hard not to read the Commission's assertion that equivalence is 'not a vehicle for liberalizing international trade in financial services' but a mechanism for managing cross-border activity in a sound and secure prudential environment, and that 'equivalence decisions primarily benefit EU market participants',[10] as a shot across the bows to the UK and as an indication of intent in regard to any UK special pleading in relation to equivalence, whether under the current EU regime or in a bespoke Free Trade Agreement regime, as signalled by the Article 50 letter.

CMU is the current ambitious, primarily regulatory project to accelerate the construction of an EU capital market; embed market-based funding in the EU (or the raising of finance through market-based instruments rather than bank credit); and wean the EU from its dependence on bank-based funding.[11] Capital market regulation and capital market construction have long been at the intersection of several deeply embedded fault-lines which run underneath the single market. They are highly contested spheres of EU competence in relation to which different Member State preferences, shaped by diverging political interests and related varieties of capitalism and of financial system,[12] supranational and institutional

[8] For extensive assessment of the UK's position and the relevance of the equivalence mechanism to post Brexit UK/EU relations, see E Ferran, The UK as a Third Country in EU Financial Services Regulation, University of Cambridge Faculty of Law Research Paper No 47/2016, available via https://ssrn.com/abstract=2845374, and J Armour, 'Brexit and Financial Services' 33 (Supp 1) *Oxford Review of Economic Policy* (2017) S54.

[9] Commission, EU Equivalence Decisions in Financial Services Policy: An Assessment (SWD (2017) 102) (2017) (2017 Commission Equivalence Report). Section five of this paper considers the signalling which can be implied from the Report.

[10] Ibid, 5.

[11] Set out in Commission, Action Plan on Building a Capital Markets Union (COM (2015) 468) (2015). For assessments see E Micheler, 'Building a Capital Markets Union: Improving the Market Infrastructure' 17 *European Business Organization Law Review* (2016) 481, and N Moloney, 'Capital Markets Union: Ever Closer Union for the EU Financial System?' 41(3) *European Law Review* (2016) 307.

[12] For a recent example see D Howarth and L Quaglia, 'Internationalized Banking, Alternative Banks, and the Single Supervisory Mechanism' 39(3) *West European Politics* (2016) 438.

interests,[13] and private sector interests,[14] have repeatedly clashed.[15] The form of capitalism which the EU should follow; the style of regulation which should encourage or control it; the location of regulatory intervention (EU or local; euro area or single market); the extent to which related risks should be mutualized across the Member States - all have been contested, often fiercely.[16] Capital market construction is still therefore something of a work-in-progress for the EU. If the CMU agenda succeeds in facilitating market-based funding and in diversifying funding sources, and can accommodate the competing preferences on capital market construction, it may strengthen significantly the EU's financial system and its ability to deliver growth. But success will also signal that the excision of the UK, the largest and most sophisticated financial centre in the EU, from the single market has been absorbed by the EU financial system and managed by its financial governance arrangements. Much depends thus on how the EU approaches the legal mechanisms governing access by the UK to the EU as third country - the equivalence device and the related application of third country rules.

The confluence of Brexit and CMU means that these legal mechanisms matter given their potentially transformative effects on the EU capital market. Regulation has long been a contested variable in EU financial governance. Whether or not EU regulation can have transformative, market-changing effects on market development, or is at best facilitative of evolutionary processes driven by political and market forces, has long been contested and from a range of perspectives.[17] But it is hard to disavow that regulation, in the form of the EU's current third country rules, will have a determinative impact on how the EU capital market will fare post Brexit. The UK's post Brexit regulatory characterization as a third country has (assuming the current EU third country access rules will apply to the UK) two sets of regulatory consequences which are likely to have spill-over effects for the CMU project and the EU capital market. The first concerns the 'external/access' consequences and relates to how the EU's current market access rules for third countries may shape the EU capital market. The second set of consequences relate to how the current 'export' rules of EU capital market regulation (the rules which

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[13] In relation to the new institutional preferences generated by the EU's Banking Union, eg, see R Epstein and M Rhodes, 'The Political Dynamics Behind Europe's New Banking Union' 39(3) *West European Politics* (2016) 415, and S de Rynck, 23(1) 'Banking on a Union: the Politics of Changing Eurozone Banking Supervision' 22 *Journal of European Public Policy* (2016) 119.

[14] On the preferences of the EU banking sector see L Quaglia, *The European Union and Global Financial Regulation* (OUP, 2014).

[15] As has been charted in a rich comparative political economy literature. See, eg, the collection of articles in 21(3) *Journal of European Public Policy* (2014).

[16] For a review see N Moloney, 'Financial Markets Regulation' in A Arnull and D Chalmers (eds), *Oxford Handbook of European Union Law* (OUP, 2014), and D Mügge, Financial Regulation in the European Union: A Research Agenda, Centre for European Studies, Harvard University, Open Forum CES Paper Series, 10 (2012).

[17] From a legal perspective see Moloney n 16, and E Ferran, *Building an EU Securities Market* (CUP, 2004); from a comparative political economy perspective see E Grossman and P Leblond, 'European Financial Integration: Finally the Great Leap Forward' 49 *Journal of Common Market Studies* (2011) 413, and I Hardie and D Howarth (eds), *Market-based Banking and the International Financial Crisis* (OUP, 2013).

impose qualifications and conditions on engagement by EU actors with third country actors[18]) will shape the EU capital market. The scale of these 'access' and 'export' consequences is likely to be a function of the extent to which, and for how long, UK financial governance (including regulation, supervision, and enforcement) can be legally characterized as 'equivalent' to EU governance in accordance with the relevant third country rules. The uncertainties and complexities associated with the access and export rules and with equivalence are manifold and cut across many vectors, including: substantive (what is 'equivalence'?); institutional (who makes the equivalence determination and resolves disputes?); procedural (how is dynamism, in the form of change to financial governance, managed?) and environmental (the interaction with WTO/GATS rules and the geo-political/market context).

These equivalence-related regulatory challenges are a function of the EU's distinct governance arrangements for financial markets. International financial governance has also been grappling with access and export issues, albeit to a much lesser extent. The major preoccupation of international financial governance for some time has been the adoption of standards by the International Standard Setting Bodies (ISSBs), such as the Financial Stability Board (FSB - which oversees standard-setting generally) and the International Organization of Securities Commissions (IOSCO - the ISSB for capital markets). These standards reflect international reform priorities, usually steered by the G20, and are typically geared to strengthening financial stability and to supporting cross-border supervisory cooperation and coordination. But international financial governance has recently begun to adopt a more operational posture and to address the difficulties generated where regulatory systems collide.[19] It may therefore offer lessons for the EU if it constructs a new channel for UK/EU financial market access, whether in a Free Trade Agreement or otherwise.

The third country rules which govern access to the EU capital market were until the Brexit referendum a relatively quiet corner of EU financial governance, although the third country regime is of relatively longstanding.[20] Arcane and technical though they may be, the confluence of Brexit and the CMU agenda has created a crucible within which these rules are likely to acquire stronger

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[18] These include the EU banking rules which apply a higher capital charge to EU banks in relation to certain loan assets where these originate outside the EU, unless the loans are located in a jurisdiction which is 'equivalent' to the EU. The Commission's 2017 report on equivalence is clear in the priority it attaches to the export dimension of equivalence, noting that while equivalence decisions may enhance the possibilities of doing business in the EU, the equivalence process is primarily directed to prudential regulatory purposes: 2017 Commission Equivalence Report, n 9, 5-6.

[19] N Moloney, 'International Financial Governance, the EU, and Brexit: the "Agencification" of EU Financial Governance and the Implications' 17 *European Business Organization Law Review* (2016) 451, and E Helleiner and S Pagliari 'The End of an Era in International Financial Regulation? A Post-Crisis Research Agenda' 65 *International Organization* (2011) 169.

[20] As of 2017, some 212 equivalence decisions had been adopted by the Commission and 32 jurisdictions assessed as equivalent in relation to at least one aspect of EU financial governance: 2017 Commission Equivalence Report, n 9, 10. The rules have, however, received attention from comparative political economists as they reveal how Member State preferences in relation to market access are formed (section three below).

transformative effects and to become lightning rods for the formation of preferences in relation to UK/EU relations, the open-ness of the EU capital market, and the desirability of the CMU agenda. This discussion accordingly probes the implications of Brexit for the EU capital market and for the CMU agenda through the lens of the EU's current third country regulatory requirements for access and export, in a comparative and international context. The analysis adopts a legal-institutionalist analysis of the third country rules and their effects. But any analysis of EU financial regulation almost inevitably calls for a mosaic approach, particularly where the governance area is contested, and law, politics, and different forms of economic organization are tightly inter-twined, as is the case with EU capital market regulation and its access and export rules. In probing how the EU's rules and institutional structures governing third countries operate and how they might be transformed in the Brexit crucible, this discussion is accordingly informed by the comparative/international political economy literature on the governance of international financial markets and on international financial relations, and on how EU preferences on market access are formed. It also draws on the extensive functional/empirical discussions on how the EU capital market may develop post Brexit.

After a contextual section two, section three considers the current regulatory requirements governing third country access to the EU capital market and their implications for CMU. Section four examines the evolution of equivalence-related techniques internationally for capital markets and how they might be relevant for the EU. Section five speculates as to how the EU's equivalence arrangements for third countries are likely to develop, including in the context of an EU/UK Free Trade Agreement. Section six concludes.

2. THE CONTEXT: THE UK AND CAPITAL MARKETS UNION - THE INVESTMENT BANKER TO THE EU 27

2.1 MARKET CONDITIONS

The CMU agenda is designed to strengthen the fund-raising capacity of the single EU capital market, to embed market-based finance, and to reduce the EU's dependence on bank funding. It seeks to improve access to finance for firms, to diversify sources of funding beyond the currently dominant bank funding channel, and to achieve a more efficient and effective EU capital market.[21] If CMU is achieved, its determinants will be many, complex, and interlocking - and they will extend beyond the liberalizing and regulatory reforms which are the EU's traditional

[21] CMU Action Plan n 11, 4-6.

means for achieving policy outcomes for financial markets and which are contained in the CMU agenda.[22]

One determinant stands out. The success of the CMU agenda is in large part dependent on the nature of the settlement which will govern the future relationship between the UK and the EU. London has recently been identified as the leading global financial centre, beating New York, Hong Kong, Tokyo, and Singapore to the top spot.[23] The highest other EU jurisdiction in the index - which measures business environment, financial sector development, infrastructure, human capital, and reputational factors - is Luxembourg, coming in at number twelve. The London market provides a pipe-line of finance to the EU, acting as the dominant supplier of wholesale market services. These wholesale services, including asset management, risk management and hedging business (derivatives services), dealing in securities, and broking, are of acute importance to the efficiency, liquidity, and stability of the EU capital market generally. They are all the more important as the depth and resilience of liquidity in the EU capital market is currently of significant regulatory and market concern. A range of factors, including market- and regulatory-driven structural change to corporate bond markets, have led to concerns that liquidity is thinning and becoming more volatile, with related risks to the stability and efficiency of the EU capital market and to its ability to withstand shocks.[24]

A plethora of recent Brexit-related reports has identified and quantified the extent to which the UK exports to the EU the wholesale financial services which support the efficiency, liquidity, and stability of the EU capital market.[25] Among the headline figures are: over half of global financial firms have their European headquarters in London; 37% of assets under management in the EU are managed in the UK; and 46% of equity funding raised in the EU is raised in the UK.[26] In the region of 25% of UK financial services revenue derives from EU international and wholesale financial services business.[27] The UK Financial Conduct Authority has reported that over 5,000 UK firms 'passport' their services into the single market; some 2,250 passports cover the investment services critical for CMU.[28] The UK is the home of the largest stock exchange in the EU and of the most developed

[22] See Moloney, n 11.
[23] Z/Yen Group and China Development Institute, The Global Financial Centres Index 20, September 2016.
[24] Including ESRB, Macroprudential Policy Issues arising from Low Interest Rates and Structural Changes in the EU Financial System (2016), and FCA, Market-based Finance: its Contributions and Emerging Issues, FCA Occasional Paper 18 (2016).
[25] These include: IMF, Financial Services Sector Assessment Program, Financial System Stability Assessment, IMF Country Report, UK (2016); The CityUK, The UK: Europe's Financial Centre, August 2016; K Lannoo, EU Financial Market Access After Brexit, CEPS Policy Brief, September 2016; Oliver Wyman, The Impact of the UK's Exit from the EU on the UK-based Financial Services Sector (2016); and European Parliament, Briefing, M Magnus, A Margerit, and B Mesnard, Brexit: the United Kingdom and EU Financial Services, 9 December 2016.
[26] Briefing, n 25 (drawing on a range of sources).
[27] Wyman Report, n 25, 6.
[28] Letter from FCA Chairman Bailey to House of Commons Treasury Committee Chair Tyrie, 17 August 2016.

derivatives market and related clearing and settlement infrastructures, and is a major centre for related services, including credit rating services and market data production and vending services.[29] To take a specific example from the asset management sector, around 85% of European hedge funds are based in London; and from the trading sphere, some 74% of over-the-counter trading in interest rate derivatives, and 78% of foreign exchange trading, takes in place in London, while twice as many euros are traded in London as in the euro area.[30] Overall, some 35% of all wholesale financial services activity in the EU takes place in the UK.[31] Clearly, the UK/EU interdependencies go both ways. The focus of this assessment, however, is on the implications for the EU.

Market-based finance is growing in the EU,[32] propelled by the complex array of drivers, including but not limited to facilitative regulation, which shape economic systems. An abrupt rupture between the UK and the EU 27 would disrupt this evolution, given the extent to which the UK provides wholesale investment services to the EU capital market.[33] Strenuous policy and regulatory action was already called for by the CMU agenda given the scale of the effort required to embed market-based finance in a predominantly bank-based economic system.[34] Any obstruction of the pipe-line from London is likely to have material aggravating effects. This was acknowledged before and in the immediate aftermath of the Brexit vote. The Chairman of the European Securities and Markets Authority (ESMA) warned prior to the Brexit vote of the risks to CMU were the UK to leave the EU,[35] while the Vice President of the Commission made pointed reference to the continued importance of the CMU agenda post Brexit in the immediate wake of the vote.[36]

2.2 Legal Remedies

Political calculations and market realities - regionally and, particularly given the changing posture of the US to international governance and trade relations,

[29] Lannoo, n 25, 2.
[30] The CityUK, n 25, 3 and 4 (figures from 2015 in relation to hedge funds and 2013 in relation to trading).
[31] Ibid, 2.
[32] As has been charted by the Commission and the ECB: recently, Commission, European Financial Stability and Integration Review (SWD (2016) 146) April 2016, and ECB, Financial Integration in Europe (2016).
[33] Lannoo has suggested that the effects may include a reduced capacity within the EU to refinance funding requirements (n 25, 6) while a recent Bruegel study has suggested that the additional costs to the EU 27 of Brexit (beyond the losses from losing access to the UK market), assuming continuing fragmentation in EU financial markets, could be in the region of 0.05-0.1% of GDP: A Sapir, D Schoenmaker, and N Véron, Making the Best of Brexit for the EU27 Financial System, Bruegel Policy Brief February 2017 (2017 Bruegel Report).
[34] ECB*,* Financial Integration in Europe (2016)*,* 97.
[35] ESMA Chairman Maijoor warned 'if the biggest capital market of the EU would not be part anymore of that CMU, obviously that would be detrimental': H Jones, 'Brexit would damage EU Capital Market Union: watchdog says,' *Reuters*, 18 May 2016.
[36] The EU Commissioner charged with CMU stated in the wake of the vote that CMU was needed 'more than ever': Commissioner Dombrovskis, 'Remarks at the Atlantic Council', 18 July 2016.

internationally - will shape the future UK/EU settlement[37] and thus CMU. But these forces will act on law and regulation, whether in the form of a bilateral UK/EU Free Trade Agreement or horizontal EU third country rules. In the short-term, a transitional arrangement may ease the impact of the UK's departure, particularly if it is agreed over the Article 50 negotiating period. Beyond a transitional arrangement, the EU's current access and export rules and related equivalence requirements, or a bespoke access/export arrangement based on these rules, will shape UK/EU relations. If neither a transitional arrangement or final bespoke agreement transpires (the 'sharp Brexit' option), the UK's access to the EU capital market will be managed through WTO and GATS requirements. These trade rules will provide the UK, as a third country, with basic access rights for financial services, including in relation to 'commercial presence' (or the right to establish subsidiaries, for example).[38] But they do not address the financial regulatory requirements which will apply. In effect, the EU's current WTO/GATS commitments in relation to financial services retain the EU's 'right to regulate.' This right to regulate takes expression in the third country/equivalence rules which govern financial regulatory requirements and which will replace the UK's current passporting arrangements.

As a member of the EU, the UK benefits from the EU's unique 'passporting' arrangements which govern access by EU financial actors to the single market in financial services. Once authorized in its 'home' Member State (classically, the state where the actor is incorporated or registered), a financial actor can operate through branches or cross-border service provision based on home Member State regulation and supervision, with some limited exceptions. The 'passporting' access device, which is not replicated in any multilateral, regional, or bilateral grouping internationally, is based on the EU's 'single rulebook,' a dense thicket of harmonized rules which governs the EU financial system and which allows host EU regulators to defer to supervision by the home regulator. The passport is also based on the coordinated institutional support for supervision and risk management provided through the EU's European System of Financial Supervision (ESFS). At the heart of the ESFS are the European Supervisory Authorities (ESAs) which are charged with a range of quasi-regulatory and supervisory coordination tasks in the banking (European Banking Authority - EBA); capital markets (European Securities and Markets Authority- ESMA); and insurance/pensions (European Insurance and Occupational Pensions Authority - EIOPA) spheres. The single rulebook and the ESFS together are designed to support market access, the removal of host state control, and the prevention, or at least management, of cross-border and system-wide risks to financial stability, market integrity, and investor protection.

'Passporting' derives from free movement rights and the Treaties and is only available to EU firms - firms which are registered (incorporated) in the EU. It is

[37] Ferran, n 8.
[38] For extensive analysis see A Lang and C Conyers, Financial Services in EU Trade Agreements, Study for the ECON Committee (IP/A/ECON/2014-08) (2014).

possible that UK investment firms and infrastructures will deploy subsidiaries to set up operations in the EU 27, and thereby benefit, as EU actors subject to EU law, from passporting rights. The impact of any Brexit shock to CMU may therefore be reduced. An increasing tendency of financial actors to use subsidiaries given their effectiveness in supporting firms in shaping local business conditions to their preferences and in increasing market share[39] is beginning to be noted in the literature. But subsidiarization is predominantly associated with the banking markets and less so with capital market actors such as asset managers, investment firms, and financial market infrastructures. Capital market actors will often access the single market by establishing host branches and/or by direct, cross-border service provision from the home Member State. Since the Brexit decision there are indications that major investment banks and infrastructures are planning to locate subsidiaries in the EU 27 for passporting business, and that EU Member States are actively seeking this business,[40] while Frankfurt, Paris, Amsterdam, and Dublin have been identified as the major beneficiaries of a relocation of UK business.[41] The months following the Brexit referendum have also seen some suggestions that the EU may use delaying tactics over the negotiations to maximize the likelihood that UK firms will relocate to the EU 27 if a lack of clarity on the EU/UK settlement persists.[42]

Subsidiarization as a means for addressing UK access to the EU capital market has attractions for the CMU agenda, beyond its ability to keep the UK pipeline open. There is growing policy support for domestic/host subsidiary-based supervision, rather than remote/home supervision of branches and services. Under EU financial governance arrangements, subsidiaries are supervised in the relevant local market in which the subsidiary is registered. Branches and cross-border services are supervised remotely through the home Member State from which these service channels operate. The risk management benefits of domestic/host supervision are increasingly being highlighted, particularly in light of the incentives of local supervisors to protect financial stability.[43] In addition, subsidiaries come within the EU's fast developing supervisory coordination arrangements for financial groups, including the 'colleges of supervisors' which are overseen by the ESAs. By contrast,

[39] On incentives for subsidiarization see Z Kudrna, 'Governing the Ins and Outs of the EU's Banking Union' 17(1 and 2) *Journal of Banking Regulation* (2016) 119, and R Epstein, 'When do Foreign Banks 'cut and run'? Evidence from West European Bail Outs and East European Markets' 21(4) *Review of International Political Economy* (2014) 847.

[40] The World Economic Forum in Davos in January 2017 saw a number of global banks make statements to this effect: M Arnold and P Jenkins, 'Goldman Presses May to Protect City post-Brexit,' *Financial Times*, 30 January 2017. One major market, the Lloyd's of London insurance market, has confirmed it will set up an EU subsidiary: J Ford, C Binham, and O Ralph, 'Lloyd's of London to Establish EU base in the New Year,' *Financial Times*, 15 December 2016. In March 2017, AIG announced it was to set up a subsidiary in Luxembourg: O Ralph, 'AIG to Set Up New Base in Luxembourg to Service EU Business,' *Financial Times*, 9 March 2017.

[41] 2017 Bruegel Report, n 33.

[42] G Parker, 'Fears EU Delays on Brexit Talks will Spur Exodus of Banks to Eurozone,' *Financial Times*, 19 December 2016.

[43] A Persaud, 'The Locus of Financial Regulation: home versus host' 86(3) *International Affairs* (2010) 637.

the supervisory risks and challenges posed to the local host supervisor by 'systemic branches,' supervised remotely by the home State, have recently come on to the EU policy agenda, with EBA consulting on guidelines to facilitate cooperation and coordination between supervisors.[44] Norway, for example, has recently highlighted the supervisory challenges and risks which would be posed to its financial system were the largest foreign bank in its financial system, an EU subsidiary which represents nine percent of the Norwegian banking market and which is designated as a systemically important bank in Norway, to be transformed into a branch (as is permitted under EU/EEA law) and become subject to remote home supervision, and not local host supervision in Norway.[45] The risks posed by such home-supervised 'systemic branches' to the host market are all the greater where the branch is of a third country firm, such as a post Brexit UK firm, which operates outside the EU's supervisory governance and coordination requirements.

Subsidiarization is not, however, a cost-free strategy for UK firms.[46] In addition to the operational disruption and potentially inflexible labour laws and taxation costs which may follow, it exposes firms to the full weight of EU regulation, including the ring-fenced capital and liquidity requirements which may be onerous for certain group structures. While the Commission has recently proposed an easing of the restrictions which apply to capital and liquidity management within EU financial groups,[47] subsidiarization is unlikely to provide a complete solution for UK firms.

There are other, less legally stable routes available. UK firms will have very strong incentives to deploy creative legal techniques to ensure their access to the EU market remains open, particularly as EU 27 clients and counterparties will likely assume that considerable market and legal ingenuity will be brought to bear in ensuring that any disruption to business is limited.[48] UK firms could, for example, seek to use the EU access routes available for 'reverse solicitation' (or client-solicited investment-services business, noted in section three below) or use delegation methods to outsource UK-based business to an EU operation. These methods are not legally resilient, however, and could be vulnerable to challenge by the individual national regulators which will have jurisdiction over these access routes.

The current third country access and export arrangements are accordingly likely to have significant implications for CMU and are considered below.

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[44] EBA, Consultation on Guidelines on Supervision of Significant Branches (EBA/CP/2016/24) (2016).

[45] Norwegian Ministry of Finance, Home/Host Issues for Significant Bank Branches, Letter to the European Commission, 21 November 2016.

[46] As has been repeatedly identified in the policy debate: eg, Norton Rose Fulbright, Brexit and Financial Services: 10 things you should know (Part II), October 2016.

[47] Commission, Proposal to Revise the Capital Requirements Regulation (COM (2016) 850) (2016).

[48] It has been reported that banks are planning on using the 'workarounds' which can be found in EU law to minimize Brexit shocks: M Arnold, 'Banks Study Loopholes to Enable UK Branches to sell to EU Clients,' *Financial Times*, 2 February 2017.

3. THIRD COUNTRY RULES, THE UK, AND CMU: ACCESS AND EXPORT IMPLICATIONS

3.1 THE EQUIVALENCE REGIME

Equivalence is a legal and procedural mechanism used to manage third country access to the EU capital market (access) and how EU market actors and counterparties interact with third country entities (export). The third country regime has several distinct features. While internationally-oriented, it is powered by single market technology. The regime is a function of single market legislation and deploys the EU's supranational machinery, including the Court of Justice of the EU, the European Commission, and, at the administrative level, the ESAs. The regime has significant historical, political, and institutional legacy effects. It has been shaped by the shifting political and other interests which have shaped the single market in financial services more generally, as has been charted in the international political economy literature which examines the political and institutional dynamics of EU regulatory arrangements governing market access.[49] In relation to national political preferences, whether or not Member States have been more or less in favour of competition and open markets, or more or less concerned with internal financial stability and with protecting national markets, has tended to shape their approach to the negotiation of third country regimes.[50] The Member State debates have also been shaped by the immense variability in political preferences, reflecting the different interests at stake depending on the particular segment of the capital market engaged.[51] The related debates are of very longstanding, tracking back to the early 1990s when the single market in financial services was embryonic.[52] Institutional factors have also been determinative. The strength of the EU's regulatory capacity, or its ability to adopt and enforce rules, and to export those rules internationally, including through participation in the different ISSBs of international financial governance, has shaped its third country regimes and the extent to which they require third country actors to adhere to EU rules.[53] So too have prevailing political and market conditions. The significant tightening of third country rules over the

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[49] For an early discussion of the pre-financial crisis approach of the EU to third country market access and the related interests which drove the predominantly liberal approach see A Dür, 'Fortress Europe or Open Door Europe? The External Impact of the EU's Single Market in Financial Services' 18(5) *Journal of European Public Policy* (2011) 619.

[50] L Quaglia, 'The Politics of 'Third Country Equivalence' in Post-Crisis Financial Services Regulation in the European Union' 38(1) *Western European Politics* (2015) 167 (for a political economy perspective), and E Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' 12 *European Business Organization Law Review* (2011) 379 (for a legal/institutionalist perspective). For a discussion of the distinct interests which drove the third country regime for investment services, eg, see N Moloney, *EU Securities and Financial Markets Regulation* (OUP, 2014) 403-404.

[51] Ferran, n 8.

[52] Lannoo, n 25, 4.

[53] A Newman and E Posner, 'Putting the EU in its Place: Policy Strategies and the Global Regulatory Context' 22(9) *Journal of European Public Policy* (2015) 1316, and Quaglia, n 14.

financial crisis era, and the related 'export' of EU rules internationally, has been associated with the distinct conditions of the crisis and the related politicization of financial regulation. This led to the previously dominant policy concern to minimize regulatory burdens internationally and to prioritize EU competitiveness losing traction.[54]

It is not accordingly unexpected that the third country regime for capital markets is partial, complex, and lacking in coherence. Some capital market segments are subject to no or only very limited rules on third country access or on regulatory export. Reciprocity may or not be required for access. Registration by the third country actor with ESMA, and submission to ESMA supervision, may or not be a condition of access. The benchmarks against which equivalence (whether in relation to market access or rule export) is assessed vary. But while the third country rules vary very significantly, the procedural route to the pivotal equivalence determination is broadly similar. The Commission is typically (although not always) conferred with the power to initiate the equivalence process and the Commission's power to adopt an equivalence decision is almost always discretionary. It makes the equivalence decision in the form of an administrative act, usually under the 'examination procedure' for administrative rule-making, derived from TFEU Article 291 (this procedure is 'comitology'-based, using a committee to provide Commission oversight, and does not engage the Council and European Parliament).[55] In a limited number of cases the TFEU Article 290 procedure for delegated acts is required (which is based on Commission oversight by the European Parliament/Council through the non-objection procedure). Technical advice is usually provided to the Commission by ESMA, which engages in an extensive assessment of the relevant jurisdiction. This step is not always specified in the relevant legislation, but as a matter of practice the Commission seeks ESMA's advice. The Commission usually follows ESMA's advice but will often engage in independent assessments of the relevant jurisdiction. The equivalence decision may be indefinite, time limited, full, or partial. It may include all the relevant financial governance elements of the third country regime, or only elements.

The equivalence process is not transparent and only indications as to how it operates in the capital markets sector can be gleaned from Commission decisions on equivalence and from the related technical advice from ESMA. In its February 2017 Report on Equivalence, however, the Commission shed some light on the process - although the salience of the report in light of the upcoming Brexit negotiations suggests that caution is needed in its interpretation. The Commission regards equivalence as a primarily EU-oriented process which is designed to facilitate EU actors in interacting with non-EU markets and counterparties. Assessments are outcomes-based and concerned with results, not 'word for word

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[54] S Pagliari, 'A Wall Around Europe? The European Regulatory Response to the Global Financial Crisis and the Turn in Transatlantic Relations' 35(4) *European Integration* (2013) 391.

[55] Set out in Regulation (EU) No 182/2011 [2011] OJ L55/13.

sameness' of legal texts.[56] The principles of proportionality and of risk-based assessment guide the Commission in the exercise of its discretion in adopting equivalence decisions; its related assessment of the third country identifies the risks to the EU financial system and applies the equivalence criteria in a manner proportionate to the risks identified.[57] The Commission has indicated that factors such as the size of the third country market, its importance to the functioning of the single market, the interconnectedness between the third country market, or the risks of circumvention of EU rules are all relevant to how the Commission exercises its discretion.[58] The Commission will look beyond technical requirements and focus on regulatory objectives pursued and outcomes delivered, and has warned that an outcome is 'not necessarily or automatically positive for the jurisdiction concerned.'[59] The Commission has also underlined that the equivalence decision is unilateral and discretionary and can be changed or withdrawn by the EU as necessary 'at any moment.'[60] In exercising its discretion the Commission takes into account objectives derived from the relevant legislation empowering it to adopt an equivalence decision and from the Treaty, and has highlighted the importance of protecting the financial stability and market integrity of the single market for financial services.[61]

An examination of the main features of the third country regime as it applies to capital market regulation and of its implications for CMU follows.[62] The discussion focuses on the type of services in which the UK is currently dominant and which are of most importance to the CMU agenda: investment services, including risk management and securities and derivatives trading; provision of financial market infrastructures (trading venues and central clearing counterparties (CCPs[63])); and asset management. Investment services and infrastructures are governed by the two measures which provide the backbone of EU capital market regulation: (i) the Markets in Financial Instruments Directive II (MiFID II)/Markets

[56] 2017 Commission Equivalence Report, n 9, 4.
[57] Ibid, 8.
[58] Ibid, 9.
[59] Ibid, 8.
[60] Ibid, 9.
[61] Ibid.
[62] The technical features of the EU's third country requirements for financial services have been subject to exhaustive discussion in an extensive policy and industry literature (primarily but not exclusively from the UK) since the Brexit decision. Key industry papers include: International Regulatory Strategy Group. The EU's Third Country Regimes and Alternatives to Passporting (2017); Shearman & Sterling, Brexit and Equivalence: Review of the Financial Services Framework Across All Sectors, August 2016; Ashurst, Brexit: potential impact on the UK banking industry (2016); and AFME and Clifford Chance, The UK Referendum – Challenges for Europe's Capital Markets, March 2016. For a policy perspective see Commission, n 9 above, European Parliament, Briefing, A Duvillet-Margerit, M Magnus, B Mesnard, and A Xirou, Third Country Equivalence in EU Banking Legislation, 9 December 2016, and Report by MEP Annelise Dodds, Brexit: A New Deal for Financial Services, January 2016.
[63] CCPs manage 'counterparty risk' in derivatives contracts by 'clearing' transactions - or acting as a seller to every buyer and as a buyer to every seller. CCP clearing guarantees the performance of derivatives contracts and thereby reduces the financial stability risk to the financial system from derivatives contracts by containing the risks of a party to a contract defaulting.

in Financial Instruments Regulation (MiFIR) (2014),[64] the EU's rulebook for investment services and trading venues which imposes extensive authorisation, prudential, and conduct regulation on a wide range of investment services providers and trading venues; and (ii) the European Market Infrastructure Regulation (EMIR) (2012),[65] which addresses the derivatives market and imposes a range of far-reaching obligations, including the pivotal requirement to 'clear' certain derivatives through CCPs, as well as reporting and risk management obligations. The limited third country rules which apply to collective asset management through investment fund vehicles (individual/discretionary asset management is covered under MiFID II/MiFIR) are set out in the UCITS Directive (2009)[66] and the Alternative Investment Fund Managers Directive (2011).[67] A range of other measures cluster around these core elements. For the most part these other measures apply third country rules which are primarily 'export' in nature and which govern how EU actors engage with third country actors.[68] While many of these more ancillary measures are of significant operational importance to the EU capital market (they impose qualifications, for example, on acting as a 'primary dealer' (providing liquidity) in the EU sovereign debt market), this discussion will focus on the twin pillars of MiFID II/MiFIR and EMIR, and on the asset management regime.

3.2 Investment Services: MiFID II/MiFIR

MiFID II/MiFIR, which comes into force in 2018, contains a new third country access regime[69] for the provision of investment services (including dealing in securities, broking, underwriting, advice, and discretionary/individual asset management). Two forms of access route are covered: branches; and cross-border provision of services.

A 'third country firm'[70] may, if permitted by the relevant national regulator, establish a branch in an EU Member State. Passporting rights are not granted to the branch which is subject to the rules imposed by the national regulator – although a Member State may not treat any third country branch more favourably than an EU firm (MiFID II Article 41(2) and recital 109). In some cases, a Member State may

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[64] Directive 2014/65 [2014] OJ L173/349 (MiFID II) and Regulation (EU) No 600/2014 [2014] OJ L173/84 (MiFIR).

[65] Regulation (EU) No 648/2012 [2012] OJ L201/1.

[66] Directive 2009/65/EC [2009] OJ L302/32 (as amended).

[67] Directive 2011/65/EU [2011] OJ L174/1.

[68] Including the Short Selling Regulation (2012) (Regulation (EU) No 236/2012 [2012] OJ L86/1); the Market Abuse Regulation (2014) (Regulation (EU) No 596/2014 [2014] OJ L171/1); the Securities Financing Transaction Regulation (2015) (Regulation (EU) No 2015/2365 [2015] OJ L337/1); and the Benchmark Regulation (2016) (Regulation (EU) No 2016/1011 [2016] OJ L171/1).

[69] The new third country regime is significantly more centralized than the MiFID I regime, including in relation to the introduction of a Commission power to determine equivalence and the imposition of harmonized rules in areas previously governed by Member State discretion.

[70] Defined as a firm that would be a MiFID II 'credit institution' providing investment services or performing investment activities or a MiFID II 'investment firm' if its head office or registered office was located in the EU (MiFID II, A 4(1)(57)).

require the establishment by a third country firm of a branch (where a firm may otherwise prefer to operate remotely through cross-border service provision) in which case a harmonized regime applies. Under MiFID II Articles 39-43 Member States may require that a third country firm intending to provide MiFID II investment services to, or engage in investment activities with, retail clients or clients who request to be treated as professional (elective professional clients),[71] must establish a branch (Article 39(1)).[72] If a Member State exercises this option for, in essence, retail-facing business, the establishment of the branch in the Member State in question is subject to harmonized requirements (Article 39(2)) including in relation to authorization; information; branch management 'fitness and probity' tests and capital; a range of ongoing conduct and operational requirements which map the requirements of MiFID II/MiFIR; and conditions relating to supervisory coordination with the third country supervisor and the third country's compliance with OECD rules governing exchange of information on taxation.

The mandatory branch regime, where it applies, is cumbersome. It does not require an equivalence determination by the Commission, but it imposes a series of procedural and regulatory requirements, including the unusual imposition of capital requirements on a branch (capital requirements typically apply to subsidiaries). Most significantly, it does not support passporting; it only allows the provision of services from the branch within the jurisdiction in question. In practice, these limitations are unlikely to disrupt CMU. The UK's critical role in relation to capital market intermediation relates to the wholesale investment services it provides to the EU 27, and not to the retail-oriented business which branches are often associated with and which the MiFID II branch requirements are directed towards. The CMU agenda certainly promotes retail market investment, but retail capital markets in the EU are under-developed and primarily domestic in nature,[73] and the UK has not been a significant supplier of cross-border retail services. To the extent EU-27 retail clients require services from the UK, the 'reverse solicitation' route is available. Branch requirements do not apply where a retail or elective professional client initiates at its own exclusive initiative the provision of the service/activity, but the firm cannot market new investment products/services to the client (MiFID II Article 42). Under EU law, an investment service of this type is not deemed to be provided within the territory of the EU. This route does not, however, provide a stable legal platform for EU access as its availability depends on the local rules of

[71] 'Retail clients' are those clients which do not meet the MiFID II eligibility conditions for 'professional' clients and for 'eligible counterparties' and include individuals as well as local and regional authorities. The 'professional client' and 'eligible counterparty' classifications cover large corporates as well as regulated financial institutions. Elective professional clients are retail clients who meet identified eligibility conditions related to experience and size of investment portfolio and who can choose to be treated as professional, following an approval process.

[72] The Commission originally proposed a mandatory branch requirement, but this was resisted in the Council by some Member States as being overly restrictive of cross-border business: Moloney, n 50, 404.

[73] For a recent assessment see Commission, Green Paper on Retail Financial Services (COM (2015) 630) (2015).

the EU 27 with respect to the nature of a 'reverse solicitation', and there have long been indications that an aggressive approach by third country firms will not be tolerated by EU regulators.[74] The MiFID II branch regime may, however, become significant as a means for supporting the cross-border supply of wholesale market intermediation services from a single hub, as discussed below in relation to the cross-border services access route.

Of significantly greater importance to the CMU agenda is the extent to which the parallel cross-border services regime (MiFIR 46) facilitates access by UK firms providing wholesale market services remotely from the UK. MiFIR Article 46 covers services provided remotely by third country firms, without a branch, to eligible counterparties and professional clients (non-retail business). This regime provides an EU passport once the conditions of the regime are met, but is dependent on the third country firm registering with ESMA. ESMA registration is subject to a series of conditions (Article 46(2)), chief among them that the Commission has adopted an equivalence decision in relation to the relevant third country. In addition, the firm must be authorized to provide the proposed EU services/activities in the jurisdiction where its head office is established, and be subject to 'effective supervision and enforcement ensuring full compliance with the requirements applicable in that third country'. Supervisory cooperation requirements must also be in place.

At the heart of Article 46 is the Commission third country equivalence decision (which is governed by Article 47). This decision must provide that the 'legal and supervisory arrangements of that third country ensure that firms authorized in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in [relevant EU law, including MiFID II/MiFIR]' and that the third country provides for an 'effective equivalent system' for recognition of investment firms authorised under third country legal regimes (a reciprocity condition). Prudential and business conduct rules 'may' be considered equivalent where a series of conditions are met: firms are subject to authorization and 'effective supervision and enforcement' on an ongoing basis; firms are subject to 'sufficient' capital requirements and 'appropriate' requirements applicable to shareholders and management body members; firms are subject to 'adequate' organizational requirements in relation to internal control functions; firms are subject to 'appropriate' conduct of business rules; and the third country ensures market transparency and integrity by preventing market abuse in the form of insider dealing and market manipulation.

The equivalence decision-making process is articulated in some detail. The decision is at the Commission's discretion (Article 47) and is carried out under the 'examination process' for Commission administrative decision-making (Article 51). In carrying out the assessment the Commission should have regard to the IOSCO Objectives and Principles (recital 41) - a reference to the core standards adopted by

[74] Norton Rose Fulbright, MiFID MiFIR Series, October 2014, 3.

the major ISSB for capital markets.[75] The assessment should be outcome-based and assess the extent to which the third country regulatory and supervisory framework achieves 'similar and adequate regulatory effects' and to what extent it 'meets the same objectives as EU law' (recital 41). Equivalence decisions should only be adopted if the third country legal and supervisory framework provides for 'an effective equivalent system' for the recognition of investment firms authorised under foreign legal regimes (a reciprocity condition) (recital 44). The initiation of the equivalence assessment is at the Commission's initiative (recital 41), although Member States should be able to indicate their interest that certain third countries are assessed (without such an indication being binding on the Commission) (recital 41). In addition, the Commission and the Member States should prioritize the areas covered by G20 commitments and agreements and by agreements with the EU's largest trading partners. They should also have regard to the central role the EU plays in wholesale financial markets and ensure that the application of third country requirements does not prevent EU investors/issuers from investing in/obtaining funding from third countries, or prevent third country investors/issuers from investing, raising capital, or obtaining other financial services in EU markets, 'unless that is necessary for objective and evidence-based prudential reasons' (recital 41). The Commission should be able to prioritise among third country jurisdictions, taking into account the materiality of the equivalence finding to EU firms/clients; the existence of supervisory/cooperation arrangements; the existence of an effective equivalence system in the third country; and the interest and willingness of the third country to engage in the equivalence assessment process (recital 41).

The process is designed to be dynamic. The Commission is to assess whether the conditions under which the equivalence decision is made 'continue to persist' in relation to the third country (Article 49(3)) and the Commission is to monitor any significant changes to the regulatory/supervisory framework of the third country and 'review equivalence decisions where appropriate' (recital 41). Accordingly, provision is made for the decision to be withdrawn (Article 47(4)).

Once the third country firm is registered, a pan-EU passport becomes available, and the firm cannot be required to establish branches (Article 46(1)). In addition, relevant services can be based in an EU branch of the third country firm and, in effect, benefit from a 'wholesale passport' (Article 47(3)). A MiFID II Article 39 branch of a firm from a third country jurisdiction which is declared equivalent under MiFIR can provide services/activities to eligible counterparties/default professionals in other EU Member States (where the activities in question are covered by the Article 39 authorization). Accordingly, the Article 39 retail-oriented branch can be used as hub from which to provide wholesale services pan-EU.

As is the case for the branch regime, the requirements of the MiFIR Article 46 route can be avoided where the services flow from a 'reverse solicitation' (Article

[75] IOSCO, Objectives and Principles for Securities Regulation (2010).

41(5)), but the same legal uncertainties apply, significantly limiting this option as a stable platform for providing wholesale services to the EU 27.

3.3 THE MIFID II/MIFIR EQUIVALENCE CHALLENGE

The MiFIR Article 46 regime provides a legal platform for the provision of wholesale market intermediation services from the UK, as a third country, to the EU 27. There is no evidence yet on its operation as it does not come into force until 2018. But there are structural weaknesses in this platform which could have potentially serious implications for the provision of essential capital market intermediation services to the EU 27.

There are timing challenges. The regime applies to 'third country firms' and third countries. UK firms and the UK will not acquire this status until the UK leaves the EU. A cliff edge may therefore arise: the equivalence process cannot start until the UK leaves the EU, and the process may take some time. Certainly, there are mitigating factors. Initiation of the equivalence process is at the Commission's discretion and it is unlikely to postpone a decision which has important implications for the EU capital market. This is all the more the case as recital 41 directs the Commission to ensure that EU investors and issuers are not prevented from accessing third country funding without objective and evidenced prudential cause. On 'Brexit Day One', the UK will be able to show regulatory equivalence, meaning the ESMA and subsequent Commission equivalence processes should, at least for regulatory matters, be straightforward, given the longstanding embedding of UK financial governance within EU financial governance. In addition, the EU may consent to 'shadow' equivalence discussions, and related ESMA registration preparations, taking place over the Article 50 negotiation period so that the equivalence decision can be activated on 'Day One'.[76] Alternatively, a provisional equivalence assessment may be provided for in a transitional arrangement, assuming one can be negotiated and finalized by the end of the Article 50 process.[77] The required supervisory and cooperation agreements should also be relatively straightforward to negotiate given the extensive supervisory coordination activities the UK has engaged in, and the related cooperation and information exchange processes it has constructed, as required under EU capital markets law and following from its participation in ESMA's wide-ranging supervisory convergence activities. These will need to be adjusted, given that the UK as a third country will no longer be a member of ESMA and participate in its supervisory coordination, cooperation, and information exchange activities, but the framework for a new operating model is in place.

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[76] As has been called for by an influential UK parliament committee: House of Lords, n 1, para 58. UK MEP Annelise Dodds has called for equivalence determinations to be automatic in relation to current equivalence provisions: n 62.

[77] C Grant, Brussels Prepares for a Hard Brexit, Insight, Centre for European Reform, 21 November 2016.

On the other hand, Commission sympathy cannot be assumed. The tone of its 2017 Equivalence Report is forthright and contains little to suggest it will entertain any special pleading by the UK. It has underlined that while third countries may express an interest in being assessed, an equivalence empowerment does not confer a right to be assessed or to receive a positive determination. The Commission has also stated in forthright terms that 'the decision is a unilateral and discretionary act of the EU, both for its adoption and any possible amendment or repeal.'[78] Other obstacles are in the way. While the Commission is the decision-maker on equivalence, the 'examination' rule-making process which applies to equivalence decisions engages national political interests. Commission decision-making is overseen by the European Securities Committee, which is composed of national representatives and which operates under a qualified majority vote; it can veto the Commission's draft equivalence decision.[79] The European Parliament and Council must also be kept informed of deliberations. The EU-27 and the UK have strong incentives to ensure their financial markets remain open. But if the wider Brexit process becomes fraught, it cannot be assumed that the equivalence process will not be politicized. This is even more a risk as it is now clear that many Member States see Brexit as a competitive opportunity for their capital market sectors. In the absence of a Commission equivalence decision, Member States can choose to allow provision of MiFID II/MiFIR services/activities within their territories in accordance with their national regimes (MiFIR Article 46(4)). It remains to be seen how Member States will weigh the benefits which access to UK wholesale investment services brings against the potential competitive gain to their local markets, particularly if an equivalence vacuum leads to major UK firms setting up subsidiaries in the EU 27 and if the economic benefits outweigh the potential risks. Member States can be expected to facilitate access where it is in the interests of their capital markets, but there is an inherent instability in MiFIR Article 46 as a platform from which market intermediation services can be channelled from the UK to the EU.

There are further challenges. The equivalence assessment may prove technically problematic. The equivalence conditions are expressed in high-level and open terms which afford the Commission very significant discretion. Assuming a workmanlike environment, the requirement that the process be outcome-based augurs well for smooth decision-making. But if political conditions deteriorate, the benefits of facilitating UK access may be trumped by other considerations and Commission/European Securities Committee decision-making may become a vehicle for obstructionism. The Commission's recent underlining of the need for 'high impact' markets to be subject to rigorous review may not augur well for the UK.[80] Dynamism is a material difficulty, as is indicated in the Article 50 letter. On

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[78] 2017 Commission Equivalence Report, n 9, 8.

[79] The complex procedures are set out in Regulation 182/2011 (Regulation (EU) No 182/2011 [2011] OJ L55/13).

[80] 2017 Commission Equivalence Report, n 9, 12.

'Day One' the UK will be able to show regulatory equivalence, particularly as the UK government has indicated that the 'Great Repeal Act' which will come into force on the day the UK leaves the EU will carry over the corpus of EU law. But UK law will start to diverge – sooner rather than later. There is considerable pressure for and expectation of at least some regulatory reform.[81] A range of factors, including the need for an equivalence determination on Brexit, competitiveness concerns, and obligations to comply with ISSB standards, will shape any de-regulatory response by the UK. But even allowing for only minimal deregulation, EU capital markets law is continually updated and revised, particularly at the administrative level. Even without material change in the UK, the two regimes will almost certainly start to diverge. Considerable instability will be injected into the functioning of the EU capital market if the UK equivalence decision becomes subject to the risk of withdrawal by the Commission. The Commission has pointedly noted in its 2017 Equivalence Report that an equivalence decision can be changed or withdrawn as necessary 'at any moment' and that monitoring of equivalence may require ongoing monitoring of supervisory practices.[82] It has also underlined the discretionary nature of its equivalence powers and that a positive outcome cannot be assumed.[83] With sufficient political commitment (from both the UK and the EU), and an imaginative approach, it may be possible to design a new and more stable equivalence system which incorporates regulatory dynamism and addresses ongoing monitoring, as is suggested in section five below. But it is very unlikely that a new EU equivalence regime could be adopted prior to Brexit. A bespoke EU/UK regime, set out in a Free Trade Agreement, could be agreed, but it may run the risks of violating the 'most favoured nation' obligation which applies under the GATS - although the exemption which applies for mutual recognition arrangements will likely be helpful.[84]

Other aspects of the equivalence regime may prove problematic if political conditions deteriorate. Difficulties may arise in relation to the supervisory and enforcement aspects of the MiFIR equivalence assessment. Benchmarks for supervisory and enforcement equivalence are notoriously difficult to design given the elusive and typically locally-specific factors which shape supervision and enforcement strategies.[85] In a politically benign environment, the equivalence assessment could be formulaic as the UK's supervisory and enforcement apparatus has long formed a critical part of EU financial governance, providing the supervisory anchor to the provision of wholesale cross-border investment services

[81] The MiFID II/MiFIR requirements on commodity position limits, equity market transparency, and liquidity thresholds governing non-equity market transparency requirements, eg, have been identified as targets for deregulation: Ashurst, n 62, 9.
[82] 2017 Commission Equivalence Report, n 9, 9 and 12.
[83] Ibid, 8.
[84] See further Lang and Conyers, n 38.
[85] H Jackson, 'Substituted Compliance: the Emergence Challenges and Evolution of a New Regulatory Paradigm' 1 *Journal of Financial Regulation* (2015) 169, and J Coffee, 'Law and the Market: the Impact of Enforcement' 156 *University of Pennsylvania Law Review* (2007) 229.

to the EU from the UK. If political conditions are not so benign, the distinct aspects of UK supervision and enforcement (its risk-based approach; its reliance on administrative, rather than criminal, enforcement, to take two examples) could be deployed to lengthen or complicate equivalence decisions.

The implications for CMU go beyond UK market access, however. If equivalence difficulties arise they may compromise the ability of EU firms to transact with UK counterparties and on UK financial market infrastructures given that equivalence qualifications govern how EU capital market actors interact with third country actors. One of MiFIR's key reforms requires that trading by authorized investment firms in certain securities takes place on authorized trading venues, reflecting the G20 commitment to moving the trading of derivatives from the over-the-counter (OTC) market to regulated venues, as well as EU-specific concerns to move share trading to transparent trading venues. MiFIR requires that shares (which are admitted to a trading venue) and identified classes of derivatives must be traded on authorized EU trading venues (MiFIR Articles 23 and 28) - third country trading venues qualify if they are assessed as equivalent. Under the relevant equivalence rules for share trading, the Commission can adopt a decision that the venue's third country is equivalent if the third country ensures that the venue complies with legally binding requirements equivalent to identified EU rules governing trading venues, and is subject to effective supervision and enforcement. The derivatives trading regime is similar. A Commission equivalence decision is required determining that the legal and supervisory framework of the third country ensures that a trading venue authorized in the third country complies with legally binding requirements equivalent to identified EU requirements which are subject to effective supervision and enforcement in the third country.

Finally, consumer-protection-oriented equivalence requirements govern the sale of particular classes of financial instrument. Under MiFID II Article 25(4) certain instruments qualify for 'execution-only' distribution (in that they can be sold without investment advice) where they are traded on a third country trading venue which is equivalent to an EU 'regulated market' – the most heavily regulated form of EU trading venue. The MiFIR Article 23 share trading equivalence assessment governs this assessment.

These 'export'-related equivalence requirements under MiFID II/MiFIR are similar to those which apply to investment firm access, and are subject to Commission decision-making and the examination procedure. In some respects, they are less troublesome than the access requirements. First, Member States are empowered to activate the Article 23 MiFIR and Article 25 MiFID II share trading equivalence assessments. If Member States are incentivized sufficiently, the process may proceed more quickly than a Commission-initiated process. On the other hand, given that the initiative lies with the Member States, the extent to which CMU and EU capital market effects will be moderated will depend on how the Member States balance the risks of their firms being prevented from trading on UK trading venues against any benefits associated with driving trading to local, EU 27, or other

equivalent venues. Second, there is less Commission discretion in this area. A share trading equivalence decision must be made where the equivalence requirements are met and the relevant procedure is followed (MiFID II, Article 25(4)(a) and MiFIR Article 23). Similarly, the equivalence regime governing the trading of derivatives on third country trading venues provides that a regime 'is' equivalent when the identified conditions are met. In other ways, however, the export rules are more restrictive. The derivatives trading regime, for example, applies to a very wide set of actors: the derivatives trading obligation applies to financial counterparties and non-financial counterparties generally, and not only to regulated entities. In a benign political environment, the MiFID II/MiFIR export rules should not be problematic, but if the equivalence process does not work smoothly EU actors will be prevented from executing transactions on the UK's major, liquid trading venues, including those of the London Stock Exchange Group. Concomitant risks arise for CMU and the EU capital market, including with respect to weaker risk management, thinner liquidity, and higher transaction costs.

Finally, MiFID II/MiFIR is incomplete regarding third country access. It does not cover, for example, third country investment firm access rights to market infrastructures (trading venues and CCPs), or give third country trading venues the right to provide trading screens in the EU 27. Neither does it cover access rights for third country investment firms and trading venues to EU-authorized market-data services-providers. If access of this nature is disrupted, the stability, liquidity, and efficiency of the EU capital market is likely to be compromised.

3.4 INFRASTRUCTURE: EMIR

The second set of third country rules which are critical for CMU are set out in EMIR. EMIR imposes a series of obligations which have re-organized derivatives trading in the EU, chief among them the G20-derived requirement that certain classes of over-the-counter (OTC) derivatives[86] must be cleared through CCPs authorized in the EU. This new obligation has placed CCPs at the epicentre of the EU derivatives market: vast volumes of derivatives transactions are cleared through EU CCPs. The EMIR derivatives clearing obligation works in tandem with the MiFIR derivatives trading obligation, with the result that legally frictionless access by trading venues to CCPs, and by CCPs to trading venues, is of critical importance to the smooth operation of the EU derivatives market. Frictionless access to UK CCPs is similarly important: the four authorized UK CCPs (CME Clearing Europe,

[86] Defined as derivatives which are not admitted to trading on an EU 'regulated market' (the most heavily regulated classification of EU trading venue). The Commission, following technical advice from ESMA, determines which classes of OTC derivatives are subject to the clearing obligation. Under a parallel regime, MiFIR imposes a clearing obligation on identified classes of derivatives which are admitted to trading on regulated markets (A 29). Equivalence requirements apply to when a third country venue can be regarded as equivalent to an EU regulated market.

ICE Clear Europe, LCH.Clearnet, and LME Clear[87]) are major providers of clearing services in derivatives to the EU 27, with LCH.Clearnet a market leader in euro-denominated clearing of derivatives.[88]

EMIR permits third country CCPs to provide clearing services under EMIR, subject to an equivalence determination being made. Given the reach of the EMIR CCP clearing obligation, the consequences for a third country such as the UK if it not considered equivalent under EMIR are many and stark. They include that a third country CCP cannot have EU members (EMIR, Article 25); cannot provide clearing services for EU trading venues on which derivatives trade (Article 25); and cannot provide clearing for EU investment firms in instruments which are subject to the clearing obligation (Article 25). In addition, under EU capital adequacy rules EU investment firms and banks are required to hold more capital against exposures to third country CCPs in jurisdictions not determined to be equivalent. The consequent risk of the fragmentation of 'clearing pools' across UK and EU 27 CCPs, and of the related significant transaction costs and potential risks to financial stability which might arise if difficulties emerge with the UK equivalence decision, have frequently been raised as a particular challenge of Brexit.[89]

Further consequences follow from the complex interaction between EMIR's derivatives clearing requirements and MiFIR's derivatives trading rules. Under MiFIR, a finding of equivalence is a precondition for a third country trading venue having access to an EU CCP (and thus being able to trade instruments subject to the EMIR clearing obligation and cleared through an EU CCP), as well as for third country CCP access to an EU trading venue (Article 38). A trading venue established in a third country can request access to an EU CCP only when an equivalence decision (in accordance with MiFIR Article 28, noted above) is adopted. Similarly, a CCP established in a third country can request access to an EU trading venue only when it has been through the equivalence process under EMIR. To take a final example, MiFIR contains a mechanism for alleviating the erga omnes effect of the derivatives trading and clearing obligations (which apply to financial counterparties and non-financial counterparties within and outside the EU) where one counterparty is established in a third country which has been found equivalent in accordance with the specified conditions (Article 33).

The equivalence system for third country CCPs, which should moderate the risk of Brexit-related disruption to the EU derivatives market, is set out in EMIR Article 25. It empowers the Commission to adopt an equivalence decision determining that the legal and supervisory arrangements of a third country ensure that CCPs authorized in that third country comply with legally binding requirements equivalent to EMIR; that CCPs are subject to effective supervision and enforcement

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[87] See Bank of England, Recognized Clearing Houses, available at http://www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx#B02.

[88] U Batsaikhan, Brexit and the UK's Euro-denominated Market: the role of clearing houses, Bruegel Blog Post, 7 June 2016.

[89] Eg Lannoo, n 25, and House of Lords, n 1, paras 66-75.

in the third country on an ongoing basis; and that the legal framework of the third country provides an effective equivalent system for the reciprocal recognition of CCPs from other countries. Other conditions apply to the equivalence determination, including that supervisory cooperation arrangements are in place.

3.5 THE EMIR EQUIVALENCE CHALLENGE

By contrast with the MiFID II/MiFIR equivalence regime, there is considerable evidence of how the EMIR equivalence regime works in practice. The procedure appears to be working relatively well, with ten jurisdictions deemed equivalent in relation to difference aspects of EMIR, including the pivotal CCP requirements, by the Commission, including Australia and the US (although in relation to US Commodity Futures Trading Commission (CFTC) rules only[90]). It is not, however, speedy - the Commission's CCP equivalence decision on Australia followed some 13 months after ESMA's advice.[91] The US equivalence decision posed the most challenges, being partially agreed only in early 2016, following the conclusion of difficult negotiations which signal the difficulties which Brexit-related equivalence decisions may experience.[92] Elsewhere, however, there are grounds for optimism. The evidence suggests that ESMA, who advises the Commission on EMIR equivalence decisions, has been outcomes-focused, pragmatic, and proportionate in assessing CCP regimes internationally, drawing extensively on compliance with international standards and open to accommodating distinct national approaches where they achieve similar outcomes to those sought by EMIR.[93]

Nonetheless, the general difficulties associated with equivalence determinations cannot be discounted in relation to Brexit. This is all the more the case as political and institutional interests are particularly acute in this area and extend beyond the technicalities of equivalence determinations. The dominance of the UK as the EU centre for the trading and clearing of euro-denominated instruments has been a source of contention for some time, culminating in the UK successfully challenging the ECB's 'location policy' for euro-denominated derivatives clearing which required that such clearing take place in the euro area and be subject to ECB liquidity support.[94] Recent indications from the ECB suggest a

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[90] Both the US Securities and Exchange Commission and the CFTC have jurisdiction over derivatives trading.

[91] ESMA/2013/1159, September 2013, and Commission Implementing Decision 2014/755/EU, 30 October 2014.

[92] Commission, Press Release IP/16/807, 15 March 2016 and Commission/US CFTC, Common Approach for Transatlantic CCPs, 10 February 2016. It has been reported that while the technical experts reached a positive conclusion on equivalence fairly speedily, the political process slowed down the negotiations very considerably: House of Lords, n 1, paras 49-50.

[93] As is clear from its advice on the Australian regime: ESMA/2013/1159. ESMA stated that the 'capability of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective' and that the analysis of difference was carried out 'as factually as possible.'

[94] Case T-496/11, *European Central Bank v UK*, 4 May 2015.

concern to re-establish this policy;[95] certain Member States, in particular France, also support repatriating euro-denominated clearing to the euro area.[96]

The risks of disruption may, however, be moderated. Given the importance of UK CCPs to the EU capital market and the disruption to the EU derivatives market which an abrupt rupture with the UK market would cause, the EU and UK are likely to seek a workable arrangement. Conversely, and assuming significant market disruption, the currently contingent nature of the EMIR equivalence regime brings benefits to CMU and the EU capital market in that the Commission can withdraw an equivalence decision if unusual conditions arises such that the financial stability of the EU capital market is threatened. These could arise through supervisory failure, for example, where the risks which a third country CCP posed to the EU were not appropriately addressed by the third country supervisor. While third country CCPs must be registered with ESMA under EMIR, ESMA does not exercise supervisory powers. It is unlikely, however, that UK supervision would not appropriately address EU-located risks, particularly as it has been a member of the EMIR colleges of supervisors which coordinate supervision of EU CCPs.

3.6 Asset Management and Equivalence Challenges

The implications are similarly material in relation to the asset management of collective investment funds in respect of which the UK is the EU's largest centre, although in this market segment EU access is not governed by an equivalence assessment. Of the two pillars of EU collective investment fund regulation one, the UCITS Directive (which is concerned with 'UCITS' funds - very broadly, retail-oriented funds), does not provide for a third country access or equivalence regime. A UK authorized UCITS fund would automatically be reclassified as a third country 'alternative investment fund' (AIF) on Brexit. It would accordingly become subject to the cumbersome market access rules of the Alternative Investment Fund Managers Directive (AIFMD) (which is, very broadly, concerned with more complex, wholesale-oriented funds), which currently links EU market access to the particular local requirements which apply in each Member State and which does not provide for a passport. UK UCITS funds could accordingly no longer be marketed on a pan-EU basis and EU investor access to investment opportunities could be obstructed. The UCITS Directive does, however, provide for the delegation of some functions to third country providers, which provides a means for channelling some UK services to the EU 27.

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[95] ECB President Draghi has been reported as calling for ECB oversight of post Brexit, UK-located clearing business: J Brunsden, 'ECB Steps Up Warning on UK-based Euro Clearing after Brexit,' *Financial Times*, 23 January 2017. Consequent changes would be required to the competence of the ECB in this area as the UK's successful challenge was based on the ECB not having the power to adopt a euro area location policy. On the issues engaged see Financial Services Negotiation Forum, Euro-clearing and Brexit. The Practitioners' View, January 2017.

[96] A Barber and J Brunsden, 'EU Plan to curb City's Euro Clearing set to be Flashpoint in Brexit Talks,' *Financial Times*, 16 December 2016.

For UK funds in the form of non-UCITS funds (or AIFs) the access rules of the AIFMD would apply on Brexit. These requirements are not based on equivalence, but on authorization within the EU. Complex authorization rules currently govern the access rights of third country AIF fund managers and AIFs. At present access is governed by national law which can be highly restrictive and which exposes third country funds and managers to authorization requirements in each jurisdiction in which access is sought.[97] Provision is made under the AIFMD for a pan-EU passport, which is based on authorization in one EU Member State, full compliance with the AIFMD regime, and co-operation arrangements. The availability of such a single EU authorization as an access route is subject to complex timing rules and procedures set out in the AIFMD, which include approval by the Commission. Although ESMA has issued its technical advice on which third countries would qualify for this form of passporting,[98] the Commission has yet to decide whether a passport can follow on authorization. In the absence of such a passport, post Brexit a UK AIF will only be permitted to be marketed in individual EU markets in accordance with relevant local rules, and it will not be possible for an EU AIF to be managed by UK fund managers. While delegation of function routes are available for some fund management activities under the AIFMD, the disruption of fund management activities in the EU capital market cannot be discounted.

3.7 OTHER MEASURES

A range of other measures also bear on CMU. Some are less material. The 2003 Prospectus Directive (soon to be replaced by the 2017 Prospectus Regulation[99]), which addresses the prospectus disclosure requirements for offerings of securities, provides for equivalence assessments to be made by the Commission of third country prospectus requirements and for the consequent lifting of EU requirements.[100] In practice this equivalence regime is not material to CMU or the EU capital market. Offerings of securities to professional investors, which provide investment and risk management opportunities for the EU capital market and which support funding to the real economy, mainly occur through 'private placements' which are usually exempt from the EU prospectus regime and in relation to which France and Germany are, in any event, major EU centres.[101] The 2012 Short Selling Regulation contains a more material equivalence regime as it governs the third country market-makers who support liquidity in securities dealing in the EU. Third country market-makers benefit from a range of exemptions under the Regulation,

[97] Clifford Chance, Brexit – Assessing the Impact on Asset Managers, April 2016.
[98] ESMA, Advice to the European Parliament, the Council, and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs (ESMA/2016/114) (2016).
[99] Agreement was reached by the Council and Parliament on the reforms in December 2016.
[100] Directive 2003/71/EC [2003] OJ L345/64, A 20.
[101] Commission, n 32, 29-30.

including from its more onerous provisions, but their availability depends on an equivalence assessment.

The EU's current third country regime has accordingly several weaknesses which limit its ability to provide a stable legal platform on which EU/UK regulatory relations post Brexit could be based, and which may, depending on the progress of the EU/UK negotiations, compromise the CMU agenda.

4. MANAGING ACCESS AND EXPORT: THE INTERNATIONAL CONTEXT

4.1 Managing Access and Export and International Financial Governance

International financial governance provides something of a potential way-map for the EU as it starts to chart its post Brexit relationship with the UK. As regulation, supervision, and enforcement have become increasingly complex and divergent internationally, a series of access-related arrangements have developed - although the extent to which they are based on equivalence varies. The way-map which these arrangements provides is also partial as it reflects the distinct preferences of the states concerned, the features of the relevant markets, and the institutional capacities of the regulators involved.[102] A comparative review can accordingly only identify features which may be of use to the EU, given the very significant transplantation challenges.

The current setting for international financial governance is not particularly conducive to the development of equivalence-based access/export regimes. Prior to the financial crisis, international financial relations were often framed in terms of access, liberalization, and competition, reflecting the pre-crisis zeitgeist which privileged markets and which was sympathetic to the market's ability to self-govern. This dynamic is well-illustrated by the pre-crisis change in the posture of the US - the classic 'great power' in international finance in terms of its ability to shape international finance governance[103] - towards market access. The pre-crisis era saw the US calibrate its generally restrictive posture towards market access by adopting

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[102] On the preferences engaged see, from a legal-institutionalist perspective, P-H Verdier, 'Mutual Recognition in International Finance' 52(1) *Harvard International Law Journal* (2011) 56, and, for an international political economy perspective, P Knaack, 'Innovation and deadlock in global financial governance: transatlantic coordination failure in OTC derivatives regulation' 22(6) *Review of International Political Economy* (2015) 1217.

[103] On the influence exerted by major markets as 'great powers' see the classic account by Drezner: D Drezner, *All Politics is Global: Expanding the Reach of International Regulatory Regimes* (Princeton University Press, 2007). International financial governance is typically regarded as being shaped by a range of different preferences, including those of the domestic regulators who influence the national 'great powers' but who also drive the distinct preferences of the ISSBs.

a series of reforms designed to ease market access in order, in part, to address growing concern as to a reduction in the attractiveness of the US as a capital market to overseas financial actors following the reforms adopted in the wake of the Enron-era equity market crisis.[104] These liberalizing reforms included the first tentative steps towards a more facilitative approach to market access by means of new 'substitute compliance' mechanism (as noted below).[105] This predominantly liberal framing of international financial relations changed over the crisis-era. This period saw the securing of global financial stability through collective institutions and the adoption and oversight of common standards become the major preoccupation of international financial relations. The G20 reform agenda dictated the outline shape of reforms internationally and central steering in relation to the amplification and implementation of the reforms - through standard adoption and the monitoring of standard implementation - was provided by the ISSBs, notably the FSB. An extensive international political economy and international financial regulation literature canvasses the drivers of this change.[106] Notwithstanding this movement towards greater standardization, as the financial stability imperatives of the crisis-era have receded it has become clear that difference and divergence still characterize international financial governance. As international standards have been adopted, they have been filtered through national systems to reflect national interests and have diverged.[107] There are few incentives to concede national supervisory control given the complexities and costs associated with the allocation or sharing of related fiscal risk which the financial crisis exposed: the EU's Banking Union, forged at a moment of existential crisis for the euro area, remains a striking exception with its risk-sharing mechanisms. Enforcement remains a distinctly national affair, shaped by deeply entrenched national legal, institutional, and cultural dynamics.[108] The resulting system has been well described as a system characterized by 'mutual adaptation' and 'co-operative de-centralization'.[109] In the absence of effective means through which the quality of the foreign/third country system can be assessed and ensured there are few incentives for regulators to allow market access on the basis

[104] The loss of competitiveness was initially charted in the Paulson Report (Committee on Capital Markets Regulation, Interim Report (2008)). A subsequent and lively policy and academic debate queried whether US regulatory policy was a factor in the decline of US market attractiveness and competitiveness and if such a decline was real.
[105] See eg Jackson, n 85, and R Karmel, 'The EU Challenge to the SEC' 31 *Fordham International Law Journal* (2008) 1692.
[106] See eg E Helleiner, S Pagliari, and H Zimmerman (eds), *Global Finance in Crisis* (Routledge, 2010), and D Mugge, *Europe and the Governance of Global Finance* (OUP, 2014).
[107] A classic example concerns the EU's implementation of the Basel III agreement, which led to a finding of 'materially noncompliant' under the Basel Committee's review of EU implementation: Basel Committee, Regulatory Consistency Assessment Programme (RCAP), Assessment of Basel III Regulation – European Union, December 2014. On the divergence between the EU and US approaches to Basel implementation see K Young, 'Tying Hands and Cutting Ties: Explaining the Divergences Between the EU and US in Global Banking Reforms since the Crisis' 17 (1-2) *Journal of Banking Regulation* (2016) 46.
[108] See, eg, the survey by IOSCO: IOSCO, Credible Deterrence in the Enforcement of Securities Regulation (2015).
[109] Helleiner and Pagliari, n 19.

of foreign rules or to limit the export of their standards to transactions which may impact on their markets.[110]

Verdier has characterized the core challenge relating to market access and export as an enforcement one: how can states and their regulators be prevented from exploiting opportunities under access and export arrangements and from evading their reciprocal obligations, particularly given the difficulties in verifying compliance?[111] The challenge is all the greater as to date there has been no delegation to the collective international institutions of international financial governance (the ISSBs) to monitor access/export arrangements, although IOSCO is showing some enthusiasm for such a delegation. Its Multilateral Memorandum of Understanding (MoU) on Consultation, Cooperation and Information Exchange (2012) can act as a template for related cooperation arrangements, while its Principles Regarding Cross-Border Supervisory Cooperation (2010) similarly support supervisory cooperation. More generally, the array of standards which IOSCO has adopted can support negotiations on access and export arrangements. Most recently, IOSCO has adopted a wide-ranging report on market access arrangements which is designed to inform its members of the different design choices available.[112]

Two forms of device are usually deployed by regulators internationally to deal with market access and rule export. First, under the host state control approach or 'national treatment', financial actors (registered in their home state – in EU parlance, the third country) are simply subject to the regulatory and other governance requirements of the host country in which they provide cross-border services, although different forms of exemption or special treatment may be available. Engagement with the actor's home country is limited. While national treatment increases transaction costs for the third country actor, it supports a level playing field domestically and minimizes the regulatory risk to the local market. It also facilitates market access as exemptions may be available for the third country actor in appropriately justified circumstances.[113] These exemptions are typically not related to an assessment of the relevant home jurisdiction, however. National treatment is commonly applied by regulators globally, in a range of sectors, and in developed and emerging markets.[114]

Second, under what can be termed a 'deference' model, some form of deference to the home state (third country) where the financial actor is authorised and supervised is engaged in. This is typically achieved through an equivalence

[110] On the difficulties in comparing and assessing regulatory regimes, particularly in relation to supervision and enforcement, see, eg, Coffee, n 85, and H Jackson, 'Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' 24 *Yale Journal on Regulation* (2007) 101.
[111] N 102.
[112] IOSCO, Task Force on Cross Border Regulation. Final Report (FR/23/2015).
[113] In the US, eg, 'foreign private issuers' of securities are eligible to provide required disclosures under a tailored US SEC arrangement which imposes very similar requirements as those which apply to non-eligible issuers, but which contains certain accommodations, notably in relation to the availability of International Financial Reporting Standards (IFRS) financial reporting standards as an alternative to US GAAP reporting standards.
[114] IOSCO n 112, 7.

assessment which leads to some form of mutual recognition (whether in relation to access or rule export). Under this model, an administrative process is put in place through which the home (third country) and host regulators 'mutually recognize' their respective regulatory regimes following an assessment process.[115] The nature of the equivalence assessment varies. It can examine, for example, the 'adequacy', 'suitability,' or 'equivalence' of the other regime. Equivalence assessments can be formal and limited to rules only or they can cover supervision and enforcement (what is usually termed 'substitute compliance'). The latter assessment can be limited to an examination of the formal powers of supervisors or extend to how powers are used, including in relation to the risk tolerance of the supervisor and the resources at its disposal. The reach of the assessment can be (and usually is) limited to distinct financial sectors (such as fund-raising, brokerage, or asset management) and to discrete market segments (usually the professional markets to minimize the risks to the relevant regulators from major retail market failures). The equivalence assessment is typically outcomes-based, and not focused on a granular, line-by-line comparison of rules. The measures used to evidence the achievement of outcomes are varied but often include analyses of the relevant home/third country rules and the nature of the relevant legal system; levels of investor protection (including, for example, redress arrangements such as dispute resolution and compensation schemes); the enforcement capability of the home regulator; levels of supervisory oversight; the legal framework governing international co-operation; the outcomes of standardized assessments carried out by the IMF and/or the ISSBs; and membership of international/regional organizations. The typical model leads to host state registration of the actor in question who is then eligible for a range of exemptions from host state regulation. The extent to which the host regulator relies on home/third country supervision and enforcement varies, although host states will often retain enforcement power in identified areas. Detailed cooperation and information-sharing arrangements typically underpin the equivalence/mutual recognition arrangement. Reflecting the dynamism of financial governance, the final agreement will generally also include notification mechanisms under which both states commit to informing the other of significant changes to their regulatory regimes which may have a material impact on the mutual recognition/equivalence arrangement. In some cases, the relevant states/regulators conduct a full assessment every 4-5 years, while others rely on notification arrangements to assess the ongoing viability of the arrangement. Overall, administrative and institutional structures are thin: assessment, agreement, and monitoring are typically carried on a peer-to-peer basis by the regulators engaged.

The equivalence/mutual recognition method has several benefits.[116] It is not dependent on multilateral agreement or exposed to related defections. It preserves

[115] The recurring themes of mutual recognition regimes internationally have been reviewed recently by IOSCO. Ibid.
[116] This para draws on the extensive review by Verdier, n 102.

differentiation between regulatory regimes and useful experimentation. From the host state perspective, it supports subsidiarity in that the host regulator can dictate the regulatory outcomes for the local market. It also facilitates access to the host state market, signalling its openness to foreign business, and thereby can deepen funding sources and diversification/risk management opportunities.[117] From the home state perspective (the third country), it limits the regulatory disruption to home state actors, providing (depending on how the administrative process is designed) legal certainty and the potential for some transaction cost reduction. But there are significant risks and costs. IOSCO has described the challenge as how 'to ensure that potential solutions do not weaken the effectiveness of domestic regulation while, at the same time, not unduly constraining the cross-border offering of financial services or products.'[118] The scale of this challenge has led to there being relatively few examples of mutual recognition/equivalence regimes for capital markets internationally. The following, non-exhaustive analysis identifies the major examples relating to the capital market intermediation services which are essential to CMU and which may hold lessons for the EU.

4.2 Investment Services

Mutual recognition/equivalence regimes governing investment services are rare internationally. To take an example from a smaller market, the Malaysian Temporary License Framework, established in 2009, uses an equivalence assessment to grant exemptions from local rules.[119] Bilateral in nature, it permits individuals regulated by a foreign (home/third country) regulator to carry on regulated activities in Malaysia for short six-month periods where the individual is licensed or approved in the home jurisdiction, the regulation of the foreign licensed company in question is 'sufficiently equivalent' to the Malaysian regulatory framework, and cooperation arrangements apply. The regime is limited in scope, applying only to corporate finance and investment advice to institutional and sophisticated clients in Malaysia.

By contrast, the US - the major global capital market - has not adopted a mutual recognition/equivalence arrangement for investment services, usually following a national treatment approach which is moderated by exemptions.[120] This approach reflects the jurisdiction of the US Securities and Exchange Commission (SEC) over investment services and trading venues and its longstanding suspicion of third country regulatory, and particularly supervisory and enforcement, standards, which can be related to the deep imprinting of its investor protection mandate on the

[117] The 'TransTasman' mutual recognition regime which supports securities offerings by issuers in New Zealand and Australia by providing for mutual recognition of prospectus offer documents is regarded as a success, being credited with cost savings from 55% to 95% for firms and with accelerating the prospectus approval process: IOSCO, n 112, 15.
[118] Ibid, 1.
[119] Malaysia Securities Commission, Temporary License (with reference to Licensing Handbook).
[120] See Jackson, n 85.

agency.[121] The SEC has, for example, been resistant to equivalence-related arrangements for the placing or establishment of trading screens by foreign/third country trading venues in the US, imposing a national treatment approach.[122] By contrast, the US CFTC, which has jurisdiction over the commodity derivatives markets (which have a wholesale market orientation), has adopted a more liberal approach to the placing of trading screens for commodity derivatives trading in the US. It has adopted a bilateral, equivalence-based approach, contingent on an equivalence assessment and based on CFTC registration of the foreign trading venue.[123] The CFTC permits such screens (subject to home/third country regulation, supervision, and enforcement but CFTC registration) where the foreign trading venue is subject to comprehensive supervision and regulation by appropriate governmental authorities that is comparable to comprehensive supervision and regulation under CFTC rules and US law. The pivotal equivalence determination is based on a 'principles-based review'. The CFTC will look to determine if the foreign government authorities support and enforce regulatory objectives that are 'substantially equivalent' to the regulatory objectives supported and enforced by the CFTC. The equivalence regime also deals with dynamism, providing that an annual certification must be made by the trading venue in question (not the home/third country regulator) that there has been no material change to the home regulatory system. Where such change has occurred, this is grounds for revocation if the change alters the CFTC registration conditions. These registration conditions include that the trading venue adheres to appropriate rules on abusive trading practices, is authorized by a regulatory process that examines customer and market protections, and is subject to continued oversight by a regulator that has the power to intervene in the market and has authority to share information with the CFTC.

There were, however, indications prior to the financial crisis of a more liberal approach from the US SEC to mutual recognition/equivalence assessments of regulatory regimes governing trading venues (and broker/dealers). The 'substitute compliance' model proposed by the SEC in 2007 is the most closely examined of mutual recognition/equivalence models internationally.[124] It represented at the time a major departure from the SEC's national treatment approach and exemplified the more liberal, competition-driven approach which characterized much of international financial relations prior to the financial crisis. It did not prove to have traction as the financial crisis intervened, but it merits consideration as the 'substitute compliance' approach it adopted to equivalence assessments is potentially powerful and has since been adopted for other market segments, notably in relation to market infrastructures (as outlined below). Originally proposed by two

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[121] See generally D Langevoort, *Selling Hope, Selling Risk* (OUP, 2016).
[122] See Verdier, n 112, and Jackson, n 85.
[123] Under Part 48 of the Federal Regulations on Commodities and Securities Exchanges.
[124] See, eg, H Jackson, 'A System of Selective Substitute Compliance' 48 *Harvard International Law Journal* (2007) 103, and E Pan, 'A European Solution to the Regulation of Cross Border Markets' 2 *Brooklyn Journal of Corporate, Financial and Commercial Law* (2007) 133.

senior SEC officials in a 2007 journal article,[125] the 'substitute compliance' model called for a more liberal approach to market access to facilitate retail investors in diversifying their portfolios and to enhance market access to the US. The new model was characterized by its proponents as a 'significant departure' from SEC practice but as a logical response to internationalization and to the need to reduce the costs of access to foreign investments in the US. The new model was to be bilateral and reciprocal in nature and to support exemptions from SEC regulation. The preferences driving it were clear: it was designed to facilitate US access to services and products which would not otherwise be available. The new model adopted a light-touch approach and did not provide for dispute resolution mechanisms; compliance was to be achieved through self-monitoring and notices to the relevant home (third country) and host regulators. The core 'substitute compliance' assessment was characterized as requiring evidence that US investors would be comfortable assuming any additional risks entailed, given supervision of the third country actor by a regulator with oversight powers and an enforcement philosophy substantively similar to the SEC's. The substitute compliance assessment would assess the ability of the foreign regulator to achieve the objectives of US law, so that the SEC would not be in violation of its mandate relating to investor protection and support of strong markets. It would include examination of general legal and enforcement capability as well as specific requirements relating to the relevant market sector. Substitute compliance determinations would be underpinned by agreements on cooperation and on sharing enforcement and supervisory information. Monitoring was specifically provided for: a five-year review of comparability 'in depth and de novo' would follow and both host and home (third country) regulators would have discretion to review the arrangement at any time following a substantial change.

The SEC's substitute compliance model did not come to fruition. The SEC entered into only one mutual recognition arrangement, with the Australian capital markets regulator (ASIC), in 2008,[126] following which the financial crisis intervened and the SEC re-trenched. The practical elements of the SEC/ASIC arrangement are nonetheless instructive. The arrangement acknowledged that 'core securities regulatory principles' and the 'manner these principles are given effect via regulation' had been assessed (how was not made clear), and that the assessment recognized that regulations may appropriately be tailored to different markets and reflect different philosophies.[127] The arrangement dealt with regulatory dynamism by means of a commitment by each party that it would 'endeavour to inform' the other of pending regulatory changes that might have significant impact and of

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[125] E Tafara and R Peterson, 'A Blueprint for Cross Border Access to US Investors: A New International Framework' 48 *Harvard International Law Journal* (2007) 31.

[126] The elements (adopted on 25 August 2008) included: an SEC/ASIC Mutual Recognition Arrangement under which the SEC and ASIC agreed a framework to consider exemptions from regulation in their jurisdictions; an Enhanced Enforcement MoU; and a Supervisory MoU. Exploratory talks with Canada and the EU foundered because of challenges raised by their federal/supranational decision-making structures.

[127] SEC/ASIC, Mutual Recognition Arrangement, Item Five.

material events and operational changes. Operationally, the SEC and ASIC were to keep each other informed of changes, on notification the other regulator could request a meeting to consider whether changes were required, and the arrangement would be reviewed in full every five years, following which the regulators could mutually decide to renew or modify. Notably, either regulator could terminate with 60 days' written notification.[128] The ASIC/SEC arrangement was based on an eligible authorized financial actor being registered in the relevant home/third country jurisdiction and being eligible for exemptions in the host state – a degree of host autonomy was therefore maintained. In practice, no exemptions were issued and the arrangement was subsequently rolled into ASIC's new mutual recognition system (outlined below). Along with the substitute compliance model, the SEC around this time also committed to review the highly complex exemptions available for foreign broker-dealers under US law.[129]

The most advanced and wide-ranging mutual recognition/equivalence regime for financial services more generally appears to be that of ASIC, the Australian markets regulator. Under ASIC's bilaterally-oriented regime, where an equivalence assessment of the relevant home/third country has been adopted, an exemption from licensing requirements and ongoing regulation becomes available for foreign financial services providers, in respect of their wholesale clients.[130] ASIC has adopted a series of 'class orders' under which identified classes of financial actor regulated by the UK Financial Conduct Authority, the US SEC and CFTC, the German Bafin, and the Hong Kong and Singapore regulators are eligible for exemptive relief.[131] This mutual recognition/equivalence arrangement has its roots in the earlier 2008 ASIC/Australian Treasury consultation which explored in some detail the different policy options available for market access and related mutual recognition/equivalence frameworks. The consultation related mutual recognition to the notion of 'substantial equivalence' and proposed reforms to the (then) governing ASIC principles for recognition decisions and for the application of related discretions and exemptive relief.[132] The subsequent, highly articulated approach to mutual recognition/equivalence was set out in an ASIC Regulatory Guide which is based on a series of General and Equivalence Principles.[133] The core General Principle 1 provides that ASIC recognizes overseas (third country) regulatory regimes that are 'sufficiently equivalent' to the Australian regulatory

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[128] Ibid, Item Six.
[129] The exemptions were available in very limited circumstances where foreign broker-dealers had limited contact with the US market and only engaged with sophisticated US investors.
[130] ASIC, Principles for Cross-Border Financial Regulation, Regulatory Guide 54 (2012), and ASIC Regulatory Guide 176 (2012).
[131] ASIC, Information Sheet 157, Foreign Financial Services Providers – Practical Guidance (2015). The class orders continue to evolve. In November 2016 exemptive relief was extended to specified classes of fund manager regulated by the Luxembourg CSSF (ASIC, 16-401MR Relief for Foreign Financial Service Providers from Luxembourg).
[132] ASIC/Australian Treasury, Joint Consultation Paper, Cross Border Recognition, Facilitating Access to Overseas Markets and Financial Services, ASIC CP No 98 (2008).
[133] ASIC, Regulatory Guide 54, n 130.

regime in relation to the degree of investor protection, market integrity, and reduction of systemic risk that they achieve. The Principle makes clear that the related equivalence assessment by ASIC is to be 'outcomes-focused' and will not necessarily involve a comparison of the regulatory mechanisms used to achieve outcomes. 'Sufficiently' is tied to the degree of deference sought; if only limited exemptive relief is sought, the degree of equivalence required will be more limited. The other General Principles state that ASIC will give the 'fullest possible recognition' to sufficiently equivalent regimes and, accordingly, will limit the application of its rules as a host state; cover cooperation and enforcement in that they require that ASIC must have effective cooperation arrangements with the relevant overseas/third country regulatory authority and must be able to enforce Australian laws that apply to the relevant foreign actors (which may be achieved through conditions on a license), and that adequate rights and remedies must be 'practically available' to Australian investors and clients; and address disclosure, requiring that adequate disclosure must be made to Australian investors of the information they might reasonably require to make an informed assessment of the consequences of differences between Australian and the relevant foreign country rules. The related equivalence assessment by ASIC is governed by four Equivalence Principles which provide that: an equivalent regulatory regime is clear, transparent, and certain (in that it is not subject to indiscriminate change); consistent with the IOSCO Objectives and Principles of Securities Regulation; adequately enforced in the home/third country jurisdiction; and achieves 'equivalent outcomes' to the Australian regulatory regime. Specific principles govern the equivalence of outcomes in discrete market sectors, including markets, financial services, and financial products. The mutual recognition system is not supported by a dedicated institutional structure to monitor arrangements, but the relevant third country/home authorities must be committed to the arrangement; timely and effective cooperation is required during negotiation and assessment; and authorities must be willing to enter into enhanced effective cooperation agreements.

4.3 Infrastructure

Market infrastructures, such as trading venues and CCPs, have also been the subject of mutual recognition/equivalence arrangements internationally. As noted above, the US CFTC uses a 'substantial equivalence' test to assess whether foreign trading screens for commodity derivatives trading can be established in the US and be eligible for exemptions from CFTC regulation. In Latin America, the Mercado Integrado Latinoamericano (MILA) integrates the stock markets of Chile, Columbia, Mexico, and Peru and allows investors to trade through registered brokers who can access the common MILA trading platform to execute trades in securities in any of the four MILA member stock markets. MILA member jurisdictions have entered into a related mutual recognition arrangement which supports the operation of the integrated trading platform, although the issuers listed

on the four exchanges and brokers are authorized and supervised by their home authorities.[134]

Recently, most attention has focused on mutual recognition/equivalence arrangements for CCPs. These often very new arrangements have been shaped by the sweeping regulatory reforms required internationally under the G20 crisis-era reform agenda for derivatives markets. Despite the extensive international standards which have been adopted to embed the reforms, significant difficulties have been generated by the resulting duplicative and sometimes conflicting regulatory regimes worldwide which reflect strong and differing national preferences on how the international standards are applied.[135] Calls for greater efforts to achieve 'deference' in this area have come from the FSB and the G20,[136] and related progress is being monitored by the FSB which has called for greater transparency on how jurisdictions approach related equivalence assessments. The deference arrangements which are slowly being adopted are concerned to a much greater extent with reducing the extra-territorial impact (export) of domestic requirements on cross-border derivatives transactions than with traditional market access. They have also been politicized to a much greater than other mutual recognition/equivalence arrangements given the significant distributional effects associated with the reforms.[137]

US/EU negotiations on CCP mutual recognition/equivalence arrangements, for example, were fraught, even though the CFTC, which regulates CCPs, applies a substitute compliance model. In March 2016, the CFTC approved a substitute compliance agreement for CCPs authorized in the EU, following a highly contested and delayed equivalence agreement between the European Commission and the CFTC on CCP regulation and a related Comparability Determination by the CFTC.[138] This followed 'extensive analysis' by the CFTC and Commission of the differences between CFTC and EU regulation and their significance. Following the agreement, EU-authorized CCPs must be registered with the CFTC but can follow EU requirements in certain significant respects, in accordance with the CFTC's Comparability Determination.

Substitute compliance arrangements are also used to manage the export of the related US rules which (implementing the G20 reform agenda) impose risk management requirements on derivatives transactions more generally.[139] The SEC regime (for transactions in security-based swaps), adopted in 2014, provides that

[134] IOSCO, n 111, 14.
[135] See further Knaack, n 102.
[136] A G20 September 2013 statement called for deference by regulators where it was justified by the quality of regulatory and enforcement regimes: G20 Leaders' Declaration, September 2013, para 71.
[137] Knaack, n 102.
[138] CFTC, Press Release PR7342-16, 16 March 2016.
[139] On the highly complex requirements see A Artamonov, 'Cross-Border Application of OTC Derivatives Rules: Revisiting the Substitute Compliance Approach' 1 *Journal of Financial Regulation* (2015) 206 and P Architzel, D Berkovitz, G Bernstein, S Davis, and T Serafini, 'Dodd Frank Implementation Update: Key Differences between the CFTC and SEC Final Business Conduct Standards and Related Cross-Border Requirements' 17(3) *Journal of Investment Compliance* (2016) 31.

certain transactions/actors (not all) are exempted from certain (not all) SEC requirements where a finding of substitute compliance is made in that the foreign/third country regulatory regime is 'comparable' based on an assessment of regulatory outcomes in respect of four regulatory categories. The SEC's substitute compliance assessment is designed to be holistic and outcomes-based[140] and includes an assessment of the effectiveness of supervision and enforcement. A finding of substitute compliance can be withdrawn by the SEC after a 'notice and comment' period and is subject to periodic review. The parallel CFTC regime (for commodity derivatives) is similarly based on a substitute compliance assessment and follows a comparability-based and holistic approach which is concerned with regulatory outcomes.

4.4 ASSET MANAGEMENT/INVESTMENT FUNDS

There are very few examples of mutual recognition/equivalence arrangements relating to investment funds internationally. Singapore applies a (unilateral) recognition arrangement under which the Singaporean regulator will only 'recognize' (a precondition for market access) a foreign/third country fund if the laws and practices of the foreign jurisdiction, including with respect to investor protection and the operation of the fund, provide Singaporean investors with protection at least equivalent to that provided under Singaporean regulation.[141] The stand-out example is the recent 'Asia Region Funds Passport', a multilateral mutual recognition/equivalence regime relating to funds which is applied by Australia, Japan, South Korea, and New Zealand. The passport is designed to support cross-border offerings of eligible funds – in effect, to construct a single market for managed funds.[142] It is supported by a Memorandum of Cooperation (2016) and a related Framework Document[143] which sets out the operational detail. Its scope is limited to identified authorized funds, primarily those with a retail focus. The core obligation is for member jurisdictions, to the fullest extent possible, to recognize and respect the integrity of their respective regulation. Authorization in the relevant host state is required but an expedited process applies which reflects the passport's 'stepped approach' which allocates regulatory competence between regulators. Host rules apply in certain areas, notably where there is direct interaction between the fund and investors (such as disclosure and distribution/marketing requirements). A category of harmonized 'passport special rules' governs streamlined authorization by the host state as well as several areas which are sensitive for host regulators,

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[140] The SEC has stated that its approach is to 'focus on whether the foreign regime achieves regulatory outcomes that are comparable to [those sought by US law] rather than basing the ultimate determination on a rule-by-rule comparison': SEC, Fact Sheet, Cross-Border Security-Based Swap Activities, 1 May 2013.
[141] IOSCO, n 112, 13.
[142] Asia-Pacific Economic Cooperation, Statement of Understanding on the Establishment of the Asia Region Funds Passport.
[143] Asia-Pacific Economic Cooperation, Statement of Intent on the Establishment of the Asia Region Funds Passport, Appendix B, Asia Region Funds Passport Framework Document.

including the funds which qualify for the passport and rules governing fund delegation and custody arrangements. The home state is allocated all other rules, including those governing initial fund authorizations. Specific institutional arrangements apply in the form of a Joint Committee of member regulators which monitors the operation of the passport, recommends amendments, and assesses applications from jurisdictions for membership.

4.5 Learning from International Financial Governance

Several themes can be identified from the mutual recognition/equivalence regimes applied to capital market access (and rule export) internationally. They tend to be sector-specific, focusing on distinct market segments. They are usually bilateral - multilateral/regional arrangements are few and far between with the Asia Region Funds Passport a rare example of a multilateral arrangement. They are still relatively uncommon internationally, with the EU single market passport far and away the most advanced and extensive form of mutual recognition/equivalence arrangement internationally.[144] Regimes have been shaped by different preferences and legacies and are not easily transplantable. Different approaches are taken to equivalence, although outcomes-based approaches are common. Whether regimes require host state registration similarly varies. There is no single template internationally on which the EU could base a new mutual recognition/equivalence regime designed to accommodate the specific risks raised by Brexit for capital markets and for CMU and to accommodate EU and UK preferences. No regime internationally is as wide in scope as the EU's current (admittedly problematic) third country regime. No regime has institutional support or monitoring mechanisms of the type which a wide-ranging EU/UK arrangement would likely require.

But there are nonetheless useful lessons for the EU from the range of challenges which these arrangements have posed to their contracting parties. Examples are available of how equivalence is assessed, the benchmarks which are used, and the types of proxies (including international standards) which can be deployed. Examples are also available of how monitoring can be achieved, whether through notification requirements or formal review arrangements. Perhaps the most salient lesson is the one from the evolution of these arrangements: the US SEC substitute compliance model did not survive the financial crisis, underlining that access and export equivalence arrangements must be made resilient to financial market disruption. Engagement with supervisory coordination and cooperation and with supervisory equivalence - and not simply regulatory equivalence - must accordingly be a feature of any new EU arrangement.

[144] There are other examples of passporting, most notably the Canadian passporting arrangements which reflect the similarities in regulation across Canada's federal regulatory system and which provide that prospectus approval, applications for exemptions by regulated actors, and authorizations for dealers and advisers across the different Canadian provinces and territories can be approved by the relevant home regulator. See further IOSCO, n 112, 36.

5. BUILDING A NEW MODEL: THE EU PERSPECTIVE AND A PROPOSAL

5.1 COMPETING VISIONS OF EQUIVALENCE

Calls for a bespoke mutual recognition/equivalence arrangement to govern access and export, as part of a EU/UK Free Trade Agreement, are becoming increasingly frequent in the UK. 'TheCityUK', a leading lobbying group, has called for 'a framework for the mutual recognition of regulatory regimes, building on and going beyond the existing equivalence regimes' which would be 'embedded in a long-term, stable framework.'[145] UK Trade Minister Garnier has called for 'a special hybrid version … with a better version of equivalence or a different version of passporting.'[146] UK Financial Conduct Authority Chief Executive Bailey has called in general terms for a re-thinking of international market access arrangements and for these arrangements to be based on an equivalence assessment which is tied to compliance with international standards; home country (third country) control over culture- and incentives-related governance requirements; and host country control over conduct regulation.[147] An extensive industry report has been prepared assessing how a new approach to equivalence might be approached.[148]

The EU's preferences in relation to UK market access/equivalence are not yet clear. The EU is likely to be sensitive to the damage which an abrupt rupture from the UK capital market could wreak on the EU capital market and to the weaknesses in the current third country regime.[149] But it can be expected to make a distinction between access to and membership of the single market to protect the integrity of the single market. It will likely protect, accordingly, the distinct and hard-fought regulatory and institutional governance arrangements which support the single market in financial services and passporting and the related equivalence/third country arrangements. The Commission's delicately timed February 2017 Equivalence Report is not directed to the UK. But it has a chilly tone, emphasising that equivalence is not concerned with trade liberalization but with ensuring prudential stability, underlining the discretionary nature of Commission decision-making, and noting that equivalence decisions primarily benefit EU market participants, in particular in relation to the export rules.[150] The mood music from the ECB is similar. One member of the ECB executive board has acknowledged that the position of the City of London will require consideration but has also

[145] N 6.
[146] Quoted by Bloomberg, 16 October 2016.
[147] N 5.
[148] N 7.
[149] A leaked European Parliament ECON committee report signals the European Parliament's concern to avoid a 'badly designed' deal which excludes the main European financial centre from the single market: D Boffey, 'EU will Lose Out from Bad Brexit Deal on City, says Leaked Report,' *The Guardian*, 1 February 2017.
[150] 2017 Commission Equivalence Report, n 9.

underlined the euro area's concerns relating to financial stability, investor protection, and a level playing field for financial actors.[151] But the Commission and the ECB will not determine the Brexit negotiations on capital market access. A multitude of national and supranational interests which are political, economic, and market-facing in orientation will influence the EU's negotiating position. These interests will diverge and coalesce across shifting national, single market, and euro area coalitions and will be shaped by multiple factors, including competing perceptions of how financial markets in the EU should be organized. These interests and preferences are familiar from the development of the EU capital market and its governance arrangements. But they will be interacting in a unique context which makes their nature and interaction very difficult to predict. At the risk of reductionism, the essential question on which these interests and preferences will operate can be outlined in these terms: will an EU concern to ensure that capital markets are not disrupted and to adopt a posture signalling openness to the global economy after Brexit weigh more heavily than a concern to preserve the integrity of current governance arrangements, notably the dependence of passporting-like arrangements on single market membership and/or to seek competitive advantage over the UK? It is already clear that the structure of local financial markets, and their relative degree of exposure to financial stability risks, shapes how Member States approach market access issues generally.[152] Multiple related questions arise, including whether the EU is prepared to offer a bespoke model to the UK, prepared to cede Court of Justice oversight over any related decision-making procedures for equivalence determinations, or prepared to adopt a minimalist approach to equivalence - tied, perhaps, to a UK commitment to comply with an identified set of international standards.

There is some clarity, however. The evidence suggests that the EU will rethink - at least to some extent - its approach to equivalence more generally. The Commission is reported to be in the process of reviewing the equivalence regime[153] and has recently set out its stall on equivalence in its 2017 Equivalence Report which suggests, as discussed in section 5.3, some appetite for a recasting of the regime. The review initiative predates Brexit, reflecting a wider pre-Brexit political focus on the third country regime. Earlier in 2015 the ECOFIN Council had, in the context of CMU, called on the Commission to assess the impact of third-country regimes, including equivalence arrangements, on the structure of European capital markets and on financial sector competitiveness.[154] At the administrative ESA level, ESMA, which has built significant technocratic capacity and credibility in advising the

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[151] M Khan, 'ECB's Coeuré Raises Concerns over City's EU Access after Brexit', *Financial Times*, 22 January 2017.
[152] Quaglia, n 50.
[153] A Barber and J Brunsden, 'EU Review Casts Doubt on City's Hopes for 'Equivalence' as Brexit Last Resort' *Financial Times*, 7 November 2016, and C Grant, Brussels Prepared for a Hard Brexit, Centre for European Reform, 21 November 2016.
[154] Ecofin Council Conclusions on Commission Action Plan on Building a Capital Markets Union (Council Document 13922/15), 10 November 2015.

Commission on equivalence assessments, has called for refinements to the equivalence regime and for a strengthening of its role.[155] There are certainly grounds for suggesting that a new equivalence regime will appear in the short to medium term, although whether this takes the form of a bespoke EU/UK model which forms part of a Free Trade Agreement, or a new, horizontal third country regime set out in EU legislation and applying erga omnes, is not clear.

5.2 A Bespoke EU/UK Arrangement

The current third country/equivalence arrangements were not designed to manage the EU's relationship with the UK capital market or to moderate the risks arising from a blockage in the UK financial services pipeline - which carries some 35% of EU wholesale financial services. A bespoke arrangement, proposed in the Article 50 letter, is not accordingly to be lightly dismissed. Speculating on the shape of any bespoke equivalence arrangement to be contained in a EU/UK Free Trade Agreement is nonetheless a fraught exercise.

In principle, such an agreement should be achievable. Verdier has suggested that successful forms of mutual recognition/equivalence are usually associated with strong home (third country) and host institutions which support the rules applied in each jurisdiction; cultural, legal, and market development similarities; strong private demand for such arrangements; similar regulatory incentives for home and host states to cooperate and support market access; the creation through the equivalence process of incentives to comply; and bespoke cooperation arrangements.[156] All of these conditions are either (more or less) in place or can be constructed with goodwill and some imaginative design – but goodwill and an appetite for imaginative design cannot be assumed. Another study has suggested that equivalence can be achieved where there is parity in public policy objectives; shared regulatory principles; a shared regulatory ethos; and shared intended outcomes.[157] All four of these elements should also characterize EU/UK negotiations.

But there are two significant difficulties. First, there is an asymmetry to the different incentives of the EU and the UK, not least among them that the EU may subordinate its economic interests in the EU capital market to its wider interest in protecting the integrity of the single market and its need to signal accordingly that third country rights must be inferior to EU membership rights. Second, the related institutional issues and preferences, particularly in relation to potential supervisory solutions, are complex. EU financial governance in relation to supervision has

[155] ESMA has, eg, called for the EMIR equivalence process to be expedited: ESMA/2015/1254. More recently and more generally ESMA Chairman Maijoor has called on the EU to consider redesigning its approach to equivalence, in particular to address supervisory risks: Keynote Speech, Prime Finance Conference, 23 January 2017.

[156] Verdier, n 102.

[157] 2017 FSNF/Norton Rose Report, n 7.

national and supranational elements which interact within the European System of Financial Supervision. Supervision is an essentially national function in the capital markets sphere - national supervisors and ESMA cooperate in relation to supervisory coordination but ESMA has only very limited direct supervisory powers. Allocating the supervision of third country actors and the related fiscal risks is not therefore a straightforward task, as the AIFMD negotiations made clear. Overall, and as the often-torturous negotiations on the EU's current third country rules suggest, negotiations are unlikely to be easy.

For example, there is some support in the UK for a light-touch equivalence arrangement based on an EU/UK commitment to compliance with (identified) international standards.[158] While such an economical approach has the attraction of side-stepping the complexities and vagaries of a full equivalence assessment and of managing the regulatory divergence difficulty noted in the Article 50 letter, it is not a straightforward proposition. There is little experience with such an approach. International standards have hitherto been used to set a base line for the support of financial stability and other regulatory objectives internationally; they have not been designed for market access and to facilitate deference by host regulators. While international standards do form part of equivalence assessments internationally, compliance does not replace the assessment. Questions also arise as to which standards would ground any equivalence agreement – there are now a great number in the capital markets sphere, deriving from IOSCO's work in particular. Difficult issues also arise relating to the treatment of standards where the EU has previously 'carved out' from the standard. The EU has not followed the Basel III agreement in several respects, for example, and might be expected to resist an equivalence arrangement which allowed the UK to follow a different set of Basel rules to its competitive advantage. International financial governance already provides a cautionary tale. The US SEC's agreement to allow international/third country issuers in the US to use International Financial Reporting Standards (IFRS) rather than US GAAP for regulatory purposes in the US was dependent on compliance with IFRS as adopted by the IASB (the relevant ISSB) – not compliance with 'IFRS with carve-outs'.[159]

Supervision poses a distinct challenge. There is already some concern that the equivalence arrangement which governs third country CCP access to the EU market, and which is based on ESMA registration and third country supervision, is not sufficiently robust. ESMA has raised concerns as to the EU's 'open' approach to CCP equivalence under EMIR which relies heavily on the third country as the CCP supervisor.[160] More generally, there is some concern in the European

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[158] Ibid.

[159] SEC Press Release 2007–235, SEC Takes Action to Improve the Consistency of Disclosure to US Investors in Foreign Companies, 15 November 2007, and SEC Release Nos 33-8879 and 34-57026.

[160] ESMA Report on EMIR (ESMA/2015/1254). ESMA has warned that it has very few powers to intervene in an emergency and that the EU market may be at risk. Recently, ESMA Chairman Maijoor has warned that the EU 'is an island of equivalence and third country reliance in a world that has mostly opted

Parliament as to how the post-Brexit cross-border supply of financial services from the UK would be supervised,[161] while the Commission in its 2017 Equivalence Report has identified supervision as an area needing more attention.[162] Would or should the EU require that all UK financial actors seeking EU market access under a new equivalence regime register with ESMA, and what degree of supervisory oversight would the EU require to protect the financial stability of the EU financial system? The complexities then start to mount. Under current constitutional arrangements, could ESMA be appropriately empowered to register and have (some degree of) supervisory oversight over a potentially wide range of UK financial actors, bearing in the mind the over 5,000 UK passports currently in use? Aside altogether from the fiscal risk allocation problem, the *Meroni* restriction on the exercise of discretionary power by EU agencies may prove troublesome; ESMA's supervisory powers are circumscribed and limited to ensure compliance with *Meroni*.[163] If not ESMA, then which Member State would act as the EU supervisory anchor for cross-border activity from the UK? There are examples from the Prospectus Directive and the AIFMD but they are sector specific. Alternatively, would UK-based home/third country supervision, supported by supervisory cooperation arrangements managed through ESMA and built on the coordination arrangements in which the UK currently participates, suffice – functionally and politically? It is also difficult to envisage an equivalence arrangement without some form of monitoring and dispute resolution authority to avoid defection problems. But the EU is unlikely to cede oversight by the Court of Justice of the EU. It is also unlikely to cede Commission monitoring and decision-making, given the Commission's long experience in this area. The European Parliament is increasingly active in international financial governance and may also seek an oversight role.[164] GATS considerations also arise. A bespoke model may breach the GATS 'most favoured nation' (MFN) clause. Exceptions to the MFN obligation are, however, available for 'economic integration arrangements' which can include mutual recognition/equivalence agreements.[165]

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for registering individually those infrastructures and market participants which want to do cross-border business' and raised concerns as to whether 'sufficient assurance' is available that the risks of third country infrastructures in the EU are adequately assessed and addressed by the third country regulator: Keynote Speech, Prime Finance Conference, 23 January 2017.

[161] J Brunsden, 'MEPs Urge Closer Oversight of City of London after Brexit,' *Financial Times*, 10 March 2017.

[162] N 9, 12.

[163] Case 9/56 *Meroni v. High Authority* [1957-1958] ECR 133. The Court of Justice of the EU has ruled in the *Short Selling* case that ESMA can exercise direct supervisory/intervention powers but its discretion must be controlled through conditions set at the legislative level: Case C-270/12 *UK v Council and Parliament*, 22 January 2014.

[164] European Parliament, ECON Committee, Report on the EU Role in the Framework of International Financial, Monetary and Regulatory Institutions and Bodies (A8-0027/2016) (March 2016).

[165] The Financial Service Annex to the GATS covers mutual recognition arrangements and provides for an exception generally to the MFN principle, whether in the context of an FTA or otherwise.

5.3 A NEW HORIZONTAL EU EQUIVALENCE REGIME

Given the many uncertainties, this analysis focuses on how the Commission might design a new, EU equivalence regime for its post Brexit interaction with third countries. Leaving to one side the different EU interests and preferences which may shape a new third country/equivalence arrangement (which are considered at the end of this section), how, from an EU perspective, might a new arrangement be designed?

It is not surprising that equivalence is now on the Commission's agenda, even allowing for the Brexit incentives for placing it there. EU policy discourse on financial governance is currently framed in terms of the single rulebook and more, rather than less, harmonization. This is particularly apparent in the wide-ranging November 2016 reform agenda which the Commission has recently adopted and which seeks to respond to stakeholder concerns on the crisis era reforms.[166] A driving concern of these reforms is to remove incoherence and inconsistencies across the single rulebook. The Commission has, at the same time, signalled the importance of proportionality in the application of EU rules, but the direction of travel is clear. The equivalence regime is ripe for reform, being piece-meal, inconsistent, and subject to a range of different procedures and conditions depending on the measure in question. There is therefore a logic to constructing a single, harmonized equivalence regime in place of the current complex patchwork of rules. The logic is all the greater given the potential risk to the EU from a disruption to the EU capital market arising from defects in how the current third country rules apply. A more consistent and stable equivalence process would put third country access to the EU capital market on a more secure footing, with positive spill-over effects for market stability and efficiency.

Given the Commission's current direction of travel, it is reasonable to start by proposing that any new regime be located in a horizontal single market measure (likely a Regulation) with a procedural orientation which would address how equivalence is assessed, whether for market access or rule export.[167] It is unlikely that any such measure would significantly expand the current access arrangements or restrict the current exporting arrangements, even allowing for the potential capital market benefits, given the distinct political and institutional interests, which are often sector-specific,[168] which have shaped these arrangements.[169] It is also unlikely that decision-making would depart from its current supranational orientation and

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[166] Commission, Communication, Call for Evidence – EU Regulatory Framework for Financial Services (COM (2016) 855) (2016), and Commission, Staff Working Document on the Call for Evidence (SWD (2016) 359) (2016).

[167] This discussion assumes a capital market scope, but a regime with a wider financial services reach could also be designed.

[168] The access rules for asset managers under the AIFMD being a case in point, given the distinct French interests engaged. See Moloney, n 50, 307-308, and Ferran, n 50.

[169] The Commission's 2017 Equivalence Report underlines that the different equivalence provisions are tailored to the specific needs of the measure in question: n 9, 7.

location within the single market method. While new models based on various forms of oversight and decision-making by bespoke EU/third country tribunals or committees (on the lines of the committees which oversee Free Trade Agreements, for example[170]) could be envisaged, there is little ground on which to speculate that the EU would concede the removal of the Commission as decision-maker or the Court of Justice as arbiter. The attachment to supranationalism and to EU governance methods for EU capital market governance is clear from the fierce opposition of the European Parliament to the Single Resolution Fund element of the Single Resolution Mechanism (which forms a pillar of Banking Union) being governed in part by an intergovernmental agreement.[171] Given the Parliament's close focus at present on international financial governance (noted below) it can be expected to provide stiff resistance to any such proposal – and the Commission has no incentives to propose such a model. Some institutional enhancements should, however, be adopted.

The role of ESMA should be formalised, reflecting the dominance of technocratic regulators in mutual recognition/equivalence regimes internationally. Decision-making should move closer to ESMA with the equivalence decision taking the form of a 'binding technical standard' (BTS) rather than, as at present, an 'implementing act' on which ESMA advises the Commission.[172] Where administrative rules take the form of BTSs, distinct procedural arrangements apply to rule-making. The ESAs propose the measure in question and while the Commission may ultimately veto or amend the measure, procedural constraints apply to the Commission and transparency requirements are imposed. A number of benefits would follow. ESMA now has significant experience in managing the technical and diplomatic challenges raised by equivalence determinations. Its first set of technical advice on the credit rating agency equivalence regime, for example, adopted an 'objective-based' and 'holistic' perspective, identified and assessed equivalence against seven core areas, and led to a positive Commission decision within months.[173] Its approach to the US credit rating agency regulation assessment suggests a pragmatic, outcomes-focused, and politically adept approach. ESMA reported that equivalence involved examining the 'combined effect of provisions' as well as the scope and extent of supervisory powers; that the 'few remaining uncertainties' were not material; and that it took comfort from its discussions with the SEC.[174] Likewise, in its approach to CCP regulation equivalence ESMA was concerned to avoid a 'zero sum' approach,[175] and advised that a conditional

[170] On these committees see Lang and Conyers, n 38. There is little empirical evidence from the operation of these committees which are relatively recent in origin.
[171] See, eg, N Moloney, 'European Banking Union: Assessing its Risks and Resilience' 51 *Common Market Law Review* (2014) 1609.
[172] ESMA has called for this reform in relation to the EMIR equivalence regime: ESMA/2015/1524.
[173] ESMA/2012/259.
[174] Ibid.
[175] Speech by ESMA Chairman Maijoor on 'International Co-ordination of the Regulation and Supervision of OTC Derivatives Markets', 17 October 2013.

equivalence approach be used in some cases (in that where formal regulatory equivalence was not achieved, it could be met by means of internal CCP policies and procedures). Similarly, following the delayed Commission/US CFTC CCP equivalence decision, ESMA declared it would 'do everything within its powers' to deal with the outstanding procedures for US CCP recognition in the EU.[176] A more secure embedding of ESMA in the equivalence process, and a shift to decision-making through BTSs, would also increase the transparency of the process and the opportunities for regulatory learning internationally. The equivalence process would also benefit functionally from the close links ESMA has formed with its regulatory counterparts internationally and the related soft power which follows.[177] ESMA has, for example, committed to monitoring US equivalence on rating agency regulation through cooperation arrangements between it and the US SEC.[178] Greater ESMA involvement should also reduce, at least, the potential for politicization

Substantively, and in relation to the equivalence assessment, an outcomes- or substitute-compliance-based approach, embedded in EU legislation (current references to an outcomes-based approach are in the recitals to the relevant EU measures), would give the process flexibility and respond to the reality that systems of regulation are dynamic and diverge. The related assessment could also reflect the significantly greater granularity in, and institutional support for, international financial governance since the financial crisis;[179] compliance with specified international standards could accordingly form part of the assessment process. The assessment should be primarily directed, however, to third country compliance with specific sets of principles adopted for each capital market measure which currently deploys equivalence. These principles could be developed by ESMA based on a delegation from the co-legislators in the relevant legislation. Lessons could be drawn from, for example, the Australian/ASIC model which contains an extensive set of principles governing third country access. The new model should also institutionalize the proportionality principle, which has recently become a priority concern of EU capital market governance.[180] A proportionality analysis would allow ESMA to tailor the nature of the equivalence assessment to the risks which the jurisdiction posed to the EU market, whether in terms of financial stability or market efficiency. The new model could also usefully institutionalize the subsidiarity principle which is meant to act as a guiding principle for EU capital market

[176] ESMA Press Release, 1 February 2016.

[177] See S Lavenex, 'The External Face of Differentiated Integration: third country participation in EU sectoral bodies' 22 *Journal of European Public Policy* (2015) 838 (examining the distinct functionalist dynamics and networks which such agencies can generate). The importance of such soft power to the development of international regulatory networks has been extensively documented, following Slaughter's pioneering analysis: A-M Slaughter, *A New World Order* (Princeton University Press, 2004).

[178] ESMA/2012/259.

[179] ESMA already refers to international standards in assessing equivalence, as was the case with its examination of the Australian regime governing CCPs, eg (ESMA/2013/1159).

[180] See N Moloney, 'EU Financial Governance and Brexit: Institutional Change or Business as Usual?' 42(1) *European Law Review* (2017) 112.

governance; in this context, it could signal the EU's willingness to 'defer to difference.'

More radically, the current openness of the EU's equivalence arrangements in relation to market access needs to be reconsidered. Many of the international examples considered in section four are based on a host country registration and exemption model, not on blanket market access, and allow the host regime some supervisory control over third country actors. At present, EU market-access-related equivalence determinations are not based on the 'registration and exemption' approach typically followed internationally. While ESMA registration or recognition is usually required, the registration process is typically not as detailed as a traditional authorization process would be, and does not take the form of a 'gatekeeping' exercise. Third country CCP recognition under EMIR (Article 25), for example, is procedural and not substantive in orientation, being directed in the main to the provision of information to ESMA. Similarly, third country investment firm registration by ESMA under MiFIR does not involve a substantive assessment of the risks a firm may pose to the EU, although ESMA may withdraw registration where there is documented evidence that the firm is acting in a manner clearly prejudicial to investors or the orderly functioning of markets, or is in breach of its regulatory obligations in its home country. In addition, ESMA has very limited ongoing oversight powers over third country actors. One solution to this difficulty is to require third country actors currently subject to ESMA registration to agree to more extensive ESMA registration and supervisory oversight authority.[181] But this is not a straightforward proposition, even in relation to the relatively small population of actors covered by the current ESMA registration regime. First, the *Meroni* constraint arises. While the 2014 *Short Selling* ruling suggests that as long as any new registration/supervisory powers are appropriately detailed and confined, *Meroni* would not be breached,[182] the granular requirements of ongoing supervision could place significant pressure on *Meroni*. A second and greater challenge is raised by the appropriate allocation of the fiscal risks of supervision. The immense political and institutional difficulties engaged by risk allocation and risk sharing, recently exposed by Banking Union, suggest that significant change to ESMA's supervisory role is unlikely. While ESMA currently supervises credit rating agencies and trade repositories, these actors do not pose significant fiscal risk. The potential fiscal risks posed by CCPs are of an entirely different magnitude and would require distinct risk allocation/sharing mechanisms on the lines of the Banking Union arrangements, which could rapidly become very complex in a cross-jurisdictional context. Investment firm fiscal risk, while not of the same order as CCP fiscal risk, would also require risk allocation and sharing arrangements. The easier solution may be to enhance existing ESMA-based coordination arrangements, notably colleges of

[181] A private contracting option has been suggested by one analysis which would see UK CCPs voluntarily contract to be subject to ECB supervision: FSNF/Norton Rose Report 2017, n 7.
[182] N 163.

supervisors, and incorporate third country supervisors; and to confer on ESMA a suite of new, targeted powers – these would assume third country supervision but would strengthen ESMA's oversight powers (including powers to inspect third country actors) and allow for some emergency or precautionary action (such as the suspension of activities). The new colleges could operate under EU procedural requirements, include ESMA as the EU-based 'supervisor' with certain enumerated powers, and deliver closer cooperation and coordination than the current third country regime. While EU colleges of supervisors are typically associated with the banking markets, EU oversight through ESMA of capital market colleges of supervisors is becoming more sophisticated and templates are becoming available, notably in relation to CCPs.[183] Alternatively, a third country supervisor could be required, by means of an ESMA MoU, to incorporate the risks to the EU market in its home supervision of the actor in question – but such an approach could be challenging to negotiate and to police.

The risks of third country defection and of third country regulatory dynamism, and the related dangers of abrupt withdrawals of equivalence, also need consideration. At present the equivalence regime is peppered with warning of ongoing Commission review[184] and the Commission's 2017 Equivalence Report underlines the importance of review and the possibility of decisions being withdrawn. But the current equivalence regime does not include clear procedural means for identifying risks to the EU from third country regulatory dynamism and/or defection. Drawing on the monitoring and review functions which are a feature of some regimes internationally (including the Australian and US models), formal notification of 'material' regulatory change could be required and principles governing the nature of 'materiality' established. Peer review could also be incorporated. Peer review is increasingly being used as a tool to strengthen cooperation and convergence between regulators internationally and to limit defections from international standards. It is, for example, deployed by the FSB in relation to international standards.[185] An equivalence decision could be made conditional on a positive outcome from an FSB 'country review'[186] or from the regular IMF 'Financial Sector Assessment Programs' (FSAP) reviews, and on such an outcome being sustained. IMF FSAP assessments are required every five years for those jurisdictions whose financial sectors have the greatest impact on financial stability. The related IMF Integrated Surveillance Decision considers the risks to

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[183] ESMA already sits on CCP colleges of supervisors, reviews the activities of colleges, stress tests CCPs, and engages in peer review of CCP supervision. See, eg, ESMA, Peer Review under EMIR, Art 21 (ESMA/2016/1683) (2016).

[184] The Commission's Australian CCP equivalence decision, eg, warns that the Commission, informed by ESMA, will continue to monitor the evolution of the Australian legal and supervisory framework and the conditions on which the equivalence decision was taken (Commission Decision 2014/755/EU).

[185] See FSB, Handbook for FSB Peer Reviews (2015).

[186] An FSB 'country review' addresses the implementation and effectiveness of regulatory, supervisory, or other financial sector policies in achieving the desired outcomes in a specific FSB member jurisdiction: Handbook, n 185, 2.

macro financial stability and the related policy framework in the relevant jurisdiction, while the (optional) Report on Observance of Standards and Codes (ROSC) covers compliance with ISSB standards (including IOSCO's) and leads to a Detailed Assessment of Outcomes. ESMA is already integrating these peer reviews in its equivalence assessments. In its recent quasi-equivalence review of the AIFMD, for example, it considered the capacity and track record of third country regulators in relation to supervision, including by reference to IMF FSAP findings.[187] Alternatively, ESMA's now extensive experience in peer review of its member regulators might be deployed,[188] particularly as ESMA's supervisory convergence/coordination activities are directed to the assessment of outcomes[189] – a feature of equivalence arrangements internationally. A third country might therefore be asked, as part of the equivalence process, to commit to a five-yearly ESMA review of the relevant regulatory system. Failure or indicators of concern would not lead to termination, but could lead to the opening of a bilateral EU/third country review process. Features such as these would reduce the contingent quality of the current regime.

There are, of course, difficulties with these proposals. Any consequential strengthening of ESMA's institutional position as an administrative actor within EU financial governance may not be palatable to the Member States, the Commission, or Parliament. And while a strengthening of ESMA's role would render the equivalence process more technocratic, it is impossible to remove political preferences, particularly as the Commission can veto or change any BTS on equivalence proposed by ESMA. But this may not be a significant limitation. Given the distributive effects of capital market regulation and market access decisions, and the complex related interactions with the EU's geo-political relations, it is desirable that Commission oversight provide a means through which political interests can be expressed. A move to the BTS process, however, would moderate Commission discretion, particularly as ESMA is increasingly robust in defending its proposals for BTSs against Commission revisions or veto.[190]

5.4 THE INTERESTS AT STAKE

The prospects for any such new EU regime depend on the interests and preferences at stake.

The Commission has already signalled its preferences for greater centralization of market access and of equivalence-related decisions within the Commission,

[187] ESMA/2016/1140.

[188] ESMA's peer reviews of its member supervisors are becoming increasingly granular and robust, including its peer review of best execution supervision (ESMA/2015/494) and in relation to the short selling regime (ESMA/2015/1791).

[189] See recently ESMA, Supervisory Convergence Work Programme (2017).

[190] See, eg, ESMA's querying of the revisions which the Commission requested to its proposals for bond market transparency rules under MiFIR: Letter from ESMA to the Commission, 2 May 2016 (ESMA/2016/672).

including through its original proposals for centralization of market access decisions under MiFID II and MiFIR which were watered down during the European Parliament and Council negotiations.[191] It has also signalled its preference for a more transparent and politically accountable comitology process. In February 2017, it proposed a series of reforms to amend the Comitology Regulation 182/2011 which currently governs the equivalence process.[192] The reforms are designed to reduce the number of abstentions on comitology-based decisions and to ensure the Commission receives stronger political guidance. It is hard to avoid the implication that this essentially 'housekeeping' reform could usefully provide the Commission with political cover if equivalence decisions become contested. The Commission's 2017 Equivalence Report is more revealing. The Report concludes that the equivalence regime is 'broadly satisfactory' but outlines four areas which may require 'increased attention.'[193] In a finding which does not augur well for the UK, the Commission has suggested that its risk-based, proportionate approach to equivalence may need further examination, particularly given the need to ensure proportionate treatment for 'high impact' and 'low impact' markets. It has also suggested that greater coherence be brought to the regime, particularly in terms of the equivalence assessment covering both regulatory and supervisory frameworks and in relation to the roles played by the ESAs. The final two areas for attention cover how ongoing monitoring of equivalence decisions can best be achieved, including in relation to the ESAs' role, and how the nature of the equivalence assessment can be communicated to third countries. These areas 'for increased attention' do not suggest a Commission appetite for major reform or for a noticeably more liberal approach. More revealingly, the tone of the Commission's report indicates a determination to continue to control the equivalence process and to protect the discretion currently granted to the Commission.

It can be predicted reasonably safely accordingly that the Commission is likely to support reforms which further the coherence of the equivalence regime, which extend Commission power in international financial governance, and which engage the Member States more fully, providing political cover. The Commission is unlikely to support a significant empowering of ESMA given the autonomy and discretion the Commission has long enjoyed in this area and the EU's growing capacity as an actor (often through the Commission) in international financial diplomacy.[194] The 2017 Equivalence Report acknowledges that the ESAs' role in equivalence determinations can be finessed, but its concern is primarily with the ESAs as information conduits.[195] On the other hand, the Report reveals a Commission concern for the effectiveness of third country supervisory arrangements and for

[191] MiIFID II/MiFIR Proposal (COM (2011) 656) (2011) 9 and 12-13.
[192] Commission, Proposal to Revise Regulation 182/2011 (COM (2017) 85).
[193] 2017 Commission Equivalence Report, n 9, 11-13.
[194] See, eg, N Moloney, 'The EU in International Financial Governance', 1 *Russell Sage Journal of the Social Sciences* (2017), Quaglia, n 14, and Abraham and Posner, n 53.
[195] 2017 Commission Equivalence Report, n 9, 12.

enhanced supervisory cooperation between third country and EU supervisors, including in relation to onsite inspections and data exchange, suggesting that an enhancement of ESMA's coordination powers, if not direct oversight powers, may follow.

The European Parliament, by contrast, appears increasingly suspicious of the Commission's power in international financial governance[196] and so may welcome any reforms, including the empowerment of ESMA, which dilute that power – although it has recently adopted a more sceptical posture to the ESAs, albeit primarily in relation to their regulatory governance functions (where the Parliament's prerogatives are most at stake) and less so in relation to the ESAs' role in supervisory governance.[197] The ECB may have similar preferences. Based on current evidence, it can be expected to support greater standardization and to call for reforms which enhance the EU's ability to secure financial stability – although it may have conflicted preferences in relation to any empowerment of ESMA, particularly in relation to supervisory coordination, given its dominance as Banking Union's bank supervisor.

As noted in section three, Member States' preferences on market access and rule export have historically varied depending on the market segment in question, but clashes tend to arise between those open to liberalization and those concerned to limit market access, whether for competitive reasons or because of concerns relating to financial stability.[198] Post Brexit, however, Member State preferences may change and there may be a concern to signal openness and the attractiveness of the EU market – particularly if the liquidity, stability, or efficiency of the EU capital market is compromised post Brexit. The absence of the UK may also lead to easier negotiations. While Member States are unlikely to adopt an overtly protectionist posture given the risks to EU growth, the UK can be expected to have been at the far end of the spectrum in terms of tolerance for liberalization - its absence may ease the negotiation process.[199] Some signs do not augur well, however. The highly technical Commission proposal to reform EU securitization rules, a flagship element of the CMU agenda and which was proceeding relatively speedily through the legislative process prior to Brexit, has recently hit an obstruction in the form of a post-Brexit decision wariness in some Member States, notably France and

[196] European Parliament, ECON Committee, Report on the EU Role in the Framework of International Financial, Monetary and Regulatory Institutions and Bodies (A8-0027/2016), March 2016.
[197] It has, eg, queried the ESAs' approach to adopting soft law Guidance: European Parliament, Resolution on 'Stocktaking and Challenges of EU Financial Services Regulation' (P8_TA(2016)0006), 19 January 2016.
[198] During the MiFID II/MiFIR negotiations, eg, several Member States (chief among them the UK) expressed serious reservations about the Commission's proposed third country regime, arguing that the regime was unnecessary and disproportionate, that national access routes should be maintained, and that the equivalence regime be removed: Council Progress Report on MiFID II/MiFIR: 20 June 2012 (Council Doc 11536/12).
[199] Ferran, n 8.

Germany, to include facilitative third country access rules based on equivalence lest they set a precedent for the UK.[200]

Nonetheless, there may be considerable institutional and political support for reform, particularly if the reform would represent a 'quick win' for a post Brexit EU and signal its openness to the international market. But it is unlikely that any new regime would be in place at the point at which the UK leaves the EU. The ability of the market to move operations to the EU 27, and the significant ingenuity with which UK firms can be expected to approach EU access, will reduce the level of disruption, but it will not remove the risk of significant market dislocation. In the short term, therefore, much will depend on the political environment in which a transitional arrangement is negotiated.

6. CONCLUSION

When the UK leaves the EU the EU's 'investment banker' will become a 'third country.' This re-characterization of the UK has legal consequences which have significant implications for the stability, liquidity, and efficiency of the EU capital market. The determinants of capital market growth and stability in the EU are many and various and the extent to which EU regulation is transformative of capital market evolution is contested. But the success of the CMU reform agenda, and the extent to which the EU capital market will safely absorb the loss of the UK from the single market, are likely to depend, to a significant degree, on the EU's rules governing how third countries interact with EU financial governance and how those rules evolve, whether in an EU/UK Free Trade Agreement or otherwise.

This discussion uses a legal-institutionalist analysis to examine the current suite of third country rules, their potential ramifications for the post-Brexit EU capital market and for the CMU agenda, and the institutional and other preferences which shape these rules and how they apply. The third country rules apply across two vectors: they govern access to the EU (access); and they also govern how EU financial actors engage with third country actors (export). In each case, the notion of 'equivalence' is used to permit access with a degree of deference to home/third country rules (access) or to moderate how EU regulation applies to engagement with third country actors (export). But equivalence is an elusive concept and the procedural framework within which it operates is unstable. Brexit will place further and likely intense pressure on the inherent instability in the equivalence method as it is currently constructed. Risks to the stability, liquidity, efficiency of the EU capital market and to the achievement of the CMU agenda may follow.

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[200] J Brunsden and T Hale, 'Plan to Boost EU Securitisation Market Stalls over Brexit,' *Financial Times*, 6 February 2017.

International financial governance has hitherto been largely concerned with standard-setting; there are few examples on which a new equivalence arrangement could be based. But there are some lessons from the international examples canvassed in this discussion, although they must be interpreted with caution given the extent to which equivalence regimes internationally reflect the distinct preferences and regulatory capacities of the states involved. These lessons are incorporated into a proposal for how a new equivalence regime which would limit the risks to the EU capital market could be constructed. The third country rules are, however, likely to be a location of contestation given the distinct preferences and interests which the confluence of Brexit and the CMU agenda is likely to generate. Indeed, the fate of the third country regime, and its application to UK/EU relations, will likely be a bellwether for the fate of the Brexit negotiations more generally.