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Brexit: Is Equivalence a Solution for MiFID Investment Firms?

8 October 2020

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We have considered in a broader context whether the European Union ("**EU**") equivalence framework provides an appropriate basis for the future relationship between the EU and the United Kingdom ("**UK**") – see our paper "**Brexit – Is Equivalence a Solution for Financial Services?**". With the prospect of no agreement being reached by the end of the transition period becoming increasingly likely, our view (as outlined in the above paper) with respect to equivalence generally is that the existing equivalence framework does not provide an acceptable, long-term, sustainable solution for the UK-based financial services industry as a whole to access EU markets. Predictability, stability and transparency are key for financial services firms to implement their distribution, marketing and growth planning in the medium to long-term and the existing regime does not offer these benefits.

In this paper, we consider whether equivalence offers any solutions specifically for firms regulated under the Markets in Financial Instruments Directive ("**MiFID**") and, if not, how the various implications for MiFID firms of the UK's withdrawal from the EU might be addressed. We have also prepared papers assessing and summarising the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: **insurance**, **derivatives clearing**, **banking**, **investment funds**, and **fintech and payments**; together with an analysis of equivalence as a viable or relevant mechanism in each case.

Equivalence and MIFID Investment Firms

As for many other sectors, Brexit presents various challenges for the investment-firm market, in particular for UK MiFID firms accessing EU markets and clients upon the potential expiration of the financial services passports of those UK MiFID firms on 31 December 2020.

Licencing Issues

Once the UK becomes a "third-country" from the perspective of EU law, and on the assumption that no substantial agreement is reached on the continued provision by UK MiFID firms of investment services within the EU, UK MiFID firms will be (at least partially) restricted from engaging in investment services in

the EU and with EU clients.

In Ireland, there is a prohibition under Regulation 5(1) of the European Union (Markets in Financial Instruments) Regulations 2017 (the "**MiFID Regulations**") from acting as an investment firm or holding oneself out as an investment firm without a licence granted by a competent authority in the EU / European Economic Area ("**EEA**"). This dual prohibition (both in acting as an investment firm and in holding oneself out as an investment) presents a difficult challenge for third-country investment firms offering services to Irish clients, including managing legacy books of business and accepting new business from EU clients and counterparties.

It has been reported that the UK has sought a "*comprehensive, permanent equivalence decision*" in respect of the UK and in a much broader sense than is provided for in respect of other third countries. Such a notion was rebuffed by the EU's chief negotiator, Michel Barnier, noting that "*there will not be general open-ended or ongoing equivalence negotiations on financial services*". In any event, such "equivalence decision", in order to be useful, would have to be radically different to anything currently provided for under EU law and would in effect have to treat the UK as within the EEA for the purposes of relevant legislation. For a more detailed consideration of this point, please see our paper "**Brexit – Is Equivalence a Solution for Financial Services?**".

EU-Wide Equivalence Provisions

The Markets in Financial Instruments Regulation ("**MiFIR**") provides for a limited equivalence regime for third-country firms to operate within the EU without a branch in respect of the provision of investment services to per se professional clients and eligible counterparties. These provisions are contained in Articles 46 and 47 of MiFIR and have recently been amended and expanded (by Regulation 2019/2033), with such changes to take effect from 26 June 2021.

In our view, the Article 46 exemption will be of limited use for UK firms, at least in the short term. In this regard, prior to a third-country firm being able to utilise the Article 46 exemption, the country in which it has its head office needs to have been formally deemed "equivalent" by the European Commission, in terms of its supervisory, organisational, capital adequacy, enforcement, conduct and legal framework. Further, the European Securities and Markets Authority ("**ESMA**") is required to monitor the regulatory and supervisory developments, the enforcement practices and other relevant market developments in third countries for which equivalence decisions have been adopted by the Commission and on the basis of that monitoring activity, the Commission will report annually to the European Parliament and Council annually. From a third-country firm's perspective, therefore, its ability to continue to carry out limited trading activity in the EU will be subject to legal, regulatory and market developments in its home country and the view of EU organisations of such developments.

Further, third-country firms whose home country has been deemed equivalent is required to submit an application to operate on that basis to ESMA. This application process can take 180 working days, after which ESMA will inform the applicant third-country firm in writing with a fully reasoned explanation whether the registration has been granted or refused.

On the basis of the foregoing, in the short term at least, equivalence provisions provided for under MiFIR offer very little comfort to UK firms seeking to continue to provide investment services to per se professional clients and eligible counterparties post-Brexit. In this regard:

- the UK has not received any determination of equivalence from the European Commission for this purpose, nor is there any indication that it will do so;
- following any determination of equivalence, any UK firm seeking to utilise this exemption needs to undertake a lengthy application process; and
- there is an inherent instability to relying on such an exemption, given the potential for the laws of the UK to diverge from those of the EU, post-Brexit.

In the short term, however, there are certain Irish-specific provisions, detailed in the section below entitled *Management of Legacy Books of Business and Possible Engagement with EU Clients from the UK*, which may be more useful for UK firms continuing to provide limited investment services to Irish clients, post-Brexit.

Given these limitations, however, many of our clients have instead sought to establish an Irish subsidiary and seek a MiFID authorisation in order to continue to provide investment services to Irish and other EU clients.

Establishing EU Subsidiaries – Substance and Outsourcing

In the early days following the Brexit vote, there were fears that UK financial institutions might seek to obtain European licences by opening small subsidiaries (or, less likely, branches) with limited EU personnel and substance, but with large parts of the 'real' activity being outsourced back to the UK. Both the European Banking Authority ("**EBA**") and ESMA on the one hand, and the European Central Bank ("**ECB**")'s Single Supervisory Mechanism ("**SSM**") on the other, have, through their opinions and pronouncements regarding 'shell banks' and booking models, made it clear that this will not be tolerated (see 2017 and 2018 EBA opinions on Brexit and the ECB guidance on booking models).

In this respect, ESMA has stated that competent authorities, such as the Central Bank of Ireland ("**Central Bank**") should:

> *"…reject any relocation request creating letter-box entities where, for instance, extensive use of outsourcing and delegation is foreseen with the intention of benefitting from an EU passport, while essentially performing all substantial activities or functions outside the EU27…"*

and that investment firms

> *"…can only outsource or delegate tasks or functions, but not responsibilities. Market participants wishing to engage in outsourcing or delegation remain fully responsible for the tasks or functions that are outsourced or delegated. In other words, the ability to direct and control outsourced or delegated functions must always be retained by the market participant initiating the outsourcing or delegation…".*

The EBA, ECB and local competent authorities have placed increasing focus on substance requirements, including ensuring, in outsourcing-heavy business models, that robust controls are in place.

In Ireland, the Central Bank took a robust approach to substance requirements very early following the UK's vote to depart the EU in 2016. The Central Bank requires that the so called "mind and management" of every firm authorised by it be located in Ireland. As such the Central Bank needs to be satisfied that the

key personnel responsible for the day-to-day management of any Irish subsidiary and its activities will be physically located in Ireland. There are no express guidelines in terms of the specific numbers required by the Central Bank, as this will generally depend on the nature, scale and complexity of the business. The Central Bank places heavy reliance on the ESMA guidance in order to assess whether the "mind and management" of a firm are located in Ireland. The numbers of senior management and staff required to be based in Ireland is driven entirely by the scale and complexity of an Irish firm's business model. The Central Bank also places significant focus on the resources allocated to the various control functions, in particular, compliance, risk and internal audit.

Irish subsidiaries authorised under the MiFID Regulations will also need to comply with the corporate governance requirements of an investment firm under the Central Bank's Corporate Governance Code for Investment Firms (the "**Corporate Governance Code**"). Certain of these requirements will influence overall substance considerations for such a firm. The requirements that will apply in respect of board structure will depend on the risk rating (or PRISM rating) that the Central Bank assigns the relevant firm during the authorisation but typically the Central Bank will requires the presence of independent directors on the board. The Central Bank expects that board meetings would physically take place in Ireland.

In our experience, all outsourcing arrangements whether intra group or with a third party, have come under increasingly strict scrutiny by the Central Bank in recent years. While outsourcing to a firm in a third country (as the UK would be, where no agreement is reached), is permitted, it is important that the correct structures be put in place, in accordance with the EBA Guidelines on outsourcing and the MiFID Regulations (and delegated regulations), as the Central Bank will closely scrutinise any such arrangements. In particular, the Central Bank typically expects the following to be in place:

- an outsourcing agreement between the Irish firm and any outsourced service provider, whether intra group or a third party, to whom functions are outsourced, that complies with all relevant requirements;
- detailed service level agreements in order to ensure the Irish firm oversees the performance of outsourced activities;
- designated persons within the Irish firm with responsibility for overseeing each outsourced activity on a first-line basis;
- an outsourcing policy setting out how the Irish firm governs outsourcing; and
- demonstration that the board of directors takes full responsibility for the outsourcing governance, including in respect of ensuring service levels are met, that the policy is adhered to and any residual risks arising are properly identified and addressed by second and (if applicable) third lines of defence.

The Central Bank's substance-heavy approach may initially have caused surprise in some quarters in London, particularly when compared to some early assurances from other EU member states that they would accommodate a more lean corporate structure. However, the Central Bank proved to be prescient in anticipating where the EBA, ESMA and the ECB would arrive at on this point - and many are now relieved that they do not have to further adapt their Irish plans and structures or to include greater substance than they were originally led to believe would be necessary. The vast majority of UK groups that require an EU authorisation to continue providing services after December 2020 have already obtained that authorisation or restructured their activities as required in order to do so. But a key risk to those newly established operations in the coming years will be supervisory scrutiny of their activities, and in particular their reliance on their UK group services entities or affiliates, to determine whether these arrangements meet with EU authorities' substance expectations. Each newly established entity in Ireland will also need to be careful to operate within the confines of the conditions of authorisation imposed on them by the Central Bank and within the business plan and programme of operations approved in the course of the authorisations processes, ensuring any material deviation therefrom is done only with regulatory approval. Groups should consider internal and external verification exercises in advance of any regulatory inspection to ensure that their legal and regulatory requirements, in addition to the Central Bank's expectations, are being met.

For those (relatively few) UK investment firms with EU clients that have not sought, or are not likely to have obtained by year end, EU authorisations, the legal landscape is complex and needs to be analysed on state-by-state and business-by-business bases.

Management of Legacy Books of Business and Possible Engagement with EU Clients from the UK

For those UK MiFID firms who have not already established subsidiaries in other EU Member States, typically we have seen the suspension by such firms of new business with EU clients. However, certain UK MiFID firms have wished to retain a limited level of engagement with EU clients and in particular the ability to manage legacy books of business. While noting absolutely that any circumstances have to be assessed on a fact-specific basis, there are some possible options for UK credit institutions to engage with EU clients:

- **Safe Harbour**

  There is a potential avenue for the continued provision of investment services to Irish **per-se professional clients and eligible counterparties** if UK investment firms satisfy the conditions of the so-called "safe-harbour" exemption, provided under the MiFID Regulations. However, we understand that this exemption has been transposed differently across the EU, such that it may not be a viable model for the provision of investment services to institutional clients and counterparties in all circumstances. Obtaining local advice in each market is essential.

  Firms using the safe-harbour provisions under the Irish MiFID Regulations will also need to monitor the developments of any UK equivalence determination as described further above.

- **Exclusive Initiative**

  With respect to **retail clients and opt-up professional clients**, the MiFID Regulations provide that third-country firms may provide investment services to such clients at their "exclusive initiative" without the need for authorisation. It goes on to provide that third-country firms cannot market to such retail or opt-up professional clients other than through a branch established (and regulated) in Ireland in respect of new categories of investment products or investment services, which is consistent with the concept of those Irish clients

  approaching a third-country firm at their exclusive initiative, rather than as a response to solicitation.

  The "exclusive initiative" exemption has been implemented into Irish law but as yet is not the subject of any detailed guidance, either at Irish or EU level. ESMA has provided some guidance by means of Q&A and has recently suggested, in a 2018 letter to Valdis Dombrovkis, that the regime needs to be re-considered and narrowed further for investor protection reasons. ESMA's current approach to reverse solicitation is very restrictive – it permits the third-country firm to respond to a specific unsolicited request for a product or service, and in the course of that provision to then offer additional products of the same category, but once the product or service originally requested has been completed, the firm cannot offer further products / services without a fresh "reverse enquiry".

- **Characteristic Performance**

  A further argument possible argument which a UK MiFID firm may present when dealing with EU clients is that such investment services are characteristically performed in the UK (or otherwise in a third country). The Commission's "*Commission Interpretative Communication on the Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive*" of 20 June 1997 (the "**Commission Communication**") contains some useful principles when determining where a regulated activity is being performed. The Commission Communication examines when a banking authorisation needs to be passported into other EEA Member States.

  Although written in respect of the Second Banking Directive which has since been replaced by CRD IV and the Capital Requirements Regulation, this guidance note has not been withdrawn by the European Commission and contains some useful principles which are still relevant to our consideration of the concepts underlining the provision of regulated financial services on a cross-border basis. In the context of cross-border services, therefore, a customer's residence does not *necessarily* align with the jurisdiction where relevant business is deemed to have been carried out

  The Commission observes, *inter alia*, that:

  > *"A bank may have non-resident customers without necessarily pursuing the activities concerned within the territory of the Members States where the customers have their domicile"*.

  The key test for determining where a service takes place is where the "*place of characteristic performance of the contract*" is located, the characteristic performance of the service being the "*essential supply for which payment is due*".

  One of the factors relevant to this analysis is so-called reverse solicitation, where a service is supplied to a beneficiary "*who has gone in person, for the purpose of receiving that service, to the Member State where the institution is established".*

  UK MiFID firms need to tread carefully in this regard, noting potential legal hurdles in each jurisdiction where their clients are. As set out above, the prohibitions against holding out need to be carefully managed and marketing / promotional activity in Ireland needs to cease.

In addition, ESMA has made it quite clear that for investment advice in particular, such a service is considered to take place where the advice is received, such that no characteristic performance argument can be made in respect of investment advice unless an EU resident is physically in a third country at the time of receipt.

These are complex legal concepts and in our experience do not present easy options in practice. Detailed legal and factual analysis of existing books of business and future business models is necessary before any UK financial entity can rely with confidence on these concepts. However, such concepts provide for a possible avenue for UK investment firms in dealing with EU clients.

- **Exclusively Intra-group Investment Services**

  The MiFID Regulations also provide for an exemption from authorisation for firms that only provide services on an intra-group basis. This exemption may be useful for certain UK investment firms providing services to EU affiliates.

The Future

Clients that have established subsidiaries in Ireland have told us that the political and regulatory risks for them were too uncertain to rely on potential equivalence or other measures to retain their pre-Brexit structures. Their decisions to establish here were based on the strength of the talent pool, the reputation of the regulator, the proximity to and cultural similarities to the UK and the proven track record in the area. We continue to see a steady stream of further applications from firms who want to establish in the EU and recognise Ireland as an increasingly important hub for the investment services sector.

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Please get in touch with your usual Matheson contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this paper.

Full details of Matheson's Financial Institutions Group, together with further updates, articles and briefing notes written by members of the team, can be accessed at www.matheson.com. Further Brexit-related updates, articles and briefing notes may be accessed on our Brexit Forum.

Contacts

Joe Beashel
Partner
T +353 1 232 2101
E joe.beashel@matheson.com

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