Impact of MiFID II for Non-European Based Firms

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MiFID II Matters

As the January 3, 2018 MiFID II deadline approaches, many organizations in Europe are solidifying their solutions. But what of companies based outside of the European Union and the EEA? What impact, if any, will MiFID II have on these organizations?

MiFID II, which is made up of two linked pieces of legislation, namely the revisions to the original MiFID directive of 2007, combined with the Markets in Financial Instruments Regulation (MiFIR), is generally considered to be one of the most far reaching pieces of legislation to come out of Europe in many years.

MiFID II establishes general requirements in relation to several key areas:

- Authorization and operating conditions of investment firms.
- Provision of investment services by third country firms (non-EU) via the establishment of a branch within the EU.
- Authorization and operation of EU-regulated markets (RM, MTF, OTF).
- Authorization and operation of Data Reporting Service Providers (APA, CTP, ARM).
- Supervision, cooperation and enforcement by EU regulators.

Though many think of it as just a European piece of legislation, depending on the business model of the overseas, non-EU organization – be it asset manager, bank or other, MiFID II could affect a wide range of functions including trading, product development, client services, human resources and IT infrastructure.

The following table (Figure 1) outlines the challenges presented by MiFID II and their associated impacts on non-EU firms.

MiFID II Challenges and Impacts

MiFID II Challenge	Key factors for consideration	Impact on non-EU firms
Pre- & Post-Trade Transparency	In addition to trading venues, MiFID II mandates that SI and investment firms publish Indications of Interest and trades via an APA. MiFID II extends these requirements across all asset classes thus shining a light on previously unlit instruments.	The improved market transparency that MiFID II provides across all asset classes may be an opportunity for non-EU organization to focus on these markets given improved price discovery and insight.
Market Structure	The extension of the MiFID II transparency requirements across all asset classes has led to a change in market structure with the introduction of new venues, such as OTF to add to the existing MTF, RM and SI as well as APA.	Any non-EU based organization that trades through an EU based venue, or an EU based SI, such as the international arm of a large bank will have those transactions reported by the venue or SI.
Best Execution	Best execution requirements have been extended across all asset classes as well as a tightening of the language from “reasonable” to “sufficient” measures to prove the quality of execution.	The EU based entity of a non-EU head office will need to prove best execution as it is deemed an investment firm by MiFID.
Transaction Reporting	MiFID II mandates an additional 65 fields for transaction reporting as well as additional reference data such as limits and SI Denominator. Increased analysis based upon this data is required to support areas such as Systematic Internaliser determination.	Any non-EU registered head office that has a branch or legal entity in the EU will need to report transactions to their local NCA. Any non-EU branch of an EU head office also has to report its transactions to the head office’s home regulator.
Investor Protection	MiFID II requires research to be accounted for separately and not included in any “soft dollar” deals. Consequently the value of research will be more paramount with buy-side being more selective in the research they take.	EU based investment firms will need to offer research separately irrespective of client location. This will have to be paid for directly or via a Research Payment Account (RPA).

Figure 1

Numerous legal texts have discussed how companies outside of the EU may interact with the EU markets going forward – the so-called third country firm regime – but very little has been written on how this would potentially be implemented and what the day-to-day implications would be on such firms. This paper therefore takes more of a pragmatic and practical view of the impact of MiFID II.

First, we should consider the nature of any non-EU based company's relationship with the EU (Figure 2).

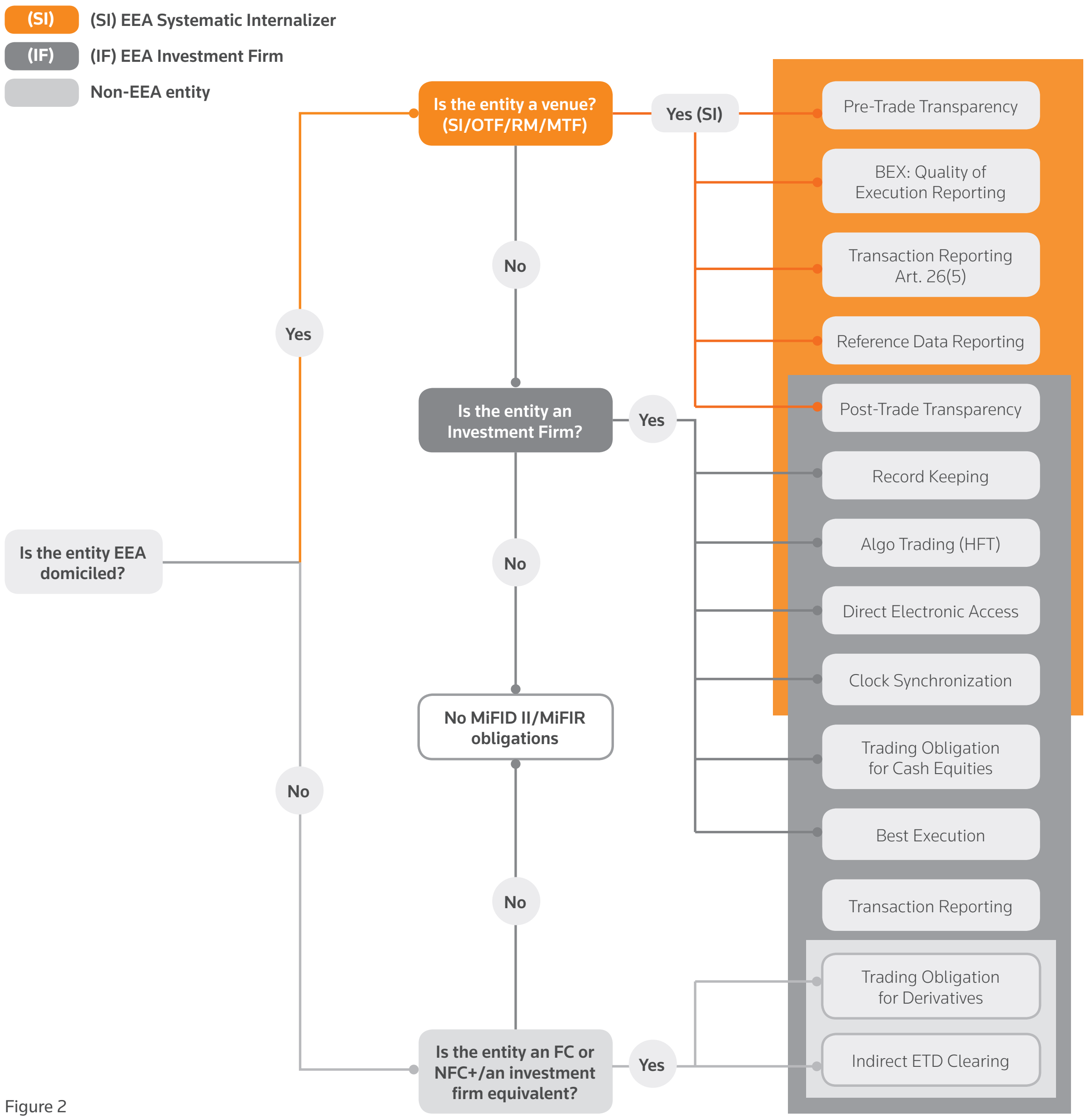

Figure 2

Although it seems a very basic question, the place to start is with the entity.

Whether it is your own organization or the organization with which your company is dealing, the location of that entity is paramount. If it resides within the EU or the EEA, it will be obligated to meet many of the MiFID II requirements as the prior diagram (Figure 2) illustrates. This would include branches that have been set up as entities.

Let us first consider a company that is headquartered outside of the Union but has a branch or presence inside the Union. Under the current definitions from ESMA, the headquarters, subject to its home regulator obtaining equivalence, would be deemed a third country firm.

There are two options for overseas-headquartered companies offering services to EU based clients, many of whom will be classified as retail or elective professional clients. The first is to establish a branch within an EU country. There are several advantages to this approach, not least of which may be the ability to passport into other EU countries from that branch, but with that access comes certain obligations. As the diagram (Figure 2) shows, by establishing a legal entity structure, that branch would be deemed an investment firm as far as MiFID II is concerned and would need to meet the requirements, such as: (i) transaction reporting; (ii) ongoing disclosure materials such as best execution, costs, and strategies; (iii) revised client agreements; and (iv) new policies.

Opening a branch, however, may be the only possible way to establish a presence in certain countries such as France or Germany that are perhaps seen as more protectionist than others, and the conditions that have to be met to establish a branch are challenging:

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

Not all Member States may insist on establishing a branch, however, and this is the second option for a non-EU company. For example, the UK has decided, under Article 39, that companies can carry on business for retail and elective professional clients without the need to establish a branch, but it is felt, particularly in a BREXIT environment, that jurisdictions that have been traditionally more protectionist will elect to require third country firms to establish a branch to access their retail markets. This would represent a significant business model change for many organizations.

The implications on establishing a branch are significant, and if non-EU headquartered companies are looking to do so they will need to consider what they need to support their MiFID II obligations in terms of data, transparency, record-keeping, investor protection and transaction reporting. These may not be obvious in the home country but they will be necessities for the EU-based branch.

The second type of relationship to be discussed involves companies headquartered within the EU but with a branch or branches that are outside of the EU. In this scenario, not only might there be regulatory implications on the branch, such as transaction reporting, but there may also be customer service or competitive implications that a branch may need to respond. In the prior diagram (Figure 2), this is illustrated by the bottom branch. Even though you may not be an EEA-based entity, it is clear that both the Derivatives Trading Obligations and the Indirect ETD Clearing Obligations apply.

The question as to whether an overseas branch of an EU-headquartered company should transaction report is currently unclear and open to interpretation but there are several arguments as to why this may be required.

In Section 1.1.8.3 of its Consultation Paper of December 2015 on transaction reporting, ESMA indicated that Article 26(1) of Regulation (EU) 600/2014 states that investment firms shall report the transactions to "the competent authority". Accordingly, the general principle for the reporting of transactions under MiFIR Article 26, is that investment firms will have to send all their transaction reports to their home competent authority. This is independent of whether the transaction was executed by the head office of the investment firm or by one of its local or foreign branches, including foreign branches located outside the EEA, or by a combination of the head office and its branches.

Unfortunately, what was a very clear statement concerning the transactions executed by foreign branches located outside the EU/EEA in the Consultation Paper was subsequently missing from the ESMA Guidelines that followed, leading many to believe that ESMA no longer required this.

What should be noted, however, is the view of the French competent authority (AMF), which seems to indicate that the transactions executed by non-EU branches of an investment firm must also be included in the reporting to be done by the head office to its competent authority, and that there is no change in that respect to that position that prevailed under MiFID 1. Article 14(3)(d) of the draft RTS 22 on transaction reporting could provide some support in that respect.

Last but not least, it should be recalled that the primary objective of this reporting obligation, which applies to financial instruments admitted to trading or traded on a trading venue, i.e. on a European exchange (regulated market, MTF or OTF), is to enable the competent authorities to detect and take appropriate measures against market abuse wherever it occurs in relation to such financial instruments. Reporting the transactions relating to such instruments wherever they are executed, including those that are executed outside the EU through non-EU branches of investment firms, appears to be in line with the objective of this obligation.

If it is determined that the non-EU branch does indeed need to report its transactions back via its head office, that branch may very well need to source the sufficient data to be able to enrich its transaction data accordingly, or it may be left to the head office to do so. Irrespective of who takes on the reporting obligation it is highly likely that personal data will need to be reported. Under MiFID II, data such as Investment Decision Maker, Seller, Buyer and Executor names all form part of the 65 field transaction report. If personal data of overseas staff need to be reported to EU regulators, firms may need to obtain specific releases from staff to allow them to do so.

Irrespective of whether the branch has obligations to report or not, any overseas branch is most likely offering access to EU markets and products for their clients. Consequently, the new transparency that MiFID II brings may offer opportunities to that branch which must ensure that its products remain competitive. This may include additional data to support Transaction Cost Analysis and may even include offering best execution analysis to prove to its clients that they are receiving the same level of service as if they were interacting directly with the head office.

The third and final relationship to investigate is that where the non-EU company is neither a branch of an EU head office nor has a branch within the EU, but engages with the EU without such a structure. As mentioned earlier, a non-EU company may offer investment services to retail and elected professional clients without the need to establish a branch if the Member States elect to let them do so, as in the case of the UK. Alternatively, an organization offering cross-border investment services to professional clients will register with ESMA, rather than applying for authorization from a Member State.

Such circumstances arise typically where an overseas asset manager or private bank has services that it wishes to offer its European clients but doesn't have the desire or need for an EU-based branch. Even so, certain aspects of MiFID II, such as market structure, position limits on commodity derivatives and transparency rules will all affect the relationship that the company now has with the EU markets.

An area that seems to be overlooked at present is the significance of the Legal Entity Identifier (LEI) in a post-MiFID II world. The LEI has been with us for a number of years but under MiFID II it becomes fundamental to companies who want to access European markets. Put bluntly, no LEI, no access. This applies not only to European investment firms but any firm, no matter where they are based, if they want to access and trade in EU products. Many companies are currently without an LEI and the implications of this come January 3, 2018 are far reaching. If not sourced already, any company seeking to access European markets post this date should apply for its LEI as a matter of urgency.

As in the case of the EU branch, the operating model of the non-EU company will dictate how directly impacted the company is by MiFID II, in terms of its obligations, but as a business dealing in EU markets it may decide, irrespective of its obligations, to take advantage of the increased transparency MiFID II provides and utilize tools such as Transaction Cost Analysis and best execution much more for business benefit, not necessarily regulation.

MiFID II	Subject Matter	UK Implementation	Applicable to non-EU branch?	Comments
Art. 13(2)	Compliance generally	SYSC various	Yes (prudential context only)	SYSC 1 Annex 1, 2.18: The common platform organizational requirements implementing MiFID II apply in a prudential context to a UK firm with respect to activities wherever they are carried.
Art. 13(2)	Personal account dealings	COBS 11.7	No	See comment on Arts. 19 to 24 below.
Art. 13(2)	Complaints	DISP	No	DISP 1.1 generally applies only to an EU firm in relation to activities carried out from an establishment in the EU and certain activities in an EU branch.
Art. 13(3)	Conflicts of Interest	SYSC 10	No	SYSC 1 Annex 1, 2.15 and 2.16: These common platform requirements apply to a firm in relation to activities carried on by it from an establishment in the UK and passported activities in an EEA branch (unless there is a prudential context).
Art. 13(4)	Continuity of services	SYSC various	Yes (prudential context only)	See comment on Art. 13(2) above.
Art. 13(5), 1st subpara	Outsourcing	SYSC 8	Yes (prudential context only)	See comment on Art. 13(2) above.
Art. 13(5), 2nd subpara	General organizational requirements	SYSC various	Yes (prudential context only)	See comment on Art. 13(2) above.
Art. 13(6)	Record keeping	SYSC 9	To some extent	SYSC 1 Annex 1, 2.17: The common platform record-keeping requirements apply to activities carried on by a firm from an establishment maintained in the UK, unless another applicable rule which is relevant to the activity has a wider territorial scope, in which case the common platform record-keeping requirements apply with that wider scope in relation to the activity described in that rule.
Art. 13(7) and (8)	Client money and assets	CASS	No	CASS 1.3: Generally only applies to business carried on from a UK establishment.
Art. 14	MTF operation	MAR 5	Yes	MAR 5.1: applies to MTF operated from an establishment in the UK or elsewhere.
Art. 18	Conflicts of interest	SYSC 10	No	See comment on Art. 13(3) above.
Arts. 19 to 24	Conduct of business	COBS	No (with exceptions)	COBS1.1.1R: Generally only apply to business from a UK establishment. Specific overrides include if (a) firm deals with UK clients from overseas establishment (unless overseas person exclusion would have applied if overseas establishment a separate person): COBS Annex 1 Part 2: 2 and (b) inconsistent with Directive requirements: COBS Annex 1 Part 2: 1.
Art. 25(2)	Transaction record keeping	SUP 17.4.3R	No specific territorial limitation	See comment on Art. 25(3) (transaction reporting) below.
Art. 25(3)	Transaction reporting	SUP 17	No specific territorial limitation	SUP 17.1.5R does not indicate any territorial limitation. But limited to transactions in financial instruments admitted to trading on a regulated/prescribed market and certain related derivatives (SUP 17.1.4R).

MiFID II	Subject Matter	UK Implementation	Applicable to non-EU branch?	Comments
Art. 26	MTFs to monitor compliance with their rules	MAR 5.5 and 5.6	Yes	See Art 14 (MTF operation) above.
Art 27	Pre-trade transparency for systematic internalisers	MAR 6	No specific territorial limitation	MAR 6.1 applies to MiFID II investment firms.
Art. 28	Post-trade transparency for investment firms	MAR 7	No	MAR 7.1.3: Applies to transactions executed in the UK.
Arts. 29 and 30	Pre- and post-trade transparency for MTFs	MAR 5.7 to 5.9	Yes	See Art 14 (MTF operation) above.

Figure 3

As can be seen from the table (Figure 3), many companies that conduct business outside of the EU will not be directly impacted by the introduction of MiFID II, but those that do interact with the region will need to be fully aware of the potential obligations that may affect them. Whatever the requirement, however, be it new data sources from new venues, additional data elements to support record-keeping and reporting or tools to support transaction cost analysis and best execution, Thomson Reuters is your trusted partner for MiFID II.


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