

## OPINION

### **to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union**

#### **I. 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').<sup>1</sup> In accordance with Article 44(1) of the ESMA Regulation, the Board of Supervisors has adopted this opinion.

#### **II. 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 2019.<sup>2</sup>
3. As the UK plays a prominent role in the EU Single Market, the relocation of entities, activities and functions<sup>3</sup> 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. Against this background, ESMA published an opinion<sup>4</sup> (hereinafter referred to as 'cross-sectoral opinion') which addresses cross-sectoral 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. That opinion is primarily addressed to the national competent authorities (NCAs)<sup>5</sup> of those 27 EU Member States that will remain in the EU (EU27)<sup>6</sup> and covers all legislation referred to in Article 1(2) and

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<sup>1</sup> 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).

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

<sup>3</sup> Relocation as referred to in this opinion should be understood in a broad sense and includes not only situations where an entity seeks authorisation for the first time in the EU27, but also cases where an existing entity in the EU27 is restructured (e.g. through an increase in the number of personnel) as a result of a transfer of activities and functions from a UK entity.

<sup>4</sup> ESMA opinion on general principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31 May 2017 (ESMA42-110-433).

<sup>5</sup> National Competent Authorities as defined under Art. 4 of the ESMA Regulation.

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

(3) of the ESMA Regulation, including, inter alia, Directive 2009/65/EC<sup>7</sup> (UCITS Directive) and Directive 2011/61/EU<sup>8</sup> (AIFMD).

5. This opinion sets out principles based on the objectives and provisions of the UCITS Directive and AIFMD, which are applied to the specific case of relocation of entities, activities and functions following the UK's withdrawal from the EU. It seeks to supplement the principles set out in the cross-sectoral opinion by addressing regulatory and supervisory risks in the area of Investment Management, in particular in relation to the following aspects:
  - a) authorisation;
  - b) governance and internal control;
  - c) delegation and
  - d) effective supervision.
6. Similar to the cross-sectoral opinion, this opinion assumes that the UK will become a third country after its withdrawal from the EU and is therefore without prejudice to any specific arrangements that may be agreed between the EU27 and the UK and to any future ESMA opinions or other convergence tools.
7. Through the recently established Supervisory Coordination Network, ESMA is providing a forum for reporting and discussions among NCAs regarding market participants seeking to relocate entities, activities or functions to the EU27. The objective is to promote consistency of decision-making by NCAs.
8. The following chapters cover authorised UCITS management companies, self-managed investment companies and authorised AIFMs (hereinafter jointly referred to as 'authorised entities').<sup>9</sup>

### III. Authorisation

9. NCAs should ensure full compliance with the authorisation requirements set out in the UCITS Directive<sup>10</sup> and AIFMD<sup>11</sup> (hereinafter referred to jointly as 'EU investment management legislation'). Consequently, NCAs should require applicants to provide them with a complete set of information as required by the EU investment management

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<sup>7</sup> 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).

<sup>8</sup> 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).

<sup>9</sup> While the focus of this opinion is on authorised entities and their activities covered by the UCITS Directive and AIFMD, NCAs will also need to have regard to the specificities of the Regulations on European Venture Capital Funds (EuVECA), European Social Entrepreneurship Funds (EuSEF), European Long-Term Investment Funds (ELTIF) and – when it starts to apply – Money Market Funds (MMF).

<sup>10</sup> Articles 6 to 8 and 29 of the UCITS Directive.

<sup>11</sup> Articles 6 to 9 of the AIFMD.

legislation and should carry out the complete authorisation procedure without any derogations or exemptions.

10. Relocating UK entities should undergo the same authorisation procedure and be subject to the same standards as other applicants. This means that UK-based applicants should be subject neither to preferential nor disadvantageous treatment compared to other applicants.
11. The EU investment management legislation does not provide for any reliance on previous or existing authorisations in other Member States or third countries. NCAs should therefore have access to a detailed programme of operations of all applicants even where these have or used to have an authorisation in another Member State or third country. Before granting authorisation, NCAs should, inter alia, assess and be satisfied that the policies and procedures of relocating entities ensure full compliance with the EU investment management legislation. In addition, NCAs should continue to consult each other, and share information, in accordance with the obligations in EU investment management legislation.
12. Moreover, the EU investment management legislation does not provide for any transitional provisions in case of relocations of market participants. NCAs should therefore not rely on mere confirmations from applicants that their organisational set-up and business operations are or will be in compliance with the EU investment management legislation. NCAs should rather require detailed information and evidence from applicants prior to granting authorisations and, based on the analysis of such information and evidence, be satisfied that applicants granted with authorisation will comply with the EU investment management legislation from day one.<sup>12</sup>
13. NCAs should give consideration to issues affected by relocation and to situations where the applicant is part of a group/has links with non-EU parties and should therefore assess any qualifying shareholders, group's business model/structure, the impact of potential (prudential) consolidated supervision or lack thereof, etc. NCAs should verify how any (in particular non-EU) shareholders or members with qualifying holdings are likely to influence the sound and prudent management of the authorised entity and its compliance with the EU investment management legislation. In particular, NCAs should carefully scrutinise whether the group structure within which the authorised entity will operate constitutes an obstacle to their effective exercise of supervisory functions.
14. NCAs should also scrutinise applications in order to ensure that the choice of the Member State for relocation is driven by objective factors (and not by regulatory arbitrage). 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

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<sup>12</sup> In particular, NCAs should not design fast-track authorisation processes that provide for more flexible authorisation/supervision approaches or do not ensure full compliance with EU legislation from the outset.

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 risks arising from its cross-border activities should be proportionate to the volume (for example, with reference to the 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 principles of Union law and financial sector legislation.

#### **IV. Governance and internal control**

##### Sound governance

15. The EU investment management legislation requires that authorised entities establish, implement and maintain effective governance structures and internal control mechanisms. Moreover, it is required that the persons who effectively conduct the business are of good repute and are sufficiently experienced also in relation to the investment strategies pursued and that the names of those persons and of every person succeeding them in office (hereinafter 'Senior Managers') will be communicated forthwith to the competent authorities.
16. The EU investment management legislation sets out that the conduct of the authorised entity should be decided by at least two Senior Managers meeting the aforesaid conditions<sup>13</sup> and that both the head office and registered office must be located in the same <sup>14</sup> Member State. NCAs should ensure that the members of the governing/management body of the authorised entity have the ultimate decision-making powers in regard to the business conduct of the authorised entity even where the entity is part of a corporate group.
17. Sound governance and internal control mechanisms require clarity as to the allocation of responsibilities, documented policies and procedures, structures which foster constructive challenge and the effective provision of relevant information to Senior Management, the governing/management body and, where it exists, the supervisory function.
18. NCAs should be satisfied that relocating entities have established sound governance and internal control mechanisms. In particular, NCAs should expect and receive evidence that the responsibilities listed in Article 9 of the Commission Directive 2010/43/EU<sup>15</sup> (UCITS Level 2 Directive) and Article 60 of the Commission Delegated Regulation (EU) No

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<sup>13</sup> Articles 7(1)(b) and 29(1)(b) of the UCITS Directive and Article 8(1)(c) of the AIFMD.

<sup>14</sup> Article 7(1)(d) of the UCITS Directive and Article 8(1)(e) of the AIFMD.

<sup>15</sup> Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, (OJ L 176, 10.7.2010, p. 42-61).

231/2013<sup>16</sup> (AIFMD Level 2 Regulation) have been clearly allocated to members of the governing/management body, the Senior Management and, where it exists, the supervisory function of authorised entities. The responsibilities stated therein cannot be delegated, even when the delegation is within the same corporate group.

19. Senior Managers may be designated as having particular managerial functions. However, such designation should not be taken to affect the governing/management body's overall collective responsibility for the function. Internal procedures should be adopted so that key matters continue to be escalated for consideration by the full board.
20. The allocation of responsibilities and functions within an authorised entity must be organised in a manner that avoids or mitigates conflicts of interest. Where authorised entities are part of a corporate group, this means that NCAs should be satisfied that there are no reporting lines to group functions or other individuals within the group that would contradict this principle or impair the independence of internal control functions.
21. NCAs should require detailed conflicts of interest policies and procedures, which inter alia clearly describe the identification, measurement and management of conflicts of interest at the level of the governing/management body, Senior Management and, where it exists, supervisory function of the entity. NCAs should give particular consideration to any conflicts of interest which may arise when members of the governing/management body and, where it exists, supervisory function or staff members of authorised entities hold positions in other entities. In particular, NCAs should assess conflicts of interest which may occur when individuals also hold positions or have other business relationships with a service provider of the authorised entity or a fund managed by it. In such case, NCAs should engage with the authorised entity and relevant persons in order to ensure that effective risk mitigation measures are taken.
22. In this context, NCAs should give consideration to the relevant disclosure requirements set out in the EU investment management legislation<sup>17</sup>, in particular in relation to conflicts of interest.
23. In light of the essential role of board members/Senior Management to carry out independent decision-making, to safeguard the best interests of investors, and to ensure compliance with EU investment management legislation, NCAs should assess and put additional scrutiny on individuals with high numbers of (executive or non-executive) directorships to ensure their legal and regulatory obligations and responsibilities as board members are being met. NCAs should consider the possibility of guidance on appropriate thresholds (in terms of aggregate time commitment) for directorships and be transparent on their expectations in their dealings with authorised entities. NCAs should monitor

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<sup>16</sup> Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (OJ L 83, 22.3.2013, p. 1–95).

<sup>17</sup> Including the disclosure requirements set out in Annex I point 1.8. of the UCITS Directive.

commitments so as to avoid any potential risk that governance standards may be weakened.

#### Calibration of governance structures and internal control mechanisms

24. NCAs should be prudent in assessing the required sophistication of the governance structures and internal control mechanisms as well as the human and technical resources expected from authorised entities.
25. Authorised entities should calibrate procedures, mechanisms and organisational structures to the size, nature, scale and complexity of their business and to the nature and range of activities carried out in the course of their business. NCAs should therefore assess each applicant on a case-by-case basis taking into account, in particular, the following criteria:
  - size of the authorised entity's business (value of assets under management);
  - number of (sub-)funds and share classes;
  - complexity of investment strategies pursued;
  - type and range of asset classes invested in (e.g. equity, bonds, derivatives, real estate, private equity, venture capital, infrastructure, debt);
  - geographical spread of investments;
  - use of leverage;
  - use of efficient portfolio management techniques;
  - frequency of investment activities;
  - cross-border management or marketing activities;
  - type and range of functions listed in Annex II of the UCITS Directive and Annex I of the AIFMD that are performed internally;
  - type and range of functions listed in Annex II of the UCITS Directive and Annex I of the AIFMD that are not performed by the authorised entity itself and therefore subject to delegation monitoring;
  - provision of additional MiFID services set out in Article 6(3) of the UCITS Directive and Article 5(4) of the AIFMD;
  - number and type of investors;
  - frequency of investor subscriptions and redemptions;
  - geographical distribution of marketing activities.

26. Such case-by-case analysis should not result in a situation where authorised entities of significant size and/or entities employing complex investment strategies or having a broad range of business activities could operate with only a minimum operational set-up. Consequently, NCAs should require such entities to have more sophisticated governance structures and internal control mechanisms in place than smaller entities.
27. While the EU investment management legislation sets out that authorised entities must have at least two Senior Managers, NCAs should not rely on this minimum number for all authorised entities without taking due account of the actual size of their business and/or complexity, nature and range of their business activities. Where e.g. authorised entities are of significant size, pursue complex investment strategies and/or invest in range of different asset classes or geographical regions, NCAs should request appropriate and sufficiently sophisticated governance structures (beyond the two minimum Senior Managers) in order to ensure that such entities have sufficient knowledge, experience and time commitment at Senior Management level. A prudent assessment of these factors is of utmost importance as the Senior Management of authorised entities entails a broad range of diverse tasks and responsibilities and its appropriate calibration is of paramount importance for ensuring compliance with the EU investment management legislation on an ongoing basis. NCAs should therefore receive detailed information from authorised entities and be satisfied that they commit sufficient time to properly perform their functions.
28. NCAs should ensure that the organisational structure and human and technical resources of authorised entities as well as the configuration of their Senior Management allows them to contact and meet with Senior Managers and relevant staff during normal business hours. Moreover, NCAs should be satisfied that the organisational set-up of entities allows them to carry out on-site visits of their business premises at any time (even without prior notice) and be able to meet with Senior Management at short notice (within a day). The Senior Managers of authorised entities must be able to provide all information that NCAs deem essential for their supervision.

#### Internal control mechanisms

29. Authorised entities must have effective internal control mechanisms in place in order to ensure compliance with the EU investment management legislation.
30. The UCITS Level 2 Directive and AIFMD Level 2 Regulation set out that authorised entities must always establish a compliance function. NCAs should engage with entities that intend not to comply with Article 10(3)(c) or (d) of the UCITS Level 2 Directive or Article 61(3)(c) or (d) of the AIFMD Level 2 Regulation on a case-by-case basis and require the implementation of safeguards to ensure the effectiveness of the compliance function including the mitigation of potential conflicts of interest and risks to investor protection.
31. NCAs should be satisfied that the organisational structures of authorised entities ensure that all material legal risks are assessed by individuals that have sufficient knowledge and experience in the relevant legal matters and are independent from risk-taking functions. In particular, this means that material legal risks should be assessed by individuals with no

direct or indirect reporting lines to the Senior Manager designated for operational functions such as portfolio management. Where authorised entities rely on external legal advisers to assess legal risks, the internal policies and procedures should specify the cases and situations in which external advice should be obtained, allocate the responsibilities for this process and elaborate on the subsequent decision-making procedure after receiving external advice. The internal procedures should be in accordance with the principle that material risks should be assessed by persons independent from operating units.

32. Senior Managers should only be designated with the Compliance function where they can demonstrate that they have the required knowledge and expertise and can commit sufficient time to this function despite their other tasks and responsibilities in the organisation.
33. Combining the risk, compliance and/or internal audit functions should generally be avoided as this is likely to undermine the effectiveness and independence of these control functions.<sup>18</sup>
34. NCAs should be satisfied that the organisational policies and procedures of authorised entities provide for a strong role of the internal control functions within the organisation. Internal control functions should be consulted in particular before taking significant strategic decisions (e.g. entering new markets or engaging in new asset classes, set-up of new funds, delegation of functions set out in Annex II of the UCITS Directive and Annex I of the AIFMD to third parties). This is essential in order to ensure the decision-making process includes an appropriate assessment of all relevant risks. The organisational policies and procedures of authorised entities should ensure that there is a clearly defined 'escalation procedure' in the case of disagreements between internal control functions and operating units. In the case of persisting disagreements at a higher level (e.g. disagreement between heads of unit), the final decision should be taken at the level of Senior Management. Where Senior Management or the governing/management body itself is in disagreement on matters relating to compliance with the EU investment management legislation, the internal procedures should provide for an escalation to NCAs<sup>19</sup>.
35. NCAs should be satisfied that internal control functions carry out their control activities on a continuous basis and provide regular reports to the governing/management body and, where it exists, supervisory function on the results of their control activities. Moreover, organisational policies and procedures should ensure that significant deficiencies are reported to the governing/management body and NCAs without undue delay. Where Senior Management deviates from recommendations or assessments of internal control functions, this should be documented accordingly in the regular reports. Where deficiencies detected by control functions are not effectively addressed and resolved by Senior Management in due time (e.g. due to disagreements between internal control

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<sup>18</sup> This is without prejudice to the fact that in entities with only two Senior Managers several control functions may have reporting lines to the same Senior Manager.

<sup>19</sup> This is without prejudice to the board's ultimate responsibility for decision-making.



functions and Senior Management or budgetary issues), such situations should be reported to NCAs.

#### White-label business

36. NCAs should give special consideration to authorised entities engaged in the *white-label* business (i.e. fund managers that provide a platform to business partners by setting up funds at the initiative of the latter and typically delegating investment management functions to those initiators/business partners or appointing them as investment advisers). These types of entity are already authorised in EU27 Member States and may gain additional business as a result of the UK withdrawing from the EU. However, a significant rise in business activities within a relatively short period of time may create additional operational risks. NCAs supervising such entities should therefore give special consideration to them and assess whether they continue to have sufficient human and technical resources to manage the additional business and comply with the applicable delegation requirements as further elaborated on in Chapter V below and, in particular, the substance requirements. A significant rise in the value of assets under management, managing new types of investment strategies or asset classes and/or investing in or distributing to new geographical regions will typically create the need for additional human and technical resources with the required experience and expertise and necessitate a higher sophistication of governance structures and internal control mechanisms. NCAs should assess whether the structures put in place by such entities and the resources they employ remain appropriate taking into account the principles set out in this opinion and the additional business acquired by such entities.

## **V. Delegation**

#### Assessment of delegation arrangements

37. The use of delegation arrangements may be an efficient way to perform some functions or activities. However, such arrangements (in particular when the service provider is outside the EU) are not without their risks both for authorised entities and for their NCAs and must be subject to appropriate oversight; points which this opinion seeks to address.
38. NCAs should be satisfied that authorised entities have organisational policies and procedures in place in order to comply with the delegation requirements set out in the EU investment management legislation at all times.
39. NCAs should ensure that the delegation and/or operational risk management policies and procedures of authorised entities detail all functions set out in Annex II of the UCITS Directive and Annex I of the AIFMD<sup>20</sup> that are not performed internally and are therefore

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<sup>20</sup> In this respect, consideration should be given to recital 82 of the AIFMD Level 2 Regulation that provides the following examples for supporting tasks that are not subject to the delegation requirements: (i) logistical support in the form of cleaning, catering and procurement of basic services or products, (ii) buying standard software 'off-the-shelf' and relying on software providers for ad hoc operational assistance in relation to off-the-shelf systems and (iii) providing human resources support such as sourcing of temporary employees or processing of payroll.

subject to delegation requirements. NCAs should consider applying a similar approach to other critical functions (e.g. IT).

40. In this context, NCAs should give special consideration to the appointment of investment advisers in order to ensure that the delegation rules set out in the EU investment management legislation are not circumvented. Where authorised entities appoint third parties to provide investment advice and base their investment decision on the advice provided by the third party without carrying out their own qualified analysis before concluding a transaction, such arrangements are to be considered as delegation of investment management activities. Moreover, it is not sufficient if authorised entities only carry out formal assessments in the sense that they only check whether the investment proposed by the investment advisers would breach investment restrictions. NCAs should therefore be satisfied that the policies and procedures of authorised entities provide for clear documentation and recordkeeping of their own qualified analysis carried out after the receipt of investment advice.

#### Common interpretation and supervisory focus

41. While the general delegation requirements set out in Article 20 of the AIFMD have been specified by detailed Level 2 provisions<sup>21</sup>, the UCITS Directive does not detail the general delegation requirements set out in Article 13 of the UCITS Directive, including the notion of 'letter-box entity'. As the general principles set out in both frameworks are similar, ESMA considers it essential for NCAs to have a harmonised approach on this matter and address the risks of regulatory and supervisory arbitrage.

42. Therefore, ESMA is of the view that the interpretation of Article 13 of the UCITS Directive and the relevant national laws transposing this provision should be consistent with the principles set out in Articles 75 to 82 of the AIFMD Level 2 Regulation. In this respect, NCAs should ensure that UCITS investors, which are often retail investors, benefit from at least the same level of protection as AIF investors.

43. NCAs should be satisfied that there are objective reasons for delegation. This requires that NCAs assess the (i) detailed descriptions, (ii) explanations and (iii) evidence of the objective reasons provided by authorised entities and are satisfied that the entire delegation structure is based on objective reasons.<sup>22</sup>

44. NCAs should therefore ensure that they carry out a case-by-case analysis taking into account the materiality of the delegated activity. This analysis should be based on the detailed descriptions, explanations and evidence provided by authorised entities as to why and how the envisaged delegation arrangements is justified by objective reasons in order to, for example, optimise business functions and processes, save costs, benefit from additional expertise in administration or in specific markets or investment and access to global trading capabilities. In no way should this assessment be interpreted as a mere

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<sup>21</sup> Articles 75 to 82 of the AIFMD Level 2 Regulation.

<sup>22</sup> As set out in Article 76 of the AIFMD Level 2 Regulation with regard to AIFMs.

notification procedure. NCAs should analyse the information and evidence provided by authorised entities and be satisfied that there are indeed objective reasons for the delegation and that the delegation structure does not allow for a circumvention of the EU investment management legislation and the responsibilities of authorised entities.

45. With respect to the criteria of cost saving<sup>23</sup>, authorised entities should provide evidence that the financial benefits of the envisaged delegation structure outweigh 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. Where 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.
46. In this respect, NCAs should require detailed information from authorised entities and analyse their conflicts of interest policies and procedures in order to be satisfied that an effective conflicts management in accordance with the EU investment management legislation<sup>24</sup> has been implemented – and that takes account, where relevant, of delegation to entities within the same corporate group – including the relevant disclosures to investors.
47. Delegation to non-EU entities could make oversight and supervision of the delegated functions more difficult. The same applies where authorised entities intend to implement delegation structures with longer or more complex operational chains and/or with a greater number of parties involved. Such delegation arrangements result in additional challenges both for the authorised entities and NCAs. NCAs should therefore give special consideration to such delegation arrangements and be satisfied that their implementation is justified based on objective reasons despite the additional risks which may arise from them.
48. Where authorised entities delegate portfolio management or risk management activities to non-EU entities, NCAs should be satisfied that:
  - a) the entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under the relevant ESMA guidelines<sup>25</sup>; or
  - b) appropriate contractual arrangements are put in place with entities to which portfolio management or risk management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules set out in the ESMA guidelines; these contractual arrangements should cover any payments made to the delegates' identified staff as compensation for the performance of portfolio or risk management activities on behalf of the authorised entity.

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<sup>23</sup> As set out in Article 76(1)(b) of the AIFMD Level 2 Regulation with regard to AIFMs.

<sup>24</sup> As set out under Article 80 of the AIFMD Level 2 Regulation with regard to AIFMs.

<sup>25</sup> ESMA guidelines on sound remuneration policies under the AIFMD, 3 July 2013 (ESMA/2013/232) and ESMA guidelines on sound remuneration policies under the UCITS Directive, 14 October 2016 (ESMA/2016/575).

## Due Diligence

49. NCAs should be satisfied that the delegation and/or operational risk management policies and procedures of authorised entities elaborate on the initial due diligence during the selection process. Every delegation of functions must be preceded by a written due diligence on the delegate and possible alternatives (at least for the entities relevant for their contingency planning). In this context, authorised entities should, inter alia, identify and analyse all benefits and risks (knowledge, experience, reputation, track-record, technical capabilities, effective oversight and supervision, legal system of the relevant jurisdiction, financial soundness, country and concentration risks, efficiency, pricing etc.) including conflicts of interest deriving from each candidate. Authorised entities should elaborate on how and why they select one candidate over the other and, as stated above, this should be based on objective reasons.
50. The objective of a due diligence process is to determine whether, having regard to the specific functions to be carried out by the delegate and taking into account all related benefits and risks, the potential delegate can be considered as most suitable for undertaking the delegated functions. Authorised entities have a fiduciary duty towards their investors and must act in their best interest when delegating functions. NCAs should therefore be satisfied that authorised entities have implemented appropriate policies and procedures with a view to selecting delegates based on objective reasons acting in the best interests of investors.
51. The written contractual arrangements between authorised entities and delegates should detail precisely the individual tasks and activities that are delegated and ensure that authorised entities have the right to inquire, inspect, have access or give instructions to their delegates and terminate contracts at short notice where this is justified with a view to safeguarding the best interests of investors. As the delegate may not be subject to equivalent legal and regulatory obligations, an authorised entity delegating portfolio management activities should not simply assume that the delegate will provide its services in compliance with the operating conditions set out in the EU investment management legislation (e.g. due diligence, best execution or recordkeeping requirements). Therefore, it is of utmost importance that the contractual arrangements ensure that the authorised entity is able to comply with EU investment management legislation. Moreover, the contractual arrangements should ensure that authorised entities, their internal control functions, external auditors (of both the authorised entities and the relevant funds) and NCAs have effective access to data related to the delegated functions and to the business premises of the delegate as well as require delegates to cooperate with these parties at all times.
52. NCAs should be satisfied that the policies and procedures of authorised entities ensure that the delegation agreements are drafted and/or reviewed by individuals that have sufficient knowledge and experience in the relevant legal matters and are independent from risk-taking functions with a view to ensuring that all relevant contracts are in full compliance with the EU investment management legislation. The internal policies and procedures of authorised entities should provide for regular reviews of contracts already

concluded to ensure that they continue to be in compliance with the applicable EU investment management legislation as it may further evolve over time. Moreover, the compliance function and internal audit should carry out regular controls with respect to the compliance and effectiveness of delegation arrangements and monitoring mechanisms and report their findings to the governing/management body and, where it exists, the supervisory function. A delegation of functions set out in Annex II of the UCITS Directive and Annex I of the AIFMD should not result in a situation where the scope and effectiveness of the work of internal control functions or their independence is impaired.

53. Moreover, NCAs should assess, both in the context of the authorisation process and in the course of their ongoing supervision, that authorised entities have implemented effective policies and procedures to monitor the activities of their delegates in accordance with the EU investment management legislation. NCAs should be satisfied that authorised entities monitor the performance of the delegated functions and their compliance with the EU investment management legislation on an ongoing basis and carry out regular on-site visits of their delegates even where delegates are located outside of the EU. Delegation to non-EU entities should therefore not result in a situation where authorised entities carry out less intensive desk-based oversight and/or conduct less frequent on-site visits due to the geographical location of the delegate.
54. NCAs should be satisfied that the delegation and/or operational risk management policies and procedures of authorised entities provide for contingency planning with respect to delegates and detail all necessary steps and measures in case of a change of delegates. Authorised entities should have timely access to the required expertise, technology and data to replace delegates or enable them to insource functions at short notice (e.g. due to an extraordinary termination, default of the delegate or force majeure events).
55. The delegation policies and procedures of authorised entities should provide for appropriate recordkeeping of all due diligence and delegation monitoring activities as well as the contractual arrangements and all related documents so that NCAs can access the relevant information, where required.

#### Substance

56. 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.<sup>26</sup> 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.

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<sup>26</sup> As previously set out in the ESMA Q&As on the application of the AIFMD, Section VIII: Delegation, Q&A no. 1 (ESMA34-352).

57. Authorised entities should demonstrate to NCAs that they dedicate sufficient human and technical resources to the selection of potential delegates as well as ongoing delegation monitoring activities and that all individuals involved in this process have the required skills, knowledge as well as experience and time commitment for their respective tasks. NCAs should require detailed information on the due diligence and selection process carried out by these authorised entities and how they intend to monitor their delegates on an on-going basis. For this purpose, the delegation and/or operational risk management policies and procedures of authorised entities should clearly allocate due diligence and delegation monitoring responsibilities at all levels of the organisation (in particular Senior Management, internal control functions and operational staff) and detail the nature, extent and frequency of monitoring activities, the number of individuals involved and the time committed to these activities.
58. The performance of portfolio management and/or risk management function in accordance with the high standards set out in the EU investment management legislation requires sufficient human resources both at Senior Management and staff level. Where functions set out in Annex II of the UCITS Directive or Annex I of the AIFMD are not performed internally, this creates substantial workload for authorised entities as they have to select potential delegates diligently and monitor the performance of the delegated functions on an ongoing basis.
59. While delegation arrangements may increase efficiency, it is of vital importance that NCAs ensure that authorised entities maintain sufficient resources and expertise with respect to the delegated functions in order to effectively monitor delegates and be able to constructively challenge them. The delegation and/or operational risk management policies and procedures should therefore elaborate on function-specific expertise of all individuals and/or units involved in the due diligence process and delegation monitoring activities. It is unlikely that a single person has sufficient knowledge, experience and time to monitor a broader range of complex functions (e.g. portfolio management, risk management, valuation, unit/share issue and redemption processes, marketing activities, accounting etc.) in an effective manner. NCAs should therefore engage with authorised entities that intend to allocate the monitoring of a number of functions to a single person and be satisfied that this does not raise additional risks to investor protection.
60. In light of the above, NCAs should apply additional scrutiny to situations where relocating entities, even those of smaller size employing simple investment strategies and having a limited range of business activities, 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 functions and/or monitoring of delegates. NCAs should assess the criteria set out in paragraph 25 in the course of their ongoing supervision and require authorised entities to adapt their needs for human and technical resources as business operations further evolve.
61. In the context of relocations, NCAs should be satisfied that relocating entities have transferred a sufficient amount of portfolio management and/or risk management functions for the relevant funds to their new home Member State. Granting authorisations to

relocating entities should not result in a situation in which these entities could continue to perform substantially more portfolio management and/or risk management functions for the relevant funds in their original Member State or third country on a delegation basis and therefore also maintain substantially more relevant human and technical resources there despite a relocation. Moreover, such a situation would contradict the requirement that authorised entities must have both their head office and their registered office located in the same Member State.<sup>27</sup>

62. Article 82(1)(d)(i) to (vii) of the AIFMD Level 2 Regulation include a number of qualitative criteria that have to be used when assessing the extent of delegation with regard to AIFMs. NCAs should assess these qualitative criteria on a case-by-case basis. With respect to delegation of investment management functions to non-EU entities, NCAs should assess and weigh these criteria also in light of the principle that the entire delegation structure must be based on objective reasons<sup>28</sup>. By way of example, where authorised entities intend to delegate portfolio management and/or risk management functions to a larger extent to non-EU delegates with respect to (i) UCITS investing in transferable securities issued by EU issuers or (ii) EU AIFs investing in real estate or portfolio undertakings located in an EU Member State, NCAs should require detailed information and evidence from such authorised entities on why delegation to non-EU entities to a larger extent is objectively justified despite the fact that the geographical spread of investments<sup>29</sup> serves as an argument against such delegation structure. In such case, NCAs could require additional information from authorised entities in accordance with Article 76(2) of the AIFMD Level 2 Regulation and should only permit such delegation structures if there are clear reasons and evidence to conclude that the entire delegation structure is based on objective reasons.

#### Delegation of internal control functions

63. Where authorised entities intend to delegate internal control functions, NCAs should require detailed information and evidence and be satisfied that such delegation arrangements are based on objective reasons and do not impair the effectiveness of the relevant control functions or their independence.

64. Internal control functions must carry out desk-based and on-site controls on an ongoing basis and are involved in the client acceptance and fund set-up processes (often organised in internal committees). 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 these functions.

65. Where authorised entities intend to delegate internal control functions to non-EU entities, NCAs should require detailed information and evidence from authorised entities as to the objective reasons for such delegation arrangements. NCAs should be satisfied that the

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<sup>27</sup> Article 7(1)(d) of the UCITS Directive and Article 8(1)(e) of the AIFMD.

<sup>28</sup> As set out in Article 76 of the AIFMD Level 2 Regulation with regard to AIFMs.

<sup>29</sup> As stipulated by Article 82(1)(d)(iii) of the AIFMD Level 2 Regulation with respect to AIFMs.

non-EU delegate has the required knowledge, expertise and experience and is up-to-date with EU investment management legislation and all regulatory requirements that apply to both the authorised entities and the funds managed by them.

66. NCAs should give special consideration to reporting lines and/or delegation of internal control functions within the same corporate group and the conflicts of interest arising from this. By way of example, reporting lines or delegation of internal control functions of authorised entities to group functions of delegates (e.g. delegates performing portfolio management functions) may in some cases give rise to additional conflicts of interest. NCAs should analyse the conflicts of interest policies and procedures and be satisfied that there is effective conflict of interest management in accordance with the EU investment management legislation including disclosures to investors, where necessary.
67. Moreover, NCAs should 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. Where risk management and/or portfolio management functions are delegated, it must be ensured that the risk management function is in a position to be effectively involved at all times. NCAs should therefore be satisfied that the risk management or delegation policies and procedures clearly specify the interaction between these two functions and are suitable in order to ensure that the risk management function can perform its activities in compliance with the EU investment management legislation.

#### Non-EU branches

68. 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. Where relocating entities intend to establish or maintain non-EU branches, 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. Examples of situations in which the use of non-EU branches may be considered to be based on objective reasons include where authorised entities provide services in the non-EU jurisdiction, require local marketing support or for the purposes of handling consumer complaints in the relevant non-EU country. NCAs should require relocating entities to provide them with detailed information relating to, inter alia, the activities to be performed by the branch (and their geographical distribution), its organisational structure and the persons responsible for the management of the branch and ensure that they can effectively supervise the non-EU branch.

## **VI. Effective supervision**

69. NCAs should consider the extent to which the applicant's envisaged operations in other jurisdictions might impact the NCA's resources and ability to effectively supervise the relocating entities. NCAs should ensure that initial conditions set at the moment of



authorisation are met on a continuous basis, including those relative to delegation arrangements.

70. NCAs must ensure that any delegation does not impair their ability to enforce relevant legislation. NCAs should be satisfied that they have (i) access to all information related to delegated functions that is required for the performance of their desk-based supervisory tasks and (ii) access to business premises of delegates for on-site visits in order to effectively supervise compliance with the EU investment management legislation.
71. 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.<sup>30</sup> Effective and efficient cooperation among NCAs is of utmost importance, including with authorities of third countries.

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<sup>30</sup> In this context, NCAs should take into account the 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)).