ESMA's Opinion on Supervisory Convergence in Investment Management

The European Securities and Markets Authority ("**ESMA**") has provided further guidance for national competent authorities ("**NCAs**") dealing with authorisation applications from UCITS management companies, self-managed investment companies and authorised alternative investment fund managers ("**AIFMs**") that are currently based in the United Kingdom ("**UK**") and are seeking to relocate to the other EU member states ("**EU27**").

Following the publication of its May 2017 opinion setting out general principles on its supervisory approach in relation to the relocation of entities from the UK to the EU27, ESMA has published a further opinion addressing the specific issues that arise in the area of investment management. The sector-specific opinion on investment management is one of three opinions published by ESMA on 13 July 2017, which also deal with investment firms and secondary markets.

ESMA's earlier opinion addressed the cross-sectoral regulatory and supervisory arbitrage risks that arise as a result of increased requests from financial market participants seeking to relocate in the EU27 within a relatively short period of time. ESMA's sectoral opinion on investment management (the "**Opinion**") sets out principles based on the objectives and provisions of the UCITS Directive and the Alternative Investment Fund Managers Directive ("**AIFMD**") and the application of those principles to the relocation of entities, activities and functions following the UK's withdrawal from the EU (or "Brexit"). The Opinion addresses the following issues relevant to relocations:

- authorisation;
- governance and internal control;
- delegation; and
- effective supervision.

Similar to ESMA's cross-sectoral opinion, the Opinion assumes that the UK will become a third country after its withdrawal from the EU and is without prejudice to any specific arrangements that may be negotiated between the EU27 and the UK.

The Central Bank of Ireland ("**Central Bank**") Fund Management Company Guidance, issued following the detailed "CP86" consultation process, provides a comprehensive framework relating to how UCITS management companies, self-managed investment companies and AIFMs allocate managerial functions, where they locate the persons carrying out those functions and the oversight of delegation arrangements. The introduction of this regime by the Central Bank means that Central Bank policy is already largely compliant with the Opinion.

Authorisation

According to the ESMA Opinion, no fast-track authorisation procedure should be made available to entities relocating from the UK to the EU27 and the same procedure should apply to all applicants. There should be full compliance with the authorisation requirements set out in the UCITS Directive and the AIFMD and a complete set of information should be provided to NCAs.

ESMA states that there should be no reliance on previous or existing authorisations in other member states or third countries. It is noted that the investment management legislation does not provide for transitional provisions in the case of relocations of market participants and therefore NCAs cannot rely on mere confirmations from applicants that their organisational set-up or business operations are or will be compliant with EU legislation.

NCAs should carefully scrutinise whether the group structure within which the authorised entity will operate constitutes an obstacle to the NCA's effective exercise of supervisory functions. They should also scrutinise applications to ensure that the choice of member state for relocations is driven by objective factors and not by regulatory arbitrage.

Governance and Internal Control

ESMA advises that NCAs should assess and apply additional scrutiny to individuals with high numbers of directorships and should consider the possibility of guidance on appropriate thresholds in terms of aggregate time commitment for directorships. The Central Bank has already issued guidance in relation to these matters for directors.

NCAs should assess each application on a case-by-case basis taking into account, in particular, the following criteria:

- size of the authorised entity's business (ie, value of assets under management);
- number of (sub-) funds and share classes;
- complexity of investment strategies pursued;
- type and range of asset classes invested in;
- geographical spread of investments;
- use of leverage;
- use of efficient portfolio management techniques;
- frequency of investment activities;
- cross-border management or marketing activities;
- type and range of functions that are performed internally;
- type and range of functions that are subject to delegation monitoring;
- provision of additional MiFID services;
- number and type of investors;
- frequency of investor subscriptions and redemptions; and
- geographical distribution of marketing activities.

While the UCITS Directive and the AIFMD require the authorised entity to have a least two senior managers, NCAs should examine the size of the business and / or the complexity, nature and range of its business activities to decide whether this minimum number is acceptable. ESMA states that NCAs should be able to ensure that the organisational structure and human and technical resources of authorised entities and the configuration of senior management allows NCAs to contact and meet with senior managers and staff during normal business hours. This again is consistent with the Central Bank's guidance for fund management companies.

The Opinion also addresses effective internal control mechanisms, including appropriate escalation procedures where disagreements arise in the decision-making process between internal control functions and operating units.

ESMA advises that NCAs pay particular attention to authorised entities engaged in the white-label business ie, fund platforms. These types of entity are likely to see a significant increase in business activities in a relatively short period of time as a result of the UK withdrawing from the EU, leading to additional operational risks. NCAs should assess whether the structures put in place by such entities and the resources they employ remain appropriate taking into account the principles set out in the Opinion.

Delegation

Common Interpretation of UCITS Directive / AIFMD Delegation Requirements

ESMA notes that there are no Level 2 regulations under the UCITS Directive similar to those under the AIFMD detailing the general delegation requirements set out in the Level 1 text. ESMA is of the view that the interpretation of the UCITS Directive should be consistent with the AIFMD Level 2 delegation provisions, as it is essential for NCAs to have a harmonised approach with regard to delegation.

Assessment of Delegation Arrangements

NCAs should carry out a case-by-case analysis of delegation arrangements taking into account the materiality of the delegated activity. NCAs should examine how the envisaged delegation arrangements are justified by objective reasons in order to, for example, optimise business functions and processes, save costs, benefit from additional expertise in administration or in specific markets or investment and access to global trading capabilities.

In relation to the criteria of cost-saving, as set out in the AIFMD Level 2 rules, authorised entities should provide evidence that the financial benefits of the envisaged delegation structure outweigh the estimated costs of performing the delegated function internally despite the costs of carrying out due diligence and monitoring the risk involved with the delegated function on an ongoing basis.

ESMA states that oversight and supervision of the delegated functions is more difficult where the delegation is to non-EU entities or where authorised entities intend to implement delegation structures with longer or more complex operational chains and / or with a large number of parties involved. NCAs should therefore give special consideration to such delegation arrangements and be satisfied that their implementation is justified based on objective reasons despite the additional risks that may arise from them.

Due Diligence

The Opinion sets out ESMA's expectations with regard to the due diligence to be performed on delegates and the need for effective policies and procedures to monitor the activities of delegates on an ongoing basis. ESMA acknowledges that delegation arrangements may increase efficiency, but stresses that NCAs must ensure that authorised entities maintain sufficient resources and expertise with respect to the delegated functions in order to effectively monitor delegates and be able to constructively challenge them.

Substance

ESMA advises that NCAs should apply additional scrutiny to situations where relocating entities, even those of smaller size employing simple investment strategies and having a limited range of business activities, do not dedicate at least three locally-based full time employees (including time commitments at both senior management and staff level) to the performance of portfolio management and / or risk management functions and / or the monitoring of delegates. Specifically in the context of relocations, NCAs should be satisfied that relocating entities have transferred a sufficient amount of portfolio management and / or risk management functions to the relevant funds in their new home member state.

Investment Advisors

In the context of delegation, NCAs are advised to give special consideration to the appointment of investment advisors to ensure that the delegation rules are not circumvented. Where authorised entities appoint third parties to provide investment advice and base their investment decision on the advice provided by a third party without carrying out their own qualified analysis before concluding a transaction, such arrangements are to be considered as delegation of investment management activities.

Non-EU Branches

With respect to the use of non-EU branches, ESMA states that NCAs should carefully monitor situations in which the risk of letter-box entities arises not only from the use of delegation arrangements but from situations in which EU authorised entities use non-EU branches for the performance of functions. Where relocating entities intend to establish or maintain non-EU branches, NCAs should be satisfied that the use of non-EU branches is based on objective reasons linked to services provided in the non-EU jurisdiction and does not result in a situation where non-EU branches perform material functions or provide material services back into the EU. NCAs should require relocating entities to provide them with detailed information relating to the activities to be performed by the branch (and their geographical distribution), its organisational structure and the persons responsible for the management of the branch and ensure that they can effectively supervise the non-EU branch.

Effective Supervision

ESMA advises NCAs to make authorised entities aware of 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 the relevant provisions regarding delegation to unauthorised entities or third country entities in the UCITS Directive and the AIFMD. The legislative provisions require that cooperation arrangements be in place between the NCAs and the competent authorities in the third countries.

Comment

As noted above, the Central Bank of Ireland's Fund Management Company Guidance sets out a detailed regime relating to the governance of UCITS management companies, self-managed investment companies and AIFMs and the oversight of delegation arrangements, so that the principles set out in the Opinion are largely reflected in current Central Bank policy.

For further information on ESMA's May 2017 opinion on general principles to support supervisory convergence in the context of the UK withdrawing from the EU, please see our briefing note. ESMA's sector-specific Opinion on investment management may be accessed here.

Please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

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