

Understanding equivalence and the single passport in financial services Third-country access to the single market

SUMMARY

Alongside closer integration of the single market in financial services on the one hand and the more general globalisation of the sector on the other, the issue of access for third-country institutions has become increasingly important – not least recently in relation to the question of access to the continent for City of London-based financial services firms in the context of the United Kingdom's withdrawal from the European Union (Brexit).

Companies established in any European Economic Area (EEA) Member State have access to the single market for financial services under single passport rights. This means that they can establish branches in other EEA countries or provide financial services across the EEA without the need for further authorisation.

The debate on access for third countries has intensified since the 2008 financial crisis, resulting in an increasing number of legal acts in recent years containing 'equivalence provisions'. These allow third countries to ask for an assessment of equivalence of their regulatory system with that of the European Union.

Equivalence, if granted, offers in most cases a much more piecemeal access to the single market than passport rights. Quite often, equivalence concerns more technical matters and does not significantly alter third-country access terms. Only in some instances can access under equivalence be considered 'passport-like', and in the most significant cases, this concerns legislation which is not yet in force.



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Background

The single market's [freedom](#) to provide [financial services](#) across the European Union (EU) stems both from the Treaties and secondary legislation. EU directives and regulations cover rules for banking, investment services and insurance, as well as investment products and financial infrastructure. The 2008 financial crisis resulted in increased [efforts](#) to stabilise and reform financial markets, by filling in regulatory gaps and strengthening financial supervision. Hence, the regulatory environment has become more complex and extensive in scope.

The debate on third-country access to the EU's financial services market has paralleled the ongoing integration of markets in Europe and the broader process of globalisation of financial services. The first steps were taken in 1989 with the [Second Banking Directive](#) which provided for reciprocal [treatment](#) of foreign banks (to that EU banks received in the jurisdiction concerned). Since the financial crisis, the EU's regulatory approach to relations with third countries has been reshaped and extended. The terms of [access](#) to the EU market outlined in many of the recent financial services acts refer to 'equivalence': access can be granted to third-country entities coming from a jurisdiction considered to have 'equivalent' regulatory provisions.

Equivalence of third-country frameworks with EU rules

Definition

The European Commission describes [equivalence](#) as follows: 'in certain cases the EU may recognise that a foreign legal, regulatory or supervisory regime is... equivalent to the corresponding EU regime.' In effect, EU authorities can rely on the compliance of foreign entities with the equivalent foreign framework. According to the Commission, there are three main benefits from this approach:

- overlaps in compliance are reduced or completely eliminated;
- selected services, products and activities of third-countries' entities are acceptable for European regulatory purposes;
- it reduces the burden for EU financial institutions exposed to an equivalent third-country prudential regime.

Equivalence is a response to the need to adjust a highly regulated industry to the challenges of globalisation while maintaining the necessary level of supervision. Some [experts](#) argue that the equivalence regime is an incentive for third countries to change their domestic rules towards EU norms. Non-equivalence increases the cost for third-country firms to provide services in the EU or to EU counterparts, as EU requirements need to be complied with, together with the domestic regulation of the third country. Other [researchers](#) consider that even if some costs are imposed, the EU remains open to foreign service-providers, which can find ways to adapt.

Equivalence therefore strives to find a balance between protectionism and liberalism, regulatory [competition](#) and regulatory cooperation; in many instances externalising EU rules by setting equivalence provisions where the international rules in place are weaker.

Equivalence provisions

Many recent financial services directives and regulations include third-country equivalence provisions. The latter are specifically customised to fit the needs of each specific act. They stipulate cases in which the EU may consider foreign regulatory and supervisory frameworks as equivalent (and under which criteria and to what extent this can occur). Equivalence is determined by assessing if a third-country framework is

equivalent to EU rules, particularly those concerning legally binding requirements, effective supervision by authorities, and attaining the same results as with the EU legal system.

The process

Technical assessments of equivalence in financial services are carried out by the European Commission (Directorate-General for Financial Stability, Financial Services and Capital Markets Union). Typically, the Commission takes into account technical advice from bodies such as the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). Assessments usually include dialogue with the authorities of the assessed country.

A decision on equivalence may be taken in the form of an [implementing or delegated act](#). Delegated acts are potentially more easily opposed (either the European Parliament acting by absolute majority or the Council of Ministers acting by a qualified majority can object to them on any grounds whatsoever). Implementing acts may only be opposed on the predefined grounds.¹

Decisions may apply to the whole framework of a third country or only to selected authorities, but not to individual firms. They may also be granted for an indefinite period or with a time limit. Provisions on equivalence often contain information on the possibility of withdrawal of the decision.

The [length](#) of the process may also vary considerably as the European Commission has no fixed deadlines.

Analysis of the time needed to obtain equivalence for the European Market Infrastructure Regulation ([EMIR](#)) show that it took between two and four years.² Even if a decision is supposedly technical, some experts argue that it is inherently [political](#).³ Finally, in some cases (for instance EMIR), even after an equivalence decision is granted, individual firms still have to apply to ESMA for recognition.

Single passport rights

Applying [single passport rights](#) in financial services began in the late 1980s and early 1990s. It has been developed through legislative deregulation as well as re-regulation at the European level, and was influenced by the experience of the 2008 financial crisis. The single passport is based on the principle of mutual recognition and harmonised prudential measures, and essentially means that a European financial institution which has been authorised by its domestic authority has the right to establish a branch or provide services in any other European Economic Area (EEA) Member State⁴ without the need to seek further authorisation or another licence.⁵ Whenever an institution provides its services in a Member State other than that in which it is established, the competent authority of the home Member State is mainly responsible for its supervision.

European banks which use passporting rights avoid the need to establish separate subsidiaries⁶ throughout the EEA. Since subsidiaries are separate legal entities with their own balance sheets, they are subject to host country supervision and regulation. They

Is the equivalence regime to become more rigorous?

The [Financial Times](#) (FT) reported in November 2016 that the Commission is considering reforming the equivalence rules with the aim of increasing transparency and allowing for deeper equivalence checks in case there exists a close financial interaction between the EU and a third country. The [Centre for European Reform](#) also envisages that the rules will be tightened.

FT reporters said that deliberations on reforming the rules will look at ways of 'streamlining and strengthening the approval process so it is more stringent for systemically relevant jurisdictions'.

need to meet capital requirements as well as pay local taxes. Operating branches under a passporting rights regime, or providing services out of one Member State across the EEA is therefore more time- and cost-effective.

Third-country businesses, unless equivalence provisions explicitly state otherwise, need to obtain authorisation in each Member State where they wish to enter the market. Analysts argue that Member State [attitudes](#) vary from very protective to liberal.

The other way of accessing the single market in financial services is by establishing a subsidiary in one Member State and operating from there using single passport rights. This seems to be the option most preferred by third-country market entrants.

Comparison of equivalence and single passport rights

It is important to note that single passport rights are permanent whereas equivalence may be withdrawn unilaterally by the Commission, although this has not happened so far. Furthermore, passporting rights are in many instances wider in scope and depth than whatever has been accepted by the Commission under the equivalence regime for the third country,⁷ as outlined in more detail below.

In many instances, equivalence provisions simply do not exist in banking regulations and laws, therefore there is no possibility to apply for assessment of a third-country regulatory system. In other cases, equivalence provisions are mainly technical and narrow in scope, and as such do not provide passport-like rights of access (for instance in retail banking activities).

Banking and wholesale finance

Passport. The [Capital Requirements Directive](#) (CRD IV) and [Regulation](#) (CRR IV) cover business areas such as deposit-taking, lending, broking, payment services, securities issuance and portfolio management as well as prudential requirements. The [Markets in Financial Instruments Directive](#) (MiFID) provides for a single passport for investment services and activities of trading platforms and brokers in the EEA. Banks can, for example, execute orders for clients, trade and deal on their own account, and provide investment advice, foreign exchange services and underwriting, as well as portfolio management.

Equivalence. Provisions exist but are limited in nature and do not provide for passport-like access. Perhaps most notably, under CRR IV, if third-country regimes are considered equivalent, stipulated classes of exposures may benefit from lighter capital requirements.

MiFID II

[MiFID II](#) comprises a revised directive and a delegated regulation (MiFIR), and will enter into force on **3 January 2018**. It contains passport-like rights for companies offering wholesale investment products (for 'sophisticated investors') if their domestic regime is deemed to be equivalent by the Commission. Companies must register with ESMA, and reciprocal cooperation agreements between ESMA and the third-country regulator must be in place. Third-country institutions may also be able to offer their services to selected professional clients or retail ('less sophisticated') investors. However, the Member States may decide to maintain present rules or require the opening of a local branch, and no passport to provide services to other EEA members is available through this option.

The non-banking sector

Passport. This sector comprises entities such as asset managers, money market funds, hedge funds, private equity, real estate funds and venture capital, and relies on

passporting rights mainly established by the [Alternative Investment Fund Managers Directive](#) (AIFMD) and the [Undertakings for Collective Investment in Transferable Securities](#) Directive (UCITS). This framework allows the marketing and sale of hedge funds, UCITS funds and other alternative funds across the EEA.

Equivalence. No equivalence regime exists under UCITS. Currently, the AIFMD has no equivalence regime in effect. Third-country entities may market the [alternative investment funds](#) (AIFs) managed by them to professional investors in the EEA on a country-by-country basis only, under the existing [national private placement regimes](#), subject to fulfilment of specific conditions.⁸

AIFMD and third-country access

The directive contains provisions for EEA-type passport rights to be extended to non-EEA managers in the future under certain conditions. Third-country managers will have to be authorised in the EEA '[Member State of reference](#)' to manage EEA alternative investment funds or market both EEA and non-EEA alternative investment funds. They will be able to obtain a passport to carry out these activities across the EEA. As a prerequisite, cooperation and tax exchange agreements would need to be in place. Furthermore, foreign AIFMs will have to comply in full with the AIFMD obligations and appoint a legal representative in the Member State of reference.

The AIFMD, which entered into force in 2013, required ESMA to review the functioning of the passport for EEA Member States as well as national private placement regimes, and advise on extending passport rights to non-EEA countries by July 2015. ESMA [advised](#) the European Parliament, Council of the EU and the European Commission to 'consider whether to wait until ESMA has delivered positive advice on a sufficient number of non-EU countries before triggering the legislative procedures'. To date, ESMA has [concluded](#) that there are no significant obstacles to extending the passport to Canada, Guernsey, Japan, Jersey and Switzerland. However, seven further countries have failed to attain unqualified approval, and it is currently unclear whether and when the passport regime for third countries will come into force.

Markets infrastructure

Passport. EMIR establishes a framework for clearing of over-the-counter (OTC) derivatives and for the functioning and governance of central counterparties (CCPs), which clear OTCs. Under passporting, CCPs can offer clearing services across the EU.

Equivalence. Under EMIR, equivalence decisions, if adopted, allow a non-EEA counterparty established in a third country covered by the equivalence decision to comply with its local requirements. Importantly, a third-country CCP recognised by ESMA may provide clearing services to EEA clearing members. A third-country clearing house may have direct access to EEA markets or exchanges without having been established in the EEA only if cooperation agreements between ESMA and the third-country regulator are in place, there is an equivalence decision and ESMA recognises the clearing house.

EMIR also provides for a third-country exchange of OTC derivatives to be equivalent to an EEA-regulated market if this country responds to requirements equivalent to those applicable under MiFID, and the market is subject to effective supervision and enforcement. EMIR⁹ also contains detailed provisions on conditions which need to be fulfilled if a third-country trade repository is to provide services to counterparties subject to its reporting obligations, for instance guarantees of professional secrecy, cooperation agreements and registration with ESMA.

It is worth noting that EMIR came into effect on 16 August 2012, while provisions on equivalence applied only from 12 January 2016. To [date](#), 46 CCPs have applied to ESMA and 22 have been granted recognition.

Securities settlement (market infrastructure)

Passport. Central securities depositories (CSD), which operate infrastructure enabling settlement, can also operate across the EEA under the [Regulation on securities settlement and on Central Securities Depositories](#) (CSDR).

Equivalence. A third-country depository may provide services in the EEA by setting up a local branch. It needs to apply for recognition to ESMA if it intends to provide specified CSD services (often referred to as core services) and intends to provide them in the EEA through the branch set up in the Member State. Certain conditions, such as the existence of an equivalence decision as well as a cooperation agreement between ESMA and the third-country regulator, must also be fulfilled.

Insurance

Passport. The main legal instruments are the [Solvency II](#) Directive and the [Insurance Mediation Directive](#) (IMD). Passporting means EU insurers, reinsurers and mediators may offer their products and establish branches across the EU.

Equivalence. The IMD does not provide for an equivalence regime. Under the Solvency II Directive, there are three areas in which it exists. Most 'passport-like' rights, if equivalence is granted, exist in relation to reinsurance, since under the provisions of the directive, contracts entered into with reinsurers in a jurisdiction considered equivalent must be treated in the same way as contracts entered into with EEA reinsurers.

Equivalence may also be obtained in the solvency calculation (EEA groups with third-country subsidiaries may apply local capital requirements for these subsidiaries) and group supervision (EEA supervisors may rely on group supervision conducted in a third country in the case of EEA firms with a parent company located in this third country).

So far, only Bermuda and Switzerland have been granted full equivalence, with a further seven jurisdictions having a provisional or temporary ruling.

Reverse solicitation – a back door to the single market?

The key legislation regulating access to the single market for financial services MiFID II and AIFMD, contain provisions that recognise reverse solicitation. In the context of MiFID II, this means that where a client requests services on their own exclusive initiative, there is no requirement for the third-country provider to set up a branch (in the case of a retail or elective professional client) or register or be authorised by ESMA (in the case of professional clients or an eligible counterparty).

AIFMD allows a professional investor established in the EU to invest in AIFs on their own initiative, irrespective of where the AIFM and/or the AIF is established.

Many analysts seem to share the view that the possibility to use reverse solicitation as a means of access to the single market is rather limited as they exclude marketing activities to clients. On the other hand, lack of guidelines from ESMA or the Commission on application of reverse solicitation creates legal uncertainty and may result in investors avoiding taking that route altogether.

Insurance Mediation Directive II

IMD II, which will [apply](#) from **23 February 2018**, does not contain equivalence regime provisions. It will repeal and replace the currently binding IMD.

Payment and electronic money services

Passport. The main legal instruments are the [Payments Services Directive](#) (PSD), [Electronic Money Directive](#) (EMD) and [Second Electronic Money Directive](#) (2EMD).

Passporting rights are available to authorised payment-service providers and electronic money institutions which can provide payment services on a cross-border basis or through a branch or agent.

Equivalence. No equivalence regime is provided for.

Payment Services Directive II

PSD II, which will apply from **13 January 2018**, does not contain equivalence regime provisions.

Mortgages

Passport. Under the [Mortgage Credit Directive](#) (MCD), a credit intermediary authorised in an EEA Member State can conduct activities and services covered by its authorisation across the EEA on a cross-border basis or through a branch.

Equivalence. No equivalence regime is provided for.

Main references

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Endnotes

- ¹ These occur if the measure exceeds the competences, is not compatible with the aim or content of the basic act, or does not respect the principles of subsidiarity and proportionality.
- ² In the case of Switzerland, the Commission adopted a positive decision more than two years after ESMA's positive technical advice.
- ³ Jonathan Hill, the former Commissioner for Financial Stability, Financial Services and Capital Markets Union, [remarked](#) that 'Competitive pressures and political reality influence how people think about the equivalence process'.
- ⁴ These include the EU Member States and Iceland, Liechtenstein, and Norway.
- ⁵ Passporting, however, requires sending a notification to the relevant regulators which, unless exceptional circumstances apply, must accept the notification and not impose any additional prudential requirements (in particular cases, some local investor protection rules may apply).
- ⁶ In [legal terms](#) a branch is different from a subsidiary. It is a place of business set up in the same or different Member State to the headquarters.
- ⁷ This briefing relates to the main legal instruments concerning access to various financial services. There exist other equivalence and/or passporting regimes not analysed in this text, for example there is the Prospectus Directive [2003/71/EC](#), Short Selling Regulation (EU) No [236/2012](#), Benchmark Regulation (EU) [2016/1011/EU](#), Credit Rating Agencies Regulation (EC) [1060/2009](#). There are also relevant rules concerning accounting principles or third-country resolution proceedings.
- ⁸ These concern issues such as disclosure of information, transparency, international cooperation and anti-money laundering and terrorist financing compliance.
- ⁹ There are also provisions concerning trade repositories contained in the [Securities Financing Transaction Regulation \(SFTR\)](#). Both apply to a third-country repository which is to provide services to counterparties subject to SFTR and EMIR reporting obligations.

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