Fortress Europe? MiFID II for Non-EU private banks - third country access issues

European financial services legislation has recently demonstrated a desire by European Union (EU) co-legislators to impose extra-territorial requirements on non-EU (i.e. third country) financial services businesses accessing the EU markets. Most notably we have seen this happening with the Alternative Investment Fund Managers Directive (AIFMD) and more recently in MiFID II/MiFIR.

MiFID II/MiFIR are the European legislative texts which will amend the Markets in Financial Instruments Directive (MiFID I), implemented by EU Member States with effect from 1 November 2007. The reforms will be implemented by a Directive (MiFID II) and a Regulation (MiFIR) (referred to together in this note as MiFID II/MiFIR).

MiFID II/MiFIR furthers the aim of the European legislators to create a harmonised regime for accessing the EU markets. The greatest harmonisation is likely to be felt in terms of third country firms providing services to professional investors who can be classified as "per se professional clients" or "eligible counterparties" (as defined in MiFID II/MiFIR). By contrast, Member States retain significant discretions in relation to how third country firms will access their retail markets (that is, clients who are classified as either "retail clients" or "elective professional clients" (again as defined in MiFID II/MiFIR)).

What are the changes for providing services to EU retail clients under MiFID II/MiFIR?

Many of the EU-based clients of non-EU private banks will be classified as either retail or elective professional clients for the purposes of MiFID II/MiFIR. MiFID II/MiFIR give Member States discretion to require third country firms to establish a branch in their jurisdiction in order to do business with these types of clients. The conditions required to be met for establishing a branch are challenging:

- the third country firm is subject to authorisation and supervision in its home jurisdiction;
- co-operation arrangements are in place between the competent authorities in the Member State where the branch is located and the competent authorities in its home jurisdiction;
- the branch has sufficient initial capital at its free disposal;
- the governing body complies with the governance requirements in MiFID II/MiFIR;
- the relevant third country has signed an OECD compliant tax information exchange agreement with the relevant EU Member State; and
- the third country firm has joined a recognised investor compensation scheme within the EU.

It is not yet clear which Member States will exercise this discretion to require third country firms to establish a branch in order to carry on business with retail and elective professional clients in their jurisdiction. The United Kingdom has indicated that it does not currently intend to exercise the discretion therefore, assuming that the United Kingdom continues with this policy choice, providing services to retail and elective professional clients in the United Kingdom in the post-MiFID II world will continue in accordance with the existing overseas persons regime established under domestic law in the United Kingdom. However in our view it is more likely that jurisdictions which have traditionally been more protective of their markets will elect to require third country firms accessing their retail markets to establish a branch in their jurisdiction. This would represent a significant business model change for many non-EU private banks and is something that banks should monitor as MiFID II/MiFIR is implemented by each of the Member States where they currently do business on a cross-border basis.

What are the changes for providing services to EU professional investors under MiFID II/MiFIR?

Under MiFID II/MiFIR third country entities wishing to provide cross-border services to professional investors within the EU must register with the European Securities and Markets Authority (ESMA) rather than apply for authorisation from individual Member States.

Prior to a third country firm registering with ESMA to provide services on a pan-EU basis, the following requirements must be satisfied:

- the European Commission must adopt an equivalence decision that the legal and supervisory framework in the relevant third country is equivalent in effect to the requirements applicable to European investment firms. In addition, the third country must give reciprocal access to its markets for European investment firms;
- the third country firm must be authorised in the jurisdiction where its head office is located and must be subject to effective supervision and enforcement in its home jurisdiction; and

- co-operation agreements must be in place between ESMA and the relevant regulator in the firm's home jurisdiction.

The equivalence decision does not require strict equivalence. Nevertheless the European Markets Infrastructure Regulation (EMIR) has shown in the past that assessing equivalence is not simple and can result in extensive delays. The absence of a positive equivalence decision will not prohibit a third country firm from providing services to EU clients since MiFID II/MiFIR allow the existing national regimes to continue in parallel. However it will enable jurisdictions that have traditionally been protective of their markets to continue with protectionism in the post-MiFID II world, until a positive equivalence decision is adopted by the European Commission. In the United Kingdom, which has previously been more open in allowing third country firms to provide services to investors, it is expected that the existing overseas persons exemption will continue to allow third country firms to provide services to certain more sophisticated investors in the absence of a positive equivalence decision by the European Commission.

Are there any transitional provisions?

A transitional regime will apply in respect of the requirements for professional investors. These transitional provisions will permit pre-existing national regimes to co-exist alongside the ESMA registration regime for three years following a positive equivalence decision by the European Commission for any particular jurisdiction. Therefore assuming that a positive equivalence decision is made in relation to Switzerland with effect from 3 January 2017, private banks based in Switzerland will be able to continue providing services to professional investors in the EU under the pre-existing national regimes (for example, the overseas persons regime in the United Kingdom) until 3 January 2020.

No transitional regime applies to the new regime for retail investors under MiFID II/MiFIR.

Can a non-EU private bank provide services to EU clients on a reverse solicitation basis?

MiFID II/MiFIR permits non-EU private banks to provide services to clients (both retail and professional) within the EU at the client's "own exclusive initiative". When a client approaches a private bank on this basis, it will not be considered to be carrying out activities within the EU so will not be subject to the requirement to establish a branch or register with ESMA. However this exclusion should be interpreted narrowly; once the bank has a relationship established with the client it will not be possible for the bank to market additional products and services to the client other than at the exclusive initiative of the client. Therefore in our view it will not be a viable business model to rely exclusively on reverse solicitation within the EU.

What should private banks do to prepare for these changes?

At present much remains unclear as to how these provisions will be implemented by individual Member States. In particular, other than the United Kingdom, no other Member State has indicated whether or not it intends to exercise the discretion to require third country firms to establish a branch in its jurisdiction in order to provide services to retail and elective professional clients. Accordingly there is little that non-EU private banks can actively do at this time to implement the changes within their business model.

However, it is important that private banks establish whether their EU clients will be classified under MiFID II/MiFIR as retail clients, elective professional clients, per se professional clients or eligible counterparties. The rules in relation to client classification are not changing significantly under MiFID II/MiFIR, so private banks should therefore now begin analysing how each of their clients will be classified. This will help them determine how to continue providing services to their clients in the post-MiFID II/MiFIR world.

When does MiFID II/MiFIR come into force?

MiFID II/MiFIR comes into force on 3 January 2017.

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