KEY POINTS

- EU legislative initiatives introduced in the aftermath of the financial crisis have a direct impact on non-EU ("third country") business.
- In particular, the Alternative Investment Fund Managers Directive, European Market Infrastructure Regulation and proposed new Markets in Financial Instruments Directive and Regulation feature robust third country provisions.
- Mutual recognition between the EU and third countries may be necessary in order for the new regulatory framework to operate smoothly.

Author Leonard Ng

"Third country" issues in current EU financial services regulation

This article examines how EU financial services legislation in the aftermath of the financial crisis impacts non-EU ("third country") firms, and focuses in particular on the third country provisions of the Alternative Investment Fund Managers Directive, European Market Infrastructure Regulation and proposed new Markets in Financial Instruments Directive and Regulation.

Given the cross-border nature of financial services and other general trading activity, the concept of European Union (EU) law having an effect on "third countries" – that is, non-EU countries – is not new. Since the onset of the financial crisis, however, new legislative initiatives have brought renewed focus to the concept; these new initiatives expressly place restrictions either on the ability of third country persons to provide services to EU counterparties, or subject third country persons or transactions to EU requirements.

This article focuses on legislative initiatives in the securities (including funds) regulatory arena (as opposed to the prudential/regulatory capital arena), in particular the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulation (EMIR) and a European Commission (Commission) proposal to "recast" the existing Markets in Financial Instruments Directive (the proposal being referred to as MiFID II). The issue also arises in the context of the revision to the Market Abuse Directive and also in the new EU Short Selling Regulation; however those legislative initiatives are not discussed here.

AIFMD

The AIFMD, which is to be implemented into member state law by 22 July 2013, regulates the management and marketing by alternative investment fund managers (AIFM) of alternative investment funds (AIF).

Co-operation with third countries

Under the AIFMD, third country AIFMs may not market AIFs (of any domicile) unless certain conditions are met. Among other things, there must be co-operation arrangements between the regulator of the third country AIFM and (i) the regulator in each EU member state into which its AIF is to be marketed (where the marketing is to be carried out under the "national private placement" regime); or (ii) the regulator in the member state with whom the third country AIFM is seeking authorisation (where the marketing is to be carried out under the EU-wide "passport" regime). Where the AIF is itself a third country AIF, there must also be a co-operation arrangement between the regulator in the third country AIF's jurisdiction and the member state into which that AIF is to be marketed.

It is therefore possible that a third country regulator has to enter into numerous co-operation arrangements with EU Member State regulators. To that end, the European Securities and Markets Authority (ESMA) has recommended to the Commission that ESMA should, on behalf of all EU member states, enter into a single Multilateral Memorandum of Understanding (MMoU) with each relevant third country. Thus, in the case of a US AIFM wishing to market AIFs in to the EU, there would only be a single agreement between the US Securities and Exchange Commission (SEC) and ESMA, rather than separate co-operation arrangements between the SEC and each member state.

Passport regime

The AIFMD passport regime is particularly interesting because it allows for a third country entity (the third country AIFM) to be regulated by an EU member state regulator without actually having to establish any physical presence in the EU. This is a new approach, compared with the existing regulatory regime under the Markets in Financial Instruments Directive (MiFID I), which requires (in Art 5(4)) that "any investment firm which is a legal person [must] have its head office in the same Member State as its registered office".

However, it raises questions as to how the relevant EU member state regulator will properly supervise and enforce against the third country AIFM under the passport regime. The AIFMD introduces the concept of a "legal representative", being an entity which will be the "contact point of the AIFM in the Union… [and] perform the compliance function relating to the management and marketing activities performed by the AIFM under this Directive together with the AIFM." However, there is little by way of clarity as to the status of the legal representative; for example, will the legal representative be held jointly and severally liable to a member state regulator for a breach by the third country AIFM? The MMoU entered into between ESMA and the third country regulator is expected to contain provisions relating to co-operation on enforcement matters, so that the EU regulator may take proper enforcement action against the third country AIFM.

Third country depositaries

The other aspect of the AIFMD in relation to third countries is in respect of the choice of a "depositary", which every AIFM must engage for each of its AIF. In the case of a third country AIFM who seeks authorisation under the AIFMD, the depositary can be in the member state in which the AIFM is applying for authorisation, or in the third country in which the AIF is domiciled. However, in order for the depositary to be in the third country jurisdiction of the AIF, the third country must have laws and regulations relating to depositaries which "have the same effect" as those of the EU. During the consultation process for its advice to the Commission in relation to the Commission's

Level 2 implementing measures, ESMA had proposed that the third country would in effect have to have laws and regulations which were "equivalent" to those of the EU. However, it was pointed out by various commentators that ESMA would in effect be going beyond the text of the AIFMD. In its final advice to the Commission, therefore, ESMA reverted to the "same effect" test. However, it is uncertain as to how the Commission will make the "same effect" determination.

DERIVATIVES CLEARING AND TRADING UNDER EMIR AND MiFID II

In September 2009, the G-20 leaders agreed in Pittsburgh that:

> "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end- 2012 at the latest. OTC derivative contracts should be reported to trade repositories."

In the EU, the G-20 mandate on over the counter (OTC) derivatives is implemented *via* two separate pieces of legislation – EMIR and a new regulation proposed by the Commission as part of the MiFID II proposal – the Markets in Financial Instruments Regulation (MiFIR). EMIR deals with the obligation to clear standardised OTC derivative contracts through central counterparties (CCPs) (the clearing obligation) and the obligation to report all OTC derivative contracts to trade repositories. On the other hand, MiFIR deals with the obligation to trade all standardised OTC derivative contracts on trading venues (the trading obligation).

The third country issues in EMIR and MiFIR are twofold. First, there is the question of whether OTC derivatives contracts subject to the EMIR clearing obligation and the MiFIR trading obligation may be cleared through third country CCPs or, as the case may be, traded through third country trading venues. Secondly, there is the question of whether and how EMIR and MiFIR apply the clearing obligation and the trading obligation, respectively, to persons or transactions outside the EU.

Recognition of third country CCPs and trading venues

In relation to the recognition of third country CCPs and trading venues, EMIR provides that third country CCPs can be used where the third country CCP is recognised by ESMA. Among the conditions for recognition is that the Commission must adopt an implementing act determining that CCPs authorised in the third country comply with "legally binding requirements which are equivalent to the requirements set out under [EMIR]"; moreover, the legal framework of that third country must provide for an "effective equivalent system for the recognition of CCPs authorised under" regimes (such as the EU's) which are foreign to that third country.

This last reference to a third country providing for "an effective equivalent system for the recognition of CCPs authorised under third country legal regimes" was a controversial part of the negotiations for finalising the text of EMIR. Indeed, a Recital to EMIR provides that, given the "very special situation of CCPs… this approach does not constitute a precedent for other legislation". It will be interesting therefore to see whether the approach taken here will be repeated in relation to the trading obligation under MiFIR, currently being negotiated.

As for the recognition of third country trading venues, the Commission has proposed in MiFIR that, in order for a third country trading venue to be recognised, the third country must provide "an equivalent reciprocal recognition of trading venues authorised under [the] Directive". The issue of reciprocal or mutual recognition is addressed later in this article.

Finally, in relation to trade repositories, EMIR provides that third country repositories can be used, provided that "the legal and supervisory arrangements of a third country ensure that: "trade repositories authorised in that third country comply with legally binding requirements which are equivalent to the requirements set out in this Regulation". No indication is given as to how such equivalence will be determined.

Applying the clearing and trading obligations to third countries

In relation to how the EU clearing obligation and trading obligation apply to persons or transactions outside the EU, EMIR and MiFIR apply the clearing obligation and trading obligation, respectively, not only to transactions between EU counterparties, but also to transactions between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the EU, provided that "the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of this Regulation".

It is generally understood that this wording in EMIR and MiFIR is a reaction to the equivalent wording in the US's implementation of OTC derivatives reform. Section 722(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides that the clearing and trading obligation under that Act:

> "shall not apply to activities outside the United States unless those activities: (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act…"

However, although both the EU and the US have such wording in their respective regimes there is as yet no clarity on how such rules should be applied in practice. The complexity of the issue is highlighted in particular where a derivative contract may be between a US counterparty on the one hand, and an EU counterparty on the other, and for which the reference obligation may be in Hong Kong. Absent some clarity from the regulatory authorities, counterparties may feel unable to enter into such transactions; for example, it would not be possible to clear a single contract in two different locations.

It may be that the only workable solution is to allow the counterparties to decide which jurisdiction's regulatory framework governs the contract, but that would only be possible if all of the relevant jurisdictions declare that each other relevant jurisdiction's rules are consistent, even if not fully equivalent. Given that the clearing obligation begins sometime

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Leonard Ng is a partner in Sidley Austin LLP's Financial Service Regulatory Group in London. Email: LNg@sidley.com

in 2013, there is also the practical question of whether such co-operation between regulatory authorities can be achieved in such a short time.

MiFID II: THIRD COUNTRY FIRMS

The existing MiFID I framework does not impose restrictions on third country firms providing services into EU member states; instead, each EU member state decides the terms on which it is willing to allow third country firms to provide investment services in their individual jurisdictions. For example, the UK Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 contains an "overseas persons" exception, under which overseas persons are not required to become authorised in the UK in relation to certain regulated activities. However, such exceptions or exemptions are not harmonised throughout the EU.

The Commission's MiFID II proposal aims for a single harmonised access regime across the EU, which varies depending on the type of client the firm wishes to access:

Retail clients: Third country firms wishing to carry on any type of investment business with retail clients in the EU would be required to operate from an authorised branch based in the EU. The authorised branch would have to comply with various MiFID II obligations, including organisational requirements, post-trade disclosure requirements, transaction reporting requirements and conduct of business requirements. Once authorised, the branch would be allowed to "passport" its services across the EU on a cross-border services basis; this is a right which under MiFID I is available only to entities incorporated in the EU (ie affiliates rather than branches of third country firms).

Eligible counterparties: Third country firms wishing to provide certain specified services to EU-based eligible counterparties would not need to establish a branch in the EU. They would be required to register with ESMA, but the MiFID II obligations would generally not apply to them. However, it is important to note that, under the MiFID II framework (as with MiFID I), the only types of activities for which the concept of "eligible counterparties" applies are: (i) executing orders on behalf of clients; (ii) dealing on own account; and (iii) receiving and transmitting orders. This means, for example, that a third country custodian would not be able to use this non-branch exemption to provide custody services to eligible counterparties in the EU.

Professional clients: Professional clients are not mentioned at all in the third country provisions either in the Directive or in the Regulation, and so the status of providing investment services to this category of clients is unclear. Unless the position is clarified, third country firms will be very concerned that they will not be able to provide investment services to professional clients at all, or have to provide them only through an EU branch (thus equating professional clients with retail clients).

In order for any third country firm to provide investment services in the EU (with or without a branch), the Commission must make a declaration of "equivalence" in respect of the third country's supervisory regime. "Equivalence" encompasses equivalent market transparency and integrity, regulatory capital and corporate governance requirements. This could affect firms operating out of numerous jurisdictions; for example, the requirement for sufficient capital resources could be problematic for US investment managers, as they are not subject to capital requirements under the US regulatory regime.

In addition, as with the issue on third country trading venues as discussed above, there is a requirement that in order to be considered to be equivalent, a third country must provide "equivalent reciprocal recognition" of the prudential framework applicable to investment firms authorised under MiFID II.

IS MUTUAL RECOGNITION A REALITY?

Given the references discussed above to "equivalent reciprocal recognition" and the difficulties with determining how to address the extra-territorial effect of the clearing obligation and the trading obligation, is it time for the EU to engage with important third countries seriously in order to develop a mutual recognition framework?

The April 2007 EU-US Summit urged the acceleration towards "convergence, equivalence or mutual recognition [...] of regulatory standards", and the February 2008 Joint Statement on Mutual Recognition in Securities Markets between the Commission and the SEC envisaged the development of "a possible framework for EU–US mutual recognition for securities in 2008". Further, the Committee of European Securities Regulators in June 2009 issued a "Call for Evidence" on Mutual Recognition of Non-EU Jurisdictions. However, nothing concrete materialised out of those initiatives, possibly as a result of regulators concentrating on the financial crisis.

However, with the new legislative initiatives introducing the kinds of requirements above, the EU and the US may have no choice but to move quickly to some kind of mutual recognition arrangement. Indeed, this has been recognised by Steven Maijoor, chair of ESMA, at a speech in March 2012: "I believe that the easiest and most efficient option is relying on mutual recognition. Without mutual recognition, entities operating on a cross-border basis would be subject to different requirements and to the jurisdiction of different authorities."

OMNIBUS LEGISLATION?

Given that the third country concept appears to be more significant than before in EU financial services legislation, one wonders if there may be some possibility of a "horizontal" legislative measure to address the issues. That is, some kind of omnibus legislative measure that could address, in one place, how the EU looks at third countries from the financial services perspective. Among other things, this would mean that third country issues need not be negotiated with each new legislative initiative. It would also bring consistency to the process and give third countries more certainty in their dealings with the EU on financial services matters. However, there does not appear at this time to be any concrete initiative from the Commission to take this approach.

CONCLUSION

While much attention in this article has been paid to EU-US relationship, all of the legislative initiatives discussed affect all third countries. The ability of the EU either to determine equivalence or to enter into mutual recognition arrangements with third countries will have a material impact on the ability of cross-border financial services activity to flourish in the post-financial crisis era. ■