

# Client Update

## ESMA's Guidelines on Relocations from the UK Round 2: More Substance, Less Flexibility

Only a few weeks after the European Securities and Markets Authority (“ESMA”) published general principles on the requirements for UK-based alternative investment fund managers (“AIFMs”) and investment firms seeking to relocate to another EU member state in anticipation of Brexit (client update [here](#)), ESMA has now published more specific guidance on the same topic. As before, this guidance is addressed to the national competent authorities (“NCAs”) of the 27 member states remaining in the EU after Brexit (“EU27”). In its new guidance, ESMA repeats the general principles laid down in its previous opinion but, unhelpfully, provides more concrete views on several specific issues.

### **BUT IS IT ALL ABOUT BREXIT?**

It is clear that ESMA's guidance is mainly motivated by the expected relocations from the UK of firms that want to continue to take advantage of various EU-wide passports after the UK leaves the EU. But, in practice, the guidance will have an effect on all EU AIFMs and investment firms. ESMA seems to be using the opportunity to impose more stringent rules, to push for greater harmonisation, and to establish EU-wide supervisory standards for matters such as corporate governance, substance and delegation.

### **CHOICE OF LOCATION MUST BE SUPPORTED BY FOCUS OF PLANNED ACTIVITIES**

ESMA's position is based on the assumption that the UK will become a “third country” post-Brexit, with no special regulatory relationship with the EU. Therefore, it says, UK-based applicants will need to complete the authorisation procedure without any derogations or exemptions.

As already set out in its previous opinion, ESMA stresses that the choice of a new host member state by a UK –based AIFM or investment firm must be driven **by objective factors**. In ESMA's view, a UK market participant's choice should be subject to additional scrutiny by the new host member state NCA, taking into account the geographical centre of its planned activities (for example, the program of operations, prospective investors, promotional arrangements and the

language of offering or promotional materials). If an NCA comes to the **(subjective) conclusion** that an applicant opted for a jurisdiction in order to evade stricter standards in another member state, within which the applicant intends to carry out the greater part of its activities, ESMA says that the relevant NCA should not grant authorisation.

### GOVERNANCE: AT LEAST TWO SENIOR MANAGERS; LIMITATIONS FOR INDIVIDUALS HOLDING SEVERAL DIRECTORSHIPS

As before, ESMA stresses that NCAs must assess the governance and internal control mechanisms for each applicant on a case-by-case basis; they need to take into account certain criteria, in particular the size, nature, scale and complexity of the applicant's business. In its current opinion, ESMA gets more specific and requires a minimum number of **senior managers** (at least 2, perhaps more) to ensure that there is sufficient knowledge, experience and time commitment at the senior management level. The applicant's internal control function must play a strong role within the organization and must be consulted before any significant strategic decisions are taken.

ESMA also directs NCAs to scrutinise carefully **individuals with high numbers of** (executive and non-executive) **directorships** to ensure they have enough time to meet all their commitments. ESMA also asks NCAs to consider publishing guidance on **appropriate thresholds** (in terms of aggregate time commitment) for these positions.

### "RENTED AIFM" UNDER SCRUTINY

ESMA recognises the so-called "**white-label concept**" of rented AIFMs. "White-label business" describes AIFMs that act as authorised AIFMs for unaffiliated fund sponsors. The rented AIFM is usually advised by the fund sponsor or portfolio management is delegated by the rented AIFM to the fund sponsor. ESMA anticipates that some UK market participants, instead of relocating to the EU themselves, will make increasing use of rented AIFMs, and fears that, as a result of this increase in business, such AIFMs may face additional operational risks. ESMA therefore recommends that NCAs should check whether the resources, management structure and control mechanisms of rented AIFMs are appropriate.

### DELEGATION UNDER SCRUTINY

ESMA repeats its previously stated (and controversial) position that any function set out in Annex I of the AIFMD is delegated when it is not performed internally by the AIFM. This includes administrative tasks, marketing and other activities related to the fund's assets (for example, facility management). In addition, ESMA suggests applying a similar approach to other critical functions (for example, IT).

ESMA reiterates that an AIFM must not delegate portfolio and risk management functions to the extent that they substantially exceed the retained, internally performed functions. This

applies at the level of **each fund**, meaning that an AIFM must perform investment management functions for each fund it manages. An AIFM **cannot both delegate portfolio and risk management functions in their entirety for a single fund** (even when such functions are performed for other funds).

### ADVISORY ARRANGEMENTS UNDER SCRUTINY

ESMA recommends that NCAs should pay particular attention to advisory agreements. ESMA stresses that an AIFM must not be bound to follow the recommendations received from its investment adviser. The AIFM must conduct its own analysis and not simply follow the advice received. A mere formal or rote assessment as to whether the proposed investment complies with the investment restrictions does not suffice. If the AIFM follows the recommendations without its own substantive analysis, the advisory arrangement will constitute a **delegation of investment management activities**. The AIFM should document its own substantive analysis and keep appropriate records.

### SETTING UP BRANCHES OUTSIDE THE EU

According to ESMA, an EU AIFM is able to establish a branch in a third country. The law is ambiguous in this regard, and until now this has not been clearly established, but according to ESMA it should be possible if there are objective reasons for the establishment of that branch linked to activities performed in the third country (for example, handling investors from the third country), and if the branch does not provide material functions for the AIFM.

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Overall, the guidelines seem like an attempt by ESMA to tighten standards generally, in particular with respect to delegation, substance and corporate governance requirements for EU-authorized AIFMs and investment firms. Therefore, ESMA's position impacts not only UK firms relocating to the EU but all EU market participants. If applied on an EU-wide basis, such guidelines are likely to have a substantial impact on cross-border structures.

Please do not hesitate to contact us with any questions.

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