

Trading activities between UK and German broker-dealers post Brexit – The German regulatory perspective

Set forth below is the joint view of the undersigned law firms on the German regulatory position for UK broker-dealers who continue to deal in financial instruments with broker-dealer counterparties based in Germany following a hard Brexit (i.e. no transition period, no equivalence decision for UK investment firms pursuant to Article 47 of Regulation (EU) No 600/2014 (MiFIR)). In this paper, references to German broker-dealers mean any bank or broker-dealer (including German branches of foreign firms) based in and operating from Germany and undertaking the regulated investment service or activity of dealing on own account (*Eigenhandel* and *Eigengeschäft*). References to UK broker-dealers similarly mean any bank or broker-dealer (including UK branches of non-UK firms) based in and operating from the UK and undertaking the regulated investment service or activity of dealing on own account with a German broker-dealer.

Summary

In principle, providing the investment service of ‘dealing on own account’ (*Eigenhandel*)¹ to counterparties in Germany requires a German investment services license. Such license, however, is not required where the UK broker-dealer provides the investment service to a German broker-dealer in the following circumstances:

- Existing relationship / reverse solicitation - Where there is an existing business relationship between a UK broker-dealer and a German broker-dealer which was legitimately established pre Brexit and which covers the relevant investment service, or where a UK broker-dealer is approached by a German broker-dealer post Brexit with regard to the respective investment service at the own exclusive initiative of the German broker-dealer (reverse solicitation), the UK broker-dealer does not require a German license. Reverse solicitation only applies if the UK broker-dealer does not actively market its services to the German broker-dealer, including through a third party whose activities must be attributed to such UK broker-dealer.
- Case-by-case exemption – A UK broker-dealer does also not require a German investment services license if it has obtained an exemption from the license requirement pursuant to Section 2(5) of the German Banking Act (“KWG”) from the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – “BaFin”).

No German license is required for UK broker-dealers if they merely engage in the investment activity of dealing on own account (*Eigengeschäft*) with German broker-dealers.²

Details

Regulated Cross-Border Activities

Pursuant to Section 32(1) s. 1 KWG, anyone wishing to conduct banking business or to provide investment services in Germany commercially or on a scale that requires a commercially organised business undertaking requires a German license or EU passport, unless an express exemption³ applies. Licensable investment services include ‘dealing on own account’ (*Eigenhandel*), e.g. market-making, systematic internalization or fixed-price trading which is offered on a continuous basis.

¹ Pursuant to Section 1 (1a) s. 2 No. 4 KWG, including the activities of market making, systematic internalization and dealing on own account as a service to a client.

² Subject to the limitations set forth in Section 1(1a) s. 3 and Section 32(1a) s. 1-3 KWG for dealing on own account on a German organised market, MTF or OTF.

³ A German banking or investment services license is not required if an exemption pursuant to Section 2(5) KWG has been granted by BaFin. We understand that BaFin is currently not considering applications from UK firms, although existing exemptions remain unaffected.

Licensable services are provided ‘in Germany’ if they are performed in whole or in part through a physical presence in Germany. However, in a note dated 1 April 2005 (“**BaFin Guidance Note on Cross-Border Activities**”)⁴, BaFin issued guidance that licensable services are also deemed to be provided ‘in Germany’ if the service provider targets the German market with cross-border services from outside Germany. In this respect, BaFin follows a solicitation-based approach to licensing requirements and expects non-EEA persons to obtain a German license or exemption if they intend to actively approach any person domiciled in Germany, i.e. turn to the German market ‘in a targeted manner’ (*zielgerichtet*) with regulated activities.

Targeting the German Market

‘Targeting the German market’ means a solicitation of any person located in Germany, including eligible counterparties and professional clients. In Germany, there is no express dealer-to-dealer exemption, like in other jurisdictions. According to the BaFin Guidance Note on Cross-Border Activities, if prospective clients domiciled in Germany are contacted, directly or through a third party whose activities must be attributed, by telephone, post, fax or email on an unsolicited basis, BaFin will assume that the relevant service provider is ‘targeting’ the German market.

Passive Service Offering

BaFin, however, clarified that a license is not required where the non-German service provider does not actively approach the client, but, instead, the transaction is based on a passive service offering by the provider (*passive Dienstleistungsfreiheit*) where (i) an existing client relationship is continued within agreed parameters or (ii) the client requests on its own initiative the relevant products or services without any prior solicitation by the service provider (reverse solicitation), as is typically the case in dealings with large corporate clients or institutional investors. In BaFin’s view, institutional investors include:

- the German Federal Government, Federal States, local authorities and their institutions;
- credit institutions and investment firms within the meaning of the KWG, including investment companies within the meaning of the German Capital Investment Companies Act (*Kapitalanlagegesetzbuch*);
- private and public insurance and reinsurance companies; and
- medium-sized and large corporates within the meaning of Section 267(2) and (3) of the German Commercial Code (*Handelsgesetzbuch*).

The BaFin Guidance Note on Cross-Border Activities also states that “*bringing cross-border banking transactions and financial services within the scope [of BaFin’s guidance] relates primarily to the private client sector as well as the (retail) corporate client sector since foreign companies from non-EEA states often want to develop new client bases in these sectors by launching specific campaigns in Germany*”. This statement reflects the fact that dealings among institutional market participants are typically not based on one targeting the other, but on a comprehensive, ongoing business relationship and, hence, do not require a banking or investment services license. Where a broker-dealer in Germany has requested products or services on a reverse solicitation basis from a UK broker-dealer, the BaFin Guidance Note on Cross-Border Activities also confirms that this would not prevent the UK broker-dealer from informing the German broker-dealer about additional types of products or services as long as they fall within the scope of their existing business relationship.

⁴ The BaFin Guidance regarding the licensing for conducting cross-border banking business and/or providing cross-border financial services of 1 April 2005.

The reverse solicitation concept is also recognised in Article 46 (5) MiFIR⁵ and Article 42 MiFID II⁶. In this context, recent ESMA guidance on reverse solicitation suggests that new categories of products or services cannot be marketed under the reverse solicitation regime. To determine whether a product or service is considered to be ‘new’ for this purpose, ESMA requires a case-by-case assessment, having regard to their complexity and riskiness.⁷ In our view, such assessment must consider the comprehensive and ongoing nature of trading relationships between broker-dealers.

Continuing Dealer-to-Dealer Investment Services Post Brexit

UK and German broker-dealers who had an existing dealing relationship pre-Brexit legitimately established in accordance with EU passporting rights, must be protected post Brexit⁸. If UK broker-dealers merely continue to provide services or engage in activities with German broker-dealers which fall within the scope of their existing legitimate relationship, they should not be treated as ‘targeting’ the German market and, hence, not require a license in Germany.

For newly established relationships, it is important to consider how the international broker-dealer market works. International broker-dealers are regularly acting in the institutional markets to tap, provide and pool liquidity in financial instruments and to grant clients or counterparties access to such instruments.

When addressing counterparties in particular markets, such as Germany, international broker-dealers usually seek to tap the liquidity in financial instruments which are most actively traded in that market, or seek to diversify their market risk or counterparty credit risks by hedging their positions with local broker-dealers. This activity alone would not constitute a dealing on own account service (*Eigenhandel*), because the service provider in that case is not the UK broker-dealer seeking liquidity or a hedge, but the German broker-dealer providing that liquidity or acting as a hedging counterparty.

The activity of seeking liquidity locally often goes hand in hand with offering liquidity to local counterparties in respect of financial instruments for which liquidity is more readily accessible abroad, such as in the UK market, or through the intermediation of UK broker-dealers, in other markets around the globe. While this activity of UK broker-dealers may constitute a dealing on own account service (*Eigenhandel*), it is normally not ‘targeted’ at any particular local counterparty or market, but offered to all potential counterparties, irrespective of their location, who have or are interested in a dealing relationship with that UK broker-dealer. Where a UK broker-dealer’s liquidity offering is not specifically targeted at German broker-dealers, but offered on a global level, this would not constitute ‘targeting’ the German market and therefore not require a German license.

The participants in that market know each other, and it is often a question of mere chance whether one participant approaches the other to seek a price or to provide a price. Dealings among those broker-dealers are typically two-way, i.e. if a trading relationship is established, it is typically used by both sides for investment activities and investment services.

⁵ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

⁶ Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

⁷ ESMA Questions and Answers on MiFID II and MiFIR on investor protection and intermediaries topics of 3 October 2018 (ESMA35-43-349), Section 13, Questions 1 and 2 (last updated 25 May 2018).

⁸ This includes existing relationships which had been legitimately established between the UK broker-dealer and a (UK or other foreign) branch of the German broker-dealer, and where post Brexit the relationship is continued with the broker-dealer’s head office in Germany.

Where German broker-dealers decide to deal with UK broker-dealers on the basis of such a global offering, this should therefore, in our view, fall into the reverse solicitation exemption. This would also protect German broker-dealers' freedom to diversify their counterparties and hedging, and thereby improve financial stability.

In addition, we take the view that in those relationships not each and every transaction has to be assessed in respect of whether a particular type of transaction or product has been brought about through reverse solicitation. This approach reflects the practical reality that among institutional counterparties, in particular inter-dealer relationships, dealing services with regard to various types of transactions and products are provided in a high volume and frequency, and it is practically not possible to assess each and every transaction or type of transaction or product on a case-by-case basis. This approach is also supported by the principle of proportionality in EU and German law, as, under these circumstances, for dealings between licensed broker-dealers, a separate licensing requirement for UK broker-dealers would not be necessary to achieve the supervisory goals. Accordingly, we understand that ESMA's requirement to review whether a service was provided 'at the own exclusive initiative of the client' on a 'case-by-case basis for each investment service or activity provided'⁹ is subject to the scope of the request. In inter-dealer relationships, where dealing services are provided on an ongoing basis within an established business relationship, it is permissible, in our view, to refer to a category of investment services or activities for meeting this test, and not to each and every type of transaction or product.

Evidencing Existing Relationships

UK broker-dealers are well advised to satisfy themselves that they follow certain 'rules of the road' and establish related controls to ensure that their activities are not deemed to be 'targeting' the German market as a result of any improper marketing initiatives in Germany.¹⁰

UK broker-dealers may also wish to document their existing dealing relationship with German broker-dealers.

This note does not constitute or substitute legal advice. Each market participant should assess independently whether specific legal advice is required in relation to their business model.

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⁹ ESMA Questions and Answers on MiFID II and MiFIR on investor protection and intermediaries topics of 3 October 2018 (ESMA35-43-349), Section 13, Question 1 (last updated 25 May 2018).

¹⁰ This would also address Article 46 (5) s. 2 MiFIR which states: "An initiative by such clients shall not entitle the third-country firm to market new categories of investment product or investment service to that individual."