

The EU and the Banking Union bring out their "SPoRs"

What do the recent "supervisory principles on relocations" mean for BREXIT-proofing of business and for other market participants moving to the EU-27 and the Eurozone's Banking Union?

The European Central Bank's (**ECB**) recent statements, acting in its supervisory and regulatory role within the Single Supervisory Mechanism (**SSM**) component of the Eurozone's Banking Union, have clearly communicated its 'supervisory expectations'. This includes clarity that the SSM will not tolerate a "regulatory race to the bottom" nor the use of "empty shell companies". These statements come on top of the SSM's expectations regarding certain booking models. For many market participants looking to 'BREXIT-proof' their business operations and their legal entity structures, these statements have caused many to re-examine plans. The statements also affect those new entrants looking to set-up in the Eurozone that are not driven by BREXIT.

In both situations, the SSM's statements have provided welcome clarity on supervisory expectations and what will be considered non-compliant. In many ways this draws some firm lines and puts some power behind what has otherwise been political positioning on both sides of the Channel and the Irish Sea as to how market participants would be able to access each other's markets and customers post-BREXIT. On 31 May, 2017, the European Securities and Markets Authority (**ESMA**), which is an EU-wide European Supervisory Authority (**ESA**) released an Opinion, i.e. a legal instrument titled "General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union" (the **ESMA General Opinion**)¹.

The ESMA General Opinion, the first of a series, was released as part of the EU's and thus ESMA's priorities of improved supervisory convergence amongst the national competent authorities (**NCA**s) as well as amongst the **ESAs** that make up the European System of Financial Supervision (**ESFS**) of the EU. In practice, however, it complements and reinforces the SSM's statements to form what are now clear "**Supervisory Principles on Relocations**" or, as used herein and other publications in this series of Client Alerts, **SPoRs**. Consequently, a number of firms may need to revisit their BREXIT-planning and also start to look at their documentation and policy arrangements in much more detail.

This Client Alert looks at the contents of the SPoRs in the ESMA General Opinion and should be read in context with our Eurozone Hub's coverage of the "sector



¹ Available: <https://www.esma.europa.eu/file/22278/download?token=ltu5XwcE>

specific opinions" (**SSOs**) that were published 13 July 2017² as well as our recent Background Briefings covering SSM and other Banking Union developments.

Despite their content and tone, what the SPoRs do not do is close the door for financial services firms looking to establish themselves within, or engage through, the EU-27 and the Eurozone-19. Rather, the SPoRs, like the on-going EU reforms on assessing third-country equivalence, are welcome and necessary in providing a roadmap of who can do what, where and with whom going forward. That being said, the ESMA General Opinion is based on the assumption that the UK, post its departure, will become a "third-country" for EU regulatory purposes and is drafted as being "without prejudice" to any post-UK-EU relationship deal, including any assessment of equivalence. This echoes a number of political statements made by the EU and its Chief Negotiator, Michel Barnier, notably on 6 July 2017³

Key aims and deliverables of the ESMA General Opinion

If the SSM's principles on BREXIT relocation already seemed potentially tough, the publication of ESMA's General Opinion, setting out nine supervisory "**Principles**", will likely be of interest. Whilst these Principles are directed at NCAs, including those in the Eurozone, they supplement the Banking Union's approach communicated by the SSM and set the tone expected of regulated firms.

Crucially, these ESMA Principles however apply to a much wider audience that now needs to BREXIT-proof their business operations and legal entity structure. The ESMA General Opinion is, unlike the SSM statements, directly addressed to the EU Member States and their NCAs, but also those of the European Economic Area (**EEA**) – European Free Trade Association (**EFTA**) states of Norway, Liechtenstein and Iceland, which have access to the EU's Single Market, including for financial services, as per the EEA Agreement.

As a side note, ESMA's sister ESA, the European Insurance and Occupational Pensions Authority (**EIOPA**) issued its own form of the ESMA General Opinion on 11 July 2017⁴. That EIOPA Opinion however is addressed at setting SPoRs specifically to those (re)insurers relocating from the UK and thus, casts a much narrower net than the ESMA General Opinion's intended scope of application.

The Principles of the ESMA General Opinion, which are explored in further practical detail below, include:

- 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;

²

SSOs on:

- Fund Management: <https://www.esma.europa.eu/document/opinion-support-supervisory-convergence-in-area-investment-management-in-context-united-kingdom>
- MiFID Investor Protection: <https://www.esma.europa.eu/document/opinion-support-supervisory-convergence-in-area-investment-firms-in-context-united-kingdom>
- MiFID - Secondary Markets: <https://www.esma.europa.eu/document/opinion-support-supervisory-convergence-in-area-secondary-markets-in-context-united-kingdom>

³

See: http://europa.eu/rapid/press-release_SPEECH-17-1922_en.htm

⁴

Please refer to our Eurozone Hub's Client Alert on this development.

Hot Topics

- 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 law; and
- need to implement coordination to ensure effective monitoring by ESMA.

One of ESMA's mandates, which is set in its founding documentation, i.e. by Regulation (EU) 1095/2010 of the European Parliament and of the Council, is to promote consistent supervisory practices and a common supervisory culture within the EU. Supervisory convergence became the number one strategic priority for the entire EU and the Banking Union in 2017. Consequently, each of the components of the ESFS has some workstream or team working on delivering that within their respective mandates.

In addition to the Principles in the ESMA General Opinion, ESMA will establish a forum – the Supervisory Coordination Network – to allow NCAs to report on and discuss cases of relocations of UK market participants. As part of the on-going review of the ESFS, it is expected that ESMA will receive further supervisory powers to push forward supervisory convergence as well as to support completion of the EU's Capital Markets Union project.

The ESMA General Opinion and its Principles reflects a definitive use of the convergence tool to improve the safeguarding of investors, the orderly functioning of financial markets and financial stability. As with the SSM's statements, NCAs are reminded in the ESMA General Opinion that BREXIT will require much more supervisory engagement, conducted in a coherent and consistent manner. This means longer lead times on responses of new authorisations and proofing of reinigorated arrangements, especially in relation to regulated outsourcing or delegation arrangements from the EU-27 to a third-country entity (**TCE**) and the fact that some of the operating and outsourcing models may need to change.

That being said, there are a number of 'SPoR friendly' business models that are emerging and some might resolve these issues. Yet with the publication of the "SSOs", published 13 July 2017 (see our Eurozone Hub Client Alert) and possibly further SPoRs ahead, some of these however may need to be further adapted as additional SPoRs are rolled out to asset managers, investment firms and secondary markets amongst other areas.

The Principles in the ESMA General Opinion

Whilst the Principles are addressed to NCAs, they will be of interest to relevant market participants that are supervised by the relevant national authorities. As a word of warning whilst reading the SPoRs, the use of the word "should" in regulatory and supervisory policy documentation, and when a "should" really means a "must" i.e., an absolute obligation, as opposed to an obligation to do something with implied optionality, is becoming an issue both for policymakers as well as the community of supervised market participants, including non-native speakers and different legal and regulatory traditions tasked with interpreting the same wording.

As the Principles set out ESMA's expectations of EU-27 NCAs, like with SSM "guidance", which impose direct or indirect obligations on supervised firms, there are a number of instances where the word "should" in the text actually implies "must", "needs to" or "require" in relation to a specific action. The following sections below provide a summary of the individual Principles.

Principle 1: No automatic recognition of existing authorisations

This Principle clearly states that firms relocating, and specifically that any TCE relocating, will need to establish itself in the EU-27 to avail of relevant benefits including passporting rights. This means that any UK entity cannot simply, once it becomes a TCE, apply and expect to receive preferential treatment since it was prior to BREXIT an EU entity whilst the UK was part of the EU-28.

In a stark warning, there will be "...no automatic recognition of the authorisation granted by the UK regulator[s] into the EU-27". Despite ESMA's minor oversight that the UK currently has two relevant regulators, namely the Financial Conduct Authority and the Prudential Regulatory Authority, this statement sets out a clear need for all passported entities to reapply for appropriate authorisations for those entity(ies) that will sit within the EU-27. This may considerably impact BREXIT-proofing and legal entity structuring planning as Principle 1 sets out the expectation that the evaluation of the application is made "with fresh eyes" as opposed to "grandfathering".

Consequently, impacted market participants would be best advised to plan for longer lead times and commence the requisite processes as well as engagement with their professional advisers sooner rather than later. This is further complicated by the fact that many of the relevant departments within the NCAs as well as those components of the SSM may themselves be growing or on-boarding new headcount to deal with the increased volume of reviews.

Principle 2: Authorisations granted by EU-27 NCAs should be rigorous and efficient

This Principle sets out that authorisations granted by the EU-27 NCAs "should" i.e., they "must" be rigorous and efficient. In the context of the Banking Union, this could include the ECB-SSM component as the body with ultimate responsibility for authorising credit institutions. Specifically, Principle 2 requires that entities must meet their obligations set by the relevant legislation from "day one of their authorisation". For some jurisdictions and NCAs this may reduce the ability of relocating firms to scale up operations based on a phased approach.

Principle 2 also sets out that "some" assessments of third-country regulators may, where appropriate, be taken into consideration as part of the relevant authorisation process. This includes fitness and propriety assessments. See also our Background Briefing on the "**ECB-SSM's Fitness & Propriety Guide**" for further information on how the SSM's new rules in this area may change the process for obtaining certain approvals or at the very least cause extra timelines in the approval process.

As an overarching approach, NCAs are instructed to take account of the full degree of operations of a relevant person applying for authorisation within the EU-27 and apply "strong scrutiny" to the governance structure, human and technical resources, geographical distribution of activities as well as the outsourcing and delegation arrangements of the applicant. This means that NCAs cannot simply apply a waiver for applicants applying for authorisation, in particular TCEs, simply because they have been authorised and/or regulated in a third-country with similar or equivalent standards. Even if any UK-EU post-BREXIT deal has some degree of "equivalence" for financial services, the ESMA General Opinion sets a strong tone that any new entrant will be subject to a stringent review.

Principle 2 also flags that NCAs are encouraged to not grant authorisations where an applicant entity has opted to (re-)locate itself into a Member State to circumvent more stringent provisions in another Member State in "...which it intends to carry on the greater part of its activities." This anti-avoidance objective represents new thinking amongst the ESFS and also ties in with Principle 3.

Principle 3: NCAs should be able to verify the objective reasons for relocation

What this Principle means in practice is that NCAs are expected to check whether the planned EU-27 activity is the main basis driving the relocation of the relevant entities, the activities and the functions. NCAs will use various supervisory tools to evidence this check, however the ESMA General Opinion clearly points to the "entity's programme of operations" i.e. a Regulatory Business Plan, which in the views of ESMA and thus the ESFS components "...provide a clear justification for relocating to the Member State of establishment." NCAs are also instructed, as part of their verification of geographical scope, to obtain information on:

- prospective investors or marketing and promotional arrangements; and
- location of development of products or services.

Some of these details may be detailed in the Regulatory Business Plan of the applicant or contained in a standalone set of documentation. What the ESMA General Opinion does clarify is that, unlike some jurisdictions, applicant entities need to disclose whether they have engaged with other NCAs. The obligation upon applicants to inform a relevant NCA whether an application has been rejected by another NCA is also reinforced in Principle 3. These requirements tie in with the new obligation on NCAs to ascertain that an authorisation does not breach the anti-avoidance objective introduced by Principle 2. As a result, ESMA's supervisory expectation is that NCAs will "particularly scrutinise applications" that appear to circumvent the anti-avoidance objective.

Principle 4: Special attention should be granted to avoid letter-box entities in the EU-27

This Principle specifies and ties in with SSM statements that special attention "should" i.e., "must" be dedicated to avoid the use of "letter-box" entities or shell companies in the EU-27. This specifically aims at capturing and then assessing the use of outsourcing or delegation arrangements by relevant market participants.

In particular the Principle aims to assess the use of (1) regulatory outsourcing or delegation of substantial or critical functions; or (2) booking of risk by those within the EU-27 to those entities located outside of the EU-27. This Principle aims to prevent excessive use of regulated outsourcing and delegation that flouts the ability to sufficiently supervise the regulated activity in a manner that mitigates risk. The expectation is that NCAs will take a proportionate view on what is "substantial" based on what is commensurate with existing practices within the regulated environment. It should be noted that in EIOPA's own Opinion and its SPoRs percentage thresholds were set as to what degree of risk can be booked from the EU-27 to a TCE.

Specifically, Principle 4 sets out that:

"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 EU-27. Similar considerations may apply if entities perform substantial activities and functions through third-country branches."

This echoes the SSM's earlier statements that on using certain booking models moving risk back to TCEs. The SPoR here could not be more clear and this may prompt a rethink for a number of entities in relation to new or existing BREXIT-proofing plans as well as regulatory applications.

Principle 5: Outsourcing and delegation to third countries is only possible under strict conditions

Building upon the other Principles, Principle 5 clarifies that outsourcing and delegation to third-countries and thus TCEs is only possible under strict conditions. Principle 5 also recalls the existing regulatory principle that only functions as opposed to responsibilities may be outsourced/delegated.

NCAs are reminded to act prudently and also assess whether specific EU legislative and regulatory requirements are fulfilled prior to an entity putting the outsourcing/delegation arrangement in place. This also includes ascertaining whether any regulatory/supervisory cooperation agreements are in place amongst NCAs and third-country authorities, as this is a prerequisite introduced by relevant EU regulatory requirements for certain areas.

Principle 6: NCAs should ensure that substance requirements are met

NCAs are required to ensure that "substance requirements" are met i.e., that regulated entities have sufficient substance within the EU-27. Whilst this applies beyond just outsourcing/delegation arrangements, Principle 6 reminds NCAs that any such arrangement must be clearly structured and set-up in a way that does not hinder the efficient supervision and control of that arrangement.

What Principle 6 does clearly do, in conjunction with the other Principles, is set the SPoR, in a way that goes beyond existing EU legislative/regulatory requirements, such as in MiFID II/MiFIR or AIFMD/R by stating that:

"This implies in particular that certain key activities and functions should be present in the EU-27. These activities and functions are key to the proper functioning of the regulated entity and consequently cannot be outsourced or delegated outside the EU; this is at least the case for the substance of decision-making. 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 are crucial statements that are relevant for those firms relocating to the EU-27, but might also impact a number of firms, especially those that operate significant branches, including those in third-countries, and retain management and supervisory functions in such a third-country as opposed to within the EU-27. Principle 6 should also be viewed in light of on-going EU supervisory reform on how "significant branches" are to be categorised and supervised.

Principle 6 sets out that these "important activities" can be summarised as a minimum of the following six "activities and functions" comprised of inter alia:

- "internal control functions" – including supervisory control functions other than compliance and risk such as governance and audit etc.;
- "IT control infrastructure";
- "risk assessment";
- "compliance functions";
- "key management functions"; and
- "sector-specific functions".

These restrictions do not preclude firms from centralising these functions at a group level, but it does suggest a need to reinforce entity level responsibility to comply with the supervisory expectations set by the SPoRs and in particular Principle 6.

Principle 7: should ensure sound governance of EU entities

Building on the other Principles, notably the six activities of Principle 6, the supervisory expectation is clear that EU entities must have "the effective decision-making powers in relation to compliance of the EU authorised entity with Union law even where the entity is part of a corporate group" at board member (or such analogous function) and senior managers located in the EU-27.

Moreover, it pushes the SPoR further in stating that: "ESMA expects that 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..." NCAs are directed to satisfy themselves that this 'mind and matter' requirement is complied with by looking at the individual and collective suitability of resources present both at executive board level (or analogous equivalent) and senior manager level in the relevant Member State of establishment.

A number of existing firms may need to take corrective action in this respect and should assess the new requirements detailed in our Background Briefing on the "**ECB-SSM's Fitness & Propriety Guide**".

Principle 8: NCAs must be in a position to effectively supervise and enforce EU law

This Principle concerns itself with the adequate resourcing and capacity of NCAs to supervise and enforce EU legislative and regulatory requirements and be able to respond to market developments within the relevant Member State and any jurisdictions to which functions are outsourced/delegated. Unfortunately Principle 8 does not offer any blue-sky thinking on how to close some of the gaps on resourcing. Nor does Principle 8 offer a tie-in to Banking Union and the resulting benefits that joint supervisory teams and centralised functions have meant in creating a more uniform supervisory culture and process of engagement for regulated entities.

Principle 9: Coordination to ensure effective monitoring by ESMA

This Principle confirms and communicates that ESMA will establish new practical convergence tools in addition to the Supervisory Coordination Network. ESMA thus "...stands to ready to make use of all its powers in order to support supervisory convergence activity..."

This may be a more muted battle cry than contemporaries at the ECB have become known for in relation to Euro monetary policy as well as supervision, but it does mark a definitive step, that on top of the ESMA General Opinion, more can be expected from ESMA to drive the pan-EU priority of improving and increasing supervisory convergence efforts.

Outlook and some next steps for firms affected by the SPoRs

The SPoRs have set a new, more clearly mapped route on how financial services firms will need to structure themselves when relocating to the EU and/or Eurozone as a result of BREXIT or otherwise. In practical terms, this has a number of implications for firms, internal project teams as well as their retained legal counsel, consultants and professional advisers. As a result, the impact of the SPoRs:

- firstly, mean that in addition to tackling the diverse and rapid changing workstreams needed to BREXIT-proof and/or relocate a regulated firm, those existing plans and applications, including named individuals, need to crucially be proofed as to whether they would or could be capable of meeting supervisory expectations in an EU financial services market that is increasingly moving to deeper integration and converging standards;
- secondly, mean a greater need to take account of potentially more invasive supervisory touchpoints along each of the levels of the ESFS, including a greater scrutiny of fitness and propriety of individuals, governance and control functions as well as the written policies and procedures underpinning those systems and controls. For BREXIT-proofing workstreams, this might mean retaining appropriate legal and regulatory specialists, both within internal and external project teams that can draft, implement and ensure compliance with EU, Eurozone, respective national levels as well as third-country regimes. This dedicated workstream, whilst needing to be interoperable with license application and relocation workstreams, ought to be run separately so as to have sufficient degree of independence and an ability to challenge assumptions made by those advising on the relocation, in order to guarantee the integrity that the SPoRs expect of firms relocating; and
- thirdly, mean that timeframes for processing reviews and approvals are likely to be extended considerably whilst the frequency of supervisory inspections and engagements might increase from all levels of the ESFS and certainly the ECB-SSM and NCAs in the Banking Union. This means that firms will

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need to have appropriate advice as to what are key priorities as well as quick wins that can effectively reassure relevant supervisors that a firm is meeting if not exceeding its obligations, the supervisory expectations and the SPoRs.

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including what the SPoRs might mean for specific market participant types within or looking to enter the EU and/or the Eurozone, then please do get in touch with any of our Eurozone Hub key contacts below.

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