# SPECIAL REPORT SERIES: THIRD COUNTRY FIRMS UNDER MIFID II

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This Special Report is the seventh of the FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's ("ESMA") consultation process for the implementation of the recast Markets in Financial Instruments Directive ("MiFID II") and Regulation ("MiFIR").

Specifically, this Special Report provides an overview of the proposals relating to the treatment of third country firms seeking to provide services to EU-based customers, as set out in the recently published Discussion Paper[1] and Consultation Paper[2]. The papers contain draft technical advice and questions on the proposed Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS").

## MIFID II AND MIFIR: TREATMENT OF INVESTMENT FIRMS FROM THIRD COUNTRIES

MiFID II and MiFIR contain a number of provisions relating to the treatment of third country investment firms (i.e. entities incorporated outside the EU that seek to do business in the EU). Those provisions regulate in particular (i) the conditions under which third country firms may provide investment services to EU-based clients; (ii) the application of the Trading Obligation to third country counterparties and trading venues; and (iii) the access to EU-based central counterparties ("CCPs") and trading venues by third country CCPs and trading venues. This Special Report discusses each of these three provisions below.

## PROVISION OF INVESTMENT SERVICES IN THE EU BY THIRD COUNTRY FIRMS

Under MiFID II and MiFIR, depending on the type of their clients, third country investment firms may engage in business in the EU (i) through a branch established in the client's Member State or (ii) on a cross-border basis (i.e. without a branch in the client's Member State).

Prior to the adoption of the new legislation, the EU had not harmonised rules on access to the EU market by third country firms. As a result, each Member State could introduce national third country rules, as long as those rules complied with the general principles of the EU Treaties and did not treat foreign firms more favourably than firms established in other Member States.

### *PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES*

MiFIR introduces a harmonised regime for granting access to the EU market that permits third country firms to operate on a cross-border basis (i) from outside the EU or (ii) from an EU-based

[1] ESMA Discussion Paper (ESMA/2014/548).
[2] ESMA Consultation Paper (ESMA/2014/549).

branch. However, that harmonised regime is limited to the provision of investment services to eligible counterparties and professional clients (as listed in Annex II, Section I of MiFID II).[3]

Specifically, Article 46 of MiFIR provides that a third country firm may provide investment services to eligible counterparties and professional clients in all Member States without the establishment of a branch provided:

- The European Commission ("Commission") adopts a decision recognising that the regulatory (prudential and business conduct requirements) and supervisory regime of the third country in which the firm is established achieves the same objectives as the EU regime and provides EU investment firms with equivalent access to its markets; and
- The firm is authorised and effectively supervised in its home country in respect of the provision of the relevant services; and
- ESMA establishes cooperation arrangements with the competent authority of that third-country; and
- The firm is included in a register of third country firms kept by ESMA.

Third country firms providing services in accordance with the above provision must inform their EU-based clients -- in advance of providing investment services -- that they are not allowed to provide services to clients other than eligible counterparties and professional clients and that they are not supervised in the EU. While Article 46(7) of MiFIR provides that ESMA shall develop draft RTS to specify the information that the applicant third country firms must provide to ESMA in their application for registration and the format of information that the third country firms must provide to their clients, the Discussion Paper and the Consultation Paper are silent on those points. However, ESMA may base these RTS on the existing MiFID standards, and in particular the work of the Committee of European Securities Regulators on the passport under MiFID (as in the case of the rules that would apply to EU-based firms outlined in the Discussion Paper).

For the three years that follow the adoption of a Commission equivalence decision, non-EU firms will either register with ESMA or, in the alternative, continue to conduct MiFID business with eligible counterparties or professional clients in compliance with Member States' national regimes. Similarly, if the Commission withdraws its equivalence decision, or if the Commission does not adopt the equivalence decision, third country firms will be allowed to provide investment advice to eligible counterparties or professional clients pursuant to the applicable national provisions.

As an alternative to ESMA registration, third country firms can provide investment advice to eligible counterparties or professional clients in all Member States through an EU branch authorised by the competent Member State authority pursuant to Article 39 of MiFID II. In order to use this option (referred to as "passporting"), third country firms must be established in countries whose legal and supervisory framework is recognised as broadly equivalent by the Commission; they must also comply with the information requirements for the cross-border provision of services outlined in Article 34 of MiFID.

### *RETAIL AND ELECTIVE PROFESSIONAL CLIENTS*

Pursuant to Article 39 of MiFID II, Member States may require that firms that intend to provide investment services to retail clients and elective professional clients on their territories (i.e. clients

[3] However, third country firms will be able to provide investment services to clients on the exclusive initiative of the clients, without requiring authorisation/registration in the EU.

that may be treated as professionals at their request, as listed in Annex II, Section II of MiFID II) establish branches in those Member States.

The same provision sets out certain common requirements with which a branch of a third country firm will have to comply in order to be authorised by the national competent authority. Where a Member State implements MiFID II to require the establishment of branches, a third country firm that has not established a branch in that Member State will not be able to provide investment services to retail clients or elective professional clients. Where a Member State does not implement that requirement, the provision of services to retail clients and elective professional clients will be subject to its national laws, rather than the provisions of MiFID II..

## APPLICATION OF THE TRADING OBLIGATION TO THIRD COUNTRY COUNTERPARTIES AND TRADING VENUES

Our Special Report on market infrastructure discussed the introduction of the Trading Obligation for derivatives. Pursuant to Article 28(1) of MiFIR, counterparties subject to the Trading Obligation may comply with that obligation by conducting transactions in relevant derivative contracts on certain third country trading venues. However, they can do so only if the Commission has deemed their home jurisdiction as having an "equivalent system" for the recognition of EU trading venues for the purposes of any similar trading obligation for derivatives in that jurisdiction. Article 28(4) of MiFIR sets out this requirement in detail and states that the Commission's decisions are subject to the implementing act procedure, which is not discussed in the Consultation Paper or Discussion Paper.

Moreover, under Article 28(2) of MiFIR, the Trading Obligation extends to (i) counterparties which enter into derivatives transactions with third-country financial institutions or other third-country entities that would be subject to the Clearing Obligation if they were established in the EU and (ii) third-country entities that would be subject to the Clearing Obligation were they established in the EU and which enter into derivatives transactions that have a "direct, substantial and foreseeable effect within the EU", or where the application of the Trading Obligation is necessary or appropriate to prevent the evasion of the MiFIR rules.

Article 28(5) of MiFIR obliges ESMA to define which derivatives contracts involving third country counterparties have a direct, substantial and foreseeable effect within the EU. In the Discussion Paper (Section 3.11), ESMA states that the requirement under Article 28(5) closely mirrors the Clearing Obligation requirement under European Market Infrastructure Regulation (EMIR)[4] and proposes to take a similar approach to the one adopted under EMIR. Specifically, ESMA is of the view that there are two types of contracts that can be said to have a direct, substantial and foreseeable effect within the EU for the purposes of the Trading Obligation:

- Contracts entered into by a third country entity that has a guarantee from an EU financial counterparty (as defined by EMIR) and would be subject to the Clearing Obligation if they were established in the EU. (The EMIR rules provide for a threshold where the activity must be equal to or greater than 5% of the total OTC derivatives exposures that the EU financial counterparty faces, and constitutes an absolute value of more than EUR 8 billion. ESMA proposes to adopt a similar threshold for the Trading Obligation in order to keep the MiFIR and EMIR rules aligned); and

[4] Regulation (EU) No. 648/2012.

- Contracts entered into between two European branches of non-EU financial and non-financial counterparties (as defined in EMIR).

ESMA proposes to adopt an anti-avoidance procedure, as similar as possible to the one applied under EMIR in relation with the Clearing Obligation. This procedure could be used to require a transaction entered into by counterparties established in third countries to take place on a trading venue rather than bilaterally. The Discussion Paper mentions that ESMA will develop and publish an indicative set of criteria, similar to those under development for the Clearing Obligation, in order to measure the substance or effect on the EU of trading which would normally be subject to the Trading Obligation, but escapes it by virtue of a unique business arrangement. If a business arrangement has been entered into solely for the purpose of avoiding the Trading Obligation, then ESMA will consider applying the Trading Obligation and the national competent authorities may consider other action against a company engaged in that business arrangement.

## Access for Third Country CCPs and Trading Venues

Some of the most contentious provisions in MiFIR (Articles 35-37) concern the so-called "open access" to CCPs, trading venues and benchmark licenses. Those provisions, which we discussed in our third Special Report, set out requirements for trading venues and CCPs to have non-discriminatory access to one another and non-discriminatory access to benchmarks. Specifically, they require that (i) CCPs clear financial instruments on a "non-discriminatory and transparent" basis regardless of the trading venue on which a transaction is executed; (ii) trading venues provide, on request, trade feeds on a non-discriminatory and transparent basis to CCPs that wish to clear transactions that are traded on the relevant venue; and (iii) both CCPs and trading venues be given non-discriminatory access to benchmarks.

The above provisions are complimented by Article 38 of MiFIR, which sets out the conditions and requirements under which third country CCPs and trading venues may use the open access. As with the Trading Obligation, that access is conditional on a Commission decision that the home jurisdiction of the CCP or trading venue has in place an equivalent system of open access to market infrastructure that recognises and facilitates EU CCPs and trading venues.

## Upcoming Special Reports

In the coming days, FIA and FIA Europe will issue special reports on the remaining topics addressed in the two papers:

1) **Transaction Reporting of Instruments**
2) **Transparency Requirements for Instruments**

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For more information about these reports contact Will Acworth at FIA (wacworth@fia.org) or Emma Davey at FIA Europe (edavey@fia-europe.org)

Additional MiFID II/MiFIR documents are available here.

*Disclaimer: This report was drafted by the London office of Covington & Burling LLP on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.*