Provision of services by financial intermediaries from third countries in EU financial markets regulation

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« Swiss banks will be challenged by new third country regulations in MiFID II and MiFIR »

The hour of the regulators has arrived in the aftermath of the financial crisis. Following establishment of the Dodd-Frank Act by the USA, the EU Commission has decided to follow suit with a comprehensive packet for reworking regulations and, in particular, MiFID. On 20 October 2011, the Commission published a 200-page draft on "New rules for more efficient, resilient and transparent financial markets in Europe". However, the packet also includes an amendment from the European Market Infrastructure Regulation (EMIR) as well as a strengthening of the regulations concerning market abuse. Michael Barnier, the Commissioner-in-charge, noted that financial markets are here to serve the real economy and not the other way around. The crisis has made clear how complex and non-transparent the financial markets have become, and the regulations will attempt to counter these developments by means of new legal provisions. Financial intermediaries are concerned that, based on their views and experiences involving MiFID I, implementation costs will far exceed the EU Commission's estimates because the new regulatory packet is significantly more complex.

Swiss market participants will once again be affected by the regulatory project ex-ante and insofar as they offer services within the EU. Cross-border business originating from third countries will be regulated in detail. For example, new provisions stipulate that service offerings to retail clients will only be permitted through branches in an EU country and that there will be a standardized process for obtaining a license for such branches. The provision of services from Switzerland (off-shore) will now be subject to a standardized EU regiment. The EU Commission, the European Securities and Markets Authority (ESMA) and the competent authorities from Member States are obliged to consider the regulations from third countries as equivalent and to conclude Memorandums of Understanding (MoU) on the exchange of information and administrative assistance with relevant authorities of these countries.

Services from third countries: what are the challenges?

The recommendations under MiFID II (or "new MiFID") for a comprehensive reform and broadening of the regulations on markets for financial instruments published in mid-October by the EU Commission also call for increased rules for providers of securities services and investment activities[1] from third countries, i.e. from non-EU countries.

In the future, services to small clients (retail business) can only be offered through an authorized and regulated branch within EU borders. Authorization will be granted by the competent authorities of the EU Member State where the branch is established or where it is to be established. Authorization can only be granted if

(a) the EU Commission has recognized the regulations of the country of origin as equivalent,

(b) the service provider is subject to effective supervision and enforcement of the applicable regulations in that country, and the country of origin is not listed on the FATF list of non-cooperative countries,

[1] Securities services and investment activities that are covered by the regulatory packet include for the most part: accepting, transmitting and carrying out of contracts in financial instruments; trading for own account; portfolio administration; investment advisory; the issuing of securities; operation of multilateral (MTF) or organized (OTF) trading systems (operation of a regulated market (=classical stock market) is interestingly not mentioned); safekeeping and management of financial instruments; guarantee of loans for transactions in financial instruments; as well as further ancillary services.
Mere banking business (account management, granting of credit) is regulated in the "old" Capital Requirements Directive 2006/48 (banking directive, or CRD) and 2006/49 (Capital Adequacy Directive, or CAD), which are also undergoing comprehensive revision. The primarily concerns implementation of Basel III; as far as can be predicted, no similar approval conditions on banking from third countries, as discussed in this article, are foreseen.

(c) an agreement was concluded on the cooperation (MoUs) between the supervisory authorities of the Member State and the country of origin,
(d) the branch has sufficient capital,
(e) the organizing bodies are fit and proper,
(f) a double-taxation agreement on par with OECD standards has been concluded, and
(g) the institution from the third country is connected to an investor compensation scheme.

Authorization is bound, under further conditions, to an EU Passport for the provision of services in other EU states without having to establish a further branch in that state[2].

Cross-border business without a branch will be subject to a new regiment. The rules in this regard are found in the recommendation for the Markets in Financial Instruments Regulation, MiFIR[3]. With the exception of retail business, services will only be allowed off-shore to so-called appropriate EU customers or counterparties (i.e. professional investors[4]). Furthermore, financial intermediaries from the third countries will now be required to register with ESMA, the new European supervisory authority. Authorization by a national supervisory authority will no longer be sufficient in this case.

According to Art. 36 Para. 2 MiFIR, registration can only be granted by ESMA if
(a) the EU Commission has recognized the regulations of the country of origin as equivalent,
(b) the service provider in the country of origin is subject to effective supervision and enforcement of the regulations applicable in that country, and
(c) an agreement on the collaboration between ESMA and the competent authorities in the country of origin is in place.

Specific rules for subsidiaries of financial intermediaries from third countries are not foreseen. Subsidiaries of financial intermediaries, one way or another, are already subject to complete supervision within the EU Member State of their registered office. At most, additional measures may be instituted that include targeted requirements for the parent institution serving as a shareholder or third country measures similar to those involving off-shore businesses and branches. However, such requirements, as far as can be predicted, are not foreseen[5].

Equivalency recognition following MiFID II and MiFIR

The equivalency of the third country regulations and their recognition by the EU Commission require[6] that
- financial intermediaries in third countries are subject to a licensing process as well as an effective supervisory and enforcement process;
- appropriate capital adequacy requirements are met;
- quality standards are required for shareholders and managing bodies (fit and proper);
- adequate organizational requirements in the area of internal control are in place;
- there are adequate business conduct rules; and
- an efficient market abuse regime for the fight against insider trading and market manipulation is in force[7].

Furthermore, the regulations of the third country must call for equivalent reciprocal recognition for financial intermediaries approved in the EU.

Registration for the off-shore business

MoU with ESMA in accordance with Art. 37 MiFIR

On the basis of the recognition granted by the EU Commission, ESMA will have to reach an agreement on collaboration together with the respective third country supervisory authority (whose legal and supervisory framework has been categorized as equivalent). This agreement (which will be concluded with FINMA in the case of Switzerland) must at a minimum cover the following issues:
- the mechanism for the exchange of information between ESMA and the competent authority of the third country, including granting access to all information on third country approved financial institutions that is required by ESMA;

[2] Art. 42 MiFID II; whether the establishment of additional branches in other EU States is possible under this passporting, is not explicitly defined; thus it remains unclear whether additional approval procedures must also be carried out for all further branches in Member States. The conclusion of an MoU and a double-taxation agreement are indices for an additional license.
[3] MiFIR stands for Regulation of the European Parliament and of the Council on Markets in Financial Instruments; within the legal hierarchy, MiFIR, as an EU Ordinance, is located above MiFID II; in that it establishes immediately binding and standardized EU law while directives leaves room for national solutions.
[4] "eligible counterparties"; according to MiFID II, this includes investment firms, credit institutions, insurance companies, UCITS, pension funds, other regulated financial institutions as well as national governments and their corresponding offices, central banks and supranational organizations.
[5] Constraints on shareholders from third countries may be in conflict with free movement of capital. The free movement of capital defined in Art. 63 TFEU (Treaty on the Functioning of the European Union; introduced on 1 December 2009 with coming into force of the Treaty of Lisbon) includes the transfer of money and real capital, in particular for purposes of deposit and investing. This also applies principally for the movement of capital between EU Member States and thrid countries.
[6] Art. 41 Para. 3 MiFID II and Art. 37 MiFIR.
[7] For Switzerland, the changes in the market abuse regime, with adjustments to EU-Standards, recommended by the Swiss Federal council are important here (see BBI20116783 ff).

- a process for immediate reporting to ESMA should a service provider registered by ESMA violate the legal and supervisory provisions in the country of origin; and
- a process for coordinating the supervisory activities, including on-sight inspections if necessary.

Registration procedures with ESMA

A request to ESMA for registration can only be made by the financial intermediary from the third country if the EU Commission has declared equivalency of the regulations within the third country. MiFIR dictates that ESMA must make an evaluation on the completeness of an incoming application within 30 days. Otherwise, it must set an extension for processing of the application. ESMA shall inform the requestor in writing that includes an explanation on whether registration has been approved or declined within 180 days upon receipt of the request.

Registered financial service providers must inform clients in the EU that they are not allowed to provide services to persons other than professional clients and counterparties and that they are not subject to supervision in the EU. The service providers must provide this information explicitly and in writing along with details on the relevant supervisory authority in their country of origin.

In addition, persons established in the EU may pursue services from third country service providers registered with ESMA on their own exclusive initiative. In other words, the registered financial intermediaries may not actively advertise to market participants. The contractual relationships between the third country firms and EU investors are additionally subject to the jurisdiction of an EU Member State – apparently of free choosing. Further particulars of the registration procedure will be determined by the EU Commission based on ESMA's explicit delegation. ESMA must submit the technical regulatory standards to the EU Commission by an as-of-yet undetermined point in time.

The ESMA register will be made publically accessible via its website and will contain all information on services or investment activities that may be provided by non-EU firms and will also include reference to the competent authority in the third country.

MiFIR thus also defines the justification and the procedure for withdrawal of registration. Such a case will be reviewed and considered when evidence exists that the service provider has violated the interests of the investor, the orderly functioning of the market or the laws and rules of its state of domicile. However, withdrawal will only occur when the competent authority of the state of domicile, despite having received information from ESMA, has not taken appropriate supervisory measures and following 30 days upon which they have been informed by ESMA of the intention to withdraw the registration. ESMA shall inform the EU Commission without delay of the withdrawal; in such cases, the EU Commission will also be obligated to review its equivalency recognition with the third country.

Establishment of a branch

MoU with the national supervisory authority pursuant to Art. 41 Para. 1 lit. b MiFID II

As explained above, the establishment of a branch is consistently associated with increasing requirements locally. On the other hand, the requirements at the level of MiFID II are limited in that they only call for a MoU between the competent authorities and that the MoU includes provisions for regulating the exchange of information. Nevertheless, it was also determined that ESMA should develop further particulars for the EU Commission at the technical regulatory level which ensure that the supervisory authorities of the EU Member State can exercise its supervisory powers.

Approval process

The financial intermediaries from the third country can only submit an application to the competent authority of the EU Member State when the EU Commission has determined equivalency of the regulations. The competent authority will issue its approval ("authorization" in the terminology of MiFID II) when it is "certain" that the above-mentioned conditions pursuant to Art. 41 MiFID II are met. MiFID II also stipulates that within 180 working days following receipt of a complete application for registration, the supervisory authority of the Member State shall communicate whether registration has been granted or denied. A 30-day deadline for a check of completeness is on the other hand not foreseen. The approved branches are subject to a multitude of other provisions listed in MiFID II and MiFIR and will be monitored by the Member State's competent authority.

For branches from third countries, the national supervisory authorities must create and publish a register. ESMA shall also maintain and publish a consolidated index for this purpose.

The justification and the procedure for withdrawal of approval of a branch by the EU Member State's competent authorities are defined analogously with the withdrawal of the registration for off-shore businesses.

Grandfathering?

With respect to entry into force of the entire regulatory packet, what steps must be taken by third country service providers (and in particular service providers from Switzerland) who are and have been active in the EU with or without a branch office and to some extent with explicit recognition or approval of the competent authorities of the corresponding country? Is grandfathering possible so that no action must be taken?

MiFIR and MiFID II address these questions with transitional provisions that are almost congruent. They both guarantee a limited grandfathering, i.e. following expiration of a predetermined deadline, an approval for a branch for the purpose of providing services within the retail industry will have to be obtained from the competent authority of the corresponding EU Member State; a registration with ESMA will also be required for off-shore business with appropriate counterparties from the EU. As seen, both call for a decision regarding equivalency from the EU Commission:

- Off-shore business (Art. 45 MiFIR): "Existing third country firms shall be able to continue to provide services and activities in Member States, in accordance with national regimes until [4 years after the entry into force of this regulation].
- Branches (Art. 99 MiFID II): "Existing third country firms shall be able to continue to provide services and activities in Member States, in accordance with national regimes until [4 years after the entry into force of this directive].

The brackets surrounding the term period signifies that no definitive agreement has been reached with respect to duration. The EU Commission may additionally ensure an extension of the implementation deadline under condition of a previously existing equivalency recognition and due to foreseeable developments in supervisory law of the third country.

Impacts

In the course of its regulatory activities and in particular in the financial markets, the EU appears to be more conscious in its efforts to address the legal relationships with service providers from third countries. It is now doing so in detail through MiFIR and MiFID II, on the one hand, and is establishing significant hurdles on the other hand[8].

In all cases, equivalency recognition of third countries is required. This recognition is, among other things, dependent upon the existence of an efficient regime for the fight against market abuse. Ultimately, this means that the market abuse regime will be measured against the benchmark established by the EU standards. In this area, the EU has simultaneously published a further regulatory package[9] in which strengthening measures are also recommended. Switzerland will maintain pace with its redefining of the stock market offences; however, due to the even newer steps in the EU, Switzerland will again fall back unless the Swiss parliament takes the new EU regulatory initiatives into consideration during the advisory sessions. If the EU changes are not adopted in Switzerland, a gap which the EU Commission cannot accept without further measures, might appear between the regulations during the equivalency review.

Another hurdle could be the MoUs. Of course, agreements of cooperation already exists between the competent authorities of the most important European financial centers where Swiss financial institutions are active. However, because new requirements apply and recognition of equivalency is called for, a review of these agreements cannot be ruled out. In addition, a MoU for off-shore business shall be concluded with ESMA, a process which is not necessarily easy and which will require a certain period of time.

For approval as a branch, further requirements are relevant that lie far outside the realm of responsibilities of individual financial institutions. One such example is the FATF List of Non-Cooperative Countries and Territories which fortunately is no longer an issue for Switzerland. Another example is the coming into being of an agreement for prevention of double-taxation according to the OECD model, which may be of some brisance for Switzerland in the current environment.

If these hurdles are overcome, which will require a great deal of effort from Swiss political authorities and FINMA, then the remaining conditions will have to be fulfilled by the financial institutions themselves. The financial institutions will have to apply with the relevant competent authorities for approval as a branch for on-shore business and with ESMA for granting of registration for off-shore business. ESMA will already be overburdened with finding solutions to EU internal problems, thus applications for registration will not receive first priority despite a processing deadline of 180 days.

In order to ensure that all conditions are fulfilled following expiration of the transitional periods and that Swiss financial institutions who wish to continue activities in the EU have achieved their approval or registration, it is recommended that parties react on a timely basis. This applies firstly for the state authorities who must establish the foundation so that financial institutions are able to submit applications. Despite the fact that transitional rules will apparently last until 2019, negotiations with EU authorities will conceivably require significant time; thus the time currently available should be utilized. As soon as MiFID II and MiFIR are adopted and clarity on the new rules exists, the required steps must be introduced. Efficiency will be achieved if financial institutions can agree upon processes and approaches with authorities.

[8] Similar requirements are found, for example, in the Directive on Alternative Investment Fund Managers, AIFM (Art. 35ff.)

[9] Proposal for a Regulation on insider dealing and market manipulation (market abuse) is designated as MAR and should replace MAD (http://ec.europa.eu/internal_market/securities/docs/abuse/COM_2011_651_en.pdf); und Proposal for a Directive on criminal sanctions for insider dealing and market manipulation (http://ec.europa.eu/internal_market/securities/ docs/abuse/ COM_2011_654_en.pdf)

Summary

So that financial institutions from third countries are only able to offer services on-shore, the EU is sealing off borders and installing further barriers. For services which can be offered off-shore, a new direct registration with ESMA will be required. The conditions for both will be strict and difficult to fulfill despite the fact that the latest MiFID and MiFIR recommendations are not set in stone and changes can still be made during the advisory stages with the EU parliament and EU council; however, the general direction is quite clear, especially with respect to the rules applying to third countries. As is currently recommended, significant entry requirements must be taken into consideration.

The new rules regarding relationships with providers from third countries will also have consequences for Swiss political authorities (namely the SIF and FINMA) and financial institutions. The state authorities are obligated to contact the EU Commission and ESMA, and in the case of branch businesses, to contact the domicile state's competent authorities in order to create the conditions required for the approval of a branch and for registration of off-shore business with ESMA. Swiss service providers must evaluate whether and how they would like to organize their cross-border business within the EU under the new legal framework and whether they will submit the required approval applications and bear the related costs.

Need for action for Swiss banks?

Swiss banks, insofar as they are active in securities business and they offer and would like to continue offering services in the EU that are covered by MiFID and MiFIR, must take into consideration a multitude of questions during the evaluation of its options and needs for action. The fact remains that both EU citizens (for sincere reasons such as Swiss banking know-how and political stability) remain interested in continuing business relationships with Swiss banks and that Swiss banks will continue look upon the EU market with interest. They will have to weigh by means of a cost-benefit analysis whether cross-border business still makes sense and whether cross-border business should and can be maintained. The decisions to be taken are illustrated in the following graphic: