The Challenges of Third-country Access Under MiFID II

MiFID II will simplify market access for non-European Union firms doing wholesale business but servicing retail clients will remain burdened by regulation.

MiFID II will introduce new market access rules for third-country investment firms (TCFs) incorporated outside the European Union (EU) seeking to do business through a branch or on a cross-border basis. The long-awaited reforms will harmonize certain aspects of market access but still leave non-EU asset managers facing a degree of uncertainty.

Market access split between client categories

Currently under MiFID I, TCFs are unable to passport their authorization across borders. As a result, their market access is up to the discretion of individual EU Member States. MiFID II aims to implement a more harmonized approach, by introducing two new options for third country firms based on the target clients they want to service. The intention is to eliminate, or at least reduce, the need for TCFs to deal with different regulatory regimes when operating across borders.

Business without borders

The new regime distinguishes between market access for the provision of services to eligible counterparties and 'per se' professional clients, versus retail clients and elective professional clients (EPCs). EPCs, also known as 'opt-up' clients, include public authorities and private individual investors who have opted to be treated as professional clients generally, or for a particular service or transaction. The option most relevant for TCFs will depend on their client base, meaning firms will need to ensure they have appropriate policies and procedures in place to correctly categorize prospective clients.

MiFID II will also implement a framework known as the "cross border model" to grant EU market access to TCFs that service eligible counterparties, and 'per se' professional clients. The framework will allow TCFs to conduct business across borders and avoid the need to establish local branches as long as they are registered by the European Securities and Markets Authority (ESMA).

The home country needs to recognize an equivalent system under the local regulatory regime to the prudential and business conduct requirements set out in MiFIR, MiFID II, and the Capital Requirements Directive IV. In addition, the investment firm must be recognized and authorized, and the home competent authority must have a co-operation agreement in place with ESMA.

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KEY INSIGHTS

- Asset managers need firm grip on how to categorize prospective clients
- Smaller firms pursuing retail business could face reinforced protectionism
- 'Equivalence' tests add a layer of doubt to third-country access

No passport for retail business

Harmonized access has not yet been extended to retail clients or EPCs, meaning Member States can continue to apply their own national rules. As a result, TCFs will be unable to conduct their services and activities across borders to these clients and will be required to establish a branch in the other Member States following local regulatory

> TCF registration will rely on certain conditions, including an equivalence requirement that must be confirmed by the European Commission.

requirements. The conditions regarding the establishment of branches have been harmonized which preclude Member States from adding additional conditions.

TCFs can be exempt from the requirement to set up a branch when the client initiates, as an 'exclusive initiative' the provision of the investment service or activity. This 'exclusive initiative' is likely to be interpreted narrowly by both regulator and firms, and TCFs may find it difficult to rely on in practice. It prevents firms from marketing their new investment products or services in the EU unless requested at the client's initiative. This creates a challenge for TCFs who advertise services through the internet or those that may seek to extend a client relationship beyond the original product or service.[2]

Protectionism in the Member States

The new regime may prove a useful development for both non-EU asset managers and EU investors by helping to create a level playing field and potentially reducing the costs and risks of doing business in Europe. Industry experts have been disappointed that the MiFID II reforms will not reduce the fragmentation of market access to retail customers. With Member States free to require the establishment of a local branch in their jurisdictions, small and medium-sized asset managers could face the challenge of reinforced protectionism.[3]

The cross-border model for wholesale business will be welcomed by asset managers, but the equivalence decision requirement has raised concerns from industry. While the drafting of MiFID II would suggest the application of equivalence should be reasonably flexible, the process has proven to be time-consuming under other regulations. In the past, EU regulators have been inclined to apply a line-by-line equivalence test which favours third-country regimes closely modelled on the EU at the expense of more independent jurisdictions such as the United States.[4] Authorities are working to speed up the legal process for equivalence, but formal ratification with the US is currently outstanding.[5]

Whereas 'passporting' is a permanent right granted for the provision of financial services for beneficiaries and firms established in the EU and EEA, 'equivalence' is more narrow and the rights granted benefit institutions in a third-country, those rights can be withdrawn. The new regime will require asset managers to ensure they have processes in place to categorize their current or prospective clients effectively to reap the benefits of harmonized market access. With equivalence precluded for retail business, firms will need to establish branches in competing EU jurisdictions to keep up with local regulations and be prepared to respond to possible regulatory hurdles.

> Authorities are working to speed up the legal process for equivalence

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1. International Bar Association (May 2016) Third country firms' access to the EU market under MiFID II & MiFID II and MiFIR 2. King & Wood Mallesons (August 5, 2016) MiFID II - Third country access to EU markets 3. International Bar Association (2016) 4. Funds Europe (September 2015) MiFID II - Harmonising third-country access 5. Financial Times (August 7, 2017) MiFID II Drives U.S. Investment Industry Frantic

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