fieldfisher

Will ESMA's July opinions make a difference for UK asset managers?

ESMA's July 2017 Opinions might inform how UK asset managers' plans post Brexit may develop. They indicate the direction of travel which ESMA wish to take on the post Brexit scenario for EU based firms and EU regulators. However, whether some of them are within ESMA's powers is debatable, so whether these non‐binding guidance indications will therefore in the end have any impact, is at present unclear.

ESMA published initial principles in May, which were relatively uncontentious, followed by some slightly more contentious specific opinions issued in July concerning:

- management of UCITS and AIFs and
- MiFID firms

The basic principles

The publication in May of the "Principles to Support Supervisory Convergence in the context of the UK withdrawing from the EU" were relatively high level and unobjectionable. The ESMA Opinion set out nine principles:

- no automatic recognition of existing authorisations;
- authorisations granted by EU 27 regulators should be rigorous and efficient;
- regulators should be able to verify the objective reasons for relocation;
- special attention should be given to avoiding letterbox entities in the EU 27;
- outsourcing delegation would already be possible under strict conditions;
- substance requirements should be met;
- there should be sound governance;
- regulators must be in a position to effectively supervise and enforce EU law; and
- there is a role for co-ordination to ensure effective margining by ESMA.

The devil though is in the detail which has now been published by ESMA in July in a series of further opinions which flesh out the detail on some of these principles.

Opinion regarding the management of UCITS and AIFs: ESMA 34-45-344

ESMA 34-45-344 sets out an opinion to support supervisory convergence in the area of investment management in the context of the UK withdrawing from the European Union. This new opinion seeks to set out principles based on the objectives and provisions of UCITS and AIFMD which are to be applied to the specific case of relocation of entities, activities and functions following Brexit on the basis that the UK becomes a third country.

By covering UCITS and AIFMD, and jointly referring to them as "EU investment management legislation", ESMA is in effect talking about EU investment fund provisions.

ESMA make the following observations:

Authorisation

A general statement that is helpful is that UK based applicants should be subject neither to preferential nor disadvantageous treatment compared to other applicants.

At first glance it does not seem unreasonable that ESMA state that there must be full compliance with authorisation requirements, with a complete authorisation procedure followed without any derogations or exemptions for relocating UK entities. There is no provision for reliance on previous or existing authorisations in other Member States or third countries. Moreover, the Directives do not provide for any transitional provisions in the case of relocation of market participants.

However, there are some rather curious implications behind comments within the text of ESMA's opinion:

- Regulators are asked to 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 EU investment management legislation. And in particular, carefully scrutinise whether the group structure within which the authorised entity will operate constitutes an obstacle to their effective exercised supervisory functions.
- Regulators are also to scrutinise applications to ensure that the choice of Member State for relocation is driven by objective factors and not by regulatory arbitrage. They should not grant authorisations 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.

Governance and internal control

Not unreasonably, reference is made to the need to establish, implement and maintain effective governance structures and internal control mechanisms, and ensure persons who conduct the business are of good repute and sufficiently experienced and senior managers are identified to the relevant regulators.

However, the Opinion goes further than some firms which are located in the most likely relevant EU jurisdictions of Luxembourg and Dublin might wish.

ESMA refer to at least two senior managers meeting conditions and that the head office and registered office must be located in the same Member State.

A key point which is emphasised is that regulators should ensure that *"member of the governing/management body of the authorised entity have the ultimate decision making power in regard to the business conduct of the authorised entity, even when the entity is part of a corporate group."* Responsibilities in Article 9 of the UCITS Level 2 Directive and Article 60 of the AIFMD Level 2 Regulation cannot be delegated, even when the delegation is within the same corporate group.[1]

Consequently:

- internal procedures should be adopted so that key matters continue to be escalated for consideration by the full Board;
- regulators should be satisfied there are no reporting lines to group functions or other individuals within the group that would contradict the principle that allocation of responsibilities and functions within an authorised entity must be organised in a way that avoids or mitigates conflicts of interest: there should be 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. Regulators are asked to assess conflicts of interest that might occur when individuals also hold positions or have other business relationships with the service provider of the authorised entity or fund it manages and then, if this exists, to ensure there are effective risk mitigation measures taken;
- the essential role of the Board members/senior management to carry out independent decision making is obviously key. In the light of this and to safeguard the best interests of investors and ensure compliance with EU legislation, regulators should assess and put additional scrutiny on individuals with a high numbers of executive or non-executive directorships to meet their legal and regulatory obligations and responsibilities as Board members, and ensure they are being met. This leads on to a discussion as to whether there should be guidance on appropriate thresholds for time commitment for directorships and transparency on expectations and their dealings with authorised entities.

Authorised entities should calibrate procedures, mechanisms and organisational structures, and regulators should assess on a case by case basis each applicant, taking into account the following criteria:

- the size of the authorised entity's business (AUM);
- number of funds or sub-funds and share classes;
- complexity of investment strategies;
- type and range of asset classes in which the funds invest;
- geographical spread of investments;
- use of leverage;
- use of EPM techniques;
- frequency of investment activities;
- cross border management or marketing activities;
- types and range of functions listed in Annex II of UCITS and Annex I of AIFMD that are performed internally;
- types and range of functions listed in Annex II of UCITS and Annex I of AIFMD that are not performed by the authorised entity itself and therefore subject to delegation monitoring;
- provision of additional MiFID services under Article 6(3) of UCITS or Article 5(4) of AIFMD;
- number and type of investors;
- frequency of investors' subscriptions and redemptions;
- geographical distribution of marketing activities.

After such careful case by case assessment though, the upshot really is set out in one sentence in ESMA's opinion:

"Such case by case analysis should not result in a situation where authorised entities of significant size and/or activities employing complex investment strategies or having a broad range of business activities could operate with only a minimum operational set up." Regulators should require such entities to have more sophisticated governance structures and internal control mechanisms in place than smaller entities, which basically means more local substance.
There is a clear indication that ESMA do not expect regulators to rely on the minimum number of at least two senior managers for all authorised entities without taking due account of the size of the business and/or complexity, nature and range of business activities.

As regards internal control mechanisms, again, an analysis on a case by case basis is necessary, and regulators are expected to require implementation of safeguards to ensure the effectiveness of the compliance function, including mitigation of potential conflicts of interest and risks to investor protection.

There is specific reference to assessment of material legal risks. ESMA suggests that regulators should be satisfied that organisational structures 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"*. So 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. There is reference to the possibility of relying on external legal advisers to assess legal risks but, in this case, the internal policies and procedures should specify the cases and situations in which external advice should be obtained, allocate the responsibilities to this process and elaborate on the subsequent decision making procedure after receiving external legal advice. The principle is that material risks should be assessed by persons independent from operating units.

Combining risk compliance and/or internal audit functions should generally be avoided. There must be a clearly defined escalation procedure in the case of disagreements between internal control functions and operating units, with the final decision taken at the level of senior management. Where senior management or the

[1](By reference to Articles 7.1(b) and 21.1(b) of UCITS and Article 8.1(c) of AIFMD; and Articles 7.1(d) of UCITS and Article 8.1(e) of AIFMD respectively.)

governing/managing bodies itself is in disagreement on matters relating to compliance with EU investment management legislation, the internal procedures should provide for escalation to the local regulators (without prejudice to the Board's ultimate responsibility for decision making).

If senior management deviates from recommendations or assessments of internal control functions, these should be documented accordingly in regular reports. Where deficiencies detected by control functions are effectively addressed and resolved by senior management in due time, e.g. due to disagreements between internal control functions and senior management or budgetary issues, such situations should be reported to local regulators.

Not surprisingly, given the number of hosted models which might arise, ESMA suggest that regulators should give special consideration to authorised entities engaged in white label business where fund managers provide a platform for business partners by setting up funds at the initiative of the latter and then delegating investment management to the initiators or appointing them as investment advisers. It is acknowledged that these hosted models will likely get more business post Brexit. There is concern that host Mancos might require additional human or technical resources to manage the additional business and comply with the applicable delegation requirements, and in particular the substance requirements.

Delegation

Delegation is key. For UK investment managers, even though their Mancos will likely not need to be moved if there is a Luxembourg and Dublin one at present, it has always been assumed that delegation works now and so delegation should work in the future.

Obviously enough, delegation arrangements must be assessed. They should be subject to appropriate oversight. Regulators should be satisfied that authorised firms have organisational policies and procedures in place to comply with the UCITS and AIFMD provisions: detailing all the functions in Annex II of UCITS and Annex I of AIFMD that are not performed internally and so are subject to delegation requirements – and consider applying a similar approach to other critical functions, such as IT.

The important sentence here is: ***"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."*** If there is no qualified analysis review of the advice received before concluding a transaction, this will be considered as delegation of investment management activities. A formal assessment to check no breach of investment restrictions will not count for this purpose. Regulators are therefore required to be satisfied that there is clear documentation and recordkeeping of the Management Company's qualified analysis after receipt of investment advice.

It is acknowledged that the UCITS Directive does not have detailed general delegation requirements whereas AIFMD does (in Articles 72-82 of the AIFMD Level 2 Regulation). Given the general principles are similar, ESMA is considering it essential that regulators take a harmonised approach and address the risks of regulatory and supervisory arbitrage. Consequently, ESMA indicates that interpretation of Article 13 of the UCITS Directive and relevant national laws transposed in this provision should be consistent with those set out in Articles 75-82 of the AIFMD Level 2 Regulation. UCITS investors should benefit from at least the same protection as AIF investors.

As a consequence, for both UCITS management companies and AIFMs, there should be objective reasons for delegation. Yet again, there is a case by case analysis to be undertaken. This expects descriptions, explanations and evidence of reasons provided by authorised entities as to why and how envisaged delegation arrangements are justified objective, for example to 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. It should not be a pure notification procedure. Again the point is to check for objective reasons and ensure that a delegation structure does not allow for circumvention of EU investment management legislation and the responsibilities of the authorised entities.

This analysis is necessary where there is delegation within a group.

In the light of Brexit, the second important sentence to note from the Opinion states: ***"Delegation to non-EU entities could make oversight of supervision of the delegated functions more difficult."*** ESMA indicates that regulators are to be required to 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"***. Regulators should be satisfied that:

- the entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements and remuneration that are equally as effective as those applicable under the relevant ESMA Guidelines; or
- appropriate contractual arrangements are put in place to ensure that there is no circumvention of remuneration rules set out in ESMA Guidelines covering payments made to delegates' identified staff as compensation for performance of portfolio or risk management activities on behalf of the authorised entity.

Due diligence processes are necessary: the regulators should be satisfied on the initial due diligence during the selection process. Every delegation must be preceded by a written due diligence on the delegate and possible alternatives (at least for entities relevant for their contingency planning). There must be records setting out why there is a selection of one candidate over another.

The purported objective of the process is whether the potential delegate can be considered as most suitable for undertaking the delegated functions, with authorised entities having a fiduciary duty to their investors and acting in their best interest.

Delegation contracts should be precise regarding the delegation details and ensure that authorised entities have the right to enquire, inspect and 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. Most importantly: *"As a 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 operating conditions set out in the EU investment management legislation, e.g. due diligence, best execution or recordkeeping requirements. Therefore it is of the upmost importance that the contractual arrangements ensure that the authorised entity is able to comply with the EU investment management legislation. Moreover, the contractual arrangements should ensure that the authorised entities, their internal control functions, external auditors (of both the authorised entities and the relevant funds) and the relevant regulators have effective access to data related delegated functions and the business premises of the delegate as well as requiring delegates to operate with these parties at all times."*

Policies and procedures for the authorised firms must ensure that delegation agreements are drafted and/or reviewed by individuals that have sufficient knowledge and experience of the relevant legal matters and are independent from risk taking functions so that all relevant contracts are in full compliance with EU investment management legislation. There should also be regular reviews of contracts already concluded to ensure that they continue to comply as EU investment management legislation may evolve over time. In addition, compliance functions and internal audits should carry out regular controls with respect to compliance and effectiveness of delegation arrangements and monitoring mechanisms and report to the governing/management body and, where it exists, the supervisory function. Any delegation *"should not result in a situation where the scope and effectiveness of the work of internal control functions or their independence is impaired."*

The regulators are asked to assess that the authorised entities have implemented effective procedures to monitor activities of delegates in accordance with EU investment management legislation. And this is expected to require regular onsite visits. Delegation to non-EU entities should not result in a situation where the authorised entities carry out less intensive desk based oversight and/or conduct less frequent onsite visits due to the geographical location of the delegate. There also need to be checks of the contingency planning with 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 extraordinary termination, default of the delegate or force majeure events).

Appropriate recordkeeping is expected of all due diligence and delegation monitoring activities as well as the relevant contractual arrangements and all related documents so that regulators can access that information where required.

Substance:

The Opinion indicates that a delegation of investment management functions should not be made ***"to an extent that exceeds by a substantial margin the investment management functions performed internally"***.

This is worrying particularly when ESMA expect the assessment to be carried out in relation to, and at the level of, each individual fund and not in relation to a group of funds. Authorised entities must therefore be able to perform the investment management functions for each fund they manage and cannot delegate for any particular fund in their entirety even when they perform such functions for other funds. This would be a challenge obviously enough to most asset managers with delegation of investment management currently in place.

Authorised entities are expected to demonstrate that they have sufficient human and technical resources applied to the selection of potential delegates as well as ongoing delegation monitoring activities, and that all individuals involved have the required skills and knowledge, as well experience and time commitment for their respective tasks. This is at senior management and staff level. Policies therefore need to ***"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 one person will have 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."*** It is therefore expected by ESMA that regulators should engage with authorised entities that intend to allocate their monitoring of a number of functions to a single person and be satisfied that this does not raise additional risks to investor protection.

ESMA is expecting regulators to apply additional scrutiny to situations where relocating entities, even though there is smaller size employing its simple investment strategies and having a limited range of business activities, do not dedicate at least three locally FTE (including time commitment at both senior management and staff level) to the performance of portfolio management and/or risk management functions and/or monitoring of delegates.

It is therefore effectively expected that relocating entries must have transferred a sufficient amount of portfolio management and/or risk management functions for the relevant funds to their new home Member State, and the relocation should not result in a situation where those entities 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 the relocation. ESMA base this on contradicting the requirement that the head office and registered office must be located in the same Member State (Article 7.1(d) of UCITS and Article 8.1(e) of AIFMD).

Again, UCITS is not specific so, ESMA is crossing over the Article 82 (1)(d)(i)-(vii) of AIFMD Level 2 Regulation to all funds, whether UCITS or AIFs. Regulators are asked to undertake an assessment on a case by case basis by reference to qualitative criteria. Regulators are asked to permit such delegation structures only if there are clear reasons and evidence to conclude that the entire delegation structure is based on objective reasons.

There is particular scepticism for delegation of internal control functions. ESMA point out that these activities "*usually necessitate a local presence*". Where delegated to non-EU entities, the regulator should be satisfied that the non-EU delegate has the required knowledge, expertise and experience and is up to date with the EU investment management legislation under all regulatory requirements that apply to both the authorised entities and the fund managed by them.

Clear reporting lines must be in place to mitigate conflicts of interest.

Non EU branches:

Use of non EU branches for performance of some functions should not be used to circumvent matters. The risk of letterbox entities may arise not only from the use of delegation arrangements but from situations in which the EU authorised entities use non-EU branches for the performance of certain functions. ESMA assert that this should also be based on objective reasons linked to services provided in a non-EU jurisdiction and should not result in a situation where non-EU branches perform material functions or provide material services back into the EU. The objective reasons might be providing services in the non-EU jurisdiction which require local marketing support or handling complaints in that non -EU country, and therefore seem to be expected to be relatively limited.

Effective supervision

As might be expected by some of the comments made above, regulators should ensure that they have the ability to enforce relevant legislation and so have access to relevant information and to business premises of delegates. It is indicated that regulators 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 21(c) and (d) of AIFMD. In addition, a number of other provisions in the EU investment management legislation require co-operations to be in place between the regulators and the competent authorities of third countries."* (In this connection, note European Parliament Resolution of 5 April 2017 on negotiations with the UK following its notification that it intends to withdraw from the EU, 2017/2593 RSP.)

In emphasising that effective and efficient co-operation amongst regulators themselves is of upmost importance, including the authorities of third countries, this might mean effective communications between all regulators but also might reinforce the ESMA drive for having consistency as between regulators and therefore no pragmatic views to be taken by Luxembourg and Dublin.

Opinion concerning MiFID firms post Brexit: ESMA 35-43-762

ESMA's Opinion entitled: an "Opinion to support Supervisory Convergence in the area of Investment Firms in the context of the UK withdrawing from the European Union" looks at the principles based on the objectives and provisions of the MiFID framework. It follows up on the general principles to support supervisory convergence in the light of Brexit set out in ESMA's May 2017 Opinion.

This July Opinion focusses on how operations in third countries should work for MiFID firms, given the prospect, post Brexit, that the UK will become a third country after its withdrawal from the EU. Many of its comments though ought equally to be applicable now to any MiFID firm which has operations in a country which is currently a third country.

This Opinion is relevant to firms carrying on MiFID business, addressing the cross sectorial regulatory and supervisory arbitrage risks that arise given the increased requests from participants seeking to relocate in the EU 27 within a relatively short period of time. Clearly its overall objective is to get "consistent decisions" taken by local regulators, i.e. convergence and one presupposes the convergence to ESMA's preferred view on interpretation of the EU MiFID provisions

Authorisations

Given that it is most likely a new MiFID firm which most UK based asset managers will need to set up, it is the process for setting up a new EU based MiFID firm on which most will be focusing.

As one might expect, ESMA indicate that a complete set of information should be required under the MiFID framework and the complete authorisation process should be carried out without any derogations or exemptions. Regulators are asked not to design fast track authorisation processes that provide for flexible authorisation/supervision approaches compared with approaches not in relation to any other EU entity or do not otherwise ensure full compliance of EU legislation.

There are no transitionals and so there must be compliance from day one with the MiFID framework, and there can be no reliance on previous or existing authorisations in other Member States or third countries. Particular attention should be paid to whether group structures are an obstacle to effective supervision by regulators and, where the group has links with non EU entities, regulators should assess the qualifying shareholders and group

business models/structures and impact of potential prudential consolidated supervision or lack thereof etc. There is a need to identify objective factors not based on regulatory arbitrage for the choice of Member State for relocation.

Substance requirements

Letterbox entities should be avoided so relocating entities will be expected to have appropriate substance.

Governance and internal controls:

Sound governance and effective internal control mechanisms

MiFID investment firms, whether they are credit institutions providing investment services or straightforward investment management MiFID firms, are required to have effective governance structures and internal control mechanisms. Board members and senior managers in the EU 27 are expected to have effective decision making powers, even when the investment firm is part of a group. Where there is no a meaningful presence in the chosen jurisdiction, for example senior management and/or persons in key compliance and risk functions are not present, this may provide grounds for not granting or withdrawing authorisation.

At least two persons of requisite knowledge, experience and sufficient time commitment conditions should effectively direct the business of the applicant firm. Sound governance and internal control mechanisms must provide clarity as to the allocation of responsibilities, and policies and procedures must have constructive challenge and effective involvement of Board members/senior managers.

A single senior manager should not decide on the overall direction of the investment firm without the endorsement of other members of the management body.

In the interests of avoiding conflicts of interest, internal control functions should in principle operate independently from operating units (in line with proportionality considerations considered in the Opinion). Where part of a group, regulators must be satisfied that any reporting lines to the group do not impair the independence of internal control functions. Effective internal control mechanisms are expected (whether under Article 13 MiFID I or Article 16 MiFID II).

Combining risk management, compliance or internal audit should generally be avoided as this may undermine effectiveness and independence. Regulators are expected to engage with smaller firms with a very narrow and non-complex range of activities that may consider it disproportionate to appoint for example a separate full time officer for compliance or for safeguarding client assets (i.e. one that does not perform any other functions) and ensure that appropriate safeguards are implemented by the investment firm so that the effectiveness of such functions is not compromised, and to mitigate any conflicts of interest or impact on the firm's overall compliance with the MiFID framework.

Where the investment firm is part of a group, regulators should ensure that responsibility for compliance and risk function permanently rests with the MiFID firm, which needs to be in charge of monitoring its own compliance risks. (This, post Brexit, implies that there must be some considerable MiFID firm responsibility at local level.)

Not surprisingly therefore, an investment firm's governance structures and configurations of human and technical resources must be satisfactory to ensure they can discharge their roles – and then regulators must be able to have access to contact and meet with Board members, senior managers and relevant staff etc.

Appropriate financial and non-financial resources and programme of operations

A MiFID firm should have appropriate financial and non-financial resources and programme of operations. The example given is that regulators should consider a firm's policies and systems to ensure compliance with all relevant organisational and conduct of business requirements such as safeguarding client assets or best execution. Close attention should be paid to the risks arising out of a situation where a firm chooses to execute client orders using a single venue. The firm must be able to demonstrate that it is acting in its clients' best interests if it is reliant on a specific venue for continuation of its own services. The arrangements should not preclude executing client orders using an alternative venue should execution quality deteriorate etc.
ESMA ask regulators to pay close attention to arrangements where the investment firm uses or proposes to use another party that is based in a non-EU jurisdiction to place or execute client orders. If the non-EU execution venue is not subject to similar regulatory requirements, the regulator should consider how the investment firm will be able to ensure that the other party provides sufficient execution quality and information to allow them to monitor ongoing performance, e.g. based on clear contractual terms.

Regulators are asked particularly to assess situations where there are close links with non-EU entities given the heightened conflicts of interest risks.

Proportionality

Certainly proportionality is acknowledged. Appropriate sophistication of governance resources and internal control mechanisms, as well as human and technical resources, will vary depending on the nature, scale and complexity of a firm's business (including complexity of investment strategies and activities pursued, the geographical distribution of activities, the type and range of functions/services performed internally or outsourced, and the expected number and type of investors).

Any derogation of exemption from general requirements to establish internal control functions with dedicated staff independent from operational functions must be duly justified based on the principle of proportionality.

There are no derogations or exemptions expected in relation to internal control functions where firms are of "significant size or have a broad or complex range of activities".

Outsourcing

The outsourcing of critical and important functions is currently subject to strict requirements – see Article 14.1 of the MiFID Implementing Directive and prospectively Article 31 of MiFID II Delegated Regulation. ESMA indicate that outsourcing arrangements should not create undue operational risks or impair the quality and independence of a firm's activities and internal controls or the ability of the investment firm and regulator to supervise compliance with regulatory requirements.

Organisational policies and procedures will need to be reviewed as part of MiFID projects in any event. ESMA emphasise that it is not just sufficient to undertake assessments of whether there is any breach of regulatory requirements, but provide control and challenge to the quality and performance of services outsourced, and carry out their own qualified analysis. The quality of service received should be assessed.

Again, there is a wish to seek objective reasons for the outsourcing arrangements so firms do not create letterbox entities or circumvent the MiFID framework and the responsibilities of investment firms. (Paragraph 34 of the Opinion makes this clear.) A firm's analysis of reasons should be based on the firm's descriptions about the expected benefits of the envisaged outsourcing arrangement compared to the estimated costs of performing the outsourced functions internally, and taking into consideration the costs of carrying out due diligence and monitoring the risks involved with the outsourcing function on an ongoing basis. (Reference is made to Article 14(2) of the MiFID Implementing Directive and prospectively Article 31(2) of MiFID II Delegated Regulation.)

Where the delegation is put in the same corporate group, regulators should assess the due diligence which firms carry out in more detail and be satisfied that there are objective reasons despite the additional conflicts of interest which such an outsourcing structure may entail.

Clearly there should be a review of conflicts of interest policies and procedures to ensure effective management of conflicts, including relevant disclosures to clients. ESMA emphasise that this is particularly important where the EU firms outsource functions and services to entities which are part of the same corporate group. ESMA suggest that one viable risk mitigation measure could be to have a sufficient number of non-executive members supervising the outsourcing functions that are independent from the parent undertaking and other group entities. One can see the role of non-executive members increasing.

A point relevant to Brexit consequences is that ESMA indicate that outsourcing to non-EU entities is thought to make oversight and supervision of outsourced functions *"more difficult"*. Regulators are therefore asked to give special consideration to such outsourcing arrangements and risks arising from them.

Due diligence

Due diligence processes must be followed.

Written contractual arrangements need to be adequate for the purpose. They should be specific for the tasks and activities outsourced and ensure firms have the right to enquire, inspect, access and instruct such providers as well as terminate contracts at short notice where this is justified to safeguard the best interests of clients. Regulators are asked to verify, and investment firms must ensure, that service providers have the relevant authorisation required by law to perform the outsourced functions/services and that functions/services are provided in compliance with all applicable EU requirements (including confidentiality of information, data protection, safeguarding of client assets etc). Contractual arrangements must ensure that the service provider performs the outsourced functions/services in compliance with the MiFID framework at all times. Where the service provider might not be subject to equivalent legal and regulatory obligations, this heightens the risks of ongoing and permanent compliance with the EU rules.

Compliance and internal audit functions must carry out regular controls with respect to the compliance and effectiveness of outsourcing and monitoring mechanisms, and report their findings to the governing body and, where it exists, the supervisory functions. Outsourcing to non-EU affiliated or not entities should not result in a situation where the scope and independence of internal control functions is impaired or where there are fewer visits due to geographical issues.

There must be contingency planning in place.

Regulators must have access to all information necessary to supervise compliance of the performance of outsourced functions with the MiFID framework.

Substance and outsourcing of critical functions/services

As regards substance, there is use of that much overused phrase that a MiFID firm must not become a letterbox entity - picking up on the letterbox wording included in Recital 19 of the MiFID I Implementing Directive (2006/73/EC).

Paragraph 43 of the Opinion indicates that a firm should therefore not outsource services/functions to an extent that it exceeds by a substantial margin the services/functions performed internally.

Investment firms should dedicate appropriate internal human and technical resources and expertise to the supervision of service providers and ensure that all individuals involved have the skills, knowledge, experience and time commitment to monitor effectively service providers and be able to constructively challenge them. It is thought unlikely that a single person has sufficient knowledge and experience and time to monitor a broad range of services/functions in an effective manner, so any such

proposal would require careful consideration by the relevant regulator. Regulators are also asked to pay particular attention to the extent to which investment firms, particularly those adopting online business models, are reliant on technology and/or bespoke IT systems to understand whether this presents a risk to continuity of services.

The Opinion may be read to suggest that delegation of EU portfolio management outside of the EU may be viewed with suspicion. Where a firm intends to outsource portfolio management functions to non-EU entities with respect to portfolios investing instruments issued by EU issuers or portfolios of collective investment undertakings located in EU Member States, ESMA seem to be sceptical that such outsourcing arrangements to non-EU entities would be appropriate and objectively justified.

Where an investment firm outsources on boarding processes, the nature of controls to oversee and assess the performance of service providers should be considered: this may be a reason to withhold authorisation where a firm cannot appropriately demonstrate and ensure effective oversight.

Where there is outsourcing, it should be noted that senior management responsibilities cannot be delegated and the importance and required involvement of internal control functions of a firm's operations and key decisions usually necessitates a local presence. So regulators should expect certain roles, such as those exercising significant influence over the investment firm's conduct, either not be outsourced or alternatively be performed in the home Member State. If that is not the case, the firm must appropriately demonstrate that the EU entity providing the functions has the required knowledge, experience and expertise and is up to date with the EU regulatory framework, and the outsourcing will not impair the effectiveness of these functions.

Another point to note, given the prospect of Brexit, is paragraph 47 of the Opinion. ESMA indicate that certain key functions should be outsourced outside the EU only under strict conditions, given that ESMA take the view that such outsourcing is very likely to endanger robust internal governance and sound and effective risk management, or the operational independence of the investment firm, and therefore undermine the MiFID passporting regime.

In the case of underwriting and placing activities or execution services to be provided to EU clients, while certain back office functions could be outsourced to non-EU entities (subject to the full compliance of MiFID requirements and outsourcing), the marketing and the performance of underwriting/placing services or execution services (including client facing or risk management functions) should in principle be performed internally by the investment firm or EU service providers. **"Outsourcing of order execution functions to non-EU entities should not occur where the investment firm cannot satisfy that it complies with its own overarching best execution obligations."** An investment firm's outsourcing safekeeping functions should pay particular attention to the service provider's local laws and how these may impact its duties to EU clients and their rights to access own assets, especially in the case of insolvency of the service provider (or any sub-contractor).

Any outsourcing to the cloud should be implemented in the manner that complies with applicable European legislation and regulators must be allowed to perform its supervisory roles, and so any encryption keys should always be provided where requested.

Non EU branches

Clearly there is a concern about using non-EU branches to get around the provisions which would apply to a delegation. Use of non-EU branches must be based on objective reasons linked to the services provided in the non-EU jurisdiction and should not result in a situation when such non-EU branches perform material functions or provide services back into the EU. The example of local marketing support is mentioned, so limited use of branches is expected.

Effective supervision

ESMA suggest that the EU 27 regulators should ensure that the firms comply with EU legislation on a continuous basis including such EU legislation relating to outsourcing. Regulators are expected:

- not to grant or withdraw authorisation if laws, regulations or administrative provisions of a third country governing one or more natural or legal persons with which the firm has close links prevent it from being able to exercise its supervisory functions;
- to understand any commercial arrangements between the investment firm and another authorised investment firm in order to assess how the risks arising will be managed, particularly where after Brexit the UK investment firm would become a third country firm. The objective here is to ensure that the relevant MiFID conduct of business and organisational requirements will be met and to ensure that all parties involved in the provision of investment services and activities are appropriately authorised and continue to have the right to provide services to EU clients in accordance with the MiFID framework;
- to give special consideration, post Brexit, to any outsourcing of portfolio management to UK entities which should only be permitted where the conditions under Article 32 MiFID II Delegated Regulation are met, including the requirement that co-operation arrangements between regulators and the UK competent authorities must be in place. Current outsourcing arrangements to UK service providers will need to be reassessed.
- to 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 "client's own exclusive initiative" exemption. There is clearly concern from ESMA that the own initiative will be an abused option.

Overall, the recurring themes are that there must be increased substance from that previously expected for a MiFID firm in a local state, and outsourcing arrangements must be reviewed very carefully: first, so that the senior manager's responsibilities and control functions are effectively operated via the home member state and, secondly, to ensure that any delegation to non EU entities, which will shortly include the UK, does not in any way preclude full application of the MiFID framework.

ESMA's powers

The impact of these ESMA Opinions will depend on how local regulators respond to them and prospectively how any proposals to enlarge ESMA's powers might progress.

There is potential for these Opinions to have quite a substantial impact on UK asset managers – particularly in relation to delegation arrangements from Luxembourg and Dublin funds back to the UK. These impacts though would equally affect the many delegation arrangements to third countries which are currently in place around the world. So pushback to ESMA on some of the terms is likely to be quite considerable should effective delegation of investment management to third countries be prevented or hindered.

fieldfisher

Contacts

Kirstene Baillie
Partner - London

E: kirstene.baillie@fieldfisher.com
T: +44 (0)20 7861 4289

This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed.

© Copyright Field Fisher Waterhouse LLP 2015. All rights reserved.

Field Fisher Waterhouse LLP is a limited liability partnership registered in England and Wales with registered number OC318472, which is regulated by the Solicitors Regulation Authority. A list of members and their professional qualifications is available for inspection at its registered office, Riverbank House, 2 Swan Lane, London, EC4R 3TT. We use the word "partner" to refer to a member of Field Fisher Waterhouse LLP, or an employee or consultant with equivalent standing and qualifications.