

OPINION

General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union

Legal basis

1. The European Securities and Markets Authority's (ESMA) competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council (the 'ESMA Regulation').¹ In accordance with Article 44(1) of the ESMA Regulation, the Board of Supervisors has adopted this opinion.

Background

2. The United Kingdom (UK) on 29 March 2017 notified the European Council of its intention to withdraw from the European Union (EU) pursuant to Article 50 of the Treaty on European Union (TEU). The withdrawal will take place on the date of entry into force of a withdrawal agreement or, failing that, two years after the notification on 30 March 2019². This opinion takes into account the European Parliament resolution³ and the European Council guidelines⁴.
3. As the UK plays a prominent role in the EU Single Market, the relocation of entities, activities and functions following the UK's decision to withdraw creates a unique situation which requires a common effort at EU level to ensure a consistent supervisory approach to safeguard investor protection, the orderly functioning of financial markets and financial stability.
4. This opinion should be seen as a practical tool to achieve supervisory convergence. It addresses regulatory and supervisory arbitrage risks that arise as a result of increased requests from financial market participants seeking to relocate in the EU27 within a relatively short period of time. This opinion is addressed to the national competent authorities (NCAs)⁵, in particular of those 27 EU Member States that will remain in the EU ('EU27')⁶.

¹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, p. 84–119.

² Article 50 further allows the European Council, in agreement with the Member States, to extend this period.

³ European Parliament resolution of 5 April 2017 on negotiations with the United Kingdom following its notification that it intends to withdraw from the European Union (2017/2593(RSP)).

⁴ European Council guidelines of 29 April following the United Kingdom's notification under Article 50 TEU (EUCO XT 20004/17).

⁵ National Competent Authorities as defined under Article 4 of the ESMA Regulation.

⁶ The opinion is also addressed to the NCAs of the EEA-EFTA States Norway, Liechtenstein and Iceland as per the EEA Agreement.

5. Until the UK has withdrawn from the EU, the EU legislative framework applicable to financial markets will remain in force in the UK. The opinion assumes that the UK will become a third country after its withdrawal from the EU. This is without prejudice to any specific arrangements that may be reached between the UK and the EU.
6. In the course of the UK withdrawing from the EU, UK-based market participants may seek to relocate entities, activities or functions to the EU27 in order to maintain access to EU financial markets. In this context, these market participants may seek to minimise the transfer of the effective performance of those activities or functions in the EU27, i.e. by relying on the outsourcing or delegation of certain activities or functions to UK-based entities, including affiliates. It is therefore necessary to ensure that the conditions for authorisation as well as for outsourcing and delegation do not generate supervisory arbitrage risks.
7. New authorisations must be granted in full compliance with Union law and in a coherent manner across the EU27. Any outsourcing or delegation arrangement from entities authorised in the EU27 to third country entities should be strictly framed and consistently supervised. Outsourcing or delegation arrangements, under which entities confer either a substantial degree of activities or critical functions to other entities, should not result in those entities becoming letter-box entities.
8. EU27 NCAs need to prepare for an increase in activities related to authorisation and supervision. ESMA will be vigilant as regards the need for NCAs to ensure that they have the ability to adequately handle authorisation requests and carry out effective supervision in line with Union law, as well as the capacity to respond to relevant market developments.
9. This opinion sets out principles based on the objectives and provisions of the legislation referred to in Article 1(2) and (3) of the ESMA Regulation, which are applied to the specific case of relocation of entities, activities and functions following the UK's withdrawal from the EU. The opinion aims to foster consistency in relation to authorisation, supervision and enforcement.
10. It covers all legislation referred in Article 1(2) and (3) of the ESMA Regulation including, in particular, Directive 2011/61/EU⁷ (AIFMD), Directive 2009/65/EC⁸ (UCITS Directive), Directive 2004/39/EC⁹ (MiFID I) and Directive 2014/65/EU¹⁰ (MiFID II) (hereinafter referred to as 'the relevant legislation').
11. ESMA intends to develop sector-specific opinions in areas such as those concerning asset managers, investment firms and secondary markets.

⁷ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, (OJ L 174, 1.7.2011, p. 1–73).

⁸ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), (OJ L 302, 17.11.2009, p. 32–96).

⁹ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1–44).

¹⁰ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, (OJ L 173, 12.6.2014, p. 349–496).

12. This opinion does not prejudice any future opinions or other convergence tools issued by ESMA.

General principles

3.1. Principle one: No automatic recognition of existing authorisations

13. NCAs are responsible for granting authorisation to EU entities. An entity established in a third country needs to establish itself in the EU27 to be able to benefit from the EU passport today and going forward. Similarly, an entity established in the UK needs to establish itself in the EU27 to be able to continue to benefit from the EU passport once the UK has withdrawn from the EU. In order for such entities to establish themselves in the EU27, they need to seek authorisation from the relevant EU27 NCA.
14. No recognition of authorisations granted by third country authorities is foreseen in Union law. Similarly, and although the UK enjoys full rights as an EU Member State until it withdraws from the EU, there cannot be any automatic recognition of the authorisation granted by the UK regulator into the EU27. This is not foreseen in Union law, nor would the conditions of authorisation in this context be identical to those which the UK authorities had to examine before granting an authorisation.
15. The authorisation process takes time and in order to ensure efficiency, entities seeking to relocate in the EU 27 are urged to approach the relevant NCA as early as possible.

3.2. Principle two: Authorisations granted by EU27 NCAs should be rigorous and efficient

16. NCAs should ensure that conditions set by the relevant legislation are met from day one of the authorisation.
17. Upon assessing an application for authorisation, NCAs should satisfy themselves that the entity has provided sufficiently detailed information to allow them to assess that the entity complies with the requirements under the relevant legislation and ESMA guidance. NCAs should have access to a detailed programme of operations.
18. NCAs may take some aspects of the assessment of third country regulators into consideration where appropriate. This would be the case, for example, as regards fit and proper requirements. In addition, as UK entities are currently subject to EU legal requirements, NCAs should have regard to the assessment of the UK authorities where the essential requirements to be met are not impacted by the relocation as confirmed by relevant documentation. This does not prejudice the full compliance with Union law and applicable national law in the Member State of establishment.
19. At the same time, NCAs should apply strong scrutiny to, inter alia, the entities' governance structure, human and technical resources, geographical distribution of activities, as well as outsourcing and delegation arrangements.

20. Without prejudice to Principle four, NCAs should not grant authorisations where the activity carried out indicates clearly that the entity has opted for the legal system of a Member State for the purpose of evading the stricter standards in force in another Member State within the territory of which it intends to carry on the greater part of its' activities¹¹.
21. The application of this principle does not impair the rights of authorised entities to provide services on a cross-border basis in accordance with principles of Union law and financial sector legislation.

3.3. Principle three: NCAs should be able to verify the objective reasons for relocation

22. NCAs are expected to check that the planned EU27-based activity is the main driver for relocation of entities, activities and functions. The entity's programme of operations should provide a clear justification for relocating to the Member State of establishment.
23. In order to establish a clear view on the geographical distribution of planned activities from the perspective of targeted clients and/or services development, as part of the programme of operations NCAs should obtain information such as that on:
- (i) prospective investors or marketing and promotional arrangements; and
 - (ii) location of development of products or services.
24. In addition, NCAs should obtain information from the applicant entities on whether they have engaged with, or their application has been rejected by, another NCA.
25. ESMA expects that NCAs will particularly scrutinise applications where it appears that an entity intends to pursue the greater part of its activities in other Member States and will 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.
26. The application of this principle does not impair the rights of authorised entities to provide services on a cross-border basis in accordance with principles of Union law and financial sector legislation.

3.4. Principle four: Special attention should be granted to avoid letter-box entities in the EU27

27. The use of outsourcing or delegation arrangements by relevant market participants may be an efficient way to perform some functions or activities. However, outsourcing and delegation can also pose a number of challenges both for entities and for the NCAs supervising such entities, especially when the outsourcing or delegation of activities or functions is critical to the functioning of the market participant. Such concerns are heightened where

¹¹ Recital 39 of MIFID I, and see also Recital 73 of UCITS Directive.

the service provider is located outside the EU, as the ability of entities and NCAs to, respectively, control and supervise may be significantly impacted.

28. NCAs should reject any relocation request creating letter-box entities where, for instance, 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 EU27. Similar considerations may apply if entities perform substantial activities and functions through third country branches.

3.5. Principle five: Outsourcing and delegation to third countries is only possible under strict conditions

29. As a general principle, EU market participants can only outsource or delegate tasks or functions, but not responsibilities. Market participants wishing to engage in outsourcing or delegation remain fully responsible for the tasks or functions that are outsourced or delegated. In other words, the ability to direct and control outsourced or delegated functions must always be retained by the market participant initiating the outsourcing or delegation.

30. NCAs should be prudent when determining the extent to which an entity can rely on outsourcing or delegation. Under certain Union legislation, outsourcing or delegation arrangements to a third country entity are conditional on prior cooperation agreements between the EU NCA and third country authority.

3.6. Principle six: NCAs should ensure that substance requirements are met

31. NCAs should require that any outsourcing or delegation arrangements are clearly structured and set up in a way that does not hinder their ability to efficiently and effectively supervise.

32. ESMA believes that comprehensive information should be provided by market participants to ensure that NCAs have sufficient knowledge of outsourcing and delegation arrangements and the ability to properly supervise them.

33. NCAs should have effective access to all data related to the outsourced or delegated activities or functions and to the business premises of the entity to which the activities or functions are outsourced or delegated.

34. Outsourcing and delegation arrangements should not have an impact on business continuity, confidentiality and conflicts of interest, which have to be appropriately managed.

35. This implies in particular that certain key activities and functions should be present in the EU27. 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.

36. Some important activities and functions deserve special scrutiny and in certain sector specific circumstances cannot be outsourced and delegated without threatening the activity of the regulated entities and the possibility of effective supervision by NCAs. These important

activities and functions comprise, inter alia, internal control functions, IT control infrastructure, risk assessment, compliance functions, key management functions and sector-specific functions.

3.7. Principle seven: NCAs should ensure sound governance of EU entities

37. Board members and senior managers in the EU27 need to have the effective decision-making powers in relation to compliance of the EU authorised entity with Union law even where the entity is part of a corporate group.
38. ESMA 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 role¹², if not on a full-time basis. NCAs should satisfy themselves that the applicant entity disposes of decision-making powers in the targeted Member State of establishment by assessing, inter alia, the quality and the appropriate presence of executive board members and senior managers in the Member State of establishment. This is to ensure that executive board members and/or senior management are able to effectively carry out their responsibilities. These responsibilities should include, but should not be limited to, having sufficient knowledge and relevant experience as well as dedicating sufficient time to fulfil their duties.
39. ESMA reminds NCAs that, in accordance with Union law, they have to check that EU entities comply with governance requirements and that they have the ability to effectively control the outsourced or delegated activities or functions. This includes having the technical knowledge and the capability to request the necessary changes to outsourced or delegated services, to monitor the relevant deployment and to assess the quality of those services provided.
40. In addition, as regards risk management capacity, EU entities should have adequate levels of own funds as well as liquidity, and these should be readily available to them, also taking into account possible insolvency.

3.8. Principle eight: NCAs must be in a position to effectively supervise and enforce Union law

41. NCAs should have adequate resources and capacity both to monitor the effective application of the relevant legislation and respond to market developments.
42. NCAs should be in a position to ensure effective supervision of entities. In particular, NCAs should ensure that initial conditions set at the moment of authorisation are met on a continuous basis, including those relative to outsourcing and delegation arrangements. In addition, NCAs must ensure that any outsourcing or delegation does not impact their ability to enforce the relevant legislation. This implies that NCAs should be able to conduct on-

¹² ESMA acknowledges that some of these functions when exercised at small companies may not constitute a full-time occupation, in which case some flexibility can be considered on a case-by-case basis.



site inspections of outsourced or delegated activities or functions without any prior third party authorisation.

43. NCAs should ensure that they have all the relevant information in order to properly supervise EU entities. Effective and efficient cooperation among NCAs is of utmost importance in this respect, including with authorities in third countries.

3.9. Principle nine: Coordination to ensure effective monitoring by ESMA

44. As foreseen in Article 29(2) of the ESMA Regulation, ESMA will establish new practical convergence tools in the form of a forum for reporting and discussions among NCAs regarding market participants seeking to relocate entities, activities or functions to the EU27. This Supervisory Coordination Network will be put in place to promote consistent decisions are taken by NCAs. Authorisation and supervision of, and potential enforcement against, supervised entities is and remains a competence of the NCAs.
45. ESMA stands ready to make use of all its powers in order to support supervisory convergence activity through follow-up work including bringing cases for discussion in the context of this Supervisory Coordination Network, providing opinions to NCAs, conducting peer reviews and initiating investigations of possible breaches of Union law as the need may arise.