HOW CAN UK FINANCIAL SERVICES FIRMS CONDUCT BUSINESS IN THE EU POST BREXIT?

When the Brexit Transition period runs out at the end of 2020, UK financial services firms (including third country firms that have previously relied on their UK based affiliates) will in theory lose their ability to carry out regulated financial services business with clients based in the member states of the European Economic Area (EU27) due to the loss of passporting rights.

UK firms will then be left with two options; either establish an appropriately licensed EU27 affiliate, with the requisite passporting rights. Or alternatively comply with the licensing requirements of each EU27 member state in which they wish to provide financial services, either by establishing a licensed branch in that member state or by relying on (to the extent it is possible) a local exemption.

Many UK firms have as of date opted to establish authorised affiliates within an EU27 member state with requisite passporting rights to continue to operate their EU based businesses. For those firms that have not taken this step they find themselves in the position of either having to relinquish their EU footprint and consequent revenues or wait to see whether "equivalence" is granted by the EU to UK based firms to continue to offer financial services and products within the EU27.

EQUIVALENCE

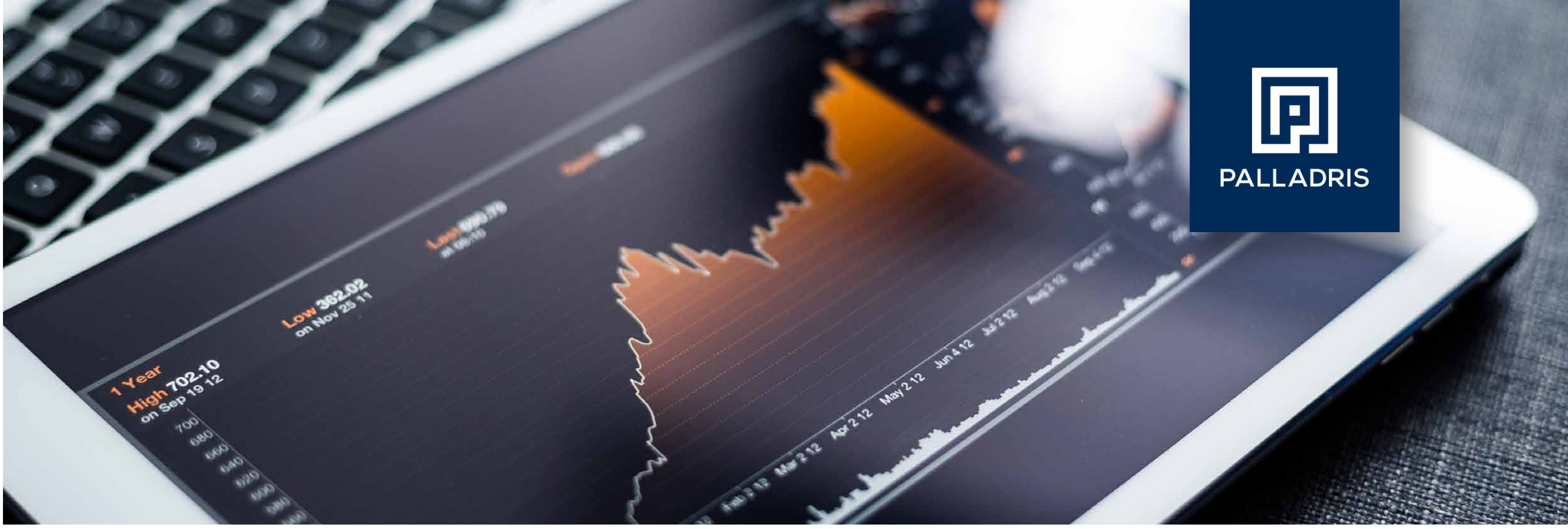
Under MiFID II, third-country investment firms located in an "equivalent" jurisdiction that want to provide financial services to "wholesale," i.e. non-retail, clients in the EU27 ("eligible counterparties" namely professional clients), can apply for a single registration with the European Securities and Markets Authority (ESMA). This registration would then be valid across all member states.

For the ESMA to grant UK firms equivalence will largely depend on whether the UK government agrees to the so called "level playing field rules" which would require strict alignment with EU laws and regulations in respect of financial services. Whilst at present the UK's regulatory regime is fully aligned with the EU, unfortunately the UK government has repeatedly called for EU/UK market access to be on the basis of mutual recognition and reciprocal equivalence which would be objectively assessed. This would allow for potential divergence by the UK in the future. The EU predictably have rejected such an approach and have insisted on their strict alignment position and this has thus far resulted in no agreement on the issue leaving UK firms with no clear timetable and indication as to whether equivalence is likely to be granted.

IS REVERSE SOLICITATION AN ANSWER TO THE LOSS OF PASSPORTING RIGHTS?

For UK firms that have not set up an authorised entity in an EU27 member state and are not keen on relinquishing revenues whilst the equivalence discussions are played out, one potential (but limited) risk-based solution is available namely to operate under a reverse solicitation approach.

UK Firm (utill end of transition period) →	Passport →	Ability to service EU27 clients
UK – Third Country Firm (after transition period) →	Local EU authrised entity →	Passported to carry out business across the EU27
UK – Third Country Firm without passport and or Equivalence →	Reverse Solicitation →	No direct marketing or Solicitation



WHAT IS REVERSE SOLICITATION?

Reverse solicitation or otherwise known as reverse enquiry is a concept which permits an EU27 client to reach outside the EU single market and acquire financial services and products from non-EU firms. In doing so, the EU27 customer gives up legal and regulatory protections afforded to it by its national laws and EU rules and regulations, but instead relies on the third-country regulatory regime and any bilateral contractual arrangements with the third country firm.

Reverse solicitation rules are implemented in Article 42 of MiFID II, which permits a third country firm to provide investment services and activities to clients on the "exclusive initiative" of that client, without requiring authorisation or registration in the EU.

Historically some EU27 jurisdictions like the U.K., the Republic of Ireland and, to a lesser extent, Luxembourg have been a little more flexible and provided for more open wholesale financial markets access, in which cross-border transactions may take place with third-country entities, without necessarily imposing strict local licensing requirements. In the U.K. this has taken place under the "overseas persons exemption" allowing institution-to-institution cross-border business without the need for local licensing of the third country firm.

By contrast, most other EU27 Member States have legislated for more restrictive financial markets access, where local clients, and even some of their largest banks, may only access third-country financial institutions on a reverse solicitation basis. For example, in Germany if the provision of financial services was initially commenced at the client's exclusive request (the reverse solicitation exemption applies to that particular service), this includes visits to clients as well as telephone calls and electronic messages. Although if potential clients domiciled in Germany are approached by third country entities by direct mail, fax or email for the purpose of offering financial services, the foreign entity requires a license.

The regulatory background

According to Article 42 of MiFID II, where a retail or professional client established or situated in the EU initiates at its own exclusive initiative the provision of an investment service or activity by a third country firm (i.e. post-Brexit, UK firm) that firm is not subject to the requirements of Article 39 MiFID II (the requirement to obtain a license).

However, Recital 111 states that "where a third-country firm solicits clients or potential clients in the European Union or promotes or advertises investment services or activities together with ancillary services in the EU, it should not be deemed as a service provided at the own exclusive initiative of the client".

Article 42 of MiFID II also states that such an initiative by a client shall not entitle the third country firm to market new categories of investment products or services to that client.

ESMA's Interpretation

Contained within ESMA released MiFID II related FAQs on reverse solicitation, (last updated on 25 May 2018), entitled "Provision of investment services and activities by third country firms".

The key elements of ESMA's interpretation:

- Willingness to disregard disclaimers and examine the substance of the fact pattern;
- marketing new products to an existing client is likely to face more scrutiny;
- reverse solicitation should not be assumed;
- firms should be able to provide records tracking the relationship with the client.

WHAT ABOUT THE INTERBANK MARKET IN THE CONTEXT OF REVERSE SOLICITATION?

If an FX and OTC Derivatives market maker in third country firm is streaming prices via an electronic platform to all (wholesale) dealers globally, including those located in an EU27 jurisdiction there may be a degree of tolerance. Since arguably the market maker would not be directly targeting clients within the EU27 jurisdiction and it would be down to the exclusive initiation of the EU27 wholesale client if it in response approached the market maker to trade on the price. Also, it can be argued that the third country market maker was not going onshore in to the EU27 jurisdiction as the platform streaming the prices was located outside the jurisdiction. However even in this situation there are likely to be limitations since the approach is predicated on the client approaching the interbank counterpart based in the third country initially on a reverse enquiry basis in order to be set up.

Clearly even in the dealer to dealer scenario there are some practical problems with managing such an arrangement since solicitation of any business by for example cold calling the client, sending trade ideas, presentations, research papers and or visiting the client in country could potentially mean that the market maker would be directly soliciting within the jurisdiction (note due to gold plating of MiFID II and local solicitation rules this could vary from country to country in the EU) which would typically be regarded as a licensable activity in breach of Article 39 of MiFID II and local law and regulation in that particular jurisdiction.

THE RISKS OF A REVERSE SOLICITATION MODEL

In most EU27 jurisdictions a business model which relies exclusively on reverse solicitation carries significant regulatory and reputational risk and may be vulnerable to challenge. In particular, reverse solicitation as a concept, although recognised under MiFID II, is not harmonised across the member states.

Consider for example (i) the rules on what is permitted and prohibited marketing, since they vary materially across member states. It is therefore a matter of local law as to what constitutes marketing and what maybe permissible as marketing in one EU jurisdiction may not in another. Note the different interpretations of marketing between Germany, France and Spain. (ii) consider how difficult it maybe to evidence whether a client genuinely initiated a transaction. This is because certain business models by their very nature involve continuous client interaction across a range of communication mediums. So, it may be very difficult, in all circumstances, to control client coverage behaviour by relationship managers' or provide a sufficient audit trail to evidence client initiation.

In addition, there is the risk of unenforceability of contract. This is because if a local competent regulatory authority could took the view that the business conducted within its jurisdiction with a local client by a firm resident in a third country arose out of solicitation in breach of local requirements and the criteria of Article 42 and Recitals 85 and 111 of MiFID II had not been followed, it may declare that such business was being done in breach of Article 39 (which is the requirement to establish a branch and acquire authorisation). Unauthorised business in such a context would normally be voidable at the insistence of the local client. In these circumstances a third country firm would essentially be handing a free put option to an EU client in the case that they wanted to walk away from a transaction(s).

Finally, it should be noted that not having a local licence does not in itself take a third country firm out of the jurisdictional reach of a local EU regulator. Article 70(4)(a) of MiFID II provides that a breach of Article 39 is a breach of MiFID II. Which in these days of extra territorial reach by regulators through either the college of regulators or sanctioning firms and employees cannot be taken lightly.

CONCLUSION

UK financial services firms that consider reverse solicitation as a potential solution to the loss of passporting rights in a post Brexit world need to consider very carefully the inherent risks in taking such an approach. Using reverse solicitation wrongly can have severe repercussions which may include criminal and regulatory sanctions and the risk that clients may seek to rescind their contract on the basis of breach of law and or regulation. Nevertheless, some firms may determine that reliance upon reverse solicitation is a risk worth taking whilst they await a post Brexit regulatory environment to develop.

Any U.K. or for that matter any other third country firm that relies on reverse solicitation needs to ensure that this is based upon carefully drafted compliance processes, accurate record retention and effective framework documentation.

We hope that this client briefing note was helpful and if your firm opts to run a reverse solicitation strategy and wants to mitigate the risks involved in such an approach please contact Palladris so that we can help you craft compliance guidelines and documentation to ensure that your firm is able to navigate the regulatory risks inherit in such a model.

Some suggested Reverse Solicitation Guidelines

Factors that should be taken into account when determining whether the provision of an investment service or activity to a client in the EU might fall within the scope of Article 42 of MiFID II.

i. Client's Own Exclusive Initiative – The client must make contact with the relevant third country entity as a result of its own exclusive initiative for each investment service or activity provided.

ii. Retention of Records – The relevant third country entity must retain records tracking the duration of the relationship with the client, including evidence proving that the first contact was made by the customer.

iii. No New Investment Products or Services – Firm cannot market new categories of investment products to a client with whom it has a relationship that was established at the client's own exclusive initiative.

This list is not conclusive but merely an indication as to some of the key factors to be taken into account.

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Contact Palladris for guidance as to how to navigate the issues discussed above and ensure that your firm is able to meet the challenges raised by Brexit as best possible.

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