Third country provisions in the EC Proposal for a revised Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR)

Briefing paper on the implications for EU markets and the EU economy

This briefing paper was drafted by the International Regulatory Strategy Group (IRSG) of the City of London. IRSG is a practitioner-led body comprising leading figures from the financial and professional services industry. It aims to contribute to the shaping of the European and international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK.

I. Introduction

1. Every day, EU and third country firms interact through the capital markets in many different and sometimes complex ways. These activities are fundamental to funding and managing the real economy. They impact on capital raising by Governments and corporates, and on pension and savings provision in the EU, and they give employment to many EU firms engaged in investment, banking, financial advisory and professional services.

2. To enable international capital flows to continue, both into and out of the EU, significant amendments are needed to the MiFID/R proposals. MiFID/R needs to balance the need for access to international markets with maintaining high standards of investor protection and market integrity within the EU. We believe this can be done. Section II below outlines some common examples. Section III below explains why the Commission's proposed approach based on equivalence and reciprocity does not provide a workable solution for EU investors and corporates. Section IV suggests some alternative solutions.

II. Examples of common financial market activities and services where EU entities interact with third country firms

(i) **Investment management**. EU investment managers need to be able to invest freely in financial instruments in all third country markets in order to deliver diversified long term value for EU investors. To be able to do this, they routinely use affiliates, custodians, brokers and asset managers in those third countries to provide them with required services ranging from advice, through execution, to safekeeping. Many of these services provided to the EU asset manager typically constitute a MiFID service.

Example of delegation of investment management services
Investment managers commonly delegate asset management decisions. The EU is a major centre of global investment management and many EU managers enter into global mandates with clients from all over the world. Typically, however, only a portion of that global mandate would be managed within the EU, usually the EU investment portfolio, cash management and FX hedging activity. The rest will be outsourced either to affiliates, normally in the major centres in Asia, North America or Latin America, or to non-affiliates in the emerging markets. These external managers may sub-delegate further in other jurisdictions. All of these outsourcing arrangements are based on current MiFID provisions but it is questionable whether they could continue under the new draft proposals.

(ii) **Investment Research**. EU investors, companies, investment managers, and broker dealers rely on third country firms to provide research and other information about investment opportunities and local market conditions, to enable them to make timely and informed investment decisions. These services provided typically constitute a MiFID service. An open and continuous flow of information is essential if investors and issuers are to be properly served and protected.

(iii) **Initial Public Offerings, Mergers, and Acquisitions**. Large EU companies need to access investors worldwide for initial public offerings and debt issuance. They use third country investment banks to manage and advise in key third country markets, whose regulators (for example Hong Kong) may also require the use of a local firm. These third country firms may be providing a service to the EU company. Restricting EU companies' access to them could hinder their ability to source a low cost of capital which in turn could detrimentally affect EU investment, jobs and growth. Similar services are required when EU companies acquire third country listed companies.

Example of an Initial Public Offering (IPO) by an EU company in Asia
A large EU company is considering an IPO. It is advised by its EU banking advisers to list simultaneously on an EU regulated market and in Hong Kong. A Hong Kong based investment bank is required under Hong Kong law for the IPO and listing there. Local and international banks in Hong Kong compete to obtain roles in the offering by contacting the company and its advisers. A syndicate of EU and Hong Kong underwriters is formed to back simultaneous public offerings. After the IPO, the company engages in a debt funding programme, issuing bonds in different markets and currencies around the world. The syndicates underwriting and distributing these bonds include Hong Kong and other third country firms, who may also offer the company hedging services linked to the debt issues. The Hong Kong firms are potentially offering investment services from outside the EU to the EU company. They are regulated in Hong Kong, but the Hong Kong regime differs in many respects (some stricter, some less strict) from the EU regime which means they may find it difficult to acquire a MiFID licence.

(iv) **Execution of transactions**. Here are three simple examples of international transactions potentially constituting a MiFID service. First, EU investors need to be able to buy and sell third country investments. To do this they may have execution services provided directly by third country brokers. Or they may use EU intermediaries to send orders to third country firms. Executing orders and advice on execution generally constitute a MiFID service in the EU. EU firms may seek to become remote members of trading platforms to facilitate local execution. Second, the reverse is also true. EU trading platforms need to be able to offer remote membership to third country firms: restrictions on these activities would affect liquidity in EU markets, particularly SME growth markets, and the ability of companies to raise capital to finance growth. Third, another common example of the need for cross border execution is the case of EU or third country executives who move in and out of the EU over their career and who use third country brokers directly for continuity of advice and local knowledge. In addition, EU employees of third-country companies who receive share incentives need open access to share dealing services provided in the third country by their head office.

(v) **OTC derivatives trading**. EU firms transact with counterparties globally in OTC derivatives. The FSB has recently reported on the divergent application within the G20 of the requirement that standardised derivatives should be traded on electronic platforms, where appropriate. It is therefore possible that third countries may not adopt requirements similar to the EU's to trade on multilateral organised trading venues. Even where third countries do adopt rules on trading, these rules might not be deemed equivalent by the European Commission, which would lead to uncertainty whether EU firms could have access to them (or whether third country firms would have access to EU trading venues). The recently issued consultation by the Singaporean authorities where a trading obligation is not envisaged shows that Asian jurisdictions may not adopt similar requirements to the EU.

Example on OTC derivatives trading between an EU and an Asian investor
Asian investors which are investing in EU government, bank or corporate bonds may wish to risk-manage their foreign exchange exposure to the Euro or interest rate exposures with OTC derivatives hedges with EU banks. If the EU had imposed a requirement to conclude relevant transactions on regulated markets, MTFs, OTFs or recognised third country venues, but the Asian jurisdiction had not imposed such a requirement for the contract in question, it might be impossible, impractical or unattractive for the Asian investor to conclude such transactions on EU venues. Even if the Asian investor was required to execute the trade on a specific venue, it might not be clear if the EU bank was permitted to do that under MiFID/R, pending an equivalence finding. In such circumstances, the attractiveness for the Asian investor to enter into relevant risk management transactions or indeed to invest in EU bonds which originate the exposure might be substantially diminished, affecting the ability of governments and corporates to raise the funding they require to grow their businesses and create jobs.

(vi) **Risk management**. EU banks need to manage their own and their clients' interest rate, currency, and commercial risk. They routinely make derivative contracts with third country subsidiaries or other firms to provide these risk management services to EU companies and investors.

(vii) **Safekeeping and administration of client assets**. To minimise costs and manage risks, EU investment managers and broker dealers use a network of custodians to safeguard and administer client assets in third countries where the client does not have custody operations. Custody is proposed to become a MiFID core service, and third country custodians would require a licence under the MiFID Proposals.

(viii) **Sovereign debt issuance**. To provide funding for Member States' sovereign debt, third country investors need routine, instant, open access to EU markets, in particular in those countries where EU primary dealers do not have affiliates.

III. Why an alternative approach is needed

3. The Commission's proposals would limit investment and funding opportunities by imposing barriers to third country firms providing valuable services. They would prohibit firms outside the EU from providing MiFID services and activities in the EU unless the relevant third country was judged by the Commission to have regulation with equivalent effect to MiFID and CAD (Capital Adequacy Directive) requirements, and to provide reciprocal recognition of the EU prudential regulatory framework. The only exception is where the service is provided at the initiative of the EU firm for cross border provision of services (the so-called solicitation test).

Equivalence

4. A strict equivalence regime cannot accommodate the wide range of circumstances (as described in section II above) in which EU investors and issuers benefit from services provided by third country firms. It would be disproportionate to the risks involved in many MiFID services. Some regimes do not, for example, apply prudential regimes to asset managers (eg US). The EU should adopt a cooperative model based on a common or comparable set of laws and rules. Imposing equivalent regulation would have the effect of deterring services from third countries and imposing extraterritorial requirements. EU investors and issuers could be harmed, rather than protected.

Reciprocity

5. The application of reciprocity would operate against the EU's best interests. Some third country jurisdictions require the use of locally regulated firms. However to exclude these countries on reciprocity grounds would deny EU investors and issuers access to those markets. Access by governments, central banks and debt management agencies would similarly be blocked. It is furthermore unrealistic to expect all those countries, with whom EU firms currently interact, to agree to accept a regime based on equivalence. Many developing markets may not be resourced to do so.

6. The proposed solicitation test would help in many circumstances. However such a test cannot address the wide range of interactions and communication that are common in financial markets. Brokers for example will typically call their clients with research ideas. A narrow solicitation test could in fact prevent EU investors from getting the information and advice they need.

IV. A more effective approach: IRSG's proposed amendment of the Proposals

7. A harmonised regime for third country firms dealing with eligible counterparties, professional, and retail clients could bring significant benefits for market participants by securing for EU investors and issuers access to a wide range of products, activities, and services whilst providing appropriate protection for investors. But the regime needs to be introduced in a way that recognises the complexity of international markets and regulatory structures, and does not impose rigid deadlines which would disrupt investors and issuers if not met. Distinctions need to be made between retail and wholesale markets. International financial markets, and the way they are regulated, are complex so the EU needs to approach this issue in a well-constructed and adaptable way. To maintain Europe's position and influence, and to give EU investors and issuers safe access to a wide range of worldwide financial services, markets, and products, while making the necessary improvements consistent with the Commission's objectives, we suggest the following modified regime for third country firms.

(a) **EU branches of third country firms**. There should be a harmonised regime with an EU passport, based on the MiFID 2 Proposal but with modifications to the exemptions and conditions described in (d)-(g) below for third country firms having branches in the EU, enabling the branch to provide services or activities EU-wide to retail clients. Member States should however be able to retain national regimes for branches of third country firms providing services or activities without a passport, at least until the Commission has made a decision on equivalence in relation to a particular country.

(b) **Cross-border business with eligible counterparties and regulated firms**. There should be a harmonised exemption for third country firms providing services or activities to eligible counterparties. Such an exemption is particularly important for third country firms' dealings with 'core' eligible counterparties (governments, central banks, debt management offices, inter-governmental bodies, investment managers, broker-dealers, banks, and members of the same group) which need, and have the expertise, to use global markets routinely. The exemption should also apply to business intermediated through third country firms or on EU trading platforms by EU-authorised, and therefore MiFID-compliant, banks and investment firms; and to third country firms to which services have been delegated subject to MiFID, AIFMD, or UCITS Directive requirements (where the nature of the service means the client may not be able to be categorised as an eligible counterparty).

(c) **Cross-border business with professional clients**. To protect EU investors' and issuers' access to third country markets, in addition to the Commission's proposed exemption for third country firms whose business does not involve solicitation, there should be a harmonised regime, based on the MIFIR Proposal but with modifications to the exemptions and conditions described in (d)-(g) below, enabling third country firms to provide services or activities to 'per se' professional clients (regulated firms would fall under the exemption in (b) above), subject to registration with ESMA and an equivalence condition being based on high-level equivalence. Member States should be able to retain national regimes for third country firms providing services and activities to professional clients within a Member State, without an inflexible deadline, at least until the Commission has made a decision on equivalence in relation to a particular country.

(d) **Exemption for unsolicited business**. To ensure that EU investors and issuers can make decisions with full information about products, services, local market conditions, and opportunities, the exemption for unsolicited business should include continuing interaction between EU clients and third country firms within an established relationship.

(e) **Exclusion for services not provided to EU clients, or not provided in the EU**. Where a MiFID authorised firm acts as an intermediary to obtain services from a third country firm, the indirect provision of services by the third country firm to the EU firm should not be treated as taking place in the EU and triggering the MiFID requirements. Where the characteristic performance of the services or activities takes place outside the EU, MiFID should also not apply.

(f) **Equivalence condition**. Equivalence conditions should not be tied to the details of MiFID and CAD legislation. Such conditions should at most be based on similarity of regulatory objectives, in line with international standards, with regard to investor protection and financial stability.

(g) **Reciprocal recognition**. Reciprocal recognition should not be imposed as a condition for third country access. As a major trade bloc which stands to benefit from open markets, the EU needs to set an example to the rest of the world, in particular to developing economies. Furthermore, recognition of other countries' regimes benefits the EU, since it encourages the rest of the world to come to the EU for financial services. If third countries do not allow reciprocal recognition, it is their markets which will be harmed: the EU should not make the same mistake.

(h) **Risk-based application of venue execution requirements in the cross-border context.** Venue execution requirements should be applied in the cross-border context only on a case by case basis for specific products and for trading with specific countries where benefits have been identified that outweigh the disadvantages that such an approach could bring, especially where the lack of fit with non-EU markets would harm global risk management structures. Similar to the approach suggested by the European Parliament for EMIR, the decision to make a certain contract subject to a venue execution requirement should also contain a risk-based decision 'whether and subject to what conditions the [execution] obligation applies in the case of transactions with persons in a third country'.

8. We set out below a table that summarises where we believe changes to the European Commission proposal are needed to address these points. We would be happy to provide more detailed suggested text for full amendments.

V. Summary of Suggested Approach

MiFID2/MiFIR - Third Country Firms Main objectives	Achieved by
Retain the proposed regime for branches of third country firms but on the basis that firms only need to be authorised under that regime if they wish their branch to have a passport under which it can provide services in other Member States (subject to an equivalence determination but removing the reciprocity requirement)	Amending Recital 72 (MiFID) Amending Article 41
Member States' competent authorities can continue to authorise 3rd country firms to provide services to all categories of clients in their own territory only without the need for registration with ESMA	Amending Recital 72 (MiFID) New Articles 46a and 46b MiFID2
However, those 3rd country firms that wish to provide cross-border services for 'per se' professional clients and eligible counterparties , without a branch, should be registered with ESMA and have undergone an equivalence assessment, carried out by the Commission, of their home country's regulatory and supervisory regime.(but with no reciprocity condition)	Amend Recital 34 (MiFIR) Amend Article 36 (MiFIR)
Require Member States to allow third country firms to provide cross-border services to eligible counterparties covered by Article 30 MiFID2 without authorisation or registration (and without equivalence or reciprocity conditions)	New Article 35a MiFIR
Make clear that a third country firm is not considered to be providing services in the EU triggering potential authorisation/registration requirements, if: • If there is already an existing relationship between an EU citizen and a 3rd country firm (before the new Directive/Regulation comes into force), then any contact between the client and the 3rd country firm should be deemed as taken place outside the EU and should not be subject to the Directive (New MiFID)/Regulation. • Where an EU authorised firm is acting as an intermediary between a 3rd country firm and clients within the EU, the 3rd country firm should not be deemed to be providing services within the EU. It is for the EU intermediary, registered under MiFID, to ensure that clients are accorded the necessary protections under the Directive. • If an EU citizen is based outside the EU and approaches a 3rd country firm for investment services, then those services should be seen as taking place outside the EU and so should not be subject to the Directive(New MiFID)/Regulation.	Amend recital 74 MiFID2 and recital 36 MiFIR