



ESMA Issues Investment Management Opinion on Brexit Relocations

On 29 March 2017, the UK informed the Council of the European Union of its intention to withdraw from the EU ("**Brexit**"). Consequently, faced with the prospect of losing their EU passporting rights, many UK investment management entities are in the process of relocating to one of the remaining EU member states ("**EU27**"). Fears that these relocation decisions are being influenced by potential regulatory arbitrage has prompted the European Securities and Markets Authority ("**ESMA**") to issue general and sector-specific opinions to the EU27 regulators outlining minimum authorisation and supervisory standards to be applied to relocating entities.

Cross-sectoral Opinion

ESMA's [first opinion](#) addressing this risk of potential regulatory arbitrage was issued to national competent authorities (the "**NCA**s") of the EU27 (including the Central Bank of Ireland (the "**CBI**")), on 31 May 2017. In it ESMA prescribed nine high level principles (the "**Principles**") aimed at fostering consistency in the authorisation and supervision of relocating AIFMs, UCITS management companies (including entities authorised to act as both an AIFM and a UCITS management company) and MiFID firms. The Principles provide that the EU27 NCAs should:

1. Not provide automatic recognition to an EU27 entity based on an existing authorisation of an affiliated entity in the UK;
2. Rigorously assess applications for authorisation by EU27 entities;
3. Be able to verify the objective reasons for a relocation;
4. Avoid the authorisation of letter-box entities;
5. Ensure that outsourcing and delegation to entities in non-EU countries is only possible under strict conditions;
6. Ensure that an EU27 entity has sufficient substance;
7. Ensure that an EU27 entity complies with sound governance requirements;
8. Have adequate resources and capacity to monitor, supervise and enforce EU law;
9. Co-ordinate with each other to ensure effective monitoring by ESMA.

ESMA also signalled its intent to publish further sector specific opinions, which would add more detail to the high-level Principles. On 13 July 2017, ESMA held true to its stated intention and published three further sector-specific opinions, including one on investment management.

Investment Management Opinion

The [Investment Management Opinion](#) (the "Opinion"), (again addressed to the EU 27 NCAs) covers authorised UCITS management companies, self-managed investment companies and authorised AIFMs (the "**Entities**"). The Opinion assumes that the UK will become a third country after its withdrawal from the EU, which is currently scheduled to occur on, or before, 30 March 2019 and adds more detail to the Principles regarding: Authorisation; Governance and Internal Control; Delegation; and Effective Supervision and essentially acts as indirect guidance to relocating Entities on compliance with authorisation and supervision standards. This guidance could also be used to inform the drafting of application documentation.

Helpfully, there seems to be some interplay between certain aspects of the Opinion and the CBI's [Fund Management Company Guidance](#) ("**CP86**"), which has the stated aim of "...*enhancing the effectiveness of fund management companies...*". CP86 addresses the allocation of managerial functions in Entities, the requirement for written policies and procedures and the required interaction of Entities with the CBI, amongst other matters. As we consider some of the key aspects of the Opinion, we also highlight some examples where requirements are similar to those under CP86.

Authorisation

In addition to requesting detailed authorisation applications from relocating Entities, NCAs are advised to scrutinise applications¹ to ensure that the choice of a member state of the EU27 for relocation is "...*driven by objective factors (and not by regulatory arbitrage)*".

In considering this principle, NCAs are recommended to carefully assess the geographical distribution of planned activities of Entities. For example, if UK Entities were to relocate to Ireland to manage Irish investment funds, this may be a persuasive objective factor in choosing Ireland as a relocation domicile.

ESMA notes that the application of this principle does not impair the right of Entities to provide services on a cross-border basis in accordance with EU law.

Governance and internal control

The principles for NCAs in the areas of governance and internal control mechanisms provide valuable guidance for Entities in the design of their organisational structures. Many of these principles are already a feature of the legal and regulatory framework in Ireland and so will be familiar to Entities regulated here.

For example, the requirement that the persons who effectively conduct the business of the Entities² are of good repute is addressed by the fitness and probity regime in Ireland. Further, conditions concerning sound governance and internal control mechanisms³ are similar to those of CP86 regarding the allocation of managerial functions amongst designated persons; the requirement for documented policies and procedures; and the introduction of a new organisational effectiveness role. The requirement that the allocation of managerial functions to senior managers should not affect the overall collective responsibility of the boards of the Entities for those managerial functions,⁴ is also analogous to CP86 provisions.

Specific guidance is included for those Entities that may be hired by third party asset managers (referred to as 'white-label business'). The Opinion effectively suggests that such Entities re-assess their organisational structures to ensure that their resources remain appropriate after mapping their business models against the principles issued by ESMA and as a result of additional business acquired due to Brexit.

Asset managers should also be mindful of the guidance requiring detailed conflicts of interest policies and procedures⁵ and it is suggested to design those policies and procedures by using this guidance as an aid.

One aspect likely to generate debate and necessitate further clarification from ESMA is the suggestion (in paragraph 25) that a regulatory function listed in Annex II of the UCITS Directive or Annex I of the AIFMD, but which is not performed by an Entity must still be subject to delegation monitoring. This interpretation of delegation is restated in the Opinion's guidelines on delegation arrangements (paragraph 39), and it will be interesting to see the CBI's response to this point.

¹ Para. 14

² Para. 15

³ Para. 17

⁴ Para. 19

⁵ Para. 21 et seq.

Delegation

Turning to delegation, ESMA's primary concern is to mitigate the risk of letter-box Entities being authorised in the EU27. In noting that the letter-box entity tests in the UCITS Directive are not as extensive as in AIFMD, ESMA offers guidance to NCAs that the UCITS letter-box tests should be consistent with the equivalent tests in AIFMD⁶; effectively bringing the UCITS letter-box tests up to the AIFMD standard. Again, the approach of the CBI in this area will be much anticipated.

The Opinion provides detailed guidance for NCAs on the expected standards for Entities in performing oversight of delegates (focussing on the assessment of delegation arrangements), common interpretation and supervisory requirements, due diligence on delegates, the required substance to be retained at the level of the Entities, the delegation of internal control functions and the use of non-EU branches. Aspects of this guidance are echoed in CP86, which also provides helpful and extensive guidance on the oversight of delegates.

ESMA expects robust due diligence to be carried out on delegates during the selection process, with objectively-reasoned, clear and documented decision-making on why one delegate was chosen over another. NCAs are advised to give "*special consideration*" to delegation to non-EU entities as such arrangements could make oversight and supervision of the delegated functions more difficult.

Written contracts should be put in place between Entities and delegates⁷ and these contracts must ensure that Entities comply with EU investment management legislation and do not assume that delegates will provide services in compliance with that legislation.

ESMA's guidance for NCAs on substance requirements⁸ for Entities that utilise delegation arrangements, will be of particular interest to asset managers. Specifically the recommendation that NCAs should apply additional scrutiny to relocating Entities that do not dedicate at least three locally based, full-time employees to the performance of portfolio management and/or risk management functions and/or monitoring delegates.

Paragraph 62 addresses the delegation of portfolio management and/or risk management functions to non-EU entities (e.g. UK entities post Brexit). ESMA recommends that NCAs should require detailed information and evidence from Entities on why delegation to non-EU entities is objectively justified in a scenario where the Entities manage: (i) a UCITS that invests in transferable securities issued by an EU issuer; or (ii) an EU AIF which invests in EU real estate, where the location of the investment funds and asset class serves as an argument against such delegation to non-EU entities.

This guidance again emphasises the importance of asset managers having well thought-out delegation arrangements in place, based on robust objective reasons.

In relation to the delegation of internal control functions, asset managers should be conscious of the guidance in paragraph 67 whereby ESMA recommends that NCAs be satisfied that the risk management function is not limited to ex-post controls "*...but is to be involved in the investment process before transactions are concluded.*" The risk management function requires to be effectively involved at all times.

Paragraph 68 addresses the establishment of non-EU branches and recommends that 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.*"

⁶ Para 42

⁷ Para 51

⁸ Paras 56-62

Effective supervision

NCAs are required to ensure that any delegation does not impair their ability to enforce relevant legislation and be satisfied that they access to information in relation to delegated functions and have access to the business premises of delegates for on-site visits.

ESMA also repeats the guidance contained in its initial cross-sectoral opinion that under certain EU legislation (such as AIFMD), outsourcing or delegation arrangements made with a third country entity are conditional on prior co-operation arrangements being in place between the NCA and the competent authority in that third country.

How can we help?

William Fry's Asset Management and Investment Funds team is advising asset managers, in conjunction with their international advisers, on their Brexit contingency plans, particularly where Ireland has been considered as a relocation domicile for a UK entity. We are currently advising AIFMs, UCITS management companies and MiFID firms in relation to obtaining authorisation in Ireland. As questions arise in relation to the work of ESMA in this area, and its application in Ireland from a practical perspective, please contact any of the following or your usual William Fry contact.

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