

MiFID II Supervisory briefing

On the supervision of non-EU branches of EU firms providing investment services and activities

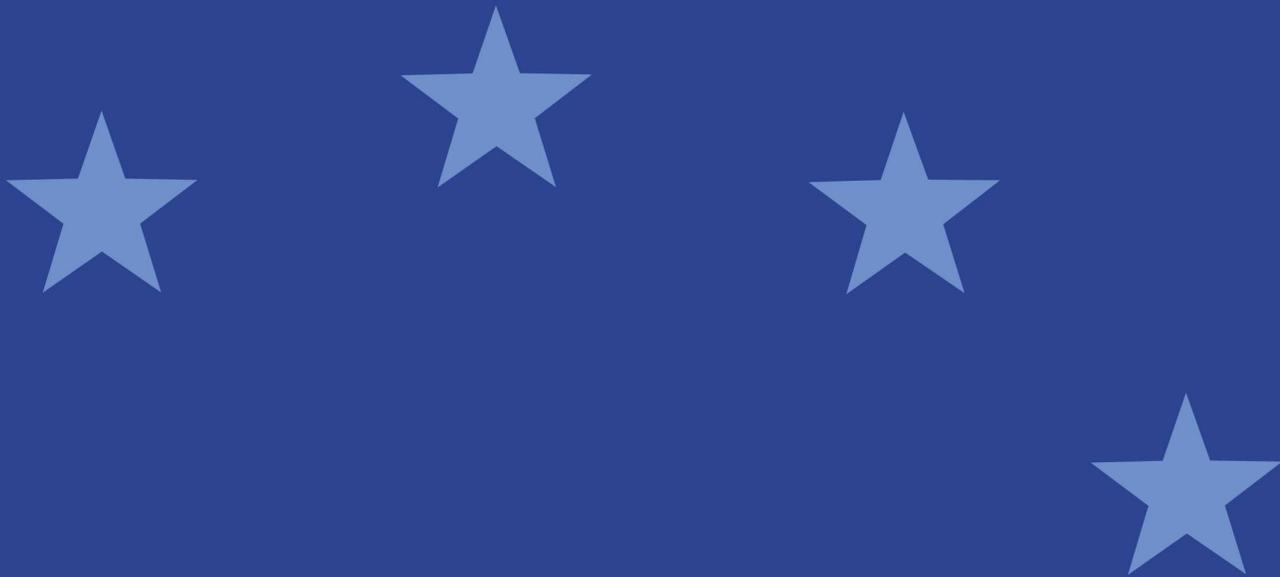


Table of Contents

1	Introduction	4
1.1	Overview	4
1.2	Scope.....	5
1.3	Status of this document.....	5
1.4	Purpose.....	6
2	Supervisory briefing.....	7
2.1	Supervisory expectations in relation to the authorisation of investment firms (Programme of operations).....	7
2.2	Ongoing activities of non-EU branches (including reporting and collection of information).....	9
2.3	Supervisory activity and cooperation with non-EU Competent Authorities	10

1 Introduction

1.1 Overview

1. ESMA is mandated to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices.
2. The Supervisory Coordination Network (SCN), that ESMA established to enhance mutual understanding through information exchange, sharing of good practices and discussion of key issues arising from relocation as a consequence of the UK withdrawal from the EU, has observed that a number of firms moving their business from the UK to the EU27 were/are planning to retain or to establish significant branches in the UK.
3. The Opinion to support supervisory convergence in the area of investment firms in the context of Brexit that ESMA issued on July 2017¹ (hereafter the “ESMA Opinion”) already stressed that EU27 Competent Authorities (CAs) should carefully monitor the risk of letter-box entities that arises not only from the use of outsourcing arrangements but also from situations in which EU investment firms use non-EU branches to perform material functions or provide services back into the EU².
4. ESMA is aware that the described situation could undermine the possibility for CAs to effectively supervise the activities performed by EU firms through branches established in non-EU jurisdictions and the existence of the conditions with which EU firms must comply when providing investment services and/or performing investment activities in accordance with MiFID II.
5. While these issues were initially identified in the context of the discussion on the risks arising from the UK withdrawal from the EU, they appear relevant beyond Brexit and it is thereby important to address them in a convergent manner among CAs as regards all third countries. Therefore, this supervisory briefing takes into account any case where an EU firm establishes a branch in a non-EU jurisdiction.

¹ Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union, ESMA35-43-762 (ESMA Opinion on relocation of investment firms): https://www.esma.europa.eu/sites/default/files/library/esma35-43-762_opinion_to_support_supervisory_convergence_in_the_area_of_investment_firms_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf, paragraph 49.

² ESMA Opinion on investment firms, paragraph 49: “NCAs should carefully monitor situations in which the risk of letter-box entities arises not only from the use of outsourcing arrangements but from situations in which EU investment firms use non-EU branches for the performance of functions/services with respect to EU clients. Where investment firms 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 the services provided in the non-EU jurisdiction and does not result in a situation where such non-EU branches perform material functions or provide services back into the EU. The use of non-EU branches may be based on objective reasons, e.g. where firms provide services in the non-EU jurisdiction or require local marketing support. NCAs should require relocating entities to provide them with detailed information relating to, *inter alia*, the activities (and their geographical distribution) to be performed by the branch, its organisational structure and the persons responsible for the management of the branch and ensure that they can effectively supervise the non-EU branch”.

6. Concerns on the risk of the establishment of “empty shell” companies have also been expressed by the other European Supervisory Authorities (ESAs)³, in their Opinions published in preparation to the UK withdrawal from the EU, and by the Single Supervisory Mechanism (SSM), in the FAQs dedicated to the procedures for the relocation of banks to the euro area in the context of Brexit⁴.
7. This supervisory briefing has been designed for competent authorities as an accessible instrument to supervise the establishment of branches in non-EU countries by EU firms.

1.2 Scope

8. This supervisory briefing is aimed at competent authorities (CAs, as defined under MiFID II⁵). It is also meant to give market participants indications of compliant implementation of the MiFID II provisions and of the recommendations expressed in the ESMA Opinion on investment firms.
9. It applies in relation to the following provisions and recommendations:
 - Articles 5, 21, 22 and 69 of MiFID II;
 - Articles 21 to 25 of the MiFID II Delegated Regulation No 2017/565;⁶
 - Paragraphs 13 and 49 of the ESMA Opinion.

It is also consistent with the approach followed under MiFID II RTS on authorisation⁷ and MiFID II RTS on passporting.⁸

1.3 Status of this document

10. This supervisory briefing is issued under Article 29(2) of the ESMA Regulation⁹ which enables ESMA to develop new practical instruments and convergence tools such as supervisory briefings. The purpose of these tools is to promote common supervisory

³ See: EBA Opinion on issues related to the departure of the United Kingdom from the European Union (EBA/Op/2017/12) <https://eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+BREXIT+Issues+%28EBA-Op-2017-12%29.pdf>; EIOPA Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (EIOPA-BoS-17/141) https://eiopa.europa.eu/Publications/Opinions/EIOPA-BOS-17-141%20Opinion_Supervisory_Convergence.pdf.

⁴ See: <https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html>.

⁵ Article 4(26) of MiFID II.

⁶ Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

⁷ Commission Delegated regulation (EU) 2017/1943 of 14 July 2016 supplementing Directive 2014/65 of the European Parliament and of the Council with regard to regulatory technical standards on information and requirements for the authorisation of investment firms.

⁸ Commission Delegated regulation (EU) 2017/1018 of 29 June 2016 supplementing Directive 2014/65 of the European Parliament and of the Council with regard to regulatory technical standards specifying information to be notified by investment firms, market operators and credit institutions.

⁹ 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.

approaches and practices especially in relation to situations where changes to business models or concerning practices emerge. The content of this supervisory briefing is not subject to any 'comply or explain' mechanism for CAs and is non-binding.¹⁰

1.4 Purpose

11. This supervisory briefing is designed to help EU CAs make their judgment during the authorisation and the supervision of investment firms and of credit institutions providing investment services and/or performing investment activities (collectively referred to as "firms") that intend to establish (or have established) a branch in a non-EU jurisdiction. The supervisory briefing is structured around the following three elements:

- a) Supervisory expectations in relation to the authorisation of investment firms;
- b) Ongoing supervisory activity of non-EU branches (including reporting and collection of information);
- c) Supervisory activity and coordination with non-EU Competent Authorities (non-EU CAs).

¹⁰ 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.

2 Supervisory briefing

2.1 Supervisory expectations in relation to the authorisation of investment firms (Programme of operations)

12. One of the main concerns in the three ESAs' Opinions published in preparation to the UK withdrawal from the EU relates to the possibility that firms relocating into the EU from the UK would be managed as empty shells or letter box entities.
13. The recommendations expressed in the ESMA Opinion on investment firms reflected and stressed existing EU legislative sectorial frameworks and principles according to which applicants submitting a request for authorisation to an EU CA should describe and explain (inter alia) the proposed organisational structure, the governance regime, and the expected geographical organisation of the business.
14. According to paragraph 49 of the ESMA Opinion, CAs should be satisfied that the use of non-EU branches is based on objective reasons linked to the services provided in the non-EU jurisdiction and does not result in situations where such non-EU branches perform material functions or provide services back into the EU. For example, the set-up of a branch in a non-EU country by a firm would make sense when the firm intends to provide services in that non-EU jurisdiction or to require local marketing support.
15. In order to assess the abovementioned objective reasons and to assess that non-EU branches do not perform material functions or provide services back into the EU, CAs should consider with attention the programme of operations that applicants will submit in the context of the authorisation procedure under Articles 5 et seq. of MiFID II. In particular, CAs should make their judgment on the substance of the business activity, the organisation, the governance and the risk management arrangements of the applicant in relation to the establishment and the use of branches in non-EU jurisdictions. To enable the identification of hurdles that could prevent the effective exercise of their supervisory functions, CAs should take into account the complexity and clarity of the applicant's organisational arrangements, the geographical location of the branches of the firm, the activity that the latter would perform and the relationship of the applicant and its branches with other entities of the group.
16. It is important that the organisational structure of the applicant and the relevant procedures of the risk management function fit with the nature, scale and complexity of the business activity of the applicant and with the geographical distribution of its business. The distribution of staffing between branches and the applicant firm (including considerations on the seniority of staff) and the arrangement of local risk management need to be commensurate and overall balanced with the articulation of the business, its expected geographical distribution of activities and total volumes.
17. With respect to non-EU branches, the applicant's programme of operations should therefore explain how the EU head office will be able to monitor and manage any non-

EU branches arrangements, and ensure that competent authorities have full access to all information they need to fulfil their supervisory functions.

18. For such purposes, an applicant seeking authorisation as an investment firm in accordance with Title II of MiFID II and that plans to establish branches in non-EU jurisdictions should clarify the role of these branches in the programme of operations and provide, for each non-EU branch, detailed information on (*inter alia*):
- a) The name, address and contact details of the non-EU branch from which documents may be obtained by the competent authority;
 - b) An overview explaining how the non-EU branch will contribute to the investment firm's or group's strategy;
 - c) The activities and the functions that will be performed by the non-EU branch (including any activity provided to the firm's head office or other EU entities of the group, taking into account paragraph 49 of the ESMA Opinion) and their geographical distribution;
 - d) The expected number and the geographical distribution of the clients with which the non-EU branch will be dealing;
 - e) A description of the type of clients or counterparties with which the branch will be dealing and of how the investment firm will establish the contractual relationships and deal with those clients and counterparties;
 - f) A description of how the firm will ensure that any local legal requirements in the non-EU jurisdiction do not interfere with the compliance by the EU firm with legal requirements applicable to it in accordance with EU law.
 - g) The following information on the organisational structure of the non-EU branch:
 - i. Reporting lines between the non-EU branch manager(s) and the EU head office;
 - ii. (If the investment firm is member of a group) Description of the manner in which the non-EU branch fits into the corporate structure of the investment firm or of the group;
 - iii. Explanation on how local control and oversight of risks will be performed;
 - iv. Explanation on how the activities and services provided by the non-EU branch will be controlled by the compliance function and the internal audit function of the applicant in the EU;
 - v. Explanation on how risks originated in the non-EU branch will be managed by the applicant in the EU;
 - vi. Details of senior manager(s) of the applicant directly responsible for the oversight of the non-EU branch;

- vii. Details of individuals performing key functions within the non-EU branch, including the individuals responsible for day-to-day non-EU branch operations, compliance, risk management, and dealing with complaints;
 - viii. The composition and distribution of staff with specific indication of where staff members of the applicant (including EU head office and non-EU branches) will be located, its seniority and the type of presence (i.e. full time, part-time, secondment);
 - ix. Arrangements to deal with situations where senior managers or executives or other key function holders are allowed to carry out functions in more than one group entity (so called “dual hatting”).
- h) The EU head office supervision of the activities carried out by the non-EU branch and relevant risk management arrangements.
19. CAs should be satisfied that the applicant’s programme of operations and the objective reasons on which the establishment of non-EU branches is based enable them to conclude that the risk of letter-box entity is properly addressed and to ensure that the applicant is able to comply with all the legal requirements stemming from the relevant EU legislation. When assessing authorisation requests CAs should give particular attention to circumstances where such conditions could not be fully fulfilled, for example when the legislation of the non-EU State where a branch is going to be established would not allow the applicant to comply with legal requirements in accordance with EU law or when specific additional arrangements are needed to ensure that the EU firm retains full control and oversight of branches’ activity.
20. Relevant legislation: Title II of MiFID II.

2.2 Ongoing activities of non-EU branches (including reporting and collection of information)

21. In order to allow CAs to appropriately monitor firms providing investment services or activities on an ongoing basis, firms should provide the CA of their home Member State with relevant information on any new non-EU branch that they plan to establish or on any material change in the activities of non-EU branches already established. Relevant information should be in line with paragraphs 16 to 18 of the previous chapter 2.1 of this Supervisory briefing.
22. In accordance with Article 22 of MiFID II, appropriate measures shall be in place to enable CAs to obtain the information needed to assess the compliance of firms with the operating conditions provided under MiFID II.
23. Depending on the organisation of CAs’ ongoing supervisory activity and taking into account the importance of non-EU branches for the relevant firm under their supervision,

CAs should request, on an ad hoc or on a periodic basis, information on at least the following aspects concerning the activities of non-EU branches:

- a) Information on the number and the geographical distribution of clients served by non-EU branches;
- b) Information on the activities and the functions provided by the non-EU branch to the EU head office;
- c) Information on the activities and the functions provided by the non-EU branch to other entities of the group;
- d) Outcome of the regular assessment that the compliance function has to perform in accordance with Article 22 of MiFID II Delegated Regulation No 2017/565 and that should include the assessment of the activities performed by the non-EU branches.

24. In order to facilitate the collection of information on the nature and the scale of the activities and functions performed by non-EU branches of EU firms, CAs may prepare templates that the relevant EU firms should use.

25. Relevant legislation: Articles 21 and 22 of MiFID II and Articles 22 and 23 of MiFID II Delegated Regulation No 2017/565.

2.3 Supervisory activity and cooperation with non-EU Competent Authorities

26. CAs should put in place internal criteria and arrangements to supervise comprehensively and in sufficient depth the activities that branches of EU firms under their supervision perform outside of the EU.

27. For that purpose, CAs should prepare plans for the supervision of non-EU branches of EU firms and identify resources dedicated to this activity. These resources should be capable of performing a critical screening of the firms under their supervision that have established non-EU branches, including information received or to be requested in relation to these branches.

28. In line with Article 69 of MiFID II, CAs should, inter alia, be able to have access to any document or other data which they consider relevant for the performance of their supervisory duties on non-EU branches of EU firms that fall under their supervision and to carry out on-site inspections or investigations.

29. In order to strengthen their ability to supervise non-EU branches, CAs may put in place a specific framework for cooperation with non-EU CAs where non-EU branches are based. The existence and extent of supervisory cooperation should be taken into account in the assessment of CAs' ability to understand and monitor the risks posed by non-EU branches of EU firms.

30. Any established cooperation among EU and non-EU competent authorities should aim at an open, transparent and proactive exchange of information and views and should facilitate EU CAs on-site inspections or investigations on non-EU branches of firms under their supervision. A collaborative approach among EU and non-EU CAs could be put in place and formalised through cooperation arrangements or agreements (e.g. MoUs or other form of cooperation agreements).
31. When CAs consider that, in certain circumstances, they would not be able to ensure the appropriate degree of supervision on non-EU branches of firms under their supervision (e.g. because of the lack of regulatory or supervisory arrangements with the relevant non-EU CA), the establishment of a non-EU branch by a EU firm should be rigorously scrutinised in order to assess the impact of the operation of the branch on the sound and prudent management and the risks taken by the firm.
32. Relevant legislation: Articles 21, 22, 69 of MiFID II.