RegCORE Client Alert

European Securities and Markets Authority (ESMA) publishes its assessment of the Brexit relocation process

December 2022

Financial Services

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QuickTake

Since the UK's withdrawal from the EU, ESMA has used December and January to communicate its findings and future supervisory expectations on a range of Brexit related topics.[1] These publications are addressed to regulated financial services firms and in certain instances to national competent authorities (**NCA**s) in the European System of Financial Supervision (**ESFS**). On 8 December 2022, ESMA published a comprehensive "Peer Review Report"[2] following a targeted assessment on how NCAs handled firms' relocations to the EU-27 (the **Report**)[3] conducted by a Peer Review Committee (**PRC**).

During the Brexit transition period, ESMA worked closely[4] with NCAs to provide a wealth of supervisory guidance through opinions, briefings and Q&As (collectively the supervisory principles on relocations - **SPoR**s) that aimed to help market participants and NCAs when handling authorisation applications in a way that was consistent across the EU-27. ESMA's Supervisory Coordination Network (**SCN**) equally brought together senior supervisors from NCAs and assisted in establishing consensus on a number of crucial topics. These measures sought to improve convergence in NCAs' individual evaluations of authorisation requests from relocating businesses, such as investment firms, trading venues, and fund managers as well as the transfer of activities into the EU-27 and newly authorised firms.

The Report provides more information about the supervisory practice and approach employed by NCAs when reviewing and approving applications for authorisations from business relocating into the EU-27. This Client Alert assesses the contents of the Report, the takeaways for financial services firms and their supervisory

[1] See coverage from our EU RegCORE available here and here as well as here.
[2] ESMA carried out its assessment in line with the Peer Review Methodology (available here) by an ad hoc Peer Review Committee (**PRC**).
[3] Available here.
[4] together with its sister European Supervisory Authorities (**ESA**s), i.e., the European Banking Authority (**EBA**) and the European Insurance and Occupational Pensions Authority (**EIOPA**).

interaction over the forthcoming supervisory cycles with ESMA, its sister ESAs as well as the NCAs and other parts of the ESFS, including in the context of the Banking Union, with the European Central Bank (**ECB**) acting in its role as at the head of the Banking Union's Single Supervisory Mechanism (**SSM**).

ESMA expects that all EU NCAs will consider how the Report's findings and specific Recommendations apply to their authorisation and supervisory practices. ESMA plans to conduct a follow-up assessment in two years to review how NCAs' authorisation and supervisory approaches have evolved. ESMA may also revise existing as well as publish new SPoRs.

Key findings in the Report

The PRC's review (using questionnaires and on-site visits) differs from previous peer reviews (including those with respect to reviewing individual NCAs). Specifically, this review evaluated three distinct sectors within ESMA's legislative mandate, each as supplemented by specific expectations communicated by ESMA (and in part other ESAs) in the SPoRs, as follows:

1. entities offering investment services and activities (**MiFID firms**),
2. trading venues; and
3. fund managers (**UCITS/AIFMD firms**).

The Report focused its assessment on those NCAs in EU-27 jurisdictions where the majority of financial services firms' regulated activity or the greatest extent of complex operations had been transferred to. Despite the repeated discussions at the SCN level, national supervisory practises continued to vary in specific areas. Therefore, ESMA's assessment concentrated on two crucial areas: entities' (i) governance and (ii) substance requirements imposed by NCAs on relocating businesses. ESMA will likely continue to press ahead for greater convergence in these areas in addition to the outcomes and actions set out in the Report.

In addition, each sector-specific legal framework takes a unique approach to the content and level of specificity of the governance and substance standards. In summary, the regulation for MiFID businesses and trading venues (both covered under MiFID II/MiFIR) continues to be more stringent when it comes to some standards (albeit without always granular detail thus permitting flexibility for firms and NCAs), whilst the legislation relating to the fund management sector (management companies of UCITS/AIFMD firms defined for simplicity as **fund managers**) is more prescriptive on how certain requirements must be met by firms and thus how NCAs are to supervise compliance. These variations enable NCAs to implement requirements in a variety of ways (and still comply with the legal text). The requirements applicable to outsourcing and delegation arrangements provide a good illustration of these contrasts and thus conceptual divergences of how EU-level requirements are interpreted and supervised by the NCAs. Again this is an area that ESMA will seek to drive harmonisation on in addition to the specific matters set out in the Report.

On a per sector basis, this meant that ESMA focused its assessment on the following NCAs (sorted alphabetically in how they appear in the Report and herein):

- **MiFID firms** – reviewing in detail the work of the NCAs of Cyprus (CySEC), Germany (BaFin) and Ireland (CBI) based on the number of authorised relocating firms providing investment services and activities to retail clients and (ii) the complexity of these services/activities;

- **Trading venues** – focusing specifically on the NCAs of France (AMF), Ireland (CBI) and Netherlands (AFM) and given they authorised the highest number of trading venues; and

- **Fund managers** – concentrating on the work of the NCAs of France (AMF), Ireland (CBI), Luxembourg (CSSF) and Netherlands (AFM) and given they authorised the highest number of fund managers.

The Report distinguishes between overall findings and those that are specific to each sector. These are summarised in the following sub-sections below. The Report's findings evidence various shortcomings in approaches taken by the respective NCAs under review. In summary, ESMA concludes that the NCAs under review will have to significantly step up their efforts on respective standards applied by them. Table 1 (pages 11 to and including 13) in the Report summarises what is otherwise detailed in 117 pages as a stark wake up call on how the respective reviewed NCAs fall short of standards set as a matter of EU law, as supplemented by the SPoRs.

The identified findings then flow into the Report's "**Recommendations**" which, as discussed in the section further below, apply to **all** EU-27 NCAs. These Recommendations should equally factor into considerations for financial services firms looking to relocate to the EU-27, regardless of Brexit or not. Given the current reform efforts that continue at the German NCA (see our dedicated series of coverage on this development)

it is anticipated that this will likely push BaFin to step up its supervisory scrutiny as part of its authorisations work even further. The same may also apply to other NCAs covered by the Report.

Overall findings

The PRC's assessment looked at how the NCAs met the supervision requirements set at the stage of authorisation. The PRC also assessed how NCAs made sure that the relocated entities met the conditions when they commenced operations following receipt of authorisation.

The PRC also had to consider in its review the overarching goal of the assessment exercise, namely to improve supervisory convergence for all EU-27 NCAs and that Brexit was an event that could only happen once. At the same time, any lessons learned from the peer review should be focused on what will happen in the future. The PRC also noticed that the NCAs did not have a special process for handling Brexit-related applications. Consequently, the Recommendations (discussed in the next section below) as sent to the NCAs are therefore not just about something that happened in the past. Instead, they are meant to help the NCAs strengthen supervisory convergence in the authorisation process as they put these Recommendations into action.

As a key overall finding, the PRC, perhaps unsurprisingly, noted that:

- all NCAs used a risk-based approach, although to different degrees – thus leading to divergences. The PRC also noticed that different NCAs have different ideas about what a risk-based approach is. The PRC concluded that this risk-based approach sometimes led to results that were not in line with what was required by the ESMA Opinions as core part of the SPoRs;

- that the principle of proportionality was applied by NCAs on a case-by-case basis, with no clear thresholds or set criteria. The risk-based approach and the proportionality principle have sometimes led NCAs, especially when it comes to smaller firms, to only require the bare minimum; and

- all NCAs, to some extent, allowed for firms to adopt a phased-in approach when ramping up their EU operations in line with the licences (i.e. authorisations) they have applied for. In certain circumstances such firms also had to meet certain conditions for a period after the licence was issued but before the authorised entity could start doing (all of) the business it had applied for as part its authorisation application. ESMA noted that the uncertainty caused by Brexit and the COVID-19 pandemic led to this approach. Nevertheless, different NCAs applied differing levels of flexibility and diverse ways of making sure that entities were following the rules and conditions that were set up before a firm's regulated activity began.

As a result, the Report states that it is not clear whether "…all of the legal requirements and ESMA guidance were followed in all cases by all NCAs." The Report also states that the definition and use of a risk-based approach, as well as the thresholds for proportionality, are items that have not been thoroughly established and agreed on by all NCAs at the EU level. Consequently, the Report states, in particular in the Recommendations that this is a core area that ESMA will seek to better align and harmonise approaches in this area and thus foster convergence to counterbalance current fragmentation and conceptual as well as practical divergence.

Lastly, the PRC found that various NCAs permitted the use of "significant" (although it is not clear how that threshold is calculated) outsourcing/delegation arrangements and, in some cases, the relocation of a comparably small number of technical and human resources. As set out in the Report, in ESMA's view, these findings raise questions about (i) how much of regulated activity and functions have actually really moved into the EU-27 and (ii) how independent and self-sufficient the respective relocated entities actually are. This is an area that ESMA, along with the other ESAs and in the context of the Banking Union, the ECB-SSM as well as certain NCAs, notably in Germany, France and the Netherlands have been will over the course of future supervisory engagement remain quite strict on – even though the German NCA was found to have a number of shortcomings in meeting the standards in the SPoRs that ESMA expects the BaFin to apply.

MiFID firms - specific findings

The Report states that for relocations of MiFID firms, all NCAs included some form of transitional plan and inclusion of conditions as part of their granting of an authorisation. Supervisory practice in the granting of conditions however varied. The Report states that:

- The Cypriot NCA set specific and limited times for authorisation conditions. The conditions of authorisations for the German NCA had no end date. Both of these NCAs (Cyprus and Germany), however used the process of ongoing supervision to make sure that these conditions were met.

- The German NCA in particular relied on annual audits of applicant firms carried out by external auditors to keep track of the compliance with the conditions that were set. ESMA however on this point took the

view that if there is no formal, written process for keeping track of and sharing all conditions of authorisation, they might not be monitored well enough until the end of their application.

- The Irish NCA also relied on conditions accompanying authorisations and the Irish NCA made sure that respective firms were following the conditions of their licences by using the NCA's existing tools for ongoing supervision. The Irish NCA also changed how often firms had to report based on the level of risk they posed.

In general, when it comes to governance requirements, the Report concluded that NCAs seem to have (but as described below might always have applied) the right processes and procedures in place to make sure that board members, senior managers and key function holders are appropriately qualified in meeting the necessary knowledge and expertise requirements expected of them. This finding also applied to NCAs review of board members', senior managers' and key functions holders' well as the ability to dedicate sufficient time effectively manage the applicant as well as to have a meaningful presence in the EU Member State.

In particular, for small businesses, the PRC noted that two NCAs (Cyprus and Germany) did not make sure that senior managers spent enough time dedicated to the (planned) regulated functional roles. This is because these NCAs, in the PRC's view, took a flexible approach to the legal requirements requiring a MiFID firm to be effectively run by at least two people. In addition, for these two NCAs, the combination of regulation functions sometimes created conflicts of interests which did not seem to be properly addressed or mitigated by the Germany and Cypriot NCAs.

Concerning substance requirements, the PRC equally concluded that two NCAs (Cyprus and Germany), when it came to authorising smaller firms, did so despite these applicant firms not having sufficient in-house resources to meet the substance requirements set at EU law, as supplemented by the SPoRs. In particular for Germany, this was mostly because senior managers did not devote sufficient time to the authorisation project and/or were not physically present in Germany (prior to and/or following receipt of authorisation). A similar concern of the PRC is directed towards applicant firms' operating models signalling an excessive reliance on outsourcing and delegation arrangements - whether to third parties and/or on an intragroup basis. Again, these findings on substance, presence and outsourcing/delegation concern themes that the SPoRs are quite explicit on i.e., that mind and matter of a firm seeking authorisation needs to be located in the Member State of establishment of the applicant firm.

The PRC noted, specifically with the respect to the NCAs in Cyprus and Germany that possible conflicts of interest were not always sufficiently and/or correctly considered as part of the authorisation approval process. This was especially true when intra-group outsourcing arrangements were concluded, which, along with conflicts of interests not being properly dealt with in the applicant's governance structure, could put that firm's independence at risk.

Moreover, the PRC found that internal control functions were (in various circumstances) allowed to be combined with other control functions, operational functions, and sometimes even executive functions. The NCAs were not always able to fully show how these arrangements did not affect the effectiveness and independence of the relevant functions. Again, these are areas that are fundamentally out of line with existing EU legislative standards as supplemented by the SPoRs.

Trading venues - specific findings

The Report states that for relocations of trading venues, all three NCAs under assessment (France, Ireland and the Netherlands) followed the same rules as applicable to non-trading venue operators when it came to their supervisory approach and thus:

- there was no noticeable change from the NCAs' standard authorisation procedure i.e. no adaption made to account for specifics applicable to the business models and risk profiles of trading venues; however
- a pre-application phase was set up to prepare for the large number of requests and let potential trading venue applicants know about the NCAs' supervision expectations at a very early stage; and
- conditional authorisation and a phased-in move of business were used.

That being said, the PRC noted some differences between NCA's approaches. This included for example:

- the NCAs of France and the Netherlands dealing with potential trading venue applicants on a case-by-case basis, while the third NCA (Ireland) took a clear and well-defined approach to all trading venue applicants from the start, without the option to deviate; and

- the French NCA made sure to strictly follow the conditions for licences agreed upon with relocating trading venues.

Concerning governance requirements, the PRC noted differences in the controls and checks that were put in place for the organisational structures of relocating trading venues and, more specifically, the way the composition of their boards. The PRC welcomed the Irish NCA's approach, which was to set very clear and concrete obligations for all relocating trading venues. In contrast, the other two NCAs reviewed by the PRC (France and the Netherlands) decided to take a case-by-case approach to the composition of boards, with only a few general requirements being requested of trading venue applicants.

The PRC noted that France's NCA still tried to keep a certain amount of autonomy in the boards of relocated trading venues, while the Dutch NCA concluded that full autonomy could not be (sufficiently) reached because of the inherent inter-dependency of subsidiaries of international groups vis a vis their headquarters.

The PRC welcomed that all three NCAs under review put in place monitoring plans of trading venue applicants in respect of all outsourced services, including intra-group arrangements as part of on-going supervision i.e., after granting authorisation to a trading venue applicant firm. The PRC noted that such review should be considered systematically during the authorisation phase. The PRC however did however single out the best practice applied by the French NCA in monitoring the number of employees at outsourced service providers. Nevertheless, the PRC signalled that it found it worrying that none of the NCAs requested that trading venue applicant firms submit a cost-benefit analysis or maintain a formal due diligence process for intra-group outsourcing as required in the SPoRs. Moreover, the PRC noted that the overall independence of the outsourcing oversight function at a trading venue applicant firm could be indirectly affected in some cases by the problems mentioned above, notably with the governance set-up and, in particular, the boards of relocated trading venues.

Lastly, the PRC concluded that all NCAs dedicated ample attention to reviewing trading venue applicants' controls and checks on its operational systems resilience and the PRC found some good practises being applied in this area. However, the PRC specifically noted that the compliance and risk functions of trading venue applicants that had been authorised could have benefitted from having more control measures put in place, notably to strengthen safeguards required as a matter of EU law, as supplemented by supervisory expectations set out in the SPoRs.

Concerning the substance requirements of trading venue applicants, the PRC was disappointed that all NCAs allowed trading venues to relocate to the EU-27 but operate with less staff working directly from the EU than from outside the EU-27. While the PRC agreed that the general uncertainty around Brexit contributed to supervisory challenges for the NCAs, the substance requirements, specifically for trading venues, was a crucial and central component of the SPoRs and that NCAs should have given this much more attention as part of the authorisation process. As a result, the PRC encourages NCAs to set-up monitoring plans for relocated trading venues so that there is an even more balanced split between activities conducted in and outside of the EU-27.

Lastly, as with findings for MiFID firms, the PRC noted that the SPoRs for trading venues did not limit the possibility to outsource technical arrangements related to key functions (and holders) located in the EU-27. Nevertheless, the PRC observed an extensive use of this possibility, to such extent that in practice, in all three jurisdictions under review, relocated trading venues rely heavily on the technical support from their group operations (outside of the EU-27) for the performance of key functions. The PRC would have expected NCAs to further challenge relocating trading venues in this respect.

The PRC also considered that in the cases of two NCAs (France and the Netherlands), the level of compliance with the SPoRs applicable to trading venues "can be disputed" because the relocated entities and their boards are independent and have real decision-making power. Concerning the effective supervision of outsourced activities, the PRC welcomed the fact that (i) all outsourced activities were covered by entity-specific service level agreements (SLAs) that gave full access to the service providers for supervision purposes and (ii) NCAs opened communication channels with the UK authorities.

Fund managers - specific findings

The PRC's evaluation of NCA's approach to overseeing the governance of fund manager applicants paid special attention to the SPoRs concerning the fund management sector and notably the ESMA Opinion in the area of investment management. That ESMA Opinion set supervisory expectations concerning decision-making, conflicts of interest and the role of internal control functions.

The PRC pointed out that all NCAs under review conducted sufficient supervisory assessments of governance structures in place although with certain shortcomings. Specifically, these concerned the reviews

of fund manager applicants' conflicts of interest management and related disclosures along with the absence of strong and independent roles of internal control functions within fund manager applicant firms.

The PRC also found problems with the way the principle of proportionality was evaluated by NCAs. In this situation, some NCAs used very different quantitative thresholds, with some being up to 20 times higher in some EU Member States when compared to others. The PRC concluded that more needs to be done to ensure that the proportionality principle is applied in a way that ensures supervisory convergence and a level playing field for market participants in all Member States.

When evaluating the NCA's approach to supervision in terms of substance, the PRC specifically reviewed the supervisory expectations of NCAs concerning the number of senior managers, human and technical resources, delegation arrangements, and the monitoring of white label service activity by fund manager applicant firms. The PRC found that three NCAs (Ireland, Luxembourg and the Netherlands) did not meet the standards set in the SPoRs. Consequently, only France's NCA managed to fully meet the supervisory expectations set in EU legislation, as supplemented by the SPoRs concerning the review of adequacy of senior managers and human and technical resources at fund manager applicant firms.

The PRC also concluded that none of the NCAs under review met supervisory expectations in relation to delegation arrangements. Indeed, the PRC observed that none of the NCAs performed a comprehensive review of delegation arrangements, in particular the objective reasons for delegation and compliance with due diligence requirements.

ESMA has, since 2020, been concerned with what it calls "white-label service providers" and activity in particular in the fund management sector. ESMA defined such providers and activity in the context of a 2020 Letter on the AIFMD Review[5] as:

> "Meaning fund managers that provide a platform to business partners by setting up funds at the initiative of the latter and typically delegating investment management functions to those initiators/business partners or appointing them as investment advisers or informally following their guidance/instructions. ESMA addressed risks stemming from white-label service providers in the context of Brexit-related relocations in paragraph 36 of the ESMA opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (ESMA34-45-344)."

ESMA equally stated in the Letter on the AIFMD Review that:

> "These types of fund managers exist since many years in several Member States, whereas NCAs in other Member States have expressed doubts as to whether those business models would be in line with the AIFMD and UCITS regimes. Should such business models be permissible in the view of the European Commission, more specific regulatory provisions would be advisable, in particular to address the distinct and significant conflicts of interest and investor protection risks faced in these cases. This is mainly because the initiator/business partner of white-label (or third-party) funds is also the client of the authorised AIFM or UCITS management company and may therefore decide to replace the authorised AIFM or UCITS manager with another white-label service provider. In many cases, the relevant funds even carry the name of the initiator/business partner. Therefore, the initiator/business partner may effectively be able to exercise significant influence over the authorised AIFM or UCITS manager. Where the initiator/business partner performs portfolio management on a delegation basis or is appointed as investment adviser, the authorised AIFM or UCITS management company will face significant conflicts of interest since controlling and challenging the delegate/investment adviser in the best interest of investors may come at the risk of losing a client/business partner and therefore losing its own revenue/management fees. Changes should also be reflected in the UCITS Directive."

In the absence of such legislative changes concerning white label services providers, the PRC used the context of the Report to review and assess how NCAs are addressing the supervisory expectations (technically binding but not as a matter of law) communicated in the SPoRs on white label service providers.

The PRC consequently concluded that white label service providers were only relevant in the context of the operations of the Irish and Luxembourgish NCAs. The Netherlands confirmed that they have no white label service providers subject to their supervision and the French NCA notified the PRC that any of the white label service providers operating under their supervision were not Brexit related. It is quite conceivable that ESMA may publish standalone guidance on its supervisory expectations (generally and not just in the context of the SPoRs) on white label service providers whether as a prelude or complementary addition to any further legislative rulemaking at the EU level.

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[5] See footnote 7 on page 7 of ESMA Letter on the AIFMD Review (available here).

The Report's Recommendations

The Report sets out specific Recommendations for each of the sectors that the PRC reviewed. These apply not only to the relevant NCAs that participated in the assessment but to **all** EU NCAs. The Recommendations are equally of relevance to all market participants (whether relocating due to the EU-27 due to Brexit or not).

Consequently, ESMA will continue to promote and coordinate additional convergence work of interpretation and harmonisation of rules but equally of supervisory practices and approaches. It will do so at the EU level and also expects work to be performed at the national level by all NCAs so as to address the Report's findings and Recommendations.

Despite the Report's granularity, it remains unclear whether this supervisory convergence will be driven by ESMA using (i) a top-down approach i.e., setting prescriptive measures that NCAs will need to implement; or (ii) whether ESMA's Recommendations and work that the individual NCAs are expected to implement will be used as a catalyst (even if this does not fully close out the risk of fragmentation) to encourage other NCAs not reviewed by the PRC to nevertheless meet those standards implemented by the reviewed NCAs; or (iii) some mix of both. Either way, ESMA will want to close supervisory gaps. The other ESAs and the ECB-SSM will also have a vested interest that the improvements introduced by the Recommendations are also replicated in those areas of financial markets supervision that are beyond the scope of ESMA's supervisory and coordination mandate.

The Recommendations are summarised below and should also be read in conjunction with the respective multi-annual work programmes, as published by each of the members of the ESFS – which is summarised in "Navigating 2023" as available on PwC Legal's EU RegCORE website:

Type of firm and related area of focus	**Relevant Recommendation in the Report – directed to individual NCAs but applicable to all EU-27 NCAs**
MiFID firms	
Governance	• In relation to small firms only, the PRC noted in its findings (see above) that Cyprus and Germany "took a very flexible approach" to the interpretation of Article 9(6) MiFID II, accepting that firms be effectively managed by two full-time equivalents (**FTE**s). In light thereof, the PRC recommends that: ○ Cyprus and Germany set up requirements (in national rulemaking instruments and guidance) as to the minimum time that senior managers must commit to the management of the firm. A similar measure already exists under EU law (and the ECB-SSM has adopted similar standards in the context of Banking Union supervision) and it remains to be seen whether Cyprus and Germany will follow the existing EU standard or go beyond that (which would however reinforce rather than reduce fragmentation). ○ German sets a concrete and effective materiality threshold on alternative arrangements when a firm will be managed by only one managing director. • Concerning conflicts of interest, the PRC recommends that Cyprus and Germany ensure, for all firms, that a conflict of interest policy in place at authorisation stage and that all NCAs review such conflict of interest policy – specifically as this is contemplated in the SPoRs and notably ESMA's Opinion on investment firms. • The PRC further recommends that Cyprus and Germany "carefully consider" situations of dual hatting and address any conflicts of interest that may result form them.
Outsourcing	• In relation to "extensive"[6] outsourcing arrangements that could otherwise render an applicant firm a letter-box entity, the PRC recommends that Germany assess these situations more thoroughly. This includes ensuring that outsourcing arrangements

[6] What precisely constitutes "extensive" remains undefined as a matter of EU law and supervisory guidance as it exists in the ESFS and thus fragmentation might be permitted to continue given leeway on interpretations.

	are in place "at the moment of authorisation or, at the very least, at the commencement of operations". • In relation to intragroup outsourcing arrangements, the PRC recommends, specifically concerning Cyprus, that increased scrutiny be applied given the susceptibility of such arrangements to enhanced conflicts of interest.
Independence of internal control functions	• The PRC recommends that all NCAs increase scrutiny before permitting the combination of control functions with other functions including specifically executive, operational or other control functions.
General recommendations on governance and substance requirements	The PRC recommends that: • Germany establishes a formal process for recording all conditions of authorisation; and • Cyprus and Germany implement a formal process to follow up with firms concerning the phasing out of transitional arrangements in place.
Trading venues	
Governance	The PRC recommends that: • France and the Netherlands set clearer minimum requirements concerning the overall governance of trading venues in particular with respect to dual-hatting, time commitments and functional reporting. • France and the Netherlands establish more concrete safeguards in order to strengthen the autonomy of boards and to ensure that, beyond formal decision-making powers, there are concrete measures in place to limit the actual influence of non-EU-27 headquartered groups on its EU subsidiary. The PRC states that "These obligations should serve as a minimum set of rules that can be complemented on a case-by-case basis depending on the specific characteristics of the entity concerned (such as scale of activities, business model, etc)." In light of the above, the PRC recommends that all NCAs: • set in place concrete controls and checks during on-going supervision to monitor the effectiveness of the decision-making powers that lie with relocated trading venues and their boards. This appears particularly relevant for key functions (i.e. trading systems, admission to trading, establishment and subsequent changes to the rulebook, suspension and removal of financial instruments from trading, trading halts, market surveillance) where a significant part of the activity and technical arrangements have been outsourced to entities of the same group.
Outsourcing	The PRC recommends that all NCAs apply, as a matter of on-going supervision: • the same controls and checks that are typically required for outsourcing arrangements to third-party providers (such as assessment of risks, due diligence, cost-benefit analysis) to intra-group outsourcing subject to controls and checks being able to be tailored to nature and inherent features of intra-group outsourcing; and • systematic and formalised IT checks and controls, given, what the PRC notes as "the increasing importance of IT issues for trading venues".
Substance	• The PRC recommends that all NCAs improve the monitoring of the extent of outsourcing (e.g. in terms of number of staff and percentage of revenue that is paid back for the performance of outsourced activities) with a view to establishing a more balanced set up and repartition between activities performed outside and within the EU as part of on-going supervision. • Moreover, the PRC states that "Outsourcing should not be considered as an inevitable outcome for trading venues that belong to large international groups and NCAs should dedicate more efforts on convincing relocating entities to have more activities (including technical arrangements) being relocated, allowing only in duly justified cases the outsourcing of technical support to the performance of key

	activities. This monitoring and the consequent rebalancing of resources should be considered for both the overall organisational set up of relocated trading venues and in particular for key and important functions."
Fund managers	
Governance	• The PRC recommends that all NCAs introduce a more systematic and thorough approach to reviewing potential and actual conflicts of interest as part of their review during the authorisation stage. This includes (similar to the Recommendations for MiFID firms) a closer scrutiny of the permitted combination of responsibilities, roles, functions or reporting lines (as well as dual hatting) which could result in a conflict of interest or impair the principle of control functions' independence.
Proportionality	The PRC recommends that: • France and Ireland introduce a more systematic and thorough approach to reviewing the key policies and procedures of applicant firms; and • Ireland and Luxembourg review the current quantitative thresholds applied to determine proportionality.
Independence of internal control functions	• The PRC recommends that all NCAs scale up the efforts to review the establishment and strong role of internal control functions, verifying in particular the appropriate interaction between portfolio and risk management and sound escalation procedures.
Substance	The PRC recommends that: • Ireland, Luxembourg and the Netherlands introduce a more thorough review of the adequacy of human and technical resources; • all NCAs introduce a more systematic and thorough supervisory approach in reviewing delegation arrangements; and • Luxembourg monitor its white label industry more closely given the supervisory risks posed.

In addition to the above, the Report also serves as means of communicating "cross-cutting" Recommendations and follow-up work at the EU level to foster supervisory convergence. These specifically concern NCAs application of (i) the risk-based approach, (ii) the proportionality principle and (iii) outsourcing and delegation arrangements. These include:

Type of firm and related area of focus	**Relevant "Good Practices" identified in the Report – directed to individual NCAs but applicable to all EU-27 NCAs**
MiFID firms	
Governance	The PRC identified the following good practices in the supervisory approach of the NCAs assessed: • The Cypriot and Irish NCAs conduct interviews in addition to the written vetting process depending on the risk classification of the applicant firm, the nature of its business and/or any potential issue being identified; • The Cypriot NCA carries out a pre-approval on-site visit for each applicant firm prior to granting authorisation; and • The Cypriot and Irish NCAs impose an obligation for firms to liaise with the NCA if their activities increase by more than a certain percentage compared to the projections submitted in their business plan.
Substance	The PRC identified the following good practice:

	• The Cypriot NCA conducts on-site inspections addressing the topic of the resources dedicated to the planned activities at the authorisation stage.
Trading venues	
Governance	The PRC identified the following good practices in the supervisory approach of the NCAs assessed: • The Irish NCA setts clear obligations on Board members (e.g. independent non-executive directors as Chair for the board of a relocated trading venue), with no possibility for derogation and no possible dual hatting for certain functions; • The Irish NCA equally imposes concrete measures to mitigate operational risk relating to outsourcing (e.g. non-intermediated kill switches, local disaster recovery site); • The French NCA reviews the staff dedicated, within the group, to the performance of outsourced activities – although many other NCAs in the EU-27 already focus on this with heightened supervisory scrutiny;; • The French, Irish and Dutch NCAs require the appointment of a specific person in charge of the outsourcing oversight – although many other NCAs in the EU-27 already focus on this with heightened supervisory scrutiny; • The Dutch NCA uses detailed checklists (so-called work programme), listing all relevant requirements (EU and domestic requirements); • The Irish NCA requires the self-assessment during the authorisation phase of organisational requirements of trading venues and responding to a questionnaire on IT risks to all applicants; and • The Dutch NCA applies a six-eyes review approach for issues relating to systems' resilience involving the IT team, the authorisation assessment officers and the relevant supervisors.
Substance	The PRC identified the following good practices in the supervisory approach of the NCAs assessed: • The French NCA requiring voice brokers to be located in France - in particular those executing transactions on behalf of on EU clients; and • The French and Irish NCAs imposing tailored policies, procedures and rulebooks (FR, IE).
Fund managers	
General	The PRC identified the following good practices in the supervisory approach of the NCAs assessed: • The Dutch NCA uses detailed checklists covering the key legal requirements and paragraphs set out in the SPoRs and specific ESMA Opinions with a view to ensuring comprehensive and consistent supervisory assessments; • The French NCA conducts detailed reviews of the envisaged portfolio management process, including the review of detailed order flows (pre-placement, validation and registration of orders and reconciliation of positions etc.); • The French NCA equally conducts a comprehensive assessment of the technical resources of applicant firms to obtain a good overview of the various IT tools and systems used by applicant firms and their delegates;

	• The Irish NCA requires applicant firms to appoint an independent non-executive director as Chair of the board of directors providing for additional escalation possibilities and more independent decision-making processes; • The Luxembourgish NCA conducts a thorough review of the Risk Management Process and related documentation particularly through comprehensive and, where possible, standardised assessments.

It is quite conceivable that ESMA will publish further standards, including those that build upon the existing SPoRs and also that embed some of the good practices that the PRC did identify.

The objective of the Report and thus equally the outcomes set in the Recommendations is to draw lessons for the broader authorisation process from this extremely specific Brexit-related relocation process. This aims to leverage off the best of identified individual (national) best practices and build forward a more resilient Single Supervisory Culture across all of the ESFS so as to strengthen the EU's Single Rulebook overall. In turn, this supports the driving forward of the convergence of the interpretation of respective EU-level legislation, as accompanied by various rulemaking and supervisory guidance instruments issued by ESMA as well as other members of the ESFS and its translation into supervisory practice by NCAs. Supervisory convergence remains an on-going priority that is reiterated throughout ESMA and the other ESAs multi-annual work programmes year on year.[7] ESMA equally announced that in two years, a follow-up evaluation will be conducted to determine how the issue has evolved.

Key considerations for financial services firms and outlook ahead

The Report, its findings and its Recommendations are certainly timely even if it makes for uncomfortable reading for certain NCAs as well as various financial services firms, regardless of their maturity of their business operating model in the EU-27. What is clear is that the Report does not have the power to overturn authorisations that have been already lawfully granted. That being said, the Recommendations may nevertheless translate into increased supervisory scrutiny by NCAs setting additional requirements as part of the ongoing supervisory dialogue with those firms that were lawfully authorised following Brexit as well as with respect to those third-country headquartered firms that are in the process of seeking authorisation in the EU-27 regardless of Brexit.

For those applicant firms that have filed their authorisation applications but not received their licenses or have not yet commenced their operations for regulated activity, the Report will likely trigger firms to respond to NCAs requests for targeted amendments to documents submitted or to be submitted. This may delay both formal and informal timelines accordingly.

Equally, ESMA's emphasis on the extent of firms' outsourcing and delegation arrangements, as well as the quantity and quality of human capital actually located in the EU, shows that pressure from EU authorities in these areas will likely increase in forthcoming supervisory cycles. Consequently, some financial services firms will want to revisit their legal entity and operating models to meet regulatory requirements and supervisory expectations (as well as possible conflicts) that may arise across both EU-27 and non-EU-27 operations while still being commercially viable in light of a more uncertain and volatile macroeconomic outlook. As a result, firms are expected to be able to explain how they mitigate both their financial and non-financial risks resulting from their activity within but equally outside of the EU-27.

For those firms that are seeking to apply for authorisation, the Report, its findings and Recommendations will need to be reflected accordingly in the respective arrangements and documentation prepared as part of an application pack. Such forward planning is particularly pressing given that the ESAs, as well as the ECB-SSM in the context of the Banking Union and more broadly the NCAs across all of the EU-27, are very much returning to much more normal operating conditions following the end of the worst of the COVID-19 pandemic. This may include a much greater use by respective supervisors in the ESFS of on-site inspections, thematic reviews (including those that may build upon the ECB-SSM's "Desk Mapping Review") as well as coordinated supervisory actions (CSAs).[8]

As a result, financial services firms will want to commit dedicated in-house resources along with retaining suitable professional advisors to focus on increasing the granularity of detail submitted as part of the application process will be ever more crucial than before. Given that greater detail for authorisation processes

[7] See also coverage in Navigating 2023 available from our EU RegCORE.

[8] For coverage on a full set of recent developments of the ESFS' supervisory toolkit, please refer to coverage on PwC Legal's EU RegCORE selection of regularly updated Thought Leadership.

as well as for existing authorised firms subject to greater scrutiny being subjected to a much more detailed "comply or explain" standard, such more invasive supervisory engagement will translate into further protracted timelines (and thus costs) across various business as usual supervisory processes unless this is efficiently managed.

The Report's publication however has other effects beyond reinforcing the importance of the SPoRs and highlighting both the shortcomings along with the more limited good practices identified by ESMA. Specifically, it serves as bold and blunt messaging from ESMA to respective NCAs but equally to the other ESAs and the ECB-SSM for these to also reinforce their own supervisory convergence efforts on the interpretation, application and supervision of compliance with the rules on authorisation processes as well as supervision of on-going compliance of regulated firms with requirements set out in legislation as supplemented by the SPoRs. When all of this is taken together, this raises strategic questions for both existing authorised firms as well as prospective applicant firms in how to forward-plan for the forthcoming supervisory cycle in 2023 and beyond.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these developments. Moreover, PwC Legal's EU RegCORE Team along with the wider pan-European network of PwC Legal's Financial Services Regulatory professionals continue to maintain an extensive track record of steering applicant firms (of various degrees of business and operating models) successfully through the 'build the business' and authorisation process through to the 'run the business' and on-going compliance elements and supervisory engagement with the entirety of the ESFS.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's EU RegCORE Team via de_regcore@pwc.com or our website.

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