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MiFID II: Access to EU Markets for Third Country Investment Firms

This note discusses the MiFID II regime for access by financial institutions located outside the EU to EU customers and markets. Full harmonisation of the access regime for third country firms has not been achieved. Instead, the access regime depends on the types of clients a firm wants to provide services to and the national requirements of each Member State.

Introduction

Access to the EU markets by third country investment firms was one of the most controversial topics during the legislative process for the now finalised Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation, together known as "MiFID II." After all the debate, the result is a patchwork attempt at harmonising certain aspects of access, leaving a degree of uncertainty. The ultimate impact of the new regime on competition and the EU markets remains to be seen. Further harmonisation is not necessarily off the EU legislative agenda. In the meantime, firms should consider their business models under the new laws. MiFID II was due to apply from 3 January 2017, subject to certain transitional provisions. However, it is likely that application of the laws will be delayed for a further year.[1]

Access will generally hinge not only on the authorisation and supervision of the firm in the third country but also on the legal and regulatory regime of the third country, including equivalence assessments, cooperation arrangements and the anti-money laundering and tax regimes implemented by the third country.[2]

Access for Third Country Investment Firms

The Position Under MiFID

Access of third country firms to EU markets was not harmonised under MiFID. Third country firms do not currently have the right to "passport" their authorisation from one EU member state into other EU member states. This has led to branches of third country firms, for example US banks, being separately regulated in

[1] Whilst the application of MiFID II is likely to be delayed, whether Member States will still be required to transpose the legislation by 3 July 2016 is uncertain because that delay was not included in the Commission's original proposal. The European Parliament and Council of the European Union must now agree on the final terms of the delay and have indicated that the member state transposition deadline will also be delayed. Even though new Member State rules are imminent, the regulatory technical standards and other delegated legislation under MiFID II have not been finalised. Member State rules will depend, to a certain extent, on the finalisation of this delegated legislation and therefore anything published by Member States now is likely to be subject to change. You may like to see our client note, Formal Proposal to Delay Implementation of MiFID II Package to 2018, for further information.

[2] You may like to see our separate client note, "Extraterritoriality Revisited: Access to the European Markets by Financial Institutions, Funds and Others from Outside Europe."

each EU country where they are established. Alternatively, US banks have set up a subsidiary in one of the member states and used that entity to passport their services across the EU.

Member States have the discretion not to apply the MiFID regime to branches of third country firms authorised in their countries, provided they are subject to prudential requirements at least equal to those applicable in the EU and that more favourable treatment is not given to third country firms than to European Economic Area ("**EEA**")[3] firms. In practice, national regulators tend to impose equivalent requirements on third country firms operating in their territories. However, national exemptions may also be available for firms operating on a cross-border basis, such as the "overseas persons" exclusion available under the UK regulatory regime for firms not operating from a permanent place of business in the UK.[4]

The Position Under MiFID II

Under MiFID II, access by third country firms depends on the type of clients an investment firm intends to provide services to. The types of clients and definitions mostly follow those under MiFID, but with some tweaks. Firms will need to ensure that they have appropriate policies and procedures in place to categorise clients correctly:

- *Elective professional clients ("opt-up")*: public sector bodies, local public authorities, municipalities and private individual investors may opt to be treated as a professional client either generally or for a particular service or transaction. The investment firm will need to assess the expertise, experience and knowledge of its client, including whether the client satisfies at least two of the following: (i) the client has traded significantly ten times on average in the last four quarters; (ii) the client has cash and investments exceeding EUR 0.5 million; and (iii) the client has been a financial services professional for over a year.
- *Per se professional clients*: banks, investment firms, insurers, asset managers, funds, commodity dealers, other institutional investors and non-EU equivalent regulated entities; national and regional governments, central banks, bodies managing public debts and international and supranational institutions; large companies (whose size meets any two of: balance sheet total: EUR 20 million, net turnover: EUR 40 million and own funds: EUR 2 million) and other institutional investors whose main activity is to invest in financial instruments including those that mostly securitise assets and finance transactions.
- *Eligible counterparties ("ECPs")*: banks, investment firms, insurers, asset managers, funds, other institutional investors, non-EU equivalent regulated entities and large undertakings meeting a certain size threshold (not yet specified) consenting to be treated as an ECP.
- *Retail clients*: a client that is neither a professional client nor an ECP.

Client-Specific Applicable Regimes

For each type of client to which a third county firm intends to provide services, the applicable regime differs.

[3] The EEA is made up of EU member states and also Iceland, Liechtenstein and Norway.

[4] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 72. Please see the section below on the Current UK Regime for further information on this exemption.

ECPs and Per Se Professional Clients

Provision of services to ECPs and per se professional clients is possible on a cross-border basis without the establishment of a branch, if a firm is registered with the European Securities and Markets Authority ("**ESMA**"). To achieve registration with ESMA, the following is required:

- The firm must be authorised in its home country by the relevant regulator and be subject to supervision and enforcement by that regulator.
- A positive equivalence determination is needed for the third country, which means that the third country's prudential and conduct requirements must be of equivalent effect to the requirements under MiFID II. Such requirements include:
  - authorisation and supervision of the firm on an ongoing basis;
  - sufficient initial capital;
  - requirements applicable to shareholders and senior managers;
  - organisational controls;
  - rules preventing market abuse; and
  - that the third country has an equivalent system of recognising EU-authorised firms.
- Cooperation arrangements between ESMA and the third country regulator provide for the exchange of information, prompt notification to ESMA if the firm infringes any conditions of its authorisation and the coordination of supervisory activities, including onsite inspections.

ESMA has the power to withdraw the registration of a firm. Firms providing services to retail and/or elective professional clients through the establishment of a branch authorised under MiFID II, may use that authorisation to provide services to their ECP and per se professional clients on a cross-border basis (i.e., by using the so-called MiFIR third country passport). There is an exception to the requirement for the firm to be registered with ESMA where the relevant service/activity is at the client's own exclusive initiative.

Once registered with ESMA, a firm must inform its EU clients in writing, before providing services, that it may only provide services to ECPs and per se professional clients in the EU and that the firm is not subject to direct regulatory supervision in the EU. The firm must also offer to submit disputes relating to the relevant services to the jurisdiction of a court or arbitral tribunal in a member state.

Third country firms may continue to provide services in the EU under national regimes until three years after the adoption of an equivalence decision. As a result, existing laws in this area (such as the UK's overseas persons exclusion) will generally continue to apply for wholesale business. In the absence of an equivalence decision firms may provide services subject to a national regime but not on an EU-wide basis.

The provisions relevant for ECPs and per se professional clients are set out in MiFIR and therefore have direct effect across the EU: there is no member state discretion in implementation of the rules.

Note that such firms will also be able to "passport" any wholesale investment services or activities (to per se professional clients and eligible counterparties) into other member states if they have an authorised branch in an EU Member State, once the European Commission has deemed the firm's third country jurisdiction "equivalent."

Retail and Elective Professional Clients

Member states have the option of requiring third country firms to establish a branch to provide services to retail and elective professional clients. If a member state decides to impose this requirement:

- firms will have to obtain authorisation from the regulators in that member state and must satisfy certain conditions, such as:
  - having sufficient initial capital;
  - fulfilling requirements relating to senior management; and
  - belonging to an investor-compensation scheme; and
- the third country will also have to satisfy certain conditions, such as:
  - complying with FATF recommendations;
  - establishing cooperation arrangements between regulators;
  - entering into tax agreements; and
  - ensuring that the relevant investment services are subject to authorisation and supervision.

The intention of MiFID II is that once a third country firm's branch is authorised in one member state, it should receive the same treatment as EU-regulated branches. Once authorised, the branch must comply with certain provisions of MiFID II, including organisational requirements, conduct of business requirements and transparency and transaction reporting requirements. However, once authorised, an EU national regulator will have the power to withdraw authorisation from a firm.

No EU-wide passport is available for the provision of services to retail and elective professional clients: branches must be authorised state-by-state. There is an exception to the requirement for the firm to establish a branch where the relevant service/activity is provided at the client's own exclusive initiative (and this exception also applies in respect of ECPs and per se professional clients).

Provisions relating to retail and elective professional clients are set out in the MiFID II directive, which will need to be transposed into national laws by member states. This allows for some divergence in implementation between member states.

UK Approach

General Approach to MiFID

In its March 2015 paper, the UK government issued a consultation paper explaining that MiFID II will be transposed in the UK mainly through amendments to the Financial Services and Markets Act 2000 ("**FSMA**") and secondary legislation and rules made thereunder, in a similar manner to how MiFID was transposed. However, MiFID II, unlike MiFID, imposes obligations on market participants that are not currently regulated. Therefore, the UK will have to create new laws for these market participants, as they do not fall into the current FSMA regime and the Financial Conduct Authority ("**FCA**") does not have authority to stipulate rules for these market participants under FSMA. UK draft legislation is anticipated during the course of 2016.

Approach to Regime for Branches of Third Country Firms

In its March 2015 consultation paper, the UK Government proposed that the UK should not exercise its discretion under the MiFID II Directive to require third-country firms to establish a branch if they wish to provide investment services to retail or elective professional clients in the UK. The UK government is of the belief that the UK's current regime is well tailored to different client types and to the potential risks posed to these clients. The UK government recommended that the UK should not impose a branch requirement and should plan to retain existing national rules, such as the Oversees Person exclusion, as far as possible. This approach would mean that a UK branch providing services to retail and/or elective professional clients would not be able to passport their wholesale services to per se professional clients and ECPs using the MiFIR third country passport, which is only available to a branch that is established in accordance with MiFID II. However, it would mean that the Overseas Person exclusion would not be limited and the ability of third country firms to conduct investment business would continue under the existing regime.

However, even if the current UK regime is maintained, MiFID II will require the UK to make certain changes to its legislation. For example, legislation will have to be amended to accommodate the third country firms that have authorised branches under MiFID II in other member states. Such firms will be able to "passport" any wholesale investment services or activities (to per se professional clients and eligible counterparties) into other member states, including the UK, once the European Commission has deemed the firm's third country jurisdiction "equivalent."

Current UK Regime

At present, third country firms are subject to the same general prohibition as UK firms in that they cannot provide investment services in the UK without authorisation from the Prudential Regulation Authority ("**PRA**") and/or the FCA. There are three main ways in which a third country firm can engage in investment activities in the UK:

- Set up a UK subsidiary to apply to the PRA and/or the FCA for authorisation in its own right, to obtain the benefit of an EU passport to carry on investment business in other member states under MiFID or the Capital Requirements Directive.
- Where a third country firm has a UK permanent place of business in the form of a UK branch, it can provide investment services in the UK once its UK branch has been authorised by the PRA and/or the FCA. This branch, however, will not have the benefit of EU passporting rights.
- Some third country firms do not require regulatory approval to provide investment services in the UK, particularly if they fall within the exclusion for "overseas persons."[5] This states that a firm that enters into certain regulated activities (such as dealing in derivatives as principal or agent) from outside the UK, and who does not conduct regulatory activities through a permanent place of business in the UK, does not need to be authorised to the extent that such firm enters into transactions: (i) with or through an authorised or exempt firm; or (ii) as a result of a legitimate approach. Entering into a transaction "with or through" an authorised or exempt firm can involve entering into a transaction "with" an authorised or exempt firm as counterparty, or "through" an authorised or exempt firm acting as an agent of the overseas person. This allows overseas firms to enter into transactions through authorised credit institutions and investment firms in the UK.

  In order to rely on the overseas persons exemption, any cross-border transaction must only be the result of a legitimate approach, where a UK person approaches the overseas person and asks to enter into the

5 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 72.

transaction, or where the overseas person makes a promotion that relies on certain exemptions from the UK's financial promotion regime. Such promotions include those made to investment professionals or certain high net worth clients.

- Firms may also be exempt from requiring regulatory approval where they fall under one of the exclusions that corresponds to those currently set out in article 2 of MiFID. Article 2 includes, for example, an exemption for firms which provide investment services consisting exclusively of the administration of employee-participation schemes and an exemption for firms which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings.

Impact of the MiFID II Approach to Third Country Firms

The MiFID II approach to third country firms will impact each EU member state differently. For the EU's "open markets," such as the UK and Luxembourg, the effect of MiFID II will be slight. These "open markets" will continue to operate as they have done under the existing MiFID regime. However, the EU's "closed markets," such as France and Germany, which have traditionally been more protective of local clients, may open up as a consequence of MiFID II in particular with regard to wholesale business. However, the extent to which such markets open up will depend on how many third countries are deemed "equivalent." It seems that the threshold for reaching an equivalence decision has been set quite high.

CONTACTS

Barney Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Hervé Letréguilly
Paris
+33.1.53.89.71.30
hletreguilly@shearman.com

Tobia Croff
Milan/ Rome
+39.02.0064.1509
+39.06.697.679.209
tobia.croff@shearman.com

Kolja Stehl
London/ Frankfurt
+44.20.7655.5864
+49.69.9711.1623
kolja.stehl@shearman.com

James Campbell
London
+44.20.7655.5570
james.campbell@shearman.com

Aysuria Chang
London
+44.20.7655.5792
aysuria.chang@shearman.com

Uxshely Chotai
London
+44.22.7655.5569
uxshely.chotai@shearman.com

Anna Doyle
London
+44.20.7655.5978
anna.doyle@shearman.com

Mak Judge
Singapore
+65.6230.8901
mak.judge@shearman.com

Oliver Linch
London
+44.20.7655.5715
oliver.linch@shearman.com

Ben McMurdo
London
+44.20.7655.5906
ben.mcmurdo@shearman.com

Ellerina Teo
London
+44.20.7655.5070
ellerina.teo@shearman.com