



# MiFID II and Third Countries: How Far Does the Legislation Reach?

MiFID II, the EU's revised Markets in Financial Instruments Directive and new Markets in Financial Instruments Regulation (MiFIR), comes into effect on 3 January 2018 with the objective of improving the working of EU financial markets and strengthening investor protection. MiFID II will make major changes to the way in which European firms and markets operate. Given the international reach and interconnectedness of global financial markets, it comes as no surprise that the legislation's impact extends beyond the EU (including the EEA) to other regions, such as Asia-pacific and North America, where firms either provide or receive services from EU financial counterparties. Firms in those regions will need to evaluate the impact of MiFID II on their businesses as a matter of priority based on whether they provide investment services to EU-based clients or whether they have EU counterparties. In some cases, even if those firms are not directly subject to MiFID II, it is likely that third country firms will have to comply or facilitate compliance with the new regime by EU-based investment firms if they wish to continue doing business.

MiFID II creates new licensed activities and cuts back on existing exemptions. As a result, firms whose

business has a nexus to the EU should consider whether they need to apply for any new permissions or variations to existing licences. As regulators have six months to assess applications for authorisation (or variations of permission), the deadline to ensure

---

**It comes as no surprise that the legislation's impact extends beyond the EU (including the EEA) to other regions, such as Asia-pacific and North America.**

---

that the UK Financial Conduct Authority (the "FCA") deals with them by 3 January 2018 passed on 3 July 2017. To the extent that any remain outstanding, and not forgetting passporting notifications and waiver requests (where different time limits apply), they should now be made as a matter of urgency.

This briefing looks at some of the areas where MiFID II may impact third country firms and what steps they should take as a result.

## Quick Reference: MiFID II Rules Impacting Third Country Firms

Product	governance & classification	Inducements and research	Share trading obligation	Transparency/ reporting	Commodity derivatives	Underwriting and placing
New third-country access	Rules for manufacturers and distributors to enhance investor protection	Unbundling execution costs from research; commission ban for investment advice	Impact on third-country trading venues where an instrument is also traded on an EU venue	Impact of enhanced and expanded trade reporting	Scaled back exemptions for trading firms and increased reporting requirements	More prescriptive conflicts rules over underwriting, pricing and placing

## Third-country Access

### Position under MiFID I

Currently, each EU Member State decides whether, and on what basis, third-country firms may access their national markets, provided that this is not on more favourable terms than those available to EU firms. Third country firms may use a mixture of treaty rights, non-solicitation models and, of course, employment of regulated agents and distributors specific to each EU market.

Under MiFID II, Member States may opt into a new third-country regime under which each Member State decides whether a third-country firm needs to establish a branch in their jurisdiction to provide investment services and activities to retail or professional clients. Where a branch is established under the regime, it brings the advantage of allowing that firm to provide cross-border services to professional clients and eligible market counterparties in other EU Member States. A third-country firm may also provide cross-border services to more sophisticated clients (e.g. *per se* professional clients and eligible market counterparties) without establishing an EU branch, provided it is from a third-country assessed to be equivalent and is registered with the European Securities and Markets Authority ("ESMA"). Brexit aside, the UK has chosen not to opt in, but to keep the benefits of its Overseas Persons Exclusion, most notably by means of the exclusions for activities carried on "with or through" an authorised or exempt UK person - note that MiFID II also allows for a limited form of access to clients on their "own exclusive initiative", dispensing with the need to open a branch or register with ESMA. Nonetheless, despite

the UK's decision not to participate, the third-country regime will still be relevant for third country firms accessing other EU markets and whose home countries' legal and supervisory framework must be assessed as "equivalent". Such assessments to date have been time consuming and influenced by technical criteria, so there may be a long lead time, for example, for those undertaken for EMIR central counterparties. The existing national regimes for third-country firms will, however, continue to apply in the absence of an equivalence determination and for a transitional period thereafter.



### Changing Client Classification

Third country firms should also be mindful of changes to client classification rules and, in particular, those concerning which clients may be treated as "professional." One example concerns the mis-selling of complex derivative products to municipal authorities in the run up to the financial crisis, which has initially led to municipalities being treated as retail clients to give them better investor protection. All this may impact the ability of third country investment firms to sell complex products, whether through the new third-country access regime, or when distributing products locally using EU-based investment firms.

## Inducements and Research

Rules around inducements form a major part of the innovations introduced under MiFID II, having the objective of better protecting the end-client and increasing clarity over the quality of the services provided. In what amounts to an extension of the UK's Retail Distribution Review regime, MiFID II tightens the rules generally regarding the receipt of fees, commissions and non-monetary benefits provided by third parties. Portfolio managers and

Although the MiFID II restrictions will not be directly applicable to third country firms, they will have an indirect effect on their business.

investment firms offering independent advice are prohibited entirely from receiving inducements, except minor benefits (e.g. participating in conferences or seminars) that are capable of enhancing the quality of service and which are disclosed to clients. Potentially, this could affect distribution models where third country firms rely on EU intermediaries in return for providing remuneration or other forms of sales support. One of the most

significant changes that is likely to impact third country firms is that on inducements relating to research. The intention is to increase transparency and accountability on costs to investors, as well as to increase competition in the market for research. In a significant strengthening of the rules, MiFID II provides that in order for third party research not to be regarded as an inducement for an investment firm, it must be received in return for a direct payment by a buy-side firm out of its own resources, or payments from a separate research payment account controlled by that firm.

Although the MiFID II restrictions will not be directly applicable to third country firms, they will have an indirect effect on their business. Third country brokers may no longer be able to provide EU-based investment managers which are subject to MiFID

II (including fund managers, e.g. AIFMs subject to national gold-plating provisions) with research bundled up with the cost of dealing and execution. To alleviate this, the US SEC has recently issued no-action letters giving temporary relief to US brokers supplying paid for research and, in turn, the European Commission has provided clarification for EU-based investment firms over the rules.

In theory, third country firms will still be able to receive bundled research from EU-based brokers (according to the FCA's interpretation of the rules), but EU-based brokers may have changed their business model and started charging for research. This rule has the capacity to cause, at the very least, administrative and compliance issues where research is either received or provided in respect of a variety of jurisdictions each with their own rules.

## Product Governance

One of MiFID II's key drivers is the financial crisis which revealed mis-selling in both retail and wholesale markets. The introduction of product governance requirements is intended to reinforce obligations on supply side firms to ensure the suitability of products "manufactured" and "distributed" by them. ESMA's Guidelines interpret these terms broadly, referring to a manufacturer as "a firm that manufactures an investment product, including the creation, development, issuance or design ... including when advising corporate issuers on the launch of a new product" and a distributor as "a firm that offers, recommends or sells an investment product and service to a client investment." This means that firms must take steps to see that they analyse their target

Firms must take steps to see that they analyse their target market.

market (including identifying a "negative" market of excluded recipients), the method of distribution and ensure that the contractual documentation provides for an adequate flow of product information.

Although a third country manufacturer would not be directly subject to MiFID II product governance rules, an EU-based distributor or placement agent would in practice be unable to distribute third country products

unless the information and marketing requirements in MiFID II and the ESMA Guidelines were met. Moreover, EU-based investment firms (that are manufacturers) which collaborate with third-country firms to develop or issue products are required to outline their mutual responsibilities in a written agreement.

### ESMA's Guidelines on MiFID II Product Governance Requirements require firms to:

- ensure that the products are designed to meet the needs of an identified target market of end clients within the relevant category of clients;
- ensure that the distribution strategy is compatible with the identified target market; and
- take reasonable steps to ensure that the products concerned are in fact distributed to the identified target market.

Unsurprisingly, there is concern among some manufacturers about the difficulties of complying, especially where there is no relationship with the end-client, and that the requirements favour larger firms with more sophisticated distribution models or which sell direct. This is an issue for EU-based investment firms and third-country firms alike,

although the challenges are more acute for the latter due to geographical distance. On the positive side, to the extent that good information flows are achievable, the receipt of more detailed information about customers may benefit manufacturers in terms of product development and the better identification of customers and market segments.

## Trading Obligation

The trading obligation introduced by MiFIR seeks to return liquidity to trading venues and improve price discovery. As a general rule, EU-based investment firms will not be able to execute a trade in shares admitted to trading on an EU regulated market (or other EU trading venue) unless it takes place on such a venue, a Systematic Internaliser, or an equivalent third-country trading venue. Where, for instance, an EU-based investment firm wishes to buy Hong Kong equities and those equities are also traded on an EU regulated market (having the same ISIN), i.e. they are "dual-listed", as a general rule the trading obligation will apply. If trading is to take place on a third country trading venue, for example that venue is the primary market, an EU-based investment firm must ensure that it is "equivalent" to an EU venue (e.g. in respect of transparency rules). Such assessments over equivalence can be a lengthy process. Therefore, notwithstanding any conflicts over best execution, third country markets face, potentially, a loss of order flow and liquidity to EU venues. Industry association AFME argue that MiFIR, properly interpreted, imposes a trading obligation only where it is the EU-based investment firm that

executes the trade as opposed to placing or transmitting an order to a third country broker-dealer which is a member of the local exchange. Even so, AFME concede this interpretation would not apply when used to evade the policy behind the trading obligation.



---

Third country markets face, potentially, a loss of order flow and liquidity to EU venues.

---

Similarly, for derivatives subject to the EMIR clearing obligation under MiFIR, ESMA can declare these instruments as subject to a trading obligation that is binding on an EU entity, irrespective of whether there is a financial or non-financial counterparty based inside or outside the EU. There are also anti-avoidance provisions which can apply to third-country entities where a contract has "a direct, substantial and foreseeable effect" within the EU or where it is "necessary or appropriate" to prevent evasion.

## Trade Reporting

Measures in MiFIR that improve market transparency will also affect third country firms and financial instruments. Pre- and post-trade reporting will be extended from equities to equity-like instruments (e.g. exchange traded funds and depository receipts) and non-equities (e.g. bonds, structured finance products, emission allowances and derivatives) and will apply to non-EU instruments traded on EU exchanges. A third country firm providing quotes

and undertaking transactions to the extent they take place in the EU will also be caught. Such is the increase in the burden of these obligations (for example, more data is required for post-trade reporting and within T+1 under MiFID II), that some investment managers in the EU are dispensing with their MiFID authorisations in favour of the relatively easier burden imposed by the Alternative Investment Fund Managers Directive.

## LEIs

There are also issues with respect to market surveillance. A third country firm sending orders to an EU-based investment firm (including its EU subsidiary based in a third-country) subject to transaction reporting requirements, will need to provide its Legal Entity

---

Will third country firms and their clients have obtained an LEI by next January?

---

Identifier code or that of its clients, prior to any transaction. Will third country firms and their clients have obtained an LEI by next January? Many Asian markets have their own system of identification and this may only complicate matters.

## Best Execution

EU-based investment firms, subject to best execution, placing or transmitting orders with a third country firm, will likely require the latter to raise standards and have an order execution policy, and to show that "all sufficient steps" (previously "reasonable") were taken. This will include

providing information on the quality of execution. Third country firms should review their booking models to identify where MiFID II obligations are relevant and whether their policies, procedures and practices require updating.

## Commodity Derivatives Trading

In future, more third country businesses may have to apply for MiFID II authorisation to trade commodity derivatives and emission allowances (or derivatives of such) on EU markets. Businesses that deal in commodities as principal but which also buy and sell MiFID financial instruments for their business, will find that the existing "commodities dealer" exemption is to be abolished (although exemptions may be available for certain hedging purposes) and a second "ancillary activity" exemption will be significantly cut back. In addition, EU regulators will have to be notified (by 3 January 2018) of the exemption's use and the basis upon which it is relied; nor will the exemption be available for high frequency trading.

MiFID II introduces new position limits under which operators of trading venues can apply position

---

More third country businesses may have to apply for MiFID II authorisation to trade commodity derivatives and emission allowances.

---

management controls and regulators have the power to require any person to reduce the size of a position or their exposure to a commodity derivative listed or traded in the EU. To this end, members and participants (e.g. commercial firms) on EU trading venues will have to report details of positions on a daily basis, including those corresponding to non EU-based end clients. Applications for waivers must be made at least 21 days before 3 January 2018.

If they have not done so already, it is essential that firms review their trading activities and decide whether they need to apply to EU regulators for permissions to carry on doing business after 3 January 2018. In this regard, the FCA has published a MiFID II application and notification user guide.

## Corporate Finance

To improve transparency and competitiveness, MiFID II introduces more prescriptive conflicts rules relating to underwriting, pricing and the placing of securities. Corporate finance firms will need to provide issuers with more information on their arrangements to prevent and manage conflicts when providing advice. On pricing an offer, firms must ensure that they do not

promote the interests of other clients or indeed the firm's own interests. In practice, this means that the corporate finance arm of a third country subsidiary of an EU-based bank should review the impact of MiFID II on its business, processes, disclosures and whether any re-papering is required.



# Contacts



**Arun Srivastava**  
Partner  
London  
+44 20 7919 1285  
Mark.Simpson@  
bakermckenzie.com



**Karen Man**  
Partner  
Hong Kong  
+852 2846 1004  
Karen.Man@  
bakermckenzie.com



**Mark Simpson**  
Partner  
London  
+44 2079191403  
Mark.Simpson@  
bakermckenzie.com



**Stephanie Magnus**  
Principal  
Singapore  
+65 6434 2672  
Stephanie.Magnus@  
bakermckenzie.com



**Kristin Rice-Gonzalez**  
Partner  
Chicago  
+1 312 861 8009  
Kristin.Gonzalez@  
bakermckenzie.com



**Gavin Raftery**  
Partner  
Tokyo  
+81 3 6271 9454  
Gavin.Raftery@  
bakermckenzie.com



**Matt Kluchenek**  
Partner  
Chicago  
+1 312 861 8803  
Matt.Kluchenek@  
bakermckenzie.com



**Bill Fuggle**  
Partner  
Sydney  
+61 2 8922 5213  
William.Fuggle@  
bakermckenzie.com



**Richard Powell**  
Professional Support Lawyer  
London  
+44 20 7919 1577  
Richard.Powell@  
bakermckenzie.com



**Audrey Fairhall**  
Professional Support Lawyer  
Hong Kong  
+852 2846 2195  
Audrey.Fairhall@  
bakermckenzie.com

Baker & McKenzie LLP is a limited liability partnership registered in England and Wales with registered number OC311297. A list of members' names is open to inspection at its registered office and principal place of business, 100 New Bridge Street, London, EC4V 6JA. Baker & McKenzie LLP is a member of Baker & McKenzie International, a Swiss Verein with member law firms around the world. In accordance with the terminology commonly used in professional service organisations, reference to a "partner" means a person who is a member, partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

Baker & McKenzie LLP is authorised and regulated by the Solicitors Regulation Authority of England and Wales. Further information regarding the regulatory position together with our privacy policy is available at <http://www.bakermckenzie.com/en/locations/emea/united-kingdom/london/legal-notice>.

This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.

© 2017 Baker & McKenzie. All rights reserved.