

# CESR: The Passport Under MiFID

The Markets in Financial Instruments Directive bulletin series

March 2007 Vol.3

This is the third paper in the series tracking the CESR MiFID developments.\*

## Overview

- CESR's Consultation Paper presents proposals for a common approach on the notification procedures set out in Articles 31 and 32 of MiFID.
- There are proposals which seek to harmonise collaboration between home and host authorities in order to achieve efficient and consistent supervision of cross-border activities.
- CESR's approach was broadly welcomed at the recent Open Hearing. This bulletin summarises some of the key areas of interest.

## Outstanding issues

- CESR has applied to the European Commission for a legal interpretation concerning the phrase 'in its own territory' in terms of service provision by branches. Finalisation of CESR's approach to home/host issues in terms of branches relies on feedback from the Commission. (Note this ties in with consultation on transaction reporting).
- 'Following consideration of all responses to the consultation, if appropriate, it would still be open to CESR to consult further with the European Commission as to whether there is a case for interpretative guidance which would even more closely align any underlying legal analysis with the identified solutions by which the shared desired outcome and better regulation might be more easily delivered in practice' Para 62, Page 13, 06-669.

## CESR Process

- Consultation paper issued 15 December 2006.
- Open hearing on 2 February 2007.
- Responses due 9 February 2007.
- Final CESR publication anticipated easter 2007.

## Details of consultation paper

### 1.0 Need to determine role in the chain of execution

- 'MiFID's best execution requirements should be applied as necessary to take account of the particular function performed by each firm in the chain' Para 65, Page 16.
- Eligible counterparties have to 'ensure that any entities with which orders are placed or to which the investment firm transmits order for execution have execution arrangements that enable the investment firm to comply with L2D, Art 45'.
- 'In considering whether an investment firm has complied with the requirements, it will be relevant to examine the role performed by the firm, particularly where there is a chain of execution' Para 66, Page 16.

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- ‘CESR considers that the reference to ‘arrangements’ in Art 45(5) is intended to refer more generically to the execution approach of the intermediary’ Para 69, Page 16.
- Portfolio manager/RTO using an intermediary subject to L1, Art 21 can ‘providing certain conditions are met, be able to place a high degree of reliance on that intermediary in order to comply with its own best execution obligations under Art 45(5)’. Para 72, Page 17.
- Where a portfolio manager/RTO specifies that a transaction should be carried out on a particular venue, this constitutes a ‘specific instruction’. Para 73, Page 17.
- No prohibition on using third country venues, but portfolio managers/RTOs would need to satisfy themselves that these venues have execution arrangements or standards of execution quality which allow compliance with L2D, Art 45. If not, firm cannot use these third country venues.
- ‘When best execution responsibilities overlap, an investment firm will have to determine whether its best execution obligations are owed under Art 45 or Art 21 and how far the best execution standard delivered by an intermediary at the following point in the chain goes in satisfying the best execution requirements that apply to itself’. Para 75, Page 17.

## 1. Notification

### **Cross-border services:**

- Firms can commence service provision as soon as the home regulator informs it that notification has been made to the host regulator.
- It will still be in the firm’s interest, however, to check that its name appears on host’s register before providing services as investors might be expected to refer to the register.
- CESR members have undertaken to update registers promptly.

### **Establishment of branches:**

- ‘CESR is of the view that, in line with the approach to the provision of services, the decision to approve a branch lies with the home regulator’ Para 22, Page 5.
- Host regulator would have two months to deal with the file after notification from home regulator.
- Registration of the branch is not required for it to commence operations either on notification from the host supervisor or after this two month period – whichever is the sooner.
- In some countries, fulfilment of certain commercial provisions is necessary for the host regulator to update the register. Where appropriate, relevant CESR members have voluntarily agreed to advise the firm to consult the host’s website to find out about additional commercial requirements.
- Regulators are responsible for maintaining their own website and register.
- CESR suggests that it could set up a separate page on its own website where regulators could display the necessary information.
- Home regulators should publish an advisory note on their websites of jurisdiction where additional commercial provisions need to be met in host Member States.

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## Facets of the proposed protocol designed to facilitate the notification process:

- Standardised forms for notification.
- Arrangements regarding the time schedule of notification.
- Exchange of information regarding problems concerning passport notification.
- Home regulator to promptly advise host regulators of any decision to withdraw the authorisation of the firm.
- Methods of communication (e.g. email).

Note: there were no substantive comments regarding the notification proposals at the Open Hearing on 2 February 2007.

## Implications for firms

- CESR's proposals and its protocol should make notification procedure more straightforward.
- These procedures do not remove some of the practical challenges in those Member States where other commercial provisions exist: however, readily available information will facilitate the process.

## 2. Home/host responsibilities regarding branches

### MiFID requirements:

- Under MiFID, home regulators are responsible for branch operational issues; while host regulators are responsible for ensuring compliance with certain conduct of business rules. However, where to draw the line between 'operations' and 'conduct of business' is not clear cut.
- Also, when a branch provides services cross-border, the home regulator is responsible for ensuring compliance with these conduct of business rules.

### Practical solutions:

- 'The key proposal that emerges is that the respective home and host regulators agree among themselves – and communicate their views to relevant firms – on how best in practice to carry out branch supervision', Para 30, Page 7. Regulators to agree specific solutions or supervisory tools on a case-by-case basis.
- 'To make these provisions work, it will be essential for firms to have coherent policies and procedures to ensure that their various cross-border activities, in whatever form, are controlled properly', Para 36, Page 9.
- 'The host regulator will need to accept that it has no remit ['common good requirements'] and should trust the home regulator to approach the supervision of such business in the same manner as it would for purely domestic business; the home regulator will need to respond to the challenge of operating in such a way as to maintain the confidence of the host in its supervision', Para 37, Page 9.
- 'A shared outcome that firms have clear governance and controls over branches and their business would appear to be desirable, regardless of whether, in practice, a line can be drawn between MiFID 'organisational' and 'conduct of business' requirements', Para 41, Page 10.

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- CESR has identified a set of ‘success criteria’ which it hopes will assist in the evaluation of practical solutions. Various detailed criteria are grouped under the headings (see Annex 2):
  - Clarity.
  - Efficiency.
  - Effectiveness.
  - Pragmatism.
  - Business practice.
  - Access to complaints mechanisms.

At this stage, CESR has not given any weighting to any of the above criteria.

- Options for division of responsibilities between home and host regulators:

## Organisational issues

- ‘Regulators agree as precisely as possible where in practice the line is drawn between their respective responsibilities.
- Home regulator focuses more on organisational and control aspects of branches (than may have been done under ISD).
- Home regulator asks firm questions on organisational matters sent by the host regulator (and passes on any material findings).
- Firm provides a pre-defined set of common information on organisational matters (that includes the branch) to both home and host regulator.
- Home regulator requests co-operation in supervisory activity, through delegating or outsourcing tasks of supervision (but not responsibility) on various organisational matters to the host regulator, and/or
- Joint working (e.g. meetings with senior management, on-site visits, etc.) by home and host regulators that include coverage of organisational matters’ Para 48, Page 11.

## Conduct of business

- ‘Both host and home regulators supervise separately their relevant business of the branch (according to whether the particular activity or transaction is ‘domestic’ or ‘cross border’ respectively).
- Regulators co-operate by delegating or outsourcing between themselves the task of supervision (but not responsibility) for looking at the conduct of all the business of the branch. Whilst this might normally be expected to result in the home regulator delegating or outsourcing tasks to the host, there may also be circumstances in which delegation or outsourcing from the host regulator to the home could be appropriate.
- Joint supervision (e.g. meetings with compliance staff, file reviews, on-site visits, etc) by home and host regulators’ Para 49, Page 11.

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- 'It is possible that some of the solutions identified in order to help achieve real practical outcomes may, on first impression, appear difficult for regulators to deliver. However, CESR believes that in practice members should be able to overcome any initial reservations in order to make the beneficial solutions work and so achieve better regulation' Para 56, Page 12.
- 'Competent authorities will have to co-operate closely and communicate clearly, an area where CESR has a tradition in doing so and has built up trust among members' Para 61, Page 13.

## Further work

- 'Assuming that there is general agreement of what needs to be done, CESR may wish to build the findings in to a framework or protocol for regulators, which would also provide firms and other stakeholders with a visible sign of commitment and help explain further how agreed solutions will be delivered in practice' Para 65, Page 14.
- Some aspects may also require further work as part of fostering greater supervisory convergence and regulatory co-operation.

## Implications for firms:

- Firms need to review their structures/cross-border activities: the way in which the firm is organised will impact the supervisory approach.
- Firms need to have coherent policies and procedures to control cross-border activities and ensure MiFID protections for all clients.
- Supervisors will want a clear picture of how the business operates across the EU.
- If firms supervised on a case-by-case basis, no 'good practice' supervisory benchmarks yet exist in terms of the combination of potential supervisory tools to be used.
- Could firms with multiple branches be faced with multiple supervisory 'solutions'? For example, in some territories tasks could be delegated/outsourced to home/host regulators but not in others?

## 3. Cross-border activities of investment firms through tied agents

### MiFID requirements:

- L1 Art 23 sets out obligations of investment firms when appointing tied agents.
- L1 Art 23(4) allows registration to be carried out by governments, competent authorities, investment firms and credit institutions.
- L1 Art 32(2): a tied agent in another Member State is assimilated to a branch.
- Member States have to maintain a register of tied agents: but where tied agents are not permitted in a host Member State but are permitted by the home Member State, any tied agent established in a host Member State will be included on the home Member State's register.

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## Practical solutions

- Number of problems/quasi solutions identified:
  - Clients may not easily be able to access the relevant register of tied agents in another Member State.
  - Investment firms may be allowed (by their Member States) to verify whether tied agents are of 'sufficiently good repute and possess appropriate general, commercial and professional knowledge'. However, this may be difficult when tied agents are established in another Member State. 'CESR is of the opinion that co-operation between competent authorities will be necessary in this area' Para 77, Page 16.
  - CESR recommends that members cooperate in respect of registration, in particular where tied agents are appointed in a Member State which does not itself have a tied agent regime.
- Additional questions (which need to be considered in the context of a tied agent as an unauthorised entity):
  - How does firm and regulator assess operational risks? Are there additional considerations beyond risks involved in running a branch?
  - How will the host regulator supervise COB compliance of the non-authorised entity?
  - How should complaints from the host state be handled? Can the compensation mechanism of home state cover any losses?
  - How can the host regulator ensure that tied agent complies with AML rules?
  - How can the home regulator be sure that the investment firm's procedures are adequately implemented by the tied agent?
- At the open hearing on 2 February, CESR indicated that it will need to wait and see how investment firms use tied agents on a cross-border basis.
- CESR said it will look at pulling together and publishing information on tied agents.
- A key issue is that of compensation: it needs to be clear that home state's compensation scheme will cover any errors by tied agents which result in losses to clients. However, this is a difficult issue given that tied agents are authorised entities.

## Implications for firms

- The regime around the use of tied agents on a cross-border basis is far from 'clear': there is a need to recognise the risks inherent in such uncertainties.

## 4. Cross-border activities of MTFs

### MiFID requirements

- Investment firms and market operators operating an MTF can provide cross-border services on the basis of mutual recognition, as long as notification procedures under L1, Art 31 are followed (see above re notification of cross-border services).
- MTFs, however, do not benefit from the freedom to establish branches under L1, Art 32.

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- L1 Art 31(5) says that MTFs can provide the necessary arrangements in other Member States to facilitate access to, and use of, their systems by remote users or participants from those Member States.
- L1 Art 31(6) stipulates that in addition to its role in terms of notification, the home regulator has to communicate to the host regulator the identify of members or participants.

## Practical solution

- MiFID does not stipulate the type of 'arrangements' involved.
- 'CESR proposes to consider an investment firm or market operator operating an MTF who is authorised in a Member State, to be rendering cross border service/activities in another Member State, [...] where direct access is provided to user or participants by the investment firm or market operator operating an MTF on the territory of a Member State other than its home Member State ('connectivity test') Para 88, Page 18.
  - 'Connectivity test' covers, inter alia:
    - Placing of screens.
    - Delivery of software to facilitate access to the platform.
    - Physical presence of infrastructure.
    - Establishment of platform for trading but also facilitating direct access via Internet.

Note: at the Open Hearing on 2 February, it was suggested that the 'connectivity test' should not be tied exclusively to technology: as this could potentially limit innovation in this area.

## Implications for firms

- Investment firms and market operators operating an MTF need to consider the implications of the 'connectivity test' in relation to their existing arrangements.

## 5. Activities of representative offices

- MiFID does not provide a regime for representative offices.
- 'CESR subscribes [...] to the view that no MiFID investment services or activities can be provided through a representative office' Para 94, Page 19.
- A representative office is not a legally distinct entity.
- 'CESR is of the opinion that where an investment firm establishes an office of the same legal entity in another Member State solely for promotional purposes, that office should not be qualified as a branch under MiFID' Para 99, Page 19.

## Implications for firms

- Firms will need to ensure that no investment services or activities are conducted through the representative office, including investment advice. A clear delineation is required between permitted 'promotional' activities and investment advice/provision of investment services.

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## 6. Transitional arrangements

- Transitional arrangements need to be put in place to update supervisory records and to ensure certainty for passporting firms and users of relevant public registers.
- CESR proposes a common mapping of ISD investment services and instruments to MiFID investment services, activities and financial instruments: regulators would be responsible for updating their records based on the mapping exercise before 1 November 2007.
- Any change to existing passported services, in respect of new activities, services or financial instruments, would result in a new notification.
- 'CESR recommends that home regulators adopt a procedure by which investment firms are invited to review their current passported services, activities and financial instruments and requests any additional authorisations that come to light as a result of this review' Para 104, Page 20.

### Implications for firms

- Firms will need to review current 'passports' and determine whether these cover all relevant MiFID services, activities and financial instruments.
- If the firm's current authorisation permits investment services, activities, and/or transactions in financial instruments which are now 'core services' under MiFID or MiFID financial instruments, firms need to prepare to initiate notification procedures.
- Firms may need to extent their authorisations to cover additional services, etc. now permissible under MiFID in order to benefit from the passport.
- These issues will be more problematic in territories which are late in transposing the Directive.

## 7. Protocol between competent authorities

In addition to covering issues related to notification, CESR proposes that the protocol also cover:

- Aspects of regulatory collaboration.
- Improvement of information to, and contact with, the public.

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