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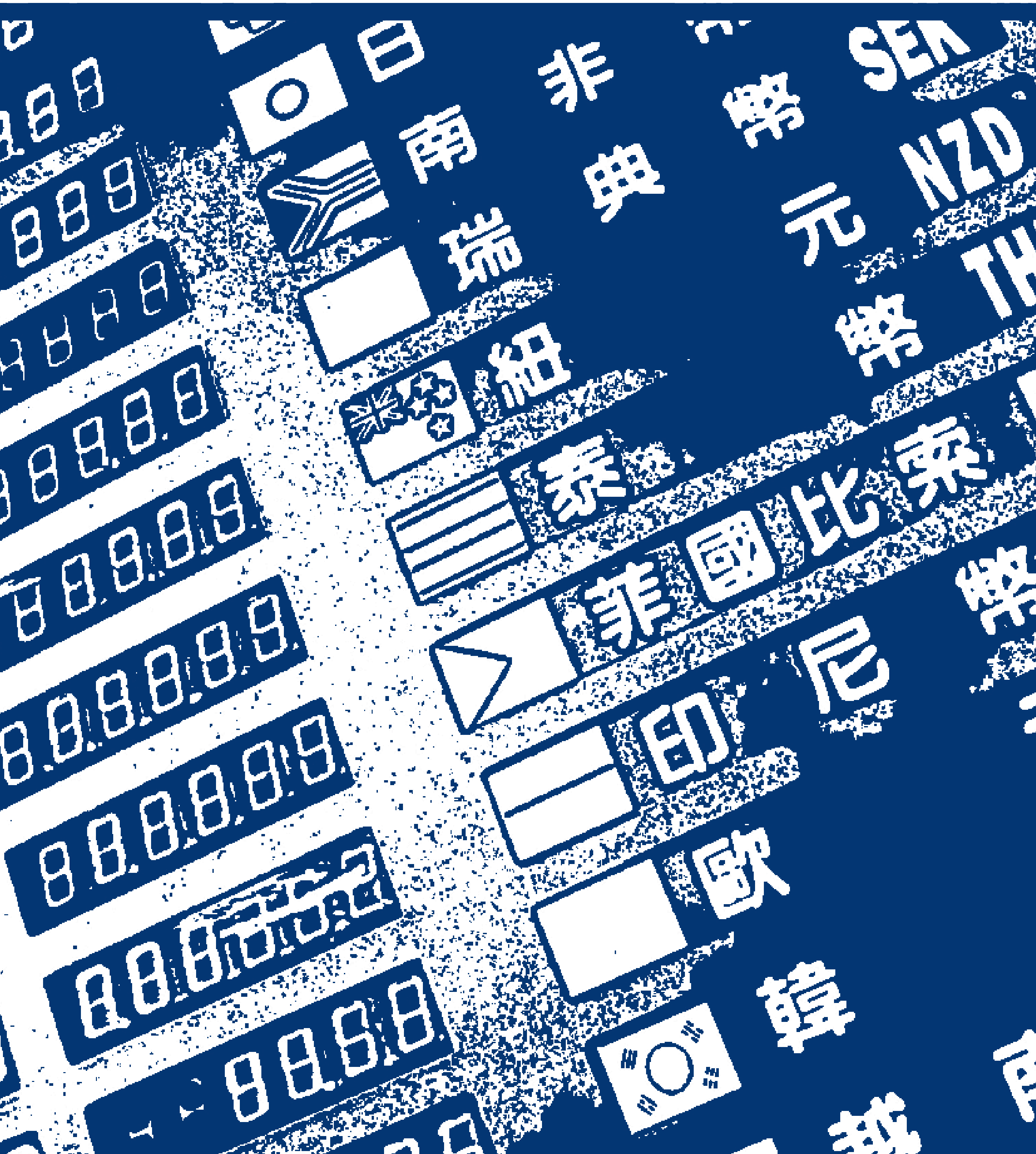

FEATURE ARTICLES

Third-country firms' access to the EU market under MiFID II: between fragmentation and harmonisation

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The revised Markets in Financial Instruments Directive ('MiFID II') and the new Markets in Financial Instruments Regulation (MiFIR) entered into force on 2 July 2014 and are expected to become applicable on 3 January 2018. These two pieces of legislation are of paramount importance for third-country investment firms[1] (non-European Union (EU) firms) because they provide rules on the access of third-country firms to the EU market.

While the referendum on the United Kingdom's membership to the EU will be held on 23 June 2016, a 'Brexit' would have significant consequences for City-based investment firms. Although leaving the EU should lead to lower regulatory costs, this could relegate the UK's status to that of a 'third country', which would restrict its access to the EU market, particularly with regard to serving EU-based retail clients. The UK financial service industry would thus be likely to find itself in a position similar to that of Switzerland. Against this background, this article seeks to provide an overview of EU market access for third-country investment firms that are traditionally banks, independent asset managers, investment advisory firms and other securities dealers. For this purpose, the current changes affecting Swiss investment firms will be used to illustrate the upcoming challenges that third-country investment firms face under MiFID II and MiFIR.

Because the new European standards do not require a branch to serve EU retail clients, the adoption of the final text of MiFID II and MiFIR was greeted with relief by some players in the Swiss financial industry. However, each Member State will have the last say and this initial relief could end up being short-lived. The complexity and legal uncertainty generated by these new European standards call for an analysis of the current situation and future challenges.

Current situation under MiFID I

Presently, under MiFID I, access to the EU market for third-country investment firms is not harmonised. The cross-border provision of investment services in the EU by third-country investment firms is accordingly subject to the national rules of each Member State, the requirements of which generally differ from one another.

Third-country investment firms that establish a branch in an EU Member State do not currently benefit from the 'European passport' to provide investment services throughout the EU. To date, the creation of a subsidiary, that is, a separate legal entity in a Member State, is the only way to obtain that precious passport.

These fragmented market access requirements, as well as the new requirements of the Swiss Financial Market Supervisory Authority (FINMA) related to the cross-border operations of Swiss banks, caused the latter to implement various risk management policies for Swiss banks' cross-border activities. Some of them have decided to open a subsidiary, usually in Luxembourg, to serve their EU clients from a single Member State. Others have chosen to keep their entire structure in Switzerland and selected a subset of EU countries where they maintain the provision of their services. In the latter case, Swiss financial institutions have adopted internal restrictions to comply with the applicable national laws of the selected Member State, in particular cross-border rules related to the visits of, communications with and instructions from clients, and restrictions on the distribution of certain financial products, in addition to consumer protection laws.

Future situation under MiFID II/MiFIR

One particular innovation of the new MiFID II/MiFIR regime is the introduction of market access rules for third-country firms. The revised directive and new regulation distinguish between market access for providing services, on the one hand, to eligible counterparties and per se professional clients[2] and, on the other hand, to retail clients.

Unlike the current situation, MiFID II creates a harmonised framework for granting access to the EU market for third-country investment firms that offer their services to eligible counterparties and per se professional clients. A third-country investment firm may, without establishing a branch, offer investment services to eligible counterparties and per se professional clients established throughout the EU, provided they are registered in the register of third-country firms kept by the European Securities and Markets Authority (ESMA). To this end, the following three conditions must be met: (1) third-country investment firms must be authorised and be subject to effective supervision in their home country with respect to the provision of the relevant service; (2) cooperation arrangements must have been entered into between ESMA and the third-country supervisory authority which, in particular, relate to coordination of supervisory activities and exchange of information; and (3) the European Commission must have adopted an 'equivalence decision' on the ESMA recommendation stating that the legal and supervisory arrangements of the third country ensure that its investment firms comply with legally binding prudential and business conduct requirements of equivalent effect to MiFID II.

With regard to retail clients, market access will not be harmonised under MiFID II. The EU branch requirement was ultimately not retained. Member States are therefore free to continue to apply their national rules. In other words, each Member State may require a third-country investment firm to establish a branch in that Member State in order to provide investment services to retail clients located on its territory. As each Member State may require the establishment of a branch, third-country investment firms will not benefit from the European passport and the opening of a branch will therefore be necessary in each country that has chosen to put such a requirement in place. It is worth noting that even if a Member State does not require the establishment of a branch, third-country investment firms must comply with national rules on the provision of cross-border services of that state. Where Member States require the establishment of a branch, MiFID II, nevertheless, provides harmonised provisions for the establishment of such a branch, which will prevent Member States from imposing additional conditions.

MiFID II provides for an exception to the requirement of establishing a branch when the client initiates, exclusively at his or her own initiative, the provision of an investment service, or activity. However, such 'exclusive initiative' is likely to be interpreted narrowly. MiFID II provides that an 'exclusive initiative' of an EU-based client does not entitle the third-country firm to market new categories of investment products or investment services unless such products/services were also requested at the client's initiative. Moreover, where a third-country firm solicits clients or potential clients in the EU, or promotes or advertises investment services or activities together with ancillary services in the EU, such will not be deemed as services provided at the client's own exclusive initiative.

As in MiFID I, a subsidiary incorporated in the EU will be entitled to serve all categories of clients throughout the EU, including retail clients. As a separate and independent legal entity governed by the laws of a Member State, a subsidiary is not considered as a third-country firm and is therefore not subject to the market access provisions in MiFID II.

Upcoming challenges for third-country investment firms

Ultimately, it appears that MiFID II and MiFIR will not help to reduce the current fragmentation of market access for the provision of financial services to retail customers. These pieces of legislation will nevertheless harmonise access to eligible counterparties and per se professional clients. Given that MiFID II introduces provisions leaving Member States free to require (or not) the establishment of a local branch, small and medium third-country investment firms may encounter a new European fortress. Indeed, it is expected that Member States with a protectionist tradition will require the establishment of a branch.

Switzerland is currently seeking to conclude bilateral agreements in order to obtain access to some major markets without establishing a branch, such as those already concluded with Germany and Austria. However, this bilateral approach has its limitations: Member States that refuse such agreements and thus require the opening of a branch will become inaccessible to small and medium Swiss investment firms, both because of the costs and the preconditions that must be met: activity subject to authorisation in Switzerland, sufficient initial capital and cooperation mechanisms.

Some major Swiss banks have already made a strategic decision to establish a subsidiary in the territory of an EU Member State in order to benefit from the European passport and thus avoid any uncertainty. This solution nevertheless may result in the relocation of certain jobs from Switzerland to the EU and a loss of expertise for the Swiss financial industry. Only a bilateral agreement for financial services between Switzerland and the EU could reverse this trend and provide for harmonised access to EU-based retail clients. Such an agreement would, however, require significant amendments to Swiss law in order for it to be in line with EU laws. This presently seems a long way off, especially in light of the complications caused by the result of the 9 February 2014 Swiss referendum to impose quotas for immigration from EU countries. With respect to the UK, the Brexit scenario is full of uncertainty over the passporting rights issue. Although a Brexit would not automatically mean an end to passporting rights, if UK voters decide to exit the EU, the UK financial industry may then face the same hurdles as Swiss investment firms regarding accessing the EU.

Notes

1 According to Art 4 (57) MiFID II, 'third-country firm' is defined as a firm that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office where located within the EU.

2 Professional clients within the meaning of s 1 of Annex 2 to MiFID II, such as credit institutions, investment firms, insurance companies, pension funds, collective investment schemes and management companies of such schemes, commodity and commodity derivatives dealers and/or large undertakings meeting certain criteria.