

ESMA ISSUES OPINION ON SUPERVISORY APPROACH TO BREXIT-RELATED RELOCATIONS FROM THE UK

On 31 May 2017, the European Securities and Markets Authority (ESMA) published an opinion setting out nine principles to support supervisory convergence in the context of relocations from the UK, following the UK's decision to leave the EU. The opinion is addressed primarily to national regulators – also known as national competent authorities (NCAs) – of the 27 Member States that will remain in the EU (EU27) but it will be relevant to firms considering relocating entities, activities or functions from the UK, including through use of delegation structures.

Overview

In order to maintain access to EU financial markets following the UK's withdrawal from the EU, UK-based market participants may seek to relocate entities, activities or functions to the EU27. In this context, ESMA sets out principles for a common supervisory approach across the EU27 for authorisation and ongoing supervision of firms relocating to the EU27, including in relation to outsourcing and delegation arrangements.

There are a couple of broad concerns that underpin these principles:

- ESMA is seeking to address regulatory arbitrage risks and ensure that NCAs seeking to attract new business from the UK do not do so on the basis of regulatory or supervisory competition. In particular, ESMA states that NCAs should not grant authorisations where an applicant is seeking to evade stricter standards in force in other Member States and that outsourcing or delegation arrangements should not result in creation of "letter-box entities" in the EU27.
- ESMA warns NCAs of the need to ensure they have sufficient resources and capacity to handle an increase in requests from UK financial market participants seeking to relocate to the

EU27 within a relatively short period of time.

Our view

Any competition between EU27 NCAs for relocating UK firms is hard to quantify, because it will take place behind closed doors. The fact that ESMA has issued this opinion is evidence that ESMA has identified a real risk of competition between regulators, leading to a weakening of supervision and regulatory harmonisation. The opinion may be intended as a "warning shot" to EU27 NCAs. Therefore, the importance of this opinion may lie not in its statement of principles (which do not say anything materially new or surprising), but in how EU27 NCAs react. Will they alter their messaging to UK firms looking to relocate?

ESMA has indicated that it will also publish sector specific guidance, e.g. specific to the relocation of MiFID investment firms. This sector specific guidance may contain material changes to existing principles and rules. The key development to watch out for will be any indication of a material increase in local substance requirements, or any material increase in the conditions to be met before delegation by an EU27 firm is permitted. Such developments would be likely to

Principles

- No automatic recognition of existing authorisations
- Authorisations granted by EU27 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

require some UK firms to change their proposed post-Brexit models.

Some of the commentary accompanying the principles is of particular interest to firms when considering their relocation business plans and presenting application proposals to EU27 NCAs. For example,

ESMA expects that the key executives and senior managers of an EU-authorised entity will be employed and work in the Member State in which it is established, to a degree proportionate to their role.

ESMA's opinion is predicated on the assumption that the UK will become a "third country" (i.e. a non-EU jurisdiction) after its withdrawal from the EU. However, ESMA notes this is without prejudice to any arrangements that may be agreed between the UK and the EU.

Principles

No automatic recognition of existing authorisations

EU27 NCAs cannot automatically recognise existing authorisations granted by a UK regulator to an entity that is seeking to relocate, as there is no basis for automatic recognition of authorisations granted by third country authorities in EU law. ESMA encourages firms seeking to relocate to approach the relevant NCA as soon as possible.

Authorisations granted by EU27 NCAs should be rigorous and efficient

When assessing applications for authorisation, NCAs should ensure that the applicant will meet relevant regulatory requirements from the point of authorisation.

Whilst it may be appropriate for NCAs to take into account aspects of assessments previously carried out by UK regulators, ESMA directs NCAs to apply "strong scrutiny" to governance structures, human and technical resources, geographical distribution of activities and outsourcing and delegation arrangements.

NCAs should be able to verify the objective reasons for relocation

ESMA expects NCAs to ensure that applicants have a "clear justification" for relocating to the Member State of

establishment, which should be driven primarily by the applicant's planned activities within the EU27.

NCAs should have a clear view on the geographical distribution of planned activities and obtain information about whether applicants have engaged with, or had applications rejected by, other NCAs.

ESMA warns against the risk of regulatory arbitrage, particularly where it appears an entity intends to pursue the greater part of its activities in another Member State, and states that an NCA should only grant authorisation if it is fully satisfied that the applicant is not seeking to evade stricter standards in force in another Member State.

Special attention should be granted to avoid letter-box entities in the EU

ESMA directs NCAs to reject relocation requests that would create letter-box entities in the EU, for example where a firm seeks to benefit from an EU passport while essentially performing all substantial activities or functions outside the EU27 through use of extensive outsourcing and delegation arrangements.

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

ESMA reiterates the general principle that EU market participants remain responsible for, and must be able to direct and control, tasks and functions that they have outsourced or delegated.

It also notes that under some EU legislation (such as outsourcing of critical or important functions under MiFID II), the ability of a firm to outsource or delegate to a third country entity is conditional on there being a cooperation agreement in place between the EU NCA and third country authority.

NCAs should ensure that substance requirements are met

In the context of outsourcing and delegation arrangements, ESMA notes that:

- the arrangements should not hinder effective supervision by NCAs;
- NCAs should have effective access to data and business premises of the outsourcee or delegate; and
- the arrangements should not impact business continuity, confidentiality and conflicts of interest.

ESMA asserts this implies that certain key activities and functions should not be outsourced or delegated outside the EU, and that in some circumstances it may not be appropriate for a firm to outsource or delegate certain important functions or activities at all. ESMA gives several examples of these important activities and functions, including internal control functions, IT control infrastructure, risk assessment, compliance, and key management functions.

NCAs should ensure sound governance of EU entities

NCAs should satisfy themselves that board members and senior management of an EU authorised entity have effective decision making powers in relation to compliance with EU law (including where the entity is part of a group) and have sufficient knowledge and experience and dedicate sufficient time to carry out their responsibilities.

ESMA also expects that the key executives and senior managers of an EU-authorised entity will be employed and work in the Member State in which it is established to a degree proportionate to their role. ESMA does indicate that there may be some flexibility, particularly for smaller firms where exercise of some

of these functions may not constitute a full-time occupation.

NCA's must be in a position to effectively supervise and enforce Union law

NCA's should have adequate resources and capacity to monitor firms' compliance with relevant legislation and respond to market developments. In the context of outsourcing and delegation, NCA's should be able to conduct on-site inspections of outsourced or delegated activities, without any prior third party authorisation.

ESMA also emphasises the need for co-operation between NCA's, and with third country authorities such as the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

Coordination to ensure effective monitoring by ESMA

ESMA intends to establish the Supervisory Coordination Network, which is a forum to allow NCA's to report on and discuss cases of relocating UK market participants and to promote consistent decisions by NCA's across the EU27.

ESMA is prepared to take further measures to support supervisory convergence, including providing additional opinions to NCA's, conducting peer reviews and investigating any possible breaches of EU law.

ESMA also intends to develop sector-specific opinions relevant to asset managers, investment firms and secondary markets.

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