



Opinions issued by the European Securities and Markets Authority to support supervisory convergence in the context of the United Kingdoms withdrawal from the European Union. October 2017.

On 29 March 2017 the United Kingdom (UK) notified the European Council of its intention to leave the European Union (EU) in accordance with the procedures set out in Article 50 of the Treaty on European Union.

In this new context of impending “Brexit” the European Securities and Markets Authority (ESMA) anticipated a surge in applications from UK market participants looking to relocate their business to one of the 27 remaining EU member states (EU27) so as to keep their European passport. It therefore issued an Opinion to national competent authorities (NCAs) intended to bolster supervisory convergence and avoid regulatory arbitrage as the process plays out. The opinion sets out a number of principles, derived from European legislation, that NCAs should apply when handling such applications so as to ensure coherent and consistent application of harmonised requirements across all Member States. ESMA is particularly concerned to avoid NCAs authorising letter-box entities, where UK market participants relocate to the EU27 but then use outsourcing and delegation arrangements to transfer a substantial part of their business activities to a third country.

ESMA also issued three sector-specific Opinions, detailing how these principles should be interpreted in the areas of *investment management*, *investment firms* and *secondary markets*.

In addition, to promote supervisory convergence on practices for authorising British entities relocating to the EU27, ESMA has set up a Supervisory Coordination Network, incorporating representatives from all NCAs.

For further information, please, [click here](#).

OPINION ON THE GENERAL PRINCIPLES TO SUPPORT SUPERVISORY CONVERGENCE IN THE CONTEXT OF BREXIT

The general principles included in this Opinion are:

PRINCIPLE ONE: no automatic recognition of existing authorisations

Once the UK leaves the European Union (EU) any British entity that wishes to continue to benefit from the passport will have to establish itself in one of the 27 remaining EU Member States. ESMA is asking NCAs that when authorising such cases they do not just automatically recognise authorisations already granted in the UK.

PRINCIPLE TWO: Authorisations granted by EU27 NCAs should be rigorous and efficient

ESMA notes that NCAs are obliged to satisfy themselves that regulatory requirements for authorisation are met from day one of the authorisation. It therefore considers it fundamental that NCAs have access to all necessary information, including a programme of activities from the applicant. However, it accepts that as UK entities are currently subject to European regulations NCAs can have regard to some assessments carried out by UK

authorities where the essential requirements are unaffected by relocation. Nevertheless, ESMA asks authorities to pay special attention in their assessments to matters of corporate governance, human and technical resources, geographical distribution of activities and outsourcing and delegation arrangements.

PRINCIPLE THREE: NCAs should be able to verify the objective reasons for relocation

ESMA expects NCAs to check that relocation applications are driven by applicant entities' intention to carry out their business in these countries and not intended merely to sidestep stricter requirements in other member states. They should therefore check if the transfer reflects objective factors by, for instance, looking at information on the geographical spread of the planned activities in the firms' programmes of activities, including points such as the location of product and service development, prospective investors or marketing and promotional plans.

PRINCIPLE FOUR: Avoid letter-box entities in the EU27

ESMA asks that NCAs reject any applications made with the clear intention of creating letter-box entities so firms can benefit from a European passport, for instance when the most substantial activities are going to be carried on outside the EU27 or through branches opened in third countries.

PRINCIPLE FIVE: Outsourcing and delegation to third countries is only possible under strict conditions

ESMA asks NCAs to exercise prudence when deciding the extent to which applicants can rely on outsourcing and delegation arrangements. It reminds them that, in some cases, European regulations make such arrangements conditional on prior cooperation agreements between EU NCAs and the authorities of the third country where the activity is to be outsourced or delegated.

PRINCIPLE SIX: NCAs should ensure that substance requirements are met

ESMA asks that NCAs obtain information on the activities being outsourced or delegated and the branches where these are carried out so that they can be properly supervised. It also reminds NCAs that activities key to the proper functioning of the delegated entity cannot be outsourced or delegated outside the EU, including the substance of decision-making or, in certain sectors and circumstances, internal control, IT control infrastructure, risk assessment, compliance and key management or sector-specific functions.

PRINCIPLE SEVEN: NCAs should ensure sound governance of EU entities

ESMA asks NCAs to make sure applicant entities locate decision-making powers within the Member State in which they are established. To this end, they should assess whether the presence of key executives and senior managers in their territory is proportionate to their responsibilities. It further reminds NCAs of their obligation to check that applicants meet all requirements on governance, capital and liquidity and have the competence to monitor the delegated or outsourced activities.

PRINCIPLE EIGHT: NCAs must be in a position to effectively supervise and enforce EU law

ESMA asks that NCAs have the resources and powers to properly monitor application of legislation and market developments. It further demands that NCAs have the right to carry out on-site inspections of delegated or outsourced activities without having to seek prior authorisation from any third party.

PRINCIPLE NINE: coordination to ensure effective monitoring by ESMA

ESMA states that it intends to use all the supervisory convergence instruments available to it to prevent regulatory arbitrage. To this end, it will not only provide opinions to NCAs, run peer reviews and initiate

investigations of possible breaches of Union law but will also create a forum for the discussion of market participants seeking to relocate to the EU27 called the *Supervisory Coordination Network*.

OPINION TO SUPPORT SUPERVISORY CONVERGENCE IN THE AREA OF INVESTMENT MANAGEMENT IN THE CONTEXT OF BREXIT

This Opinion sets out principles that NCAs should take into account when handling applications to relocate by managers of undertakings for collective investment in transferable securities (UCITS), self-managed investment companies and managers of alternative investment funds (AIFMs) in the context of Brexit. Areas considered include:

Authorisation

ESMA asks NCAs to check that where the applicant entity forms part of a group its structure poses no obstacles to effective supervision.

Governance and internal control

European legislation on asset management require that management decisions on authorised entities shall be taken by at least two senior managers, without prejudice to the board of directors' ultimate responsibility. ESMA asks NCAs to make sure that applicants meet this requirement and even to demand higher numbers of senior managers if the nature, complexity or size of the proposed businesses warrants. It also urges authorities to apply these criteria when analysing whether governance and internal control mechanisms are adequate –e.g. managers responsible for internal control are independent of those with risk-taking operational responsibilities–.

ESMA also demands that NCAs assess potential conflicts of interest, such as when employees of an investment manager also have responsibilities in one of its service providers or that individuals managing several departments have the experience and capacity to discharge all their different responsibilities.

If, as a result of Brexit, firms engaged in “white label” business end up managing more assets ESMA wants NCAs to make sure they have the structure and resources to manage the increased business properly.

Delegation

ESMA considers that investment activities have been delegated when an entity bases its investment decisions on the opinion of an adviser without carrying out any kind of qualified analysis on its own behalf. That said, it reminds authorities that authorised entities must continue to exercise investment management functions for each fund they manage and cannot be permitted to wholly delegate portfolio or risk management. Further, entities relocating to the EU27 must dedicate at least three full-time employees –including both managers and employees– to portfolio and risk management activities or, if these have been delegated, to monitoring such activities.

ESMA also asks that when entities delegate either of these two activities to management entities established outside the EU, NCAs make sure the delegated entity complies in some way with ESMA's guidelines on remuneration.

It also reminds NCAs that they should approve due diligence procedures related to the delegation of functions.

Finally, ESMA considers that the principles in level 2 regulations on alternative investment fund management firms (AIFMs) apply in the area of UCITS.

OPINION TO SUPPORT SUPERVISORY CONVERGENCE IN THE AREA OF INVESTMENT FIRMS IN

THE CONTEXT OF BREXIT

This Opinion summarises the principles that NCAs must consider when dealing with investment firms relocating to their territory in the context of Brexit.

Authorisation

As in the area of asset management, ESMA asks NCAs to check that when the applicant forms part of a group the group's structure poses no obstacle to effective supervision.

Governance and internal control

Board members and senior managers are required to have the necessary knowledge and expertise and dedicate sufficient time to efficiently manage the entity. The document now requires NCAs to check that at least two of the firms' managers meet these criteria though this should be done bearing in mind the principle of proportionality. NCAs should bear the same principle in mind when assessing applicants' governance structures, internal control mechanisms and human and technical resources.

The document also emphasises that internal control functions should be separated from operational units and, where an entity forms part of a group, NCAs should check that communication channels between entity and group do not compromise the independence of internal control functions.

Also, ESMA asks that NCAs pay special attention to whether an entity only uses a trading venue for order execution or whether this venue is established outside the EU, as it may not be acting in the best interests of its clients. It also asks authorities to review how entities will manage the additional risks of providing cross-border services.

Outsourcing

ESMA reminds NCAs of the prohibition on outsourcing arrangements that affect the functions of senior managers and involve a change in the entity's relationship and obligations to its clients.

It also noted that NCAs should approve the due diligence procedures that entities use when picking outsourced service providers and follow-up monitoring procedures. They should also be able to access outsourcing contracts, any other information they need to carry out effective supervision and even the premises of service providers.

It also recommends that some activities, such as underwriting, not be outsourced to third countries.

OPINION TO SUPPORT REGULATORY CONVERGENCE IN THE AREA OF SECONDARY MARKETS IN THE CONTEXT OF BREXIT

The Opinion on secondary markets basically focuses on the risks of regulatory and supervisory arbitrage that could arise when UK trading venues relocate to the EU27 but plan to outsource the conduct of their business back to their country of origin. In particular, ESMA sees greater risks if the service provider of the trading venue is located outside the EU. It therefore asks NCAs reviewing outsourcing agreements to take into account the scale, scope and type of activity being outsourced.

It also asks NCAs to take the following steps in relation to outsourcing arrangements:

Outsourcing arrangements

ESMA asks NCAs to check that outsourcing arrangements do not alter the responsibilities of trading venues' board members and senior managers.

Due diligence

ESMA asks NCAs to make sure trading venues have due diligence procedures for selecting service providers and for adequately monitoring their outsourced activities. NCAs should also review outsourcing contracts and other relevant information.

Outsourcing of key activities to third countries

ESMA considers the operation of the trading system to be a key activity for trading venues. It therefore asks NCAs to make sure that decisions on their design, control and monitoring should not be outsourced outside the EU. It makes the same recommendation for other activities deemed key, such as admission to trading, suspension and removal of financial instruments from trading and mechanisms to halt trading although it accepts that some technical arrangements can be located outside the EU. In any event, it reminds NCAs that they must reject arrangements that do not allow them to exercise effective supervision.

Exercise of substance of activities in EU territory

ESMA reminds NCAs that firms claiming to exercise the substance of an activity in the EU27 must have enough employees resident in the Union to do so.

Effective supervision of outsourcing arrangements with third-country service providers

To ensure effective supervision ESMA stresses that NCAs should sign cooperation agreements with the supervisory authority of any third country to which a trading venue is outsourcing certain aspects of its operations or key functions.

Finally, the Opinion states that the principles in the opinion on investment firms in the context of Brexit also apply where relevant.

Links:

[General principles to support supervisory convergence in the context of the United Kingdom in the context of the United Kingdom withdrawing from the European Union](#)

[General principles to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union](#)

[General principles to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union](#)

[General principles to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union](#)