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Memorandum

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ESMA publishes investment management "sectoral opinion" to support supervisory convergence in the context of Brexit

Last month, we reported that the European Securities and Markets Authority ("ESMA") had published a general opinion setting out certain principles in support of supervisory convergence in the context of Brexit (the "General Opinion").

By way of update, on 13 July 2017, ESMA published a suite of sector-specific opinions, building on the General Opinion, including an opinion relating to the investment management sector (the "Sectoral Opinion").

The Sectoral Opinion is aimed at National Competent Authorities ("NCAs") and seeks to ensure a consistent interpretation of requirements relating to authorisation, governance and internal control, delegation and effective supervision. However, whilst, in many parts, the Sectoral Opinion summarises the requirements of existing EU legislation relating to investment management (more specifically, UCITS and AIFMD), a number of ESMA's stated expectations go beyond the minimum requirements under the legislation.

There are too many issues arising out of the Sectoral Opinion to address in this Memorandum, but to name a few:

Objective reasons for choice of jurisdiction

One of the most controversial aspects of the General Opinion was the requirement for NCAs to assess whether a relocating firm had provided a clear justification for relocating to a particular Member State. This principle was met with particular criticism by the industry, arguing that it is contrary to EU principles of free movement of services and capital. Notwithstanding the industry response, ESMA has maintained its position.

Substance

Under the Sectoral Opinion, NCAs are encouraged to give additional scrutiny to smaller relocating entities that do not dedicate at least three locally-based full time employees (including time commitments at both the senior management and staff level) to the performance of portfolio management and/or risk management and/or the monitoring of delegates.

There will be some who will argue that this is an overreach by ESMA, since the relevant legislation sets the minimum number at two senior persons. ESMA acknowledges the legislative provisions, but stresses that two is the absolute minimum, and therefore effectively raises the bar.

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ESMA has also encouraged NCAs to consider issuing guidance on appropriate thresholds for directorships (in terms of aggregate time commitments). This may lead to gold plating by Member States and a fragmentation in regulatory standards across the EU, which has the potential to encourage the kind of regulatory arbitrage that ESMA is seeking to mitigate.

Advisory relationships

The General Opinion focused heavily on delegation. The Sectoral Opinion now addresses advisory structures. ESMA has said that NCAs should give "special consideration" to the appointment of investment advisers.

ESMA has also stated that where EU managers appoint, and base their investment decisions on, third party investment advice, if managers make investment decisions without carrying out their own qualified analysis before concluding a transaction, such arrangements are to be considered as being a delegation of investment management activities. This appears to be a new principle developed by ESMA, which cannot be traced to the legislation, and it may have a significant impact on those employing this structure.

Objective reasons for delegation

AIFMD requires an AIFM to be able to justify its entire delegation structure for objective reasons. This objective justification must be set out in the AIFM's notification to its competent authorities in the form of a detailed description, explanation and evidence. The legislation makes provision for NCAs to request further justification from the AIFM, but does not place too onerous a burden on NCAs to scrutinise the objective justifications with which they are presented.

ESMA now wishes this practice to change, stressing "in no way should this assessment be interpreted as a mere notification procedure". This is difficult to rationalise with the approach in the AIFMD as regards the delegation of portfolio management or risk management, where prior approval is only stated to be required where the delegate is neither an undertaking authorised or registered for the purpose of asset management nor subject to supervision.

Third Party AIFMs

It is clear from the Sectoral Opinion that Third Party or "white label" AIFMs are now in the spotlight. It was implicit from the General Opinion that Third Party AIFMs would come under pressure, given ESMA's focus on delegation. NCAs have however now been expressly encouraged to give Third Party AIFMs "special consideration", in order to ensure they maintain sufficient human and technical resources whilst dealing with an increased volume of work brought about by Brexit.

Comment

The tone of the Sectoral Opinion is consistent with the General Opinion. ESMA's stance does not generally appear to have softened, notwithstanding the concerns raised by the industry in response to the General Opinion. The Sectoral Opinion is expected to receive a similar response. NCAs in certain jurisdictions may also feed in to the debate, since their capacity is likely to be already stretched by the volume of authorisation applications from relocating firms without having to meet ESMA's recently pronounced expectations. It will be important to watch carefully how these themes develop.

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