

# Client Update

## ESMA Publishes Opinion on Supervisory Approach to Relocations from the United Kingdom

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### BACKGROUND

On 29 March 2017, the United Kingdom notified the European Council of its intention to withdraw from the European Union (“Brexit”). Against this background the European Securities and Markets Authority (“ESMA”) expects a higher number of UK-based market participants to relocate entities, activities or functions to the remaining 27 EU Member States (“EU27”) in order to maintain access to the European financial markets in the event that no alternative passporting arrangements are agreed during the Brexit negotiations. In that context, on 31 May 2017, ESMA [published an opinion](#) (“Opinion”) addressed to the national competent authorities of the EU27 and the EEA States Norway, Liechtenstein and Iceland (“NCA”). The Opinion seeks to ensure that the conditions for authorisation, as well as for outsourcing and delegation, do not generate supervisory arbitrage risks. According to ESMA, the relocation of entities, activities and functions following Brexit will create a unique situation which requires a common effort at EU level to ensure a consistent supervisory approach.

The Opinion covers in particular the AIFMD, the UCITS Directive, MiFID I and MiFID II, but it does not address the third-country access provisions in MiFID II, nor does it discuss the third-country passport provided for in the AIFMD, which has yet to be implemented and whose introduction is likely to be postponed further due to the Brexit negotiations. The Opinion assumes that the United Kingdom will become a third country after Brexit (without prejudice to any specific arrangements that may be reached between the United Kingdom and the European Union).

We believe that, in many respects, the Opinion goes beyond what is actually required under the applicable laws, and it is to be hoped that there will be further

discussion and that a reasonable interpretation and application of the existing laws will be applied.

We summarise below the nine principles set out by ESMA regarding relocation of functions and entities:

### **NO AUTOMATIC RECOGNITION OF EXISTING AUTHORISATIONS**

Following Brexit, and on the assumption that the United Kingdom becomes a third country for these purposes, UK-based entities may not rely on the authorisation granted by the UK regulator. ESMA's reasoning is that EU law does not foresee the recognition of authorisations granted by third country authorities. Therefore, at least until a third-country passport is introduced, third-country entities (including UK-based entities after Brexit) will need to seek an authorisation from an NCA in order to establish themselves in the European Union and to be able to benefit from the EU passport. (It is, of course, possible for an alternative approach to be negotiated as part of the United Kingdom's exit arrangements, but that is not discussed by ESMA and would seem unlikely.)

### **AUTHORISATIONS GRANTED BY EU27 NCAs SHOULD BE RIGOROUS AND EFFICIENT**

ESMA emphasises that NCAs should satisfy themselves that the entity has provided sufficiently detailed information to allow a proper assessment that the entity complies with the requirements under the relevant legislation and ESMA guidance from day one. Particular scrutiny should be applied to an entity's governance structure, human and technical resources and geographical distribution of activities, as well as outsourcing and delegation arrangements.

Where appropriate, the NCAs may take some aspects of the assessment of third-country regulators into consideration; for example, the fit and proper requirements.

### **NCAs SHOULD BE ABLE TO VERIFY THE OBJECTIVE REASONS FOR RELOCATION**

NCAs are expected to check that the planned EU27-based activity is the main driver for the request to relocate an entity, activities and functions. The entity is expected to provide a clear justification for relocating to a specific Member State. Particular scrutiny should be applied by the NCAs to applications where it appears that an entity intends to pursue the greater part of its activities in other Member States (or non-EU countries). *An NCA shall only grant authorisation in*

*such a case if it is “fully satisfied” that the Member State of establishment was not chosen for the purpose of evading stricter standards in force in other Member States.*

In order to assess and understand the operations of the applying entity, NCAs should obtain information on prospective investors or marketing and promotional arrangements and the location of development of products or services.

### **SPECIAL ATTENTION SHOULD BE GRANTED TO AVOID LETTER-BOX ENTITIES IN THE EU27**

If an entity makes extensive use of outsourcing and delegation agreements with the intention of benefitting from an EU passport, while all substantial activities or functions are performed outside the EU27, this entity could qualify as a “letter-box” entity. In order to ensure that an NCA can control and supervise effectively, NCAs are instructed by ESMA to reject any such relocation request. Similar considerations may apply if entities perform substantial activities and functions through third-country branches.

### **OUTSOURCING AND DELEGATION TO THIRD COUNTRIES IS ONLY POSSIBLE UNDER STRICT CONDITIONS**

Under existing EU law, although certain functions and tasks may be outsourced or delegated, the entity outsourcing or delegating remains fully responsible for those tasks and functions. In the Opinion, ESMA reminds the NCAs to remain prudent when determining the extent to which an entity can rely on outsourcing or delegation, in particular because under certain EU legislation the outsourcing or delegation to a third country may be subject to the conclusion of prior agreements between the respective regulatory authorities.

### **NCAs SHOULD ENSURE THAT SUBSTANCE REQUIREMENTS ARE MET**

Outsourcing or delegation arrangements need to be structured in a way that does not hinder the ability of the NCA to efficiently and effectively supervise. In addition, they must not prejudice business continuity, confidentiality and conflicts of interest, which have to be appropriately managed.

ESMA says that this means that certain key activities and functions which are vital to the proper functioning of the regulated entity need to stay within the EU27. They cannot be outsourced or delegated outside the European Union. *According to ESMA this applies particularly to the “substance of decision-making”, as well as, depending on the sector-specific circumstances in each case, internal control functions, IT control infrastructure, risk assessment, compliance functions,*

*key management functions and sector-specific functions.* In this respect, ESMA's position is not particularly clear, especially given that delegation of certain important functions is clearly permitted under current law, subject to certain conditions.

### **NCA<sub>s</sub> SHOULD ENSURE SOUND GOVERNANCE OF EU ENTITIES**

Effective decision-making powers with respect to compliance need to remain within the EU27, even if the entity is part of a corporate group. *To ensure that executive board members and/or senior management are able to carry out their responsibilities effectively, ESMA expects that they are to be 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.* Again, we believe that such a view is not consistent with the current legal requirements if it is taken to mean that executive board members of the group have to be employed by the relevant EU entity.

### **NCA<sub>s</sub> MUST BE IN A POSITION TO EFFECTIVELY SUPERVISE AND ENFORCE EU LAW**

ESMA emphasises the fact that NCA<sub>s</sub> must be in a position—both with respect to resources as well as capacities—to monitor the effective application and enforcement of EU law. NCA<sub>s</sub> are not only obliged to ensure that the requirements are adhered to at the time of authorisation, but also on a continuous basis. Any outsourcing or delegation must not impair an NCA's ability to enforce relevant legislation.

### **COORDINATION TO ENSURE EFFECTIVE MONITORING BY ESMA**

Accompanying measures to provide support to the NCA<sub>s</sub> that will be taken by ESMA include:

- Establishment of a forum—the Supervisory Coordination Network—to allow NCA<sub>s</sub> to report on and discuss cases of relocations. The Supervisory Coordination Network will also be put in place with a view to promoting consistent decisions.
- ESMA is prepared to take further measures to support supervisory convergence, including issuing Q&As, providing additional opinions to NCA<sub>s</sub> and conducting peer reviews.
- ESMA intends to develop further guidance (opinions) with respect to asset managers, investment firms and secondary markets to provide sector-specific details on the aspects described in the Opinion.

## CONCLUSION

Although relatively high level, this Opinion gives a clear indication of ESMA's approach to Brexit-driven relocations, as well as with respect to the forthcoming sector-specific guidance. It remains to be seen how individual NCAs will interpret this Opinion. However, ESMA's Opinion explicitly and/or implicitly makes clear that:

- ESMA is keen to mitigate any supervisory arbitrage from the outset and does not wish to see excessive competition between the NCAs when it comes to making themselves available to relocating UK entities.
- ESMA takes a critical view of structures which merely aim at acquiring an EU passport, while the majority of work is outsourced or delegated back to the United Kingdom (or another third country). If ESMA insists on these positions, UK entities wishing to relocate to the EU27 will need to demonstrate real substance in their Member State of establishment in order to avoid being classed as a letter-box entity.

We will continue to monitor any related developments very closely and remain at your disposal should you have any questions.

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Please do not hesitate to contact us with any questions.