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Memorandum

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ESMA opinion: Supervisory convergence in the context of Brexit

The European Securities and Markets Authority (ESMA) recently published an opinion setting out certain principles ("Principles") in support of supervisory convergence in the context of Brexit (the "Opinion").

Given the UK's importance to the provision of financial services into and across the European Union ("EU"), there is an expectation that Brexit will create a degree of disruption to the existing market, with at least some UK based firms seeking to relocate aspects of their business into one of the remaining EU member states in order to retain continued market access.

The Opinion is addressed to the National Competent Authorities ("NCAs") of EU member states, and puts the onus on NCAs to:

(i) avoid a 'race to the bottom' in regulatory standards to attract relocating firms;

(ii) properly vet local authorization applications; and

(iii) scrutinize delegation and outsourcing arrangements.

The Opinion will be of particular interest to sponsors considering relocating from the UK and entering into UK-facing delegation arrangements as part of their Brexit planning.

Key points to note arising from the Principles:

- NCAs are specifically encouraged to scrutinize applicant firms' governance structure, human and technical resources, geographical distribution of activities, outsourcing and delegation arrangements (Principle 2). One would expect this to be done as a matter of course, but the Opinion may encourage greater scrutiny than received by applicants at present. Coupled with the number of applications likely to be received in jurisdictions such as Luxembourg, it may mean that applications take longer to process than they otherwise would.

- NCAs are expected to look at an applicant firm's business and determine whether there are objective reasons for the firm to set up in their jurisdiction (as opposed to another EU jurisdiction) (Principles 2 and 3). This creates an interesting own-interest conflict for regulators.

- ESMA expects that NCAs should particularly scrutinize applications "where it appears that an entity intends to pursue the greater part of its activities in other Member States". In such circumstances NCAs are expected to "only grant authorisation if fully satisfied that the Member State of establishment was not chosen for the purpose of evading stricter standards in force in other Member States" (Principle 3). In particular, NCAs are expected to focus in on an applicant

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firm's prospective investors or marketing and promotional arrangements and the location of development of products or services.

  - It will be interesting to see how this plays out if, by way of example, a firm was seeking authorization to become a Lux authorized AIFM, with the intention of managing Lux AIFs which are to be marketed predominantly outside of Luxembourg (Principle 3).

  - It is not clear whether this is the beginning of something equivalent to the AIFMD Member State of Reference Test for EU firms, something which arguably undermines the whole concept of EU passporting and freedom to provide services across the EU.

- NCAs are instructed to reject relocation requests by application firms where there is an apparent intention to make "extensive use of outsourcing" and "delegation is foreseen with the intention of benefitting from an EU passport, while essentially performing all substantial activities or functions outside the EU" (Principle 4).

- NCAs are given directions on outsourcing, in particular that "certain key activities and functions should be present in the [EU]. These activities and functions are key to the proper functioning of the regulated entity and consequently cannot be outsourced or delegated outside the EU; this is at least the case for the substance of decision-making" (Principle 6). It is not clear what this will mean in the context of AIFMs seeking to delegate portfolio management decision making, something already clearly permitted under the relevant legislation.

- ESMA also expects that "the key executives and senior managers of EU authorised entities are 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" (Principle 7). There is a footnoted concession to this Principle for "small companies". This may be important for a number of sponsors, but the meaning of "small company" is not clear.

- As a general matter it appears that the "letter box entity" principle from AIFMD may be extended to other regulated firms – which is certainly of note because this is not enshrined in any of the relevant legislation, though the Opinion gives a fairly clear idea of ESMA's thinking.

Sponsors with any link to the UK and an interest in moving aspects of their operations to another jurisdiction should watch this space as ESMA has said that it intends to develop further sector-specific opinions on the asset management space (amongst others).

The Opinion has already proved to be controversial within the industry and sparked a flurry of commentary. However, it is clear that ESMA wants something other than "business as usual" when it comes to regulatory approval of relocating UK businesses.

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