

BREXIT: ESMA SIGNALS TOUGHER STANCE ON UK ASSET MANAGER RELOCATION TO THE EU by Paul Van den Abeele, Partner at Clifford Chance



On 13 July 2017, ESMA published three opinions setting out sector-specific principles aimed at supporting supervisory convergence in the context of requests from UK financial institutions seeking to relocate to the EU27. The opinions relate to investment management, investment firms and secondary markets and follow on from the general, cross-sectoral opinion published by ESMA in May 2017. The opinion on Investment Management covers UCITS and AIFMD structures, and asset management structures involving delegation to MiFID investment firms.

REGULATORY AND SUPERVISORY RISK

ESMA's opinion is directed at potential risks in relation to: authorisation; governance and internal control; delegation; and effective supervision. Most of the content is not surprising and what we already know about regulators' considerations when an asset manager is establishing in their jurisdiction – but the points listed below indicate a change of tone in respect of Brexit relocations – particularly in relation to substance requirements on delegation.

Keys points include:

- Regulators are asked to scrutinise circumstances in which firms make up their local substance with "directors for hire" with multiple directorships;
- Regulators should be able to contact and meet the local senior managers of the firm during normal business hours, and to be able to carry out on site visits and meet the senior managers without prior notice. We already knew that the senior managers

needed to be locally resident but this new point looks a little less tolerant of arrangements whereby some of the senior managers spend only part of their time locally (e.g. a split working arrangement);

- ESMA points to the need for a separate standalone compliance officer locally;
- Extra regulatory scrutiny for relocation proposals that envisage use of a third party UCITS or AIFM platform, as well as for proposals that envisage a UK advisor to an EU manager to ensure that the EU manager is not simply rubber stamping the advice from the UK advisor;
- ESMA proposes that the delegation rules under AIFMD should be applied in respect of UCITS delegation structures;
- Regulators are required to assess properly whether there are objective reasons for delegation. The firm must provide evidence that the financial benefits of the delegation outweigh the estimated costs of performing the delegated function in the EU firm;
- No ability to have full delegation of portfolio management, i.e. the EU firm must perform some investment management functions. This is not new, but to date there has not been much regulatory pressure on this point in AIFMD structures (i.e. we do see full delegation of portfolio management and not much focus on the EU firm's ability to scrutinise their conduct);
- ESMA pointing to a firm needing to have at least three fulltime employees for the performance of portfolio management and risk management and supervising any delegates;
- ESMA indicates that relocation plans should not result in a situation in which an asset manager "could continue to perform substantially more portfolio management and/or risk management functions for the relevant funds in their original Member State" on a delegation basis "and therefore also maintain substantially more relevant human and technical resources there despite a relocation";
- ESMA states that the risk management function should not be limited to ex-post controls, "but is to be involved in the investment process before transactions are concluded". This could be problematic for structures where the EU entity has delegated portfolio management, and has retained risk management but performs this only on an ex-post basis(i.e. it conducts checks after the event).

CONCLUSION

EU regulators are likely to conclude that they already comply with applicable legal and regulatory requirements governing their review of licence applications and delegation arrangements. The ESMA opinion does not (and cannot) change those legal and regulatory requirements. The ESMA opinion may, therefore, be simply that – an opinion of ESMA – a "steer" towards tougher appraisal of licence applications. EU regulators may note the change of tone, but continue to review relocation applications in accordance with their current approach. Of much more concern would be any proposal to revise the legal framework of AIFMD (e.g. in AIFMD 2), UCITS and MiFID in line with the tougher approach set out in the ESMA opinion, as that would require EU regulators to modify their approach.

Finally, while the ESMA opinion was prepared in the context of UK firms relocating to the EU, the approach it outlines would be equally applicable to all non-EU asset managers

and their EU fund structures, e.g. US managers with EU management companies delegating portfolio management back to the US.