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ESMA's Brexit Reminder

Although most Brexit related media coverage of the financial services sector has focused to date on banking, on insurance and on market infrastructure issues post-divorce, the asset and funds management sectors have also been considering their options.

Whilst in many ways related, the funds management and asset management industries are not the same and are subject to different, albeit again related, legal and regulatory regimes. Yesterday, twenty days before the first formal EU / UK Brexit talks are scheduled to commence, ESMA (European Securities and Markets Authority) issued an Opinion setting out a series of principles relevant to outsourcing, delegation and anti-letter-box provisions within the funds and asset management sectors. The principles are intended as a reminder to the national regulators of their obligations when assessing applications for authorisation, including Brexit related ones so one should not expect anything controversial.

The Regimes

Before briefly considering what those principles are, a quick reminder of the relevant regimes we are talking about may be useful:

(i) **UCITS** : the UCITS regime governs a certain type of EU domiciled collective investment scheme known as "UCITS"[1]. A UCITS fund is subject to strict product level rules which have facilitated a passporting regime which allows a UCITS authorised in one EU Member State to be marketed to the public throughout the Union. A UCITS can either be self-

1 UCITS is the acronym for "undertakings for collective investment in transferable securities".

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managed investment company (**SMIC**) or it can be a managed fund, in which case it must have an EU based UCITS management company (the "**UCITS ManCo**"). A UCITS ManCo has its own passport (i.e. independent of the UCITS product passport) which allows it act as UCITS ManCo to UCITS in any EU Member State. It can also be authorised to manage alternative investment funds and to provide portfolio management and investment advice and other services on an ancillary basis.

Relevant in the context of the ESMA Opinion, the UCITS regime expressly provides that self-managed UCITS investment companies and UCITS ManCos can delegate functions to third parties for the purpose of operating their businesses more efficiently. Specific provision is made for delegation that concerns investment management, in which case the mandate must only be given to undertakings which are authorised or registered for the purpose of asset management and are subject to prudential supervision. The delegation must also be in accordance with investment allocation criteria periodically laid down by the ManCo or UCITS SMIC. Where the mandate concerns investment management and it is given to a third-country undertaking (the current expectation being that the UK will be a third-country), co-operation between the supervisory authorities concerned must be ensured (i.e. an MOU or equivalent must be in place). Additional requirements apply, including that the liability of the ManCo shall not be affected by delegation of any function to third parties and, also of relevance for this note, Article 13(2) of the UCITS Directive goes on to state that a ManCo *"shall not delegate its functions to the extent that it becomes a letter-box entity"*.

This regime has allowed self-managed UCITS investment companies and UCITS ManCos to delegate investment management functions to asset managers from all over the world, both within and outside the EU. There are UCITS which have investment managers based in the U.S., Canada, Switzerland, Japan, Hong Kong and so on.

(ii) **AIFM** : the AIFMD regime is slightly different in that its focus is not on the fund product but rather is on the management company, known as the AIFM (alternative investment fund manager) and its management and marketing capacities. Interestingly, the AIFM regime has a wide coverage in that it addresses both the management and marketing of EU domiciled AIFs (alternative investment funds) and those domiciled outside the EU as well as addressing both AIFMs established within the EU and those established outside the EU. It creates a regime that facilitates the managing and / or marketing of AIFs by AIFMs where, for the moment at least, the greatest capacities and freedoms (and passports) are given to EU established and authorised AIFMs managing and / or marketing EU domiciled AIFs.

The term "managing AIFs" is defined in AIFM Directive as "*performing at least investment management functions referred to in point 1(a) or (b) of Annex 1 for one or more AIFs."* The investment management functions listed in Annex 1 are (a) portfolio management and (b) risk management.

Article 20 of AIFMD allows for delegation of AIFM functions, but again there are specific provisions regarding delegation of portfolio management or risk management, with additional rules where a delegation of portfolio management is conferred on a third country undertaking. The requirements are quite similar to UCITS in that regard, including that the AIFM's liability towards the AIFM and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party (or by any further sub-delegation) and the AIFM must not delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity.

Article 82 of the AIFM Level 2 Regulation has further provisions addressing the letter-box concept, setting out scenarios where an entity is no longer considered to be managing an AIF. Those provisions do not distinguish between EU and non-EU delegates and, again within the AIFMD regime, we see delegation of portfolio management functions to third parties both inside and outside the EU as well as non-EU AIFMs.

(iii) **MiFID** : The MiFID regime covers a wide range of investment services where those services include (but are not limited to) portfolio management and investment advice. MiFID firms are currently subject to the MiFID I regime which is being replaced with effect from early January 2018 by MiFID II, made up of a number of Directives, Regulations, Guidelines, Q&As, RTS, ITS, etc. Some MiFID firms, depending on their size and activities, may also be subject to CRD IV in certain aspects of their business.

MiFID II provides capacity for third country (i.e. non-EU) investment firms to carry on business in the EU either by setting up an authorised branch within an EU Member State, or (i.e. without a presence in the EU) on the basis of an equivalence determination or where domestic Member State law allows (in the absence of there being an equivalence determination).

The MiFID II regime also allows for outsourcing by MiFID firms. Although it imposes broad organisational requirements on investment firms, outsourcing is allowed including the outsourcing of critical or important operational functions and it is possible to outsource to third-country providers. The accompanying Commission Delegated Regulation has a dedicated section (Chapter II, Section 2) on outsourcing from which it is clear that the provision to a MiFID firm of services which form part of its investment business is likely to fall within "critical or important" outsourcing. It is also clear that it is possible to outsource functions related to the investment service of portfolio management provided to clients to a service provider located in a third-country where, similar to the UCITS and AIFM regimes, the service provider is authorised or registered in its home country and is effectively supervised by a competent authority etc. and there is an appropriate co-operation agreement in place between the MiFID firm's regulator and that of the third-country firm.

Given that no equivalence determination regarding the UK has yet been made (and it may well be that it cannot be made until, at the earliest, if and when the UK leaves the Union) and as there is no readiness for authorising (or perhaps even receiving applications from) third country branches, UK MiFID firms face some uncertainty as to how to access the Union post Brexit.

The Opinion

As ESMA explains, the UK's departure from the EU brings with it the potential relocation of UK entities to within the Union. In that context, ESMA considers that its Opinion should be seen as a practical tool to achieve supervisory convergence, where the focus is on safeguarding investor protection, the orderly function of financial markets and financial stability.

The Opinion sets out the following nine principles :

- No automatic recognition of existing authorisations;
- Authorisations granted by EU 27 NCAs should be rigorous and efficient;
- NCAs should be able to verify the objective reasons for relocation;
- Special attention should be granted to avoid letter-box entities in the EU 27;
- Outsourcing and delegation to third countries is only possible under strict conditions;
- NCAs should ensure that substance requirements are met;
- NCAs should ensure sound governance of EU entities;
- NCAs must be in a position to effectively supervise and enforce EU Union law; and
- Coordination to ensure effective monitoring by ESMA.

A link to the Opinion is found here

There is nothing controversial in the Opinion and the principles are, in effect, a reminder that there are rules and there are obligations and, just like all other applicants, those relocating from the UK will need to comply with those rules and meet those obligations. We would however, draw your attention to the following paragraphs which we think are of interest.

(i) **Paragraph 28** reads: "*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 benefiting from an EU passport while essentially preforming all substantial activities or functions outside the EU 27. Similar considerations may apply if entities perform substantial activities and functions through third country branches".

It is important to remember that anti letter-box provisions apply irrespective of whether one is delegating within or outside of the EU 27 and it would be fair to assume that any request to create a letter-box will be rejected. We view this as a restatement of the current position and not specifically Brexit related.

(ii) Perhaps the most instructive provision is found in **paragraph 36** which reads: "*Some important activities and functions deserve special scrutiny and in certain sectors specific circumstances cannot be outsourced and delegated without threatening the activity of the regulated entities and the possibility of effective supervision of NCAs. These important activities and function comprise, inter alia, internal control functions, IT control infrastructure, risk assessment, compliance functions, key management functions and sector-specific functions".*

It does need to be borne in mind that this does say "*... and in certain sectors specific circumstances cannot be …. "*. It is not a blanket prohibition on outsourcing or delegation of such functions but should probably be seen as a common sense reminder to applicants. Further clarity should emerge with the publication of ESMA' s section specific opinion on asset management which is expected shortly.

(iii) Finally, **paragraph 38** provides clarity on ESMA's position around governance. It reads: "*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 role, if not on a fulltime basis".*

This is pretty clear messaging. The accompanying footnotes states that 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.

So what are we seeing?

We are seeing increasing interest in UCITS ManCos, in AIFMs, in Super ManCos and in conversions of MiFID firms to AIFM or Super ManCos. In that latter regard we have seen, both as a result of opportunities under AIFMD but also as a reaction to MiFID II, some firms give up their MiFID authorisations and replace them with an AIFM authorisation or, in some cases, with a dual UCITS ManCo / AIFM authorisation, now being referred to as a "Super ManCo" particularly where it includes individual portfolio management, investment advice and, potentially, receipt and transmission of orders.

Managers who have – or hope to have – a significant EU client base are clearly investigating post-Brexit solutions for their fund management and asset management businesses, with authorisation combinations and outsourcing and delegation and controls and governance all “hot topics”.

If you have any questions please do not hesitate to contact your usual Dillon Eustace lawyer.

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