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ESMA's Brexit Opinion on Investment Management

As anticipated in its prior cross-sectoral opinion issued at the end of May, the European Securities and Markets Authority (**"ESMA"**) has, on July 13, 2017, issued a specific opinion relating to the investment management sector in the context of the anticipated relocation of entities, activities and functions from the UK a consequence of Brexit.

Focused on UCITS ManCos, self-managed investment companies and authorised AIFMs, the opinion addresses areas of potential regulatory and supervisory arbitrage with particular focus on authorisation, governance and internal controls, delegation and effective supervision.

Much of the opinion can be viewed as a restatement of existing legislative or regulatory requirements for UCITS ManCos and AIFMs but with emphasis on applicants looking to relocate to the EU27 as a consequence of Brexit. Market participants, regulators and, importantly, investors should welcome the opinion as a reminder to all not to cut corners when dealing with applications from entities seeking to relocate from the UK and we should all expect that European investors are fully protected in accordance with the provisions of the UCITS Directive and of AIFMD.

Certain elements of the opinion do, however, warrant further consideration and we should be careful that in pursuing the legitimate desire for regulatory convergence, we do not end up with new requirements being imposed – almost legislation by interpretation or re-interpretation – without more discussion.

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Note that we do not have any particular concerns from an Irish perspective with the general thrust of the opinion. The Irish Central Bank has been robust not only in the context of Brexit but more generally in emphasising its gatekeeper and supervisory mandates. It has also been building out its requirements of UCITS ManCos and AIFMs for many years, with new legislation, expanded fitness and probity requirements, a completed governance regime and as well as establishing more intrusive supervisory and information provision expectations.

It is also "*strongly supportive of the work of the European Supervisory Authorities to ensure convergence in how NCAs respond to Brexit*" as indicated by Michael Hudson, the Central Bank Director of Asset Management in a speech on July 26, 2017.

The Main Points

The main points of the opinion (which, in fairness, is quite clear) can be summarised as follows:

Authorisations

1. National Competent Authorities ("**NCAs**") must apply the authorisation processes in full, as required by law and without any derogations or exemptions, without relying on prior or existing UK authorisations and without any type of transitional allowances being made.

2. UK based applicants should be subject neither to preferential nor disadvantageous treatment.

3. NCAs must scrutinise applications to ensure that the choice of the Member State for relocation is driven by objective factors and not by regulatory arbitrage.

Governance and Controls

4. The opinion is strong on requirements as to sound governance, necessary internal control mechanisms and the allocation of responsibilities (organisational requirements, conflicts of interest, conduct, risk management and material contract content).

5. Emphasis is placed on the roles of board members and senior management and on their time commitments.

6. ESMA has set down 15 criteria to be taken into account when assessing an applicant, applying a type of proportionality consideration to the level of required procedures, mechanisms and organisational structures.

7. ESMA notes that the legal requirement to have at least two senior managers may not be sufficient for all applicants. NCAs will need to take into account of the size of the applicant's business and/or the complexity, nature and range of its business activities.

8. The organisational set up of applicants must be such as to enable regulators carry out on-site visits at any time (even without prior notice) and to be able to meet with senior management at short notice (within a day). Information provision requirements are also imposed.

Internal Controls

9. Internal control mechanisms (risk assessment and management compliance and internal audit) are dealt with at some length, including as to whom such functions and roles can be given, the role of internal control functions in the decision-making processes of the relevant firm and the frequency and content of reporting by those functions.

White Label

10. NCAs should give special consideration to white label activity as it foresees a sharp rise in activity as a consequence of Brexit.

Delegation

11. The opinion addresses delegation at great length:

    (i) querying the appointment of investment advisers (whether really a delegation of investment management);

    (ii) stating that the AIFMD Level 2 principles (Articles 75 to 82) should also apply to UCITS ManCos;

    (iii) requiring that NCAs must be satisfied that there are objective reasons for delegation (ESMA says that that requires the NCA to assess the detailed descriptions, explanations and evidence of the objective reasons); and

    (iv) requiring that NCAs carry out a case by case analysis of the materiality of the delegated activity.

12. Evidence of cost savings need to be provided to show that "*the financial benefits of the envisaged delegation structure outweighs the estimated costs of performing the delegated function internally despite the costs of carrying out due diligence and monitoring the risks involved with the delegated function on an ongoing basis"*.

13. Particular focus is given to delegation to non-EU entities and accompanying requirements.

Due Diligence

14. Every delegation must be preceded by a written due diligence on the delegate and possible alternatives. Authorised entities will need to elaborate on why they have chosen one entity over another.

15. The opinion say that authorised entities have a fiduciary duty towards investors and must act in their best interests when delegating functions.

16. Additional paragraphs deal with the drafting or reviewing of delegation agreements; the need to implement effective oversight / monitoring policies and procedures as well as delegation related recordkeeping.

Substance

17. Reflecting a prior ESMA Q&A regarding delegation, ESMA issues a reminder that authorised entities should not delegate investment management functions to an extent that exceeds by a substantial margin the investment management functions performed internally. This assessment must be carried out in relation to and at the level of each individual fund and not in relation to a group of funds. This means that authorised entities must perform investment management functions for each fund they manage and cannot delegate portfolio management and risk management functions for a particular fund in their entirety even where they perform such functions for other funds.

18. Authorised entities need to be able to demonstrate that sufficient human and technical resources are dedicated to the selection of potential delegates as well as to ongoing delegation monitoring activities and that all individuals involved in the process have the required skills, knowledge, as well as experience and time commitment for their respective tasks.

19. Emphasis is place on delegation policies and procedures, on allocation of due diligence and delegation monitoring responsibilities, on having sufficient resources and expertise to able to monitor delegates effectively and to be able to challenge them constructively.

20. NCAs should apply additional scrutiny to relocating entities, even small ones, that do not dedicate at least 3 locally based FTE (including time commitments at both Senior Management and Staff Level) to the performance of portfolio management and / or risk management and / or monitoring of delegates.

Delegation of Internal Control Functions

21. ESMA highlights the need for NCAs to require information from and to question entities which intend to delegate internal control functions so as to be satisfied that delegation is based on objective reasons and does not impair effectiveness and independence of the function.

22. Further paragraphs address the controls to be carried out and the more general role of the internal control functions, noting that "*these substantial activities usually necessitate a local presence. Where this is not the case, authorised entities should demonstrate to NCAs that this will not impair the effectiveness of those functions*".

23. Delegation to non-EU entities, reporting lines and/or delegation of internal control functions with the same corporate group and conflicts of interest arising are also addressed by the opinion.

24. ESMA also notes that NCAs need to 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.

Non-EU Branches

25. ESMA also says that NCAs should carefully monitor situations in which the risk of letter-box entities arises not only from the use of delegation arrangements but from situations in which EU authorised entities use non-EU branches for the performance of functions with respect to UCITS and AIFs.

Effective Supervision

26. The final section of the opinion deals with effective supervision, with a focus on where the applicant's envisaged operations in other jurisdictions might impact the NCAs resources and ability to effectively supervise. It also considers the issue of delegation potentially impairing an NCA's ability to enforce relevant legislation and the issue of access (to information and to locations).

27. ESMA says that NCAs should give special consideration to, and raise the attention of authorised entities to the fact that, as from the effective date of the UK's withdrawal from the EU, any delegations of investment management functions to entities based in the UK will only be permitted where this is in compliance with, amongst other conditions, Article 13(1)(c) and (d) of the UCITS Directive and Article 20(1)(c) and (d) of the AIFMD.

In addition, a number of other provisions in the EU investment management legislation require cooperation arrangements to be in place between NCAs and competent authorities in third countries. In other words, there may be a timing issue.

The Irish Position

As we have noted above, the Irish authorisation and supervision regime for UCITS ManCos and AIFMS already addresses the key messages from the opinion and in most elements, the opinion merely restates existing requirements, perhaps with added emphasis in places. However, we do think that certain elements of the opinion warrant further scrutiny, as explained below.

Choice of Member State not to be driven by regulatory arbitrage

At point 14 of its opinion, ESMA says that the NCAs should scrutinise applications in order to ensure the choice of the Member State for relocation is driven by objective factors and not by regulatory arbitrage. It says :

> "*NCAs should carefully assess the geographical distribution of planned activities (based on e.g. the programme of operations, information on prospective investors, marketing and promotional arrangements, the identity and geographical localisation of distributors activities, language of offering/promotional materials) and should not grant authorisations where the applicant has opted for a jurisdiction for the purpose of evading stricter standards in another Member State within the territory of which the relocating entity intends to carry out the greater part of its*

> *activities. The NCA's assessment of how an applicant plans to oversee its business and manage the risk from its cross-border activities should be proportionate to the volume (for example, with reference to value of assets under management and/or the number of investors) and complexity of the planned cross-border operations. The application of this principle does not impair the rights of authorised entities to provide services on a cross-border basis in accordance with the principles of Union law and financial sector legislation"*.

If one looks at Recital (18) to the UCITS Directive you see that it says that

> *"The principle of home Member State supervision requires that the competent authorities withdraw or refuse to grant authorisation where factors, such as the content of programmes of operations, the geographical distribution or the activities in fact pursued indicate clearly that a management company has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within the territory of which it intends to pursue or does pursue the greater part of its activities".*

There is a virtually identical provision in Recital (46) of MiFID II (but not in AIFMD).

The principle is what it is and not one that one can really argue with. What is of concern is that ESMA seems to be trying to impose its own criteria such as "*information on prospective investors*", "*marketing and promotional arrangements*", "*the identity and geographical localisation of distributors activities*" and "*language of offering/promotional materials*" as factors that should be taken into account, as well as the "value of assets under management and/or number of investors in the context of cross border activities". Although they are given as examples – and should not therefore be seen as exhaustive – it is legitimate to question whether this undermines the freedom of services rights of managers? Within a harmonised regime, managers should be free to choose where to locate, taking into account all factors which they think relevant – labour laws, speed of authorisation, taxation (personal and corporate), transparency of authorisation process, levels of bureaucracy, professional costs etc etc.

There almost seems to be a view or undercurrent that if you principally distribute in country A but are located in country B then that suggests that you may be opting for jurisdiction B for the purpose of evading stricter standards etc. That is not a reasonable assumption, certainly not where you are operating in a harmonised framework. The starting point of any assessment would really need to be as to what are the standards that are in force in the different jurisdictions and then to assess whether the standards are more strict in one jurisdiction by comparison to another. Which are the standards to assess in any event? Are they standards relating to governance, to capitalisation, to taxation, to contractual liability, to fitness and probity or other standards? And who will carry out that assessment?

Simply saying that the application of a principle does not impair those rights does not mean that that is correct.

Is ESMA legislating?

A second issue that raises a question relates to extending AIFM requirements to UCITS.

Article 13 of the UCITS Directive sets out a variety of pre-conditions that must be complied with in order for a UCITS ManCo to delegate to third parties. It concludes by saying that the management company should not delegate its functions to the extent that it becomes a letter box entity.

When one turns to the AIFMD, it has detailed provisions dealing with delegation in Article 20 which are relatively similar to the UCITS Directive provisions, including at Article 20(4) a statement that the AIFM should not delegate its functions to the extent that in essence it can no longer be considered to be the manager of the AIFM or to the extent that it becomes a letter box entity.

As readers will be aware, however, Article 75-82 of the AIFMD Level 2 Regulation sets out more detailed rules regarding delegation including Article 82 which sets out a series of provisions regarding letter box entities and where the AIFM is no longer considered to be managing an AIF. These set out additional criteria which do not appear in the UCITS regime, many of which were the subject of very considerable debate prior to AIFMD finalisation. ESMA seems to have decided that NCAs should apply the AIFM rules to UCITS, but that should not be for ESMA to make that decision, that should be for legislators.

Cost Savings

Practical issues also arise in the context of delegation and the cost saving criterion. In the UCITS Directive Article 13 makes reference to delegation to third parties "for the purpose of a more efficient conduct" of the company's business. When one turns to the AIFMD and the objective reasons for delegation, Article 20 of AIFMD refers to being able to justify the delegation on objective reasons with then Article 76 of the Level 2 Regulation explaining that the criteria which should considered when assessing whether the entire delegated structure is based on objective reasons are:

(i) optimising of business functions and process;

(ii) cost savings;

(iii) expertise in the delegate or administration or in specific markets or instruments;

(iv) access of the delegate to global trading capabilities

ESMA has now elaborated on what it considers is meant by the criterion of cost saving. According to ESMA "*authorised entities should provide evidence that the financial benefits of the envisaged delegation structure outweigh the estimated costs of performing the delegate function internally despite the costs of carrying out due diligence and monitoring the risks involved with*

the delegated function on an ongoing basis. Where the authorised entities intend to delegate functions to entities within the same corporate group, NCAs should assess the due diligence carried out by authorised entities and be satisfied that the selection of a group entity is based on objective reasons".

Hopefully NCAs will adopt a sensible approach to the practical challenges that that will pose, in particular as to how to calculate "the financial benefits" or the cost of "performing the delegated function internally". And in a group context, if a group decides to do all activity within a single group company or within two group companies (one delegating to another), why should there be a different treatment?

We just need to be careful that in seeking to quite legitimately deal with challenges posed by Brexit re-locations and the genuine desire for regulatory convergence, we don't accept changes in interpretation or new rules that have the potential for far wider application without more open discussion.

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