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The Practical Implications of MiFID II: Third Country Firms

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In this article we review the new regime being introduced by MiFID II (comprising Directive 2014/65/EU on markets in financial instruments and Regulation (EU) No 600/2014) that will provide investment firms from outside the EU (third country firms or TCFs) with access to the European Union (EU) single market for financial services.

An introductory article on the practical implications of MiFID II is available here.

MiFID II aims to harmonise the approach to TCFs among the Member States of the EU.

What follows may be of interest to investment firms located in the UK, following the decision of the British public on 23 June 2016 to exit the European Union (Brexit). At present, UK investment firms have unhindered access to the EU market. However, after the UK leaves the EU, the question of how UK investment firms will be able to access the EU is uncertain and will depend on the outcome of the exit negotiations between the EU and the UK. It is very possible that UK investment firms will be treated as TCFs and will no longer have automatic access to the EU market.

In light of this and in advance of any official date for the UK leaving the EU, existing investment firms in the UK should be aware of the MiFID II requirements for TCFs doing business in the EU and what actions they may need to take to retain access to the EU market.

1. What's New under MiFID II?

Under MiFID I, individual EU Member States have discretion as to how TCFs are to be treated. There is no uniformity of approach across the EU. The only requirement at present is that Member States do not treat TCFs more favourably than EU investment firms.

Under MiFID II, the rules applicable to a TCF will depend on a number of factors;

- the type of client which the TCF is providing services to;
- whether the legal and regulatory regime applicable to investment firms in the TCF's jurisdiction is deemed equivalent to EU standards; and
- the MiFID II regulatory approach taken by the individual Member States which the TCF wishes to access.

MiFID II draws a significant distinction between different types of clients of investment firms;

- where a TCF wishes to provide investment services to retail clients and elective professional clients in a Member State, the competent authority of that Member State may require the TCF to set up a branch.
- where a TCF seeks to provide investment services in the EU to per se professional clients and

eligible counterparties only, such a TCF can provide such services without necessarily establishing a physical presence in the EU by setting up a branch.

In this article, we examine below the various ways in which a TCF may access clients in the EU through either;

- the establishment of a branch;
- the provision of services cross-border without establishing a branch;
- compliance with the national regimes of individual Member States; or
- the 'exclusive initiative' exemption.

2. Establishment of a Branch of a TCF

As stated above, the competent authority of a Member State may require a TCF to set up a branch to provide investment services to retail or elective professional clients in that Member State. Branches of TCFs will require prior authorisation from the competent authority of the host Member State and must adhere to the following conditions:

- The TCF must be authorised and supervised in the third country for the provision of services which the TCF is seeking to provide in the EU. The TCF must be properly authorised by a competent authority that has regard to recommendations made by the Financial Action Taskforce in relation to anti-money laundering and counter terrorist financing.
- There must be a cooperation agreement, which includes an agreement to exchange information, between the competent authority of the host Member State where the TCF is seeking authorisation, and the competent supervisory authority of the TCF.
- There must be sufficient initial capital at the free disposal of the branch of the TCF.
- One or more persons must be appointed as responsible for management of the branch and they must, at all times, be of sufficiently good repute with sufficient knowledge, skills and experience to perform their duties and comply with all of the MiFID II requirements that apply to management bodies.
- The third country where the TCF is established must have signed an agreement with the host Member State which complies with Article 26 of the OECD Model Tax Convention on Income and on Capital regarding the exchange of information on tax affairs.
- The TCF must belong to a recognised investor-compensation scheme.

The TCF establishing the branch must also provide the host Member State competent authority with all relevant details of the TCF and those persons who will be responsible for management of the branch.

Member States are prevented from imposing additional requirements on TCFs as part of the granting of authorisation provided that: the above conditions are satisfied; the TCF complies with its MiFID II authorisation; and the TCF remains supervised by its home competent authority.

The branch authorisation requires a TCF to comply on an ongoing basis with a number of provisions of MiFID II relating to organisational requirements and operating conditions. The TCF is supervised in respect of these requirements by the host Member State.

Once a branch is established, then provided that the European Commission deems the legal and regulatory regime applicable to investment firms in the country of origin of the TCF as being equivalent to that in the EU, the TCF can provide services and activities throughout the EU without being required to establish additional branches in other Member States. However, it must be noted that this passporting is only available for those services and activities for which the TCF is authorised and only in respect of eligible counterparties and per se professional clients.

3. Provision of services cross-border by a TCF without establishing a branch

In order for a TCF to provide investment services to eligible counterparties and per se professional clients in the EU without establishing a branch, it must be listed on the European Securities and Markets Authority's (ESMA) register of TCFs.

ESMA will add a TCF to the register where the following conditions are met:

- The Commission has adopted a decision deeming that the TCF's country of origin has a legal and regulatory regime in respect of investment firms which is equivalent to that existing in the EU.
- The TCF is authorised in the jurisdiction where its head office is established to provide investment services or activities and is subject to effective supervision and enforcement.
- The third country has cooperation arrangements in place with the EU.

The TCF must inform its clients that it is only permitted to provide services to eligible counterparties and per se professional clients only. In addition, the client must also be informed of the name and address of the competent authority responsible for supervising the TCF.

The cooperation arrangements between ESMA and the competent authority of the third country which authorises the TCF must allow for the exchange of information and prompt notification of infringement of laws or conditions of authorisation of the TCF.

A TCF may lose its rights to provide investment services and activities cross-border in either of the following scenarios;

- ESMA exercises its power to withdraw the registration of a TCF where, e.g. the TCF has seriously infringed the provisions applicable to it in its country of origin; or
- the Commission exercises its power to withdraw its equivalence decision in respect of the TCF's country of origin.

4. Exclusive Initiative

MiFID II contains a type of reverse solicitation carve-out, under which MiFID II does not apply in situations where eligible counterparties or per se professional clients seek out investment services or activities from a TCF, at those clients own 'exclusive initiative'.

However, this provision may not be of much practical use to TCFs beyond a limited range of investment firms, as the 'exclusive initiative' rules only permit the TCF to provide the particular investment service or activity requested by the client, and do not allow a TCF to market new categories of investment product or investment service to such clients.

Next Steps

In advance of the implementation date of MiFID II on 3 January 2018, TCFs can start considering whether they might need access to a Member State either through: the establishment of a branch; cross-border without a branch; by way of national regimes; or indeed whether their business model is compatible with the 'exclusive initiative' exemption. TCFs will need to consider a number of factors, including whether they intend to provide services to wholesale or retail clients, what jurisdiction it will seek to provide investment services in and the type of investment services it wishes to provide.

In the context of Brexit, because it is expected that the UK will have implemented MiFID II into its national law by the time of its exit from the EU, it is difficult to envisage a scenario whereby the UK regulatory and legal regime will not satisfy the equivalence requirements as outlined above. This assumes that there is no

wholesale revision of the legislative and regulatory regime applicable to investment firms in the UK, which is unlikely.

UK MiFID firms currently carrying out UCITS retail distribution activities, i.e. the provision of investment advice and/or receiving and transmitting orders, are likely to find themselves unable to continue to provide that service on a pan-European basis if the UK ends up as a "third country" after Brexit negotiations have concluded. Many UCITS established in Ireland have adopted a model whereby a UK based MiFID firm provides the UCITS with distribution services.

As UCITS are intended for retail investment, then in order to continue in that UCITS distribution role post-Brexit, these firms are likely to be obliged to establish branches in each EU jurisdiction it is proposed to access. This is unlikely to be a viable solution for the UK MiFID firms, or the UCITS which have engage them, given the costs and increased risks which branch establishment would entail.

In this context, it is worth noting that the authorisation of UCITS Management Companies permits them to undertake not only investment management and administration, but also marketing activities. It may be that the future will see EU authorised UCITS Management Companies, or so-called Super Mancos (i.e. those with both AIFMD and UCITS authorisations,) filling the space once occupied by UK MiFID Firms in relation to pan European UCITS distribution.

If you would like further information on the MiFID II rules for third country firms, please contact a member of the Financial Services team.

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