SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY | CLIENT PUBLICATION

INVESTMENT FUNDS

27 August 2014

Extraterritoriality Revisited: Access to the European Markets by Financial Institutions, Funds and Others from Outside Europe

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Donald N. Lamson
Washington, DC
+1.202.508.8130
donald.lamson@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Reena Agrawal Sahni
New York
+1.212.848.7324
reena.sahni@shearman.com

Tobia Croff
Milan
+39.02.0064.1509
tobia.croff@shearman.com

Hervé Letréguilly
Paris
+33.1.53.89.71.30
hletreguilly@shearman.com

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

In an effort to harmonise investor protection across the EU and ensure effective market competition, a framework has been established for financial institutions, funds and market infrastructure established outside the EU to access European investors and markets. Under certain key pieces of current and proposed EU legislation, such access generallywill require the determination of the "equivalence" of the local regulatory system governing the non-EU institution. Further, co-operation agreements may need to be put in place between the third country and a EU member state or ESMA. This note sets out the requirements for different types of market participants to gain access to the EU markets.

Currently, access to Europe for most sectors of the financial markets is based on national laws concerning marketing to customers and the so-called "regulatory perimeter." Such national laws differ quite drastically within Europe. For example, the UK's "overseas persons exclusion" allows a considerable amount of cross-border business to be done with regulated financial institutions and large corporates within the UK. It has been cited as one of the main reasons why the city of London has retained its status as a major financial centre for international business. In contrast, the position in much of continental Europe is unfavorable to foreign institutions wishing to deal with customers without local registration. A variety of European measures are aiming to provide a greater deal of consistency for the access of third country institutions. In this client note, we consider the position of institutions outside of Europe wishing to do cross-border business under proposed and recently published European legislation. Much of this legislation is either not yet in force or remains to be invoked so, in the interim, the existing maze of national laws remains to be navigated.

Contacts (cont.)

Masahisa Ikeda
Tokyo
+03.5251.1601
mikeda@shearman.com

Kolja Stehl
London / Frankfurt
+44 20.7655.5864
kolja.stehl@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

Sylvia Favretto
Washington, DC
+1.202.508.8176
sylvia.favretto@shearman.com

Aatif Ahmad
London
+44.20.7655.5120
aatif.ahmad@shearman.com

Anna Doyle
London
+44.20.7655.5978
anna.doyle@shearman.com

Nina Garnham
London
+44.20.7655.5118
nina.garnham@shearman.com

For third country financial sector participants to access the EU markets, in addition to being properly authorised and supervised in their own country, there are various requirements relating to the legal and regulatory regime of that country that will need to be fulfilled. Those requirements relate to the "equivalence" of the third country regime to the EU regime, co-operation arrangements between the third country and EU countries or the European Securities Markets Authority ("ESMA") and the anti-money laundering and tax regimes implemented by the third country. Although there may be variation in the requirements for EU market access for different sectors and even for different types of entity within the same sector, a number of commonly imposed requirements have emerged for the recognition of third country regulatory regimes.

Equivalence Determination: the country in question must be deemed to have a legal system and a supervision regime that is equivalent to the EU regime. That determination involves ESMA providing technical advice to the European Commission on how the third country's laws and regulations compare to the corresponding EU requirements. The European Commission then puts its proposed decision, based on the technical advice, to the vote of EU member states. For financial services legislation, the European Commission has limited ability to adopt a decision that is not approved of by member states, unless delaying adoption of a decision would create a risk to the financial interests of the EU as a result of fraud or other illegal activities. An equivalence determination may be "conditional" rather than full, meaning that certain EU legislative provisions will only be disapplied for the specific area determined to be equivalent.

In relation to central counterparties ("CCPs"), in its letter to the International Organization of Securities Commissions ("IOSCO") in December 2013 concerning the equivalence decisions necessary for CCPs established outside the EU, the European Commission stated that the equivalence process "involves identifying any differences between our respective legal and supervisory arrangements and assessing whether similar regulatory outcomes are nonetheless achieved; namely the reduction of systemic risk in the financial markets."[1]

Co-operation Agreements: third country regulators must enter into co-operation agreements with either the relevant national regulator of a member state or with ESMA, depending on the type of market participant. The agreements provide for the exchange of information and methods for co-operation and communication. In recent years, such co-operation agreements have become more commonplace worldwide. The agreements are the basis for increased co-operation between regulators in the supervision of financial institutions as well as enforcement actions against those falling short of the standards.

[1] Letter from Michel Barnier, European Commissioner, to Ashley Alder, Chairman of the IOSCO Asia Pacific Regional Committee dated 20 December 2013 can be found at http://www.iosco.org/committees/aprc/pdf/20131220_Response_from_EU_to_APRC_letter.pdf.

FATF Status: the country in question must not be on the Financial Action Task Force ("FATF") list of Non-Cooperative Country and Territories ("NCCT") for having inadequate anti-money laundering and counter-terrorist financing regimes in place and therefore posing a risk to the international financial system.

Tax Agreements: the third country must enter into tax agreements with the relevant EU member state which provide for exchange of information on tax matters. Usually the agreements are required to comply with the standards set out in the OECD Model Tax Convention on Income and Capital.

The table below is a sector-specific summary of the proposed key requirements for mutual recognition or third country access in Europe (as of August 2014).

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
Investment Firms MiFID II[2]	Under MiFID II, the third country access regime depends on the type of clients an investment firm intends to provide services to.[3] Third country investment firms may provide services to retail and elective professional clients subject to the relevant national regime and provided that: (a) the non-EU country is not listed as a NCCT by FATF; (b) a co-operation agreement is in place; (c) tax agreements are in place; and (d) the services will be subject to ongoing supervision by the third country regulator. No passport to provide services throughout the EU will be available. Member states have the option to require the establishment of a branch.	MiFID II entered into force on 2 July 2014 and most provisions become applicable on 3 January 2017. For the provision of services to *per se* professional clients and eligible counterparties, a third country investment firm may continue to provide services under a national regime until three years after the adoption of an equivalence decision.	Third country investment firms will not be able to provide investment services to any clients. Third country investment firms established in countries which comply with key requirements may still need to establish a branch in one of the EEA jurisdictions and will need to seek authorisation for that branch.	MiFID II has recently entered into force so it will take some time for the equivalence decisions, co-operation agreements and other requirements to be put in place.

[2] Made up of the revised Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation.

[3] Per se professional clients: banks, investment firms, insurers, asset managers, funds, commodity dealers, other institutional investors, non-EU equivalent entities; national and regional governments, central banks, bodies managing public debts, international and supranational institutions; large companies (whose size meets any two of: balance sheet total: EUR 20M, net turnover: EUR 40M and own funds: EUR 2M) and other institutional investors who main activity is to invest in financial instruments including those that mostly securitise assets and finance transactions.

Elective professional clients ("opt-up"): public sector bodies, local public authorities, municipalities and private individual investors may opt to be treated as a professional client either generally or for a particular service or transaction. The investment firm will need to assess the expertise, experience and knowledge of its client including whether the client satisfies of at least two of: (i) the client has traded significantly ten times on average in last four quarters; (ii) has cash and investments exceeding EUR 0.5M; and (iii) has been a financial services professional for over a year.

Eligible counterparties ("ECPs"): banks, investment firms, insurers, asset managers, funds, other institutional investors, non-EU equivalent regulated entities and large undertakings meeting a certain size threshold (not yet specified) consenting to be treated as an ECP.

Retail clients: a client that is not a professional client.

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
	Third country investment firms may provide services to per se professional clients and eligible counterparties without establishing a branch in the EEA, provided that the firms register with ESMA. Such registration is subject to the following conditions being satisfied: (a) an equivalence decision; if there is no equivalence decision, the national authorisation regime remains valid. (b) the firm is authorised in the country of establishment to provide investment services; and (c) co-operation arrangements between ESMA and the third country regulator are in place. An EU passport will only be available if the firm establishes a branch, an equivalence decision is made and the firm complies with the authorisation requirements applicable to firms providing services to retail and elective professional clients (i.e. the national regime of the country of the country in which the branch is located).			
Trading Venues including Exchanges MiFID II	Derivatives trading[4] may be carried out on a third country trading venue provided that: (a) an equivalence decision has been adopted; (b) the third country provides for an effective equivalent system for the	MiFID II applies from 3 January 2017.	Third country trading venues including exchanges cannot benefit from possible increase in business resulting from the introduction of the mandatory trading obligation for derivatives.	MiFID II has recently entered into force so it will take some time for the equivalence decisions, co-operation agreements and other requirements to be put in place.

[4] MiFID II introduces a requirement for financial counterparties and non-financial counterparties exceeding the clearing threshold to trade derivatives subject to the clearing obligation under EMIR on a regulated market, MTF or organised trading facility or equivalent third country trading venue. There is no equivalence regime for trading venues for trading financial instruments other than derivatives (except for a lighter equivalence regime for trading venues for shares).

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
	recognition of trading venues authorised under MiFID II; and (c) the trading venue has clear, transparent rules on the admission of financial instruments to trading.			
Funds AIFMD[5]	Non-EU Alternative Investment Fund Managers ("AIFMs") must be authorised in an EU Member State in order to manage EU Alternative Investment Funds ("AIFs"), or to market either EU or non-EU AIFs in the EU. Authorisation of a non-EU AIFM will require: (a) full compliance with the AIFMD as though the AIFM were based in the EU; (b) a co-operation agreement to be in place; (c) the non-EU country to not be listed by the FATF as a NCCT; and (d) a tax-exchange agreement to be in place. The marketing of any non-EU AIF by an authorised EU AIFM also requires (b) and (c) to be satisfied.	The AIFMD came into force on 22 July 2013. Authorisation of non-EU AIFMs is not possible until 2015 at the earliest, and not expected to become compulsory until 2018 at the earliest. Until authorised, a non-EU AIFM may only market AIFs in accordance with national private placement regimes in EU countries. Until 2015 at the earliest, authorised EU AIFMs may only market non-EU AIFs in the EU under national private placement regimes.	Non-EU AIFMs: may not market AIFs (whether EU or non-EU AIFs) in the EU, or manage EU AIFs. EU AIFMs: may not market non-EU AIFs in the EU.	A list of co-operation agreements between EU member states and non-EU countries is available here. Some individual EU countries have published their own, more exhaustive lists of agreements. The UK list is available here.
Clearing houses EMIR[6]	For a non-EU clearing house to have direct access to European members or exchanges without needing to be established in the EEA: (a) a co-operation agreement must be	A non-EU clearing house can apply to ESMA for recognition. A list of applicants is available and was last updated on 11 August 2014.[7]	Inability of non-EU clearing houses to clear for EU clearing members and EU exchanges and trading venues.	No equivalence decisions have yet been made. ESMA's technical advice on equivalence for certain jurisdictions is available here. You may like to see our client note,

[5] The Alternative Investment Funds Directive.

[6] The European Market Infrastructure Regulation.

[7] The list of applicants is available at: http://www.esma.europa.eu/content/List-applicant-central-counterparties-CCPs-established-non-EEA-countries.

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
	entered into between ESMA and the relevant regulator in the non-EU country; and (b) a determination of equivalence must be made.			"ESMA Advice on Third Country Equivalence under EMIR" available here. Details of co-operation agreements under EMIR are not yet available.
Clearing (derivatives) brokers EMIR	A determination of equivalence – if a non-EU entity is established in a jurisdiction which has been determined as equivalent, the counterparties could comply with the equivalent rules in that country. Where two non-EU entities are trading with each other, it is open for the Commission to impose EMIR's obligations on each of the two entities if the contract falls within EMIR's extraterritoriality provisions which apply: (a) if the contract has a "direct or foreseeable effect" in the EU; or (b) if it is necessary to prevent the evasion of EMIR. The EU Level 2 legislation detailing these requirements has been adopted in fairly limited circumstances.	No co-operation agreement is required, however, the non-EU country will need to assist ESMA in preparing its technical advice on equivalence.	EU financial counterparties may be unwilling to trade with non-EU counterparties whose third countries have not been found equivalent. Brokers should also be aware of being caught by EMIR's extraterritoriality provisions.[8]	No equivalence decisions have yet been made. ESMA's technical advice on equivalence for certain jurisdictions is available here. You may like to see our client note, "ESMA Advice on Third Country Equivalence under EMIR" available here.
Insurers and Reinsurers Solvency II	A determination of equivalence on the solvency regime of the third country (adopted by either the European Commission or, in the absence thereof, by the group supervisor in consultation with other relevant supervisors) is required.	Solvency II is scheduled to come into effect on 1 January 2016.	Reinsurance contracts with non-EEA insurers will be treated differently to EEA-insurers. A bespoke approach will be needed for groups headquartered outside of Europe. For third-country insurers that are part of EEA-groups, the group will not be able to take into account the local third-country calculation of capital	Solvency II is not yet in force and therefore no equivalence determinations have been made.

[8] You may wish to read our client note, "Timing and Scope of EU Clearing Obligation for Derivatives" at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2014/07/Timing-and-Scope-of-EU-Clearing-Obligation-for-Derivatives-FIAFR-071614.pdf.

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
			requirements and available capital but will have to calculate on a Solvency II basis for the purposes of the deduction and aggregation method. For EEA-insurers with parents outside of the EEA, a determination of equivalence will enable EEA-supervisors to rely on the supervision of the parent by the non-EEA country regulator.	
Benchmark Administrators Benchmark Regulation	Benchmarks provided by administrators established in a non-EU country can be used in the EU if: (a) a co-operation agreement is in place; (b) a determination of equivalence is made; (c) the administrator of the benchmark is authorised and supervised in its own country; (d) the administrator is registered by ESMA; and (e) it complies with the IOSCO Principles for Financial Benchmarks.[9]	The Benchmark Regulation is not yet in force.	Benchmark administrators will not be able to provide benchmarks to EU-supervised entities for use within the EU.	The Benchmark Regulation is not yet in force and therefore no equivalence determinations or other arrangements have been made or put in place.
Central Securities Depositories CSD Regulation[10]	A third country central securities depository ("CSD") may provide services in the EU if: (a) a co-operation arrangement between ESMA and the third country regulator is in place (which includes the third country regulator	The CSD Regulation is not yet in force.	CSDs will not be able to operate a securities settlement system or provide notary services or central maintenance services in the EU.	The CSD Regulation is not yet in force and therefore no equivalence determinations or other arrangements have been made or put in place.

[9] The Principles for Financial Benchmarks are available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.

[10] The proposed Regulation of the European Parliament and of The Council on Improving Securities Settlement in the European Union and on Central Securities Depositories and Amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) NO 236/2012. This regulation has been politically agreed and awaits publication in the Official Journal of the European Union to be final.

SECTOR/ LEGISLATION	REQUIREMENTS	CURRENT STATUS AND ANY TRANSITIONAL PERIOD	CONSEQUENCES OF FAILURE TO PUT IN PLACE THE KEY REQUIREMENTS	APPROVED COUNTRIES
	providing periodic reports on the CSD's activities and the identities of issuers and participants in the securities settlement system operated by the CSD); (b) a determination of equivalence is made; (c) the CSD is subject to authorisation, supervision and oversight; and (d) the third country provides for the equivalent recognition of third country CSDs in its country.			

9 APPOLD STREET | LONDON | EC2A 2AP