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Commentary

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Third-Country Firms Operating Cross-Border Into the EU — Upcoming Reform

Firms outside of Europe should be aware of planned upcoming changes to how they access European markets.

Key Points:

- The EU legislators have been reviewing various financial services regimes and developing reforms that will affect how foreign firms access EU markets.
- Although arguably motivated by Brexit, the changes will affect any non-EU firms doing business cross-border into the EU, including those in the US and Asia.

Background

There has been a great deal of discussion regarding the ways in which third-country (*i.e.*, non-EEA) financial services firms can access EU markets in the context of Brexit. While much discussion has focused on whether current third-country regimes could be sufficient for UK firms to maintain their EU business post-Brexit, and what enhancements to those regimes the UK might seek as part of any future trade agreement, the EU has been quietly working on proposals that would make this access more challenging to obtain and sustain for all third-country firms in various respects. Many of these reforms were in development for some time, but have now finally been made into law, and perhaps may contribute to the fragmentation of global financial markets as alluded to by the FSB and IOSCO in recent reports.

This *Client Alert* sets out current EU reforms that will affect the way in which third-country firms access EU financial markets. Whilst the precise date and the terms and conditions of Brexit remain uncertain, UK firms seeking to maintain access to the EU post-Brexit would be wise to note these changes now. Absent any special arrangements being agreed as part of an EU-UK trade deal, the default position for UK firms will be that they are treated as third-country firms from an EU perspective. Of course, these changes are relevant not only to UK firms, but also to current third-country firms (including, for example, firms in the US and Asia) that do business into the EU or are thinking of doing so.

Overview of Key Reforms

The table overleaf sets out a high-level summary of the changes to third-country regimes in EU financial services legislation.

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Reform	What will it do?	Who will it affect?	Status and timing
Narrowing the MiFID II third-country regime	The changes will require that if activities performed by third-country firms in the EU following a positive equivalence decision by the Commission are likely to be of systemic importance, the Commission may only conclude that the third-country framework is equivalent after undertaking a "**detailed and granular assessment**". This suggests a move away from outcomes-based equivalence assessments. The Commission will also be able to impose **specific operational conditions** on an equivalence decision; for example, mandating that firms comply with requirements equivalent to the MiFID transaction reporting requirements. Further, ESMA will have to **undertake ongoing monitoring** of the position in third countries granted equivalence, in order to verify whether the conditions on the basis of which the equivalence decision was taken remain fulfilled. ESMA will have to report its findings to the European Commission annually. The changes will also **narrow the concept of reserve solicitation**, limiting the circumstances in which third-country firms can do business into the EU on a cross-border services basis. Recent MiFID II guidance has clarified that firms relying on reverse solicitation to provide a one-off service cannot use this exemption to sell the same product or service again at a later date.	Third-country firms wishing to conduct investment business in the EU (other than via an EU subsidiary)	Legislation adopted on 27 November 2019. The changes will apply from 26 June 2021.
Intermediate EU parent undertaking requirement	Third-country financial groups with two or more deposit-taking or investment banking entities established in the EU will be required to **establish an intermediate EU parent entity**. This parent entity can be either a holding company (that will need to be authorised in the EU under new requirements for holding companies)	Third-country financial groups that meet the criteria set out in the adjacent column	Legislation adopted on 20 May 2019. Existing groups will have until 30 December 2023

	or an EU authorised banking entity or investment firm. This requirement will apply only to third-country groups whose banking and investment firm entities in the EU (including both subsidiaries and branches) have total assets of at least €40 billion.		to meet this requirement.
Revised guidelines on the endorsement regime for third-country credit rating agencies (CRAs)	Revised guidelines clarify how EU CRAs should apply the test for the **endorsement of third-country credit ratings** (which requires that credit ratings produced in third countries are subject to legal requirements which are as stringent as those applicable in the EU). The changes clarify that an endorsing CRA is expected to verify, and be able to demonstrate, that the third-country CRA has established internal requirements that are at least as stringent as the corresponding requirements in the EU Credit Rating Agencies Regulation, or that the third-country CRA fulfils the endorsement requirements under the EU Credit Rating Agencies Regulation. An endorsing CRA can no longer consider this condition to be fulfilled automatically when a third-country CRA is based in a country that has been assessed as equivalent by the European Commission.	Third-country CRAs that want their ratings to be used by EU financial institutions	The new guidelines apply to credit ratings issued on or after 1 January 2019, and to existing credit ratings reviewed after that date.
Recognition and supervision of third-country central counterparties (CCPs) under EMIR	The changes introduce **a new "two tier" system for classifying third-country CCPs**: • Non-systemically important CCPs (Tier 1 CCPs) will continue to be able to operate under the existing EMIR equivalence framework. • Systemically important CCPs (Tier 2 CCPs) will be subject to stricter requirements. The proposal also includes a provision relating to CCP location. It states that a limited number of CCPs may be of such	Third-country CCPs operating in the EU	Legislation adopted on 23 October 2019. The changes apply from 1 January 2020 (although the detail needs to be set out in Level 2 legislation, and the deadline for adopting this legislation is January 2021).

	systemic importance that the requirements in relation to third-country CCPs are deemed insufficient to mitigate the potential risks. In these cases, the EU authorities would be able to decide that **a CCP will only be able to provide services in the EU if it establishes itself within the EU**.		
Supervision of third-country benchmark administrators under the EU Benchmarks Regulation	This change will **make ESMA the competent supervisory authority for third-country administrators of benchmarks that are used in the EU**. ESMA will be granted the power to recognise and approve the endorsements of third-country administrators and benchmarks. This will effectively move to a centralised EU supervisory model for third-country benchmark administrators and could change the way in which they are supervised.	Third-country providers of benchmarks used by financial institutions in the EU	Legislation adopted on 18 December 2019. These changes will take effect from 1 January 2022.
Revisions to the rules on fund marketing under the AIFMD	This change will **introduce a harmonised, broad definition of "pre-marketing"** under the AIFMD, and will require Alternative Investment Fund Managers (AIFMs) to notify the relevant regulator when pre-marketing commences. Although the change is only directed at EU AIFMs, the same rules are likely to be applied to non-EU AIFMs. A further change will mean that any subscription to a fund made within 18 months of pre-marketing activity will be deemed to have resulted from that marketing — thus **narrowing the circumstances in which AIFMs can rely on reverse solicitation**.	Third-country AIFMs	Legislation adopted on 20 June 2019. These changes will apply from 2 August 2021.

Further Policy Considerations

An ESMA speech in June 2019 highlighted the impact that some of the above changes will have on cross-border regulation and supervision. In particular, ESMA chair Steven Maijoor observed that “in cases where there may be systemic risks to the EU, the relevant toolbox available to EU regulators will become stronger, monitoring and reviews of equivalence decisions more regular, and EU legislation will apply directly”. He also commented that “one key part of the improved EU approach is the more frequent monitoring and review of equivalence decisions to detect emerging differences between EU and non-EU frameworks on time”.

As well as commenting on the potential impact of the above reforms, Mr Maijoor also suggested that the EU may start to move away from outcomes-based equivalence decisions: “it is important to underline that focussing only on high-level outcomes may sometimes result in ineffective cross-border arrangements as it would allow regulatory and supervisory differences to persist that can result in, for example, regulatory competition, risks being unaddressed, extra costs, and market fragmentation. In some areas and in some cases, more ambition is needed, and we should strive to further remove differences”.

This speech was followed by a European Commission communication on equivalence, which sets out the Commission’s current equivalence policy priorities. Of particular note, the Commission highlighted the importance of achieving mutually accommodating outcomes (*i.e.*, a third country accommodating access by EU firms will make the EU more likely to consider granting equivalence in respect of that country), that it will treat “high-impact” third countries (for which an equivalence decision is likely to be used intensively by market participants) with extra caution, that adherence to international standards will not necessarily result in a positive equivalence decision, and that the equivalence provisions do not confer a right on third countries for their framework to be assessed. This suggests that the Commission is planning to take a stricter approach towards equivalence in future.

Further, the Commission made clear that it is unlikely to harmonise the various equivalence regimes. It explained that a heterogenetic approach is needed, as long as some common principles are adhered to across the various equivalence regimes. The communication also emphasised the increasing importance the Commission places on monitoring and reviewing equivalence decisions. It is interesting to note that the communication was published as the Commission announced that it was withdrawing equivalence decisions in relation to five jurisdictions under the Credit Rating Agencies Regulation.

While most immediately concerning for the UK in the context of Brexit, this all points to the equivalence process becoming tougher for third countries in the years to come. Additionally, it seems likely that equivalence decisions could more commonly be reviewed, and potentially withdrawn.

Next Steps

Third-country and UK firms and groups that potentially are affected by these changes should note the implementation dates and plan how they will prepare. Although the lead times may seem manageable, some requirements, such as those relating to the establishment of holding companies in the EU, could take a considerable amount of time to implement.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

David Berman
david.berman@lw.com
+44.20.7710.3080
London

Kishore Bhindi
kishore.bhindi@lw.com
+44.20.7710.4785
London

Sherryn Buehlmann
sherryn.buehlmann@lw.com
+44.20.7710.3043
London

Brett Carr
brett.carr@lw.com
+44.020.7710.4695
London

Charlotte Collins
Knowledge Management Lawyer
charlotte.collins@lw.com
+44.20.7710.1804
London

Becky Critchley
becky.critchley@lw.com
+44.20.7710.4519
London

Stuart Davis
stuart.davis@lw.com
+44.20.7710.1821
London

Carl Fernandes
carl.fernandes@lw.com
+44.20.7710.4777
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Gabriel Lakeman
gabriel.lakeman@lw.com
+44.020.7710.4645
London

Anne Mainwaring
anne.mainwaring@lw.com
+44.20.7710.1018
London

Sam Maxson
sam.maxson@lw.com
+44.20.7710.1823
London

Frida Montenius
frida.montenius@lw.com
+44.20.7710.1161
London

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Denisa Odendaal
denisa.odendaal@lw.com
+44.20.7710.1845
London

Jonathan Ritson-Candler
jonathan.ritson-candler@lw.com
+44.20.7710.1815
London

Katy Sanders
katy.sanders@lw.com
+44.20.7710.4548
London

Sean Wells
sean.wells@lw.com
+44.20.7710.4662
London

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