

**MEMO# 30777**

July 14, 2017

## **ESMA Publishes Brexit Related Opinions on Supervisory Convergence and Relocations from the UK to the EU27 - Member Call on 21 July 2017**

[30777]

July 14, 2017 TO: ICI Global Brexit Task Force  
ICI Global Regulated Funds Committee  
International Operations Advisory Committee  
International Operations Working Group RE: ESMA Publishes Brexit Related Opinions on Supervisory Convergence and Relocations from the UK to the EU27 - Member Call on 21 July 2017

The European Securities and Markets Authority (ESMA) has published the following two sets of Opinions to support supervisory convergence in the context of the United Kingdom's (UK) withdrawal from the European Union (EU):

- General principles to support supervisory convergence in the context of the UK withdrawing from the EU[\[1\]](#) (published on 31 May 2017);
- Sector specific principles in the areas of investment management[\[2\]](#), investment firms[\[3\]](#) and secondary markets[\[4\]](#) (published on 13 July 2017).

ICI Global will hold a member call to discuss the Opinions on Friday 21 July 2017 at 3pm BST/10am ET. Dial-in details for the call are below.

UK: 0330 336 0036  
US: 1 917 793 0005  
PIN: 066875

Other telephone numbers:

<https://static.powwownow.co.uk/media/pdf/Powwownow-Dial-in-Numbers.pdf>

If you wish to join the member call, please advise Lesley Dunn on +44 207 961 0830 or at [lesley.dunn@iciglobal.org](mailto:lesley.dunn@iciglobal.org).

### **Cross-Sectoral Opinion**

On 31 May 2017, ESMA published an Opinion setting out general principles to support

supervisory convergence in the context of the UK withdrawing from the EU (“the Cross-Sectoral Opinion”). The stated purpose of the Opinion is to achieve supervisory convergence by addressing regulatory and supervisory arbitrage risks that arise as a result of increased requests from financial market participants seeking to relocate in the EU27 within a relatively short period of time. The Cross-Sectoral Opinion focuses, in particular, on the UCITS Directive[5], AIFM Directive[6] and MIFID,[7] and sets out the following nine principles:

- No automatic recognition of existing authorisations;
- Authorisations granted by EU27 National Competent Authorities (NCAs) should be rigorous and efficient;
- NCAs should be able to verify the objective reasons for relocation;
- Special attention should be granted to avoid letter-box entities in the EU27;
- Outsourcing and delegation to third countries is only possible under strict conditions;
- NCAs should ensure that substance requirements are met;
- NCAs should ensure sound governance of EU entities;
- NCAs must be in a position to effectively supervise and enforce Union law;
- Coordination to ensure effective monitoring by ESMA.

Extracts of the Cross-Sectoral Opinion that are of particular relevance to regulated funds and asset managers include the following:

- An expectation that NCAs will check that the planned EU27-based activity is the main driver for relocation of entities, activities and functions, including obtaining information from an entity seeking authorisation on: (i) prospective investors or marketing and promotional arrangements; and (ii) location of development of products or services, to establish a clear view on the geographical distribution of planned activities (paragraphs 22 and 23);
- NCAs should reject any relocation request creating letter-box entities where, for instance, extensive use of outsourcing and delegation is foreseen with the intention of benefitting from an EU passport, while essentially performing all substantial activities or functions outside the EU27 (paragraph 28);
- NCAs should require that any outsourcing or delegation arrangements: (i) are clearly structured and set up in a way that does not hinder their ability to efficiently and effectively supervise; and (ii) should not have an impact on business continuity, confidentiality and conflicts of interest, which have to be appropriately managed[8] (paragraphs 31 and 34);
- ESMA expects that the key executives and senior managers of EU authorised entities are employed in the Member State of establishment and work there to a degree proportionate to their envisaged role, if not on a full-time basis (paragraph 38).

Other aspects of the Cross-Sectoral Opinion may be of relevance to regulated funds and asset managers, depending on their business operations. ESMA states that it stands ready to support further supervisory convergence in the areas covered by the Opinion, including through a new “Supervisory Coordination Network” that has been established by ESMA.

## **Sector Specific Opinion on Investment Management**

On 13 July 2017, ESMA published an Opinion to support supervisory convergence in the area of investment management in the context of the UK withdrawing from the EU (“the Investment Management Opinion”). The Opinion supplements the Cross-Sectoral Opinion in the areas of: (i) authorisation; (ii) governance and internal control; (iii) delegation; and (iv) effective supervision. Extracts of the Investment Management Opinion that may be of

particular relevance to regulated funds and asset managers include those outlined below.

### **Authorisation**

- Relocating UK entities should undergo the same authorisation procedure and be subject to the same standards as other applicants (paragraph 10);
- NCAs should give consideration to issues affected by relocation and to situations where the applicant is part of a group/has links with non-EU parties and should therefore assess any qualifying shareholders, group's business model/structure, the impact of potential (prudential) consolidated supervision or lack thereof, etc. (paragraph 13);
- NCAs should also scrutinise applications in order to ensure that the choice of the Member State for relocation is driven by objective factors and should carefully assess the geographical distribution of planned activities (paragraph 14);

### **Sound Governance**

- NCAs should be satisfied that relocating entities have established sound governance and internal control mechanisms (paragraph 18);
- NCAs should require detailed conflicts of interest policies and procedures and give particular consideration to any conflicts of interest which may arise when members of the governing/management body and, where it exists, supervisory function or staff members of authorised entities hold positions in other entities (paragraph 21);
- NCAs should assess and put additional scrutiny on individuals with high numbers of (executive or non-executive) directorships to ensure their legal and regulatory obligations and responsibilities as board members are being met (paragraph 23);

### **Calibration of governance structures and internal control mechanisms**

- Authorised entities should calibrate procedures, mechanisms and organisational structures to the size, nature, scale and complexity of their business and to the nature and range of activities carried out in the course of their business<sup>[9]</sup> (paragraph 25);
- Where e.g. authorised entities are of significant size, pursue complex investment strategies and/or invest in range of different asset classes or geographical regions, NCAs should request appropriate and sufficiently sophisticated governance structures (beyond the two minimum Senior Managers) in order to ensure that such entities have sufficient knowledge, experience and time commitment at Senior Management level (paragraph 27);
- NCAs should ensure that the organisational structure and human and technical resources of authorised entities as well as the configuration of their Senior Management allows them to contact and meet with Senior Managers and relevant staff during normal business hours (paragraph 28);

### **White-label business**

- NCAs should give special consideration to authorised entities engaged in the white-label business (i.e. fund managers that provide a platform to business partners by setting up funds at the initiative of the latter and typically delegating investment management functions to those initiators/business partners or appointing them as investment advisers) (paragraph 36);

## ***Assessment of delegation arrangements***

- NCAs should be satisfied that authorised entities have organisational policies and procedures in place in order to comply with the delegation requirements set out in the EU investment management legislation at all times (paragraph 38);
- NCAs should give special consideration to the appointment of investment advisers in order to ensure that the delegation rules set out in the EU investment management legislation are not circumvented (paragraph 40);

## ***Common interpretation and supervisory focus of delegation***

- ESMA is of the view that the interpretation of Article 13 of the UCITS Directive and the relevant national laws transposing this provision should be consistent with the principles set out in Articles 75 to 82 of the AIFMD Level 2 Regulation (paragraph 42);
- NCAs should be satisfied that there are objective reasons for delegation (paragraph 43), for example, optimise business functions and processes, save costs, benefit from additional expertise in administration or in specific markets or investment and access to global trading capabilities (paragraph 44);
- NCAs should therefore give special consideration to such delegation to non-EU entities arrangements and be satisfied that their implementation is justified based on objective reasons despite the additional risks which may arise from them (paragraph 47);
- NCAs should be satisfied that the non-EU entities to which portfolio management or risk management activities have been delegated are either: (i) subject to regulatory requirements on remuneration that are equally as effective as those applicable under the relevant ESMA guidelines; or (ii) appropriate contractual arrangements are put in place (paragraph 48);[\[10\]](#)

## ***Due diligence in selecting delegates***

- Due diligence undertaken during the process of selecting a delegate should “determine whether, having regard to the specific functions to be carried out by the delegate and taking into account all related benefits and risks, the potential delegate can be considered as most suitable for undertaking the delegated functions” (paragraph 50);

## ***Substance***

- Authorised entities should not delegate investment management functions to an extent that exceeds by a substantial margin the investment management functions performed internally... based on an assessment in relation to and at the level of each individual fund (paragraph 56);
- NCAs should apply additional scrutiny to situations where relocating entities, even those of smaller size employing simple investment strategies and having a limited range of business activities, do not dedicate at least 3 locally-based FTE (including time commitments at both Senior Management and staff level) to the performance of portfolio management and/or risk management functions and/or monitoring of delegates (paragraph 60);
- NCAs granting authorisations to relocating entities should not result in a situation in which these entities could continue to perform substantially more portfolio management and/or risk management functions for the relevant funds in their original Member State or third country on a delegation basis and therefore also maintain

substantially more relevant human and technical resources there despite a relocation (paragraph 61);

- NCAs should assess the qualitative criteria[\[11\]](#) for delegation on a case-by-case basis, in light of the principle that the entire delegation structure must be based on objective reasons and require detailed information and evidence from authorised entities on why delegation to non-EU entities to a larger extent is objectively justified despite the fact that the geographical spread of investments serves as an argument against such delegation structure[\[12\]](#) (paragraph 62);

### **Non-EU Branches**

- Where relocating entities intend to establish or maintain non-EU branches, NCAs should be satisfied that the use of non-EU branches is based on objective reasons linked to services provided in the non-EU jurisdiction and does not result in a situation where non-EU branches perform material functions or provide material services back into the EU[\[13\]](#) (paragraph 68).

### **Sector Specific Opinion on Investment Firms**

On 13 July, ESMA also published an Opinion to support supervisory convergence in the area of investment firms in the context of the UK withdrawing from the EU (“the Investment Firms Opinion”). The Opinion supplements the Cross-Sectoral Opinion and covers similar aspects to the Investment Management Opinion, including in the areas of: (i) authorisation; (ii) substance requirements; (iii) Outsourcing; and (iv) Non-EU Branches. The Investment Firms Opinion is of greater relevance to asset managers undertaking business covered by the MIFID framework.[\[14\]](#)

Many aspects of the Investment Firms Opinion are similar to those in the Investment Management Opinion. In some areas, the Investment Firms Opinion includes additional considerations for NCAs beyond those in the Investment Management Opinion. One such example is where investment firms intend to outsource portfolio management functions to non-EU entities with respect to portfolios investing in instruments issued by EU issuers or portfolios of collective undertakings located in an EU Member State. As well as NCAs assessing whether, in light of the geographical spread of investments and clients between the EU and non-EU markets, such outsourcing arrangements to non-EU entities are appropriate and objectively justified (as stated in the Investment Management Opinion), the Opinion also states that NCAs should carefully consider whether such outsourcing arrangements, in particular when there are alternative providers located in the EU, ensure compliance with the MiFID framework and firms’ duties towards clients.

Other aspects of the Investment Firms Opinion may be of relevance to regulated funds and asset managers, depending on their business operations.

### **Sector Specific Opinion on Secondary Markets**

On 13 July, ESMA also published an Opinion to support supervisory convergence in the area of secondary markets in the context of the UK withdrawing from the EU (“the Secondary Markets Opinion”). The Opinion covers regulatory and supervisory arbitrage risks stemming from third country trading venues relocating in the EU27 seeking to outsource activities to their jurisdiction of origin.

### **Next Steps**

NCAs across the EU will need to consider how to implement the Cross-Sectoral Opinion and the three sectoral opinions into their regulatory processes and framework. ESMA has stated

that it stands ready to support further supervisory convergence in the areas covered by the Opinion, including through a new Supervisory Coordination Network that it has established.

Giles Swan  
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#### **endnotes**

[1] ESMA Opinion: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31 May 2017, *available from* [https://www.esma.europa.eu/sites/default/files/library/esma42-110-433\\_general\\_principles\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_context\\_of\\_the\\_uk\\_withdrawing\\_from\\_the\\_eu.pdf](https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf)

[2] ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, 13 July 2017, *available from* [https://www.esma.europa.eu/sites/default/files/library/esma34-45-344\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_investment\\_management\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-45-344_opinion_to_support_supervisory_convergence_in_the_area_of_investment_management_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

[3] ESMA Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union, 13 July 2017, *available from* [https://www.esma.europa.eu/sites/default/files/library/esma35-43-762\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_investment\\_firms\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](https://www.esma.europa.eu/sites/default/files/library/esma35-43-762_opinion_to_support_supervisory_convergence_in_the_area_of_investment_firms_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

[4] ESMA Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union, 13 July 2017, *available from* [https://www.esma.europa.eu/sites/default/files/library/esma70-154-270\\_opinion\\_to\\_support\\_supervisory\\_convergence\\_in\\_the\\_area\\_of\\_secondary\\_markets\\_in\\_the\\_context\\_of\\_the\\_united\\_kingdom\\_withdrawing\\_from\\_the\\_european\\_union.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-154-270_opinion_to_support_supervisory_convergence_in_the_area_of_secondary_markets_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf)

[5] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), (OJ L 302, 17.11.2009, p. 32-96)

[6] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, (OJ L 174, 1.7.2011, p. 1-73).

[7] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1-44) and Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments



and amending Directive 2002/92/EC and Directive 2011/61/EU, (OJ L 173, 12.6.2014, p. 349–496).

[8] Paragraph 35 of the Cross-Sectoral Opinion also states that “certain key activities and functions should be present in the EU27. These activities and functions are key to the proper functioning of the regulated entity and consequently cannot be outsourced or delegated outside the EU; this is at least the case for the substance of decision-making”.

[9] Paragraph 25, Investment Management Opinion lists criteria that NCA should consider when assessing governance and internal control, including: assets under management); number of funds and share classes; complexity of investment strategies; type and range of asset classes invested in; geographical spread of investments; use of leverage; use of efficient portfolio management techniques; cross-border management or marketing activities; type and range of functions subject to delegation monitoring; provision of additional MiFID services; number and type of investors; frequency of investor subscriptions and redemptions; geographical distribution of marketing activities.

[10] Paragraph 48(b), Investment Management Opinion states that such contractual arrangements are to be “put in place with entities to which portfolio management or risk management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules set out in the ESMA guidelines; these contractual arrangements should cover any payments made to the delegates’ identified staff as compensation for the performance of portfolio or risk management activities on behalf of the authorised entity.”

[11] Article 82(1)(d)(i) to (vii) of the AIFMD Level 2 Regulation

[12] Paragraph 62, Investment Management Opinion lists an example of where authorised entities intend to delegate portfolio management and/or risk management functions to a larger extent to non-EU delegates with respect to (i) UCITS investing in transferable securities issued by EU issuers or (ii) EU AIFs investing in real estate or portfolio undertakings located in an EU Member State.

[13] Paragraph 68, Investment Management Opinion lists the example of situations in which the use of non-EU branches may be considered to be based on objective reasons include where authorised entities provide services in the non-EU jurisdiction, require local marketing support or for the purposes of handling consumer complaints in the relevant non-EU country.

[14] Directive 2004/39/EC (MiFID I), Directive 2014/65/EU (MiFID II) and Regulation (EU) No 600/2014 (MiFIR)