

# Relocation of financial institutions following the UK's decision to leave the EU

- Danny Busch

# Introduction

- In the course of 2017, ESMA, EBA & EIOPA published:
  - opinions on regulatory and supervisory arbitrage risks
  - that arise as a result of increased requests from financial market participants
  - seeking to relocate from the UK to the EU27 within a relatively short period of time
  - in order to maintain access to EU financial markets (European passport)
- In this context, these market participants
  - may seek to minimise the transfer of the effective performance of those activities or functions in the EU27
  - by relying on the outsourcing or delegation of certain activities or functions to UK-based entities, including affiliates
- In the view of ESMA, EBA & EIOPA it is therefore necessary to ensure that the conditions for
  - authorisation
  - outsourcing and delegationdo not generate supervisory arbitrage risks

# Introduction

- **The opinions all assume that the UK will become a third country after its withdrawal from the EU.**
- **Opinions are primarily addressed to the national competent authorities (NCAs) of the 27 EU Member States remaining in the EU (EU27)**
- **ESMA opinions cover investment firms, investment funds & trading venues**
- **EBA opinion covers banks, investment firms, payment institutions and electronic money institutions, credit intermediaries and non-credit institutions admitted under the MCD**
- **EIOPA opinion covers insurance and reinsurance undertakings**

# Introduction

- Six opinions in total:
  - ESMA Opinion General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union (31 May 2017) (ESMA42-110-433) [Cross-sectoral opinion]
  - ESMA Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA35- 43-762) [Investment firms opinion]
  - ESMA Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA70- 154-270) [Trading venues opinion]
  - ESMA Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA34-45-344) [UCITS & AIFM opinion]
  - Opinion of the European Banking Authority on issues related to the departure of the United Kingdom from the European Union (12 October 2017) (EBA/Op/2017/12)
  - EIOPA Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (11 July 2017) (EIOPA-BoS-17/141)

# Principle one: No automatic recognition of existing authorisations

- 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 -> a new situation has arisen

See also the investment firms opinion + UCITS & AIFM opinion -> the MiFID / UCITS / AIFM framework does not provide for any reliance on previous or existing authorisations in other Member States or third countries

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

- NCAs should ensure that conditions set by the relevant legislation are met from day one of the authorisation.

See also the investment firms opinion + UCITS & AIFM opinion

as the MiFID / UCITS / AIFM framework does not provide for any transitional provisions in case of relocation of firms, NCAs should not rely on mere confirmation from applicants but require detailed information in order to be satisfied that applicants' organisational set-up and business operations will be in compliance with the relevant framework from day one.

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

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

- **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.**

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

- **At the same time, NCAs should apply strong scrutiny to, inter alia,**
  - the entities' governance structure
  - human and technical resources
  - geographical distribution of activities
  - outsourcing and delegation arrangements.
- **Without prejudice to Principle four (on letter-box entities), 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' activities (regulatory arbitrage)**
- **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.**

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

- **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.**
- **So the NCA should establish a clear view on the geographical distribution of planned activities from the perspective of targeted clients and/or services development.**
- **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.**

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

See also UCITS & AIFM opinion:

**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.**

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

- **Where the service provider is located outside the EU the ability of entities and NCAs to control and supervise may be significantly impacted.**
- **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.**

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

- Similar considerations may apply if entities perform substantial activities and functions through third country branches.

See investment firms opinion: 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

See for similar considerations the UCITS & AIFM opinion + trading venues opinion

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

- **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.**

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

- NCA's should be prudent when determining the extent to which an entity can rely on outsourcing or delegation.

The investment firms opinion gives the following example: where investment firms intend to outsource portfolio management functions to non-EU entities with respect to portfolios investing in instruments issued by EU issuers or portfolios of collective undertakings located in an EU Member State, NCA's should assess whether, in light of the geographical spread of investments and clients between the EU and non-EU markets, such outsourcing arrangements to non-EU entities are appropriate and objectively justified.

NCA's should carefully consider whether such outsourcing arrangements, in particular when there are alternative providers located in the EU, ensure compliance with the MiFID framework and firms' duties towards clients.

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

See for a similar example the UCITS & AIFS opinion: 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,

In both the investment firms opinion and the UCITS & AIFM opinion it is emphasized that the appointment of a third party should be preceded by a proper due diligence / selection process, including a cost / benefit analysis of outsourcing or not

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

- Trading venues opinion even prohibits outsourcing of certain key functions to third countries:

The proper functioning of the trading venue depends on the

- design
- calibration
- control, and
- monitoring of this key activity.

In order to ensure that NCAs can effectively supervise the trading venue, and take supervisory action in case of an emergency, the decision making for

- designing
- controlling and
- monitoring

the operation of the trading system should not be outsourced outside the EU27.

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

- the admission to trading of financial instruments
- the establishment of and any subsequent changes to the rulebook of the trading venue
- the suspension and removal of financial instruments from trading and mechanisms to halt trading

are key activities to ensure the orderly functioning of markets and an appropriate level of investor protection.

More specifically, since in certain cases NCAs may

- require trading venues to suspend or remove from trading certain instruments (Article 52(2) of MiFID II) or
- coordinate a market wide trading halt (Article 48(5) of MiFID II),

it has to be ensured that trading venues can immediately implement the instructions of NCAs. Therefore, NCAs should not allow the outsourcing of these activities outside the EU27.

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

- 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.

See investment firms opinion: as from the effective date of the UK's withdrawal from the EU, any outsourcing of portfolio management to UK entities will only be permitted where the conditions under Article 32 MiFID II Delegated Regulation are met, including the requirement that cooperation arrangements between NCAs and UK competent authorities are in place.

More broadly, and quite apart from relocation issues, NCAs should raise awareness that current outsourcing arrangements with UK service providers will need to be reassessed once the UK withdraws from the EU.

Effective and efficient cooperation among NCAs is also of utmost importance in this respect, including with authorities in third countries.

Similarly UCITS & AIFMD opinion

## **Principle six: NCAs should ensure that substance requirements are met**

- **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.**
- **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 include**
  - **internal control functions**
  - **IT control infrastructure**
  - **risk assessment**
  - **compliance functions**
  - **key management functions**
  - **sector-specific functions.**

## Principle six: NCAs should ensure that substance requirements are met

See also investment firms opinion + trading venues opinion: firms should therefore not outsource services/functions to an extent that exceeds by a substantial margin the services/functions performed internally

See also UCITS & AIFM opinion: authorised entities should not delegate investment management functions to an extent that exceeds by a substantial margin the investment management functions performed internally.

This assessment must be carried out in relation to and at the level of each individual fund and not in relation to a group of funds.

This means that authorised entities must perform investment management functions for each fund they manage and cannot delegate portfolio management and risk management functions for a particular fund in their entirety even where they perform such functions for other funds!

# Principle seven: NCAs should ensure sound governance of EU entities

- **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 full-time basis**

**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.**

# Principle seven: NCAs should ensure sound governance of EU entities

- 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.

As is emphasized in the investment firms opinion, it is unlikely that a single person has sufficient knowledge, experience and time to monitor a broader range of services/functions in an effective manner.

NCAs should therefore engage with firms that intend to allocate the supervision of a number of outsourced functions to a single person and be satisfied that this does not raise additional risks to the soundness or continuity of investment services or to investor protection/market integrity.

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

- NCAs should have adequate resources and capacity both to monitor the effective application of the relevant legislation and respond to market developments.
- 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 site inspections of outsourced or delegated activities or functions without any prior third party authorisation.

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

See also investment firms opinion:

NCAs should also carefully monitor third-country firms carrying out investment activities or services in relation to EU clients,

and whether such services are provided in accordance with the MiFID II/MiFIR third-country regime,

or whether such third-country firms misuse the “clients’ own exclusive initiative” exemption

# Principle nine: Coordination to ensure effective monitoring by ESMA

- 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.

# Thank you for your attention !

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