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From: Sir William Cash MP

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Trade in financial services under the future UK-EU economic partnership

The European Scrutiny Committee at its meeting today discussed your letter of 31 October 2019 in relation to the UK's new arrangement for trade in financial services with the EU, in the context of the EU and Government's respective negotiating objectives for the future relationship. In light of our discussion, there are a number of issues we wish to raise with you and various outstanding questions, which are listed at the end of this letter.

Equivalence in financial services

The Government and the EU agree that the use of unilateral 'equivalence' decisions will be the primary mechanism for granting preferential treatment of each other's financial services providers following the UK's exit from the Single Market. Equivalence, of course, offers each side flexibility to grant preferential market access but no long-term stability, because it can be withdrawn unilaterally. The benefits it provides under EU law also fall far short of the 'passporting' arrangements that apply to firms based within the Single Market.

In any event, we note that the UK and EU having taken very different positions on how equivalence should be handled. In the Prime Minister's statement of 3 February, as reiterated in the more detailed approach published on 27 February, the Government called for any withdrawal of equivalence

decisions to be "structured" (i.e. subject to mutually agreed restrictions) while ruling out "regulatory alignment". The Chancellor reiterated this in a newspaper article on 11 February, specifying the UK was asking for "measures to directly address the long-term needs of industry for a reliable equivalence process" to provide businesses with certainty. The Government has also explicitly called for an "institutional arrangement" for financial services within which regulatory cooperation and consultation would take place.[1]

By contrast, the July 2019 European Commission review of equivalence reiterated the importance the EU attaches to its ability to unilaterally vary or withdraw equivalence, and the need for non-EU countries seeking equivalence to "ensure in full the outcomes as set out in [the EU legal] framework" through their domestic regulatory approach. This latter point was made more explicit by EU Commissioner Dombrovskis in December last year, when he said that "the more systemically important the market is for the EU, the more we import potential risks, [and] the closer the regulatory alignment that is expected" in return for equivalence.[2]

The UK is therefore pursuing restrictions on both sides' legal autonomy with respect to the process by which equivalence is granted while rejecting the notion of continued alignment of the substance of UK financial services law with EU rules. Conversely, the EU has to date ruled out agreeing to limitations on the process by which it grants equivalence while insisting the UK will need to remain aligned to some extent with the substance of EU rules if it wants market access (in particular with respect to the position of UK Central Counterparties within the EU under the European Markets Infrastructure Regulation, as we discuss further below).

Given the Government's intent to pursue equivalence in all 40 areas where EU law provides for it, we were disappointed that these potential political difficulties were not substantively acknowledged in your Department's Explanatory Memorandum of 30 August 2019 on the Commission's equivalence review, or indeed your subsequent letter of 31 October last year. We have therefore taken this opportunity to seek further clarity on the Government's position on these matters.

Links between the equivalence assessment process and the wider UK-EU trade negotiations

[1] Letter from John Glen MP to Sir William Cash MP, 31 October 2019.
[2] Financial Times, "EU chief issues Brexit warning over City of London access" (2 December 2019).

First, there is a clear potential for politicisation of the equivalence process in the overall negotiations between the UK and the EU on a range of trade-related issues. Several EU leaders, including Phil Hogan, EU Trade Commissioner, Andrej Plenković, Prime Minister of Croatia and current holder of the presidency of the Council of the EU, and Leo Varadkar, Taoiseach of Ireland have recently linked the question of market access in financial services to access to UK fishing waters for EU fishermen.

On the UK's side, we note that the Government has said it expects the EU's equivalence assessments to be "technical and confirmatory of the reality that the UK" will apply EU rules fully at the point of exit (something the EU has already rejected). It apparently attaches such importance to this that, in the formal negotiating objectives laid in Parliament on 27 February, the Prime Minister hinted the UK could walk away from the trade talks with the EU altogether if by June 2020 there is no "good progress" on the "various autonomous processes" - such as the equivalence process - "on a technical basis according to agreed deadlines".

We should note firstly that it is unclear if the Government is pushing for the adoption of formal equivalence decisions by that point, or wants a commitment from the European Commission that its legal assessment has shown the UK's regulatory approach is equivalent. This distinction is of course important because any equivalence *decisions* adopted by the EU while the UK is still in the transition period will have no practical legal effect, given British firms will still be part of the Single Market until 31 December this year.

In any event, we are concerned that this focus on obtaining a positive equivalence outcome by June 2020 is, in a way, putting the cart before the horse. Irrespective of whether the Government is looking for positive equivalence *assessments* or formal *decisions* by June, the practical impact on investor and business confidence will be very limited without a wider agreement on the UK-EU relationship in financial services, including a new institutional arrangement on regulatory cooperation and "structural" withdrawal of equivalence.

Without knowing the outcome of those negotiations, which are anything but "technical and confirmatory", any equivalence assessments or decisions taken by the EU by this summer have no guarantee of being durable or stable. Any formal equivalence decisions taken outside of a structured new approach agreed with the UK could be explicitly time-limited, like those adopted by the EU ahead of a possible 'no deal' Brexit or in relation to Swiss stock exchanges in late 2018. We are looking for reassurance from the Government that, even though it appears focussed on the deadline of June 2020, it is not

losing sight of these more fundamental objectives to ensure a stable trading environment with the EU for financial services.

Structured withdrawal of equivalence decisions

Secondly, as noted, the Government's objectives for the UK-EU financial services arrangement refers to "structured processes for the withdrawal" of equivalence decisions granted by the EU to the UK or vice versa, a phrase borrowed verbatim from the previous Government's now-discarded 'Chequers' White Paper for the future relationship with the EU.[3]

As you know, European law does not generally fetter the EU's ability to repeal Decisions acknowledging equivalence of any 'third country' under sectoral financial services legislation as it sees fit, if considered necessary at very short notice.[4] We accept that as currently practised, reliance on this mechanism for cross-border trade could therefore disrupt transactions between UK financial services providers and their EU counterparties overnight, especially in areas where equivalence allows 'third country' firms to sell services into the EU from their UK base.

We therefore support the Government's request for a more structured process to withdrawal of equivalence decisions. However, the negotiating objectives of 27 February 2020 were lamentably vague about the precise proposals being made. It would be helpful if you could confirm whether the substance of 'structured withdrawal' is in essence the same as contained in 'Chequers', for example by instituting a consultation requirement with the other party before withdrawal is commenced, and transitional measures safeguarding the ability of firms to continue fulfilling their contractual obligations entered into under the framework of an equivalence arrangement intended to be withdrawn.

It is also unclear whether the UK is seeking to set out this new approach to 'structured withdrawal' in a binding treaty with the EU, or – perhaps more realistically – is requesting a political commitment from the EU to consult the Government and consider mitigating measures before an equivalence arrangement in a given area is terminated.

EU conditionality for equivalence decisions under EMIR

[3] Department for Exiting the EU, White Paper on the "future relationship between the United Kingdom and the European Union" (July 2018), page 31.

[4] In some cases where the EU is considering withdrawing registration from a particular non-EU firm operating under a wider equivalence decision, a compulsory time-limit applies. For example, under the MiFIR Article 47 equivalence process – discussed in more detail in section 3.1.1 below – registration can only be withdrawn after a thirty-day notice period.

Thirdly, with respect to the process of determining the UK's equivalence in return for preferential treatment for British financial services providers, our predecessors in the last Parliament repeatedly expressed concerns about the high level of continued regulatory alignment the EU may demand of the UK in return for granting equivalence.

This is true especially in the EU Regulations governing professional investment services (MiFIR) and clearing of over-the-counter derivatives (EMIR 2.2) respectively, where substantive, Brexit-driven changes to the equivalence process were agreed last year. We are concerned that these amendments are designed, at least in part, to give the EU greater cover to refuse or wihdraw equivalence over the longer term in a bid to incentivise companies to relocate activity aimed at EU-based customers to one of the remaining Member States.

In particular, in the case of EMIR, recent amendments approved by the remaining Member States appear to prevent British Central Counterparties (CCPs) from having any market access rights under equivalence unless the Bank of England agreed to "assure" - which we take to mean 'enforce' - supervisory decisions taken against such CCPs by the European Securities and Markets Authority (ESMA), an EU body in which the Bank no longer participates. The Government also opposed other changes to EMIR, notably as regards the 'location' and 'dual supervision' policies for non-EU CCPs considered systemically important for the EU's capital markets.

We note that the UK – then still a Member State – voted against the amendments to EMIR in October last year. With respect to the supervisory cooperation requirement, the Treasury itself stated in March 2019 that the new conditions for equivalence are so far-reaching that they could "become a barrier to market access in the future" because "third countries" like the UK "are very unlikely to bind their independent supervisors in this way".[5]

However, in a subsequent letter to our predecessors dated 9 July 2019 you mentioned that this (i.e. your Department's own) assessment of the legal text was "only one possible interpretation" of the new Regulation, referring to EMIR's new 'comparable compliance' provisions which – in your words – would allow for a large UK CCP operating under equivalence to "meet EMIR requirements while following its own domestic [British] framework".

[5] Summary Record of the meeting of the Committee of Permanent Representatives of 18 and 20 March 2019, p. 8.

Given that the 'comparable compliance' provisions under EMIR 2.2 only have relevance at the point where a systemically important British CCP were to seek recognition to operate in the EU under an equivalence decision – and where such recognition itself depends on the prior existence of a Bank of England-ESMA agreement on supervisory cooperation[6] – it is not clear to us how they would negate the effect of the Bank of England having to "assure" ESMA's decisions against UK firms. We also note that ESMA's technical advice of November 2019 on the implementation of the 'comparable compliance' mechanism does not appear to contain any cross-references to the supervisory cooperation element of the Regulation.[7]

It would therefore be helpful if you could clarify the direction of travel in the EU's interpretation of the term "assure" in the supervisory cooperation agreement required under Article 25 of EMIR, especially in the context of the 'comparable compliance' mechanism, and whether the Treasury is ruling out seeking equivalence with the EU for the clearing industry if it would in fact restrict the Bank of England's supervisory autonomy in the way suggested by the Government's own statement of March 2019.

Equivalence, regulatory alignment and the Financial Services Bill

Lastly, aside from the specific hurdles introduced for obtaining and maintaining equivalence referred to above, as we have seen the EU has become increasingly explicit that it intends to make equivalence for the UK generally conditional on commitments on continued regulatory alignment with EU financial services law. By contrast, the Prime Minister was clear in his statement of 3 February 2020 that the UK does not believe the future UK-EU relationship needs to entail *any* legal commitment to continued alignment given the UK's existing stringent standards for financial services.

There is therefore a fundamental tension between the EU's likely demands in return for granting British financial services providers preferential access to its market, and the Government's position on the commitments the UK is willing to make for such access.

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[6] Article 25(2) of EMIR, as amended, states ESMA can only grant non-EU CCPs recognition to operate into the EU if their home country has been granted an equivalence decision and that country's home regulator has entered into a cooperation agreement with ESMA which specifies – as per Article 25(7) - "the procedures for third-country authorities to assure the effective enforcement of decisions adopted by ESMA". Under Article 25p EMIR, ESMA […] shall withdraw a recognition decision […] where […] ESMA is unable to exercise effectively its responsibilities […] due to the failure of the third-country authority of the CCP to provide ESMA with all relevant information or cooperate with ESMA in accordance with Article 25(7)". Moreover, in such a case the European Commission would also review whether to withdraw equivalence from that non-EU country altogether (barring any of its firms from providing clearing services into the EU).

[7] ESMA, "Technical Advice on Comparable Compliance under article 25a of EMIR" (11 November 2019).

In this respect, we note that it remains unclear whether the upcoming Financial Services Bill will – like its predecessor, which failed to receive Royal Assent prior to the Dissolution of Parliament in November last year – contain regulation-making powers for the Treasury to update UK law in line with amendments to EU financial services legislation. Such a power, if included in the Bill, could of course be used to facilitate alignment with EU law, and therefore the equivalence process, without the need for the Government to secure an Act of Parliament. It would be helpful to receive more clarity about the substance of the Financial Services Bill in this regard.

Outstanding questions

In light of the above, we ask you to write to us by 10 April 2020 to:

- Set out the envisaged nature and role of the "institutional arrangement" on financial services to which you referred in your letter of 31 October 2019, and in particular how it is intended to relate to the equivalence process;
- Explain which specific equivalence assessments available under EU financial services law are the Government's immediate priorities, and why, as promised in your letter of 31 October 2019;
- Confirm our interpretation that the Government, when referring to the deadline of June 2020 in the Political Declaration, is seeking only positive equivalence *assessments* for its financial services regime from the EU rather than actual, legal equivalence *decisions*;
- Explain why the Government is attaching such particular importance to the deadline of June 2020 for the conclusions of the EU's equivalence assessments in the context of the wider trade negotiations, considering that any EU equivalence *decisions* would have no legal effect until 1 January 2021 and the stability to market participants they offer is highly dependent on wider UK-EU negotiations on regulatory cooperation and consultation which will still be on-going well beyond June;
- Clarify the nature of the "structural" restrictions the Government wants to impose on withdrawal of equivalence decisions by either the EU or the UK, and whether these are intended to be set out in a treaty or made as a non-binding political commitment by both sides;
- Explain if, in the absence of legally binding commitments by the EU on making equivalence decisions subject to "structured withdrawal", the Government will not pursue certain specific equivalence decisions

because the risks to market and financial stability are considered too great, and if so, which;

- In this context, provide an update on the direction of travel in the EU's interpretation of the term "assure" in the supervisory cooperation agreement required under Article 25 of EMIR for equivalence on CCPs, especially in the context of the 'comparable compliance' mechanism, and clarify whether the Treasury is ruling out seeking equivalence with the EU for the clearing industry if it would in fact restrict the Bank of England's supervisory autonomy in the way suggested by the Government's own statement of March 2019; and
- Clarify if the upcoming Financial Services Bill is intended to contain clauses allowing the Treasury to implement EU financial services legislation post-transition, analogous to similar provisions the Government sought to introduce in the previous Parliament under the Financial Services (Implementation of Legislation) Bill.

I am copying this letter to the Rt Hon Mel Stride MP, Chair of the Treasury Committee and Gosia McBride, Clerk of that Committee; the Rt Hon Hilary Benn, Chair of the Committee on the Future Relationship with the EU and Gordon Clarke, Clerk of that Committee; to Lord Kinnoull and Christopher Johnson in the Lords; to Les Saunders at the Cabinet Office; and to Aidan Irwin-Singer at your Department.

CHAIR