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Creating an exemptive regime in the EU for third country firms

This paper outlines the main features of a regime that would exempt third country banks and investment firms ("third country firms") from licensing requirements when conducting cross-border investment business with institutional investors located within the EU.

The introduction of an exemptive regime across the EU would not undermine the single market available to EU banks and investment firms under the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"). But it would address the most pressing and readily achievable priority for transatlantic securities markets and would immediately deliver benefits for intermediaries, investors, issuers and regulators. In particular, it would improve choice and reduce costs for institutional investors in the EU.

It would also be an important part of a phased and tiered approach to creating more open and integrated markets, alongside other approaches such as unilateral or mutual recognition and convergence of rules. For example, it would be possible to build on an exemptive regime by granting a broader set of exemptions to third country firms that are licensed in jurisdictions that are recognised as being well regulated, under which those third country firms would be able to access a broader range of EU investors or would be exempt from some of the rules that would otherwise apply to third country firms doing business with institutional investors.

In summary, an exemptive regime would facilitate the cross-border conduct of investment business by providing exemptions for third country firms from member states' licensing requirements, where they are dealing with an EU investor that is sufficiently expert to be able to protect its own interests, without conditioning that access on the adequacy of the third country firm's home state regulatory regime. An exemptive regime should focus on providing an exemption from licensing requirements, since these create the principal barriers to cross-border business with institutional investors. Local rules may still impose some other requirements on a third country firm taking advantage of the exemption. For example, local rules may impose a requirement on a third country firm relying on the exemption to notify the local regulator that it has begun to provide services to local investors or to consent to the jurisdiction of the local courts. The local regulator may also subject the third country firm to market conduct rules (such as market abuse rules, which apply to all market participants) and to some business conduct rules, to the extent relevant to institutional investors that have chosen to deal with the third country firm.

In this paper, references to cross border business are to business conducted by a third country firm which is not acting through a branch within the EU member state in which the investor is located. References to investment business should be read as encompassing all investment services and activities covered by MiFID, including ancillary services. References to institutional investors encompass the broad range of institutional entities, such as banks, investment firms, insurance companies, pension funds, collective investment undertakings and larger corporations, that access investment, issuance and risk management services from banks and investment firms, as well as other 'qualified investors', such as high net worth, sophisticated individuals who are also in a position to protect their own interests, i.e. broadly speaking, those investors who would be treated as professional investors and eligible counterparties under MiFID.

This paper addresses the following matters:

(1) the impact of an exemptive regime on MiFID and the single market
(2) examples of member state exemptive regimes
(3) eliminating barriers to investor choice: the business case for exemption
(4) extra-territorial legal regimes
(5) the framework for discussions between the EU and third countries, including the US.

1. The Impact of an Exemptive Regime on MiFID and the Single Market

MiFID neither requires nor precludes the development of a regime that allows cross border access to EU institutional investors by third country firms.

Article 15 of MiFID addresses one aspect of EU relations with third countries. It does not prescribe a comprehensive regime for how the EU should develop the interaction of the single market for investment business with third countries or third country firms.

Recital 28 of MiFID states that the procedures for authorisation, within the Community, of branches of investment firms authorised in third countries should continue to apply to such firms and they should not benefit from the Treaty freedoms to conduct business across the EU. This indicates that the arrangements previously set out in article 5 of the Investment Services Directive (93/22/EEC) should continue to apply. Article 5 provided that, in relation to branches of third investment country firms, member states should not apply provisions that result in more favourable treatment than that accorded to local branches of EU investment firms. This is in line with the corresponding provisions of article 38 of the recast Consolidated Banking Directive (2006/68/EC).

These provisions do not address the treatment by member states of third country firms conducting cross-border business with local investors and member states remain free to deal with the territorial application of their licensing regime to those firms, subject to their general Treaty and other obligations, such as their obligations under GATS. For example, GATS commitments already preclude member states imposing licensing requirements on some types of cross-border business by WTO members, such as investment advice.

No change to MiFID

The implementation of an exemptive regime for cross border investment business taking place between third country firms and institutional investors in the EU, does not require any amendments to MiFID. Member states can implement an exemptive regime by adjusting their existing legal arrangements for access by third country firms to local investors. These would not change the single market created by MiFID but would rather introduce greater alignment in the arrangements that have grown up over a number of years in many member states concerning the access of third country firms, in a way that would benefit EU institutional investors seeking access to the broadest range of products and services available.

The European Commission should explore all the ways in which it can support these initiatives, either through EU legislation, through the framework of trade negotiations but at the very least by recommending that member states adopt appropriate measures. However, these initiatives must not affect existing member state arrangements for access to other non-institutional investors. Member states should continue to be able to develop their current access regimes for all other investors.

No inconsistency with single market

An exemptive regime for third country firms is, by definition, different from the regime that applies to EU banks and investment firms that are subject to MiFID. EU banks and investment firms have the benefit of the single market passport which enables them to establish branches and conduct cross-border business with all classes of investor, not just institutional investors, subject only (in the case of cross-border business) to notification of their intention to conduct cross-border business to their home state regulator and compliance with their home state rules.

In contrast, an exemptive regime for third country firms would only provide those firms with a restricted ability to engage in cross-border investment business with institutional (but not retail) investors in the EU. In addition, third country firms may be subject to requirements to notify the local regulator that they have begun to provide services to local investors or to consent to the jurisdiction of the local courts. The local EU regulator may also subject the third country firm to market conduct rules (such as market abuse rules, which apply to all market participants) and to some business conduct rules, although there should only be very limited investor protection rules applicable to firms dealing with institutional investors that have chosen to deal with the third country firm. As MiFID recognises, it would be disproportionate and unduly burdensome to impose all the rules designed to protect retail investors on firms conducting business in wholesale markets where they are dealing with investors that are sufficiently expert to be able to protect their own interests. In addition, financial groups operating through EU subsidiaries would remain subject to the EU rules requiring the application of consolidated supervision or an equivalent third country regime which limits the extent to which groups can benefit from using third country entities to conduct investment business with institutional investors in the EU.

However, the primary benefit of such a regime is that it would enable EU institutional investors to access a broader range of investment services providers than is the case were they to be limited to MiFID licensed investment firms. Such investors are sufficiently expert to be able to protect their own interests if they choose to deal with third country firms.

2. Examples of member state exemptive regimes

As noted above, not all member states have exemptive regimes and there are differences of approach between those exemptive regimes already in place. Given the absence of an EU wide regime it is understandable that different arrangements have developed over time in the member states.

One of the more extensive exemptive regimes is the one that operates in Ireland. The Irish regime allows any third country firm to engage in cross-border business with Irish investors, other than individuals (natural persons), without needing a licence under the relevant Irish legislation regulating investment firms.

The UK also operates an exemptive regime, known as the 'overseas persons' regime, which applies to third country firms conducting cross-border business into the UK. These firms benefit from an exemption from UK licensing requirements so long as they observe the UK restrictions on promoting their products or services, which themselves contain exemptions allowing third country firms to promote their products or services to a defined class of professional investors and large undertakings. It also allows a third country firm to enter into transactions with a person in the UK, where the transactions are arranged by a UK licensed firm.

In Belgium, third country firms conducting cross-border investment business are exempt from licensing requirements, provided that they pre-notify the Belgian regulator of their intention to conduct cross border investment business with Belgian investors and so long as they confine their cross-border business to business with a defined class of qualifying Belgian investors, including many professional investors and larger undertakings.

3. Eliminating barriers to investor choice: the business case for exemption

MiFID already recognises that EU institutional investors should be able to engage in investment business with EU firms without the benefit of the full panoply of investor protections provided by regulatory authorities. Those institutional investors should also be able to access, in as administratively efficient a manner as is possible, investment services providers wherever they may be located outside the EU.

Currently, access to such providers is constrained to varying degrees by the arrangements of the member states governing third country firms. Many member states do not prohibit investors accessing the services of third country firms if the investor initiates the relationship. But in many regulatory regimes, the test for whether a foreign firm has triggered local licensing requirements is whether it has engaged in solicitation of local investors, often without any distinction between solicitation of an individual retail investor or of the largest and most sophisticated local bank. In theory, these regimes would allow local institutional investors to seek out foreign suppliers. In practice, unclear boundaries between solicited and unsolicited business and the highly interactive nature of wholesale markets - which makes it difficult to determine who solicited whom - can create significant legal, regulatory and reputational risk for any significant level of cross-border business.

The lack of clarity and the complexity of the national regulations governing cross-border access have a chilling effect on business between institutional investors and third country firms which is damaging to EU business. Opportunities are lost. Access to a wider range of products is foregone. Price competition is dulled. Extended access chains through EU credit institutions or investment firms add to the cost of product delivery to EU institutional investors, which ultimately puts up costs to individual investors as the ultimate end users of institutional services.

Even where an international group already has a group company within the EU that benefits from the single passport regime, licensing rules still impose significant restrictions on wholesale business. The expertise or transactional platform for particular products or services may be located in group companies outside the EU. Structuring business with EU institutional investors so that it always flows through the passported company in the EU can often be impractical or inefficient, particularly when those investors wish to access markets outside the EU. It increases complexities and increases control and compliance risks and makes it even harder for groups to achieve consistent application of global compliance standards. In any event, it is often unclear under national law whether it is possible for an EU passported firm to arrange transactions between an EU based investor and the firm's non-EU affiliate (e.g. where this is required to meet customer preferences) without the non-EU affiliate becoming subject to licensing requirements in the EU.

If the local rules also require an international group primarily operating outside the EU to book all transactions with EU investors into its EU passported subsidiary, the international group would also need to capitalise its EU subsidiary to reflect the level of business. This fragments the group's capital resources and restricts the group's ability to bring to bear its capital for the benefit of institutional investors, by taking risk positions or providing risk solutions in the form

of derivatives. EU large exposure or other rules may restrict the ability of a small, relatively lightly capitalised EU entity to lay off large positions through back-to-back transactions with affiliates. Fragmenting the group's capital and positions across multiple entities also restricts its ability to risk manage its positions centrally and multiplying intra-group transactions increases operational risks and complexity for supervisors. In any event, institutional investors would often rather deal with the better-rated, more highly capitalised non-EU entity in preference to a less well capitalised, often unrated, EU subsidiary.

Streamlining access rights of third country firms to EU institutional investors would improve choice and reduce costs. An exemptive regime for third country firms would reduce the complexity of current arrangements involving intermediaries inside the EU and provide a choice for both investors and product provider as to how they choose to configure their business arrangements to best effect. In any event, national laws should make clear that where an EU passported firm acts as intermediary, by arranging a transction between an EU investor and a third country firm, the third country firm does not become subject to national licensing requirements.

In addition, EU based banks and investment firms are seeking to provide services to institutional investors around the world and encounter similar obstacles to those that exist in the EU. The EU's willingness to support an exemptive regime will be an important demonstration of support for the cause of open and integrated wholesale markets.

4. **Extra-territorial legal regimes**

It is often asserted that US law, or certain US laws that are relevant to financial services, are extra-territorial in their reach. There is truth in this. The significance of any such extra-territoriality is another matter and requires separate analysis. For example, if one considers fraudulent market practices, US rules such as rule 10b-5 are extra-territorial in their application. What this means in practice is that if an act is committed anywhere in the world which has an effect in the United States then US regulators and courts may assert jurisdiction to deal with the alleged wrong doing. However, some EU legal arrangements are also extra-territorial in their application. For example, the EU market abuse directive applies extraterritorially to market participants outside the EU that trade in financial instruments admitted to trading on EU regulated markets, regardless of whether they trade using the facilities of EU markets or whether their activities have an effect on the market for those financial instruments in the EU.

On the other hand, it is important to understand the extra-territorial reach of laws and attitudes to enforcement of them. That is because enforcement can be done in a number of different ways and a collaborative approach among regulators is much to be preferred over any situation in which it is perceived that one regulator is racing against another in a non-collaborative manner to react to alleged wrong doing.

An exemptive regime, like a regime for unilateral or mutual recognition, contemplates that the third country firm would be subject to its home country rules when conducting cross-border business with local customers and counterparties in the EU. In a similar way, EU firms conducting cross-border business from the EU with clients and counterparties in other jurisdictions are subject to MiFID requirements relating to client categorisation and conduct of business. This is a natural and positive aspect of international activity, in that firms conducting cross-border business should be able to offer their clients and counterparties the benefit of the

standards of protection that exist in the firms' home state, irrespective of where the customers are located.

The model of the exemptive regime outlined in this paper does, however, contemplate that EU member states would also impose some requirements on third country firms conducting cross-border business with local institutional investors. For example, local rules may impose a requirement on a third country firm relying on the exemption to notify the local regulator that it has begun to provide services to local investors or to consent to the jurisdiction of the local courts. The local regulator may also subject the third country firm to market conduct rules (such as market abuse rules, which as already noted apply to all market participants) and to some business conduct rules. However, because the model focuses on cross-border business with institutional investors who have chosen to do business with the third country firm, there should only be a limited need for the local regulator to apply such rules. Local rules should only apply to the third country firm, to the extent that it can be shown that such rules are proportionate and not unduly burdensome and that they do not unduly interfere with investor choice. In particular, EU regulators should not seek powers to carry out inspections of third country firms conducting cross-border business with local institutional investors.

5. The framework for discussions between the EU and third countries, including the US

There is broad support for the objective of developing a framework agreement and a set of principles for further, more detailed discussions with third countries, including the US. The exemption regime is a tool that should be given careful consideration alongside other approaches such as unilateral recognition and mutual recognition and convergence of rules. Each of these approaches has different characteristics and can only be achieved along different timelines. The use of one approach should not preclude the use of another approach in appropriate circumstances. It is possible that different techniques may need to be used to achieve different objectives.

However, the interests of institutional investors in the EU would be best served by a rapid movement towards an exemptive approach to third country firms conducting cross-border business with institutional investors. Similarly, the EU should welcome and encourage moves by other countries to adopt a similar approach to cross-border wholesale business - while such an approach would also likely be aimed at benefiting local institutional investors, it would also benefit EU firms by providing new opportunities to conduct cross-border wholesale business.