

OPINION

to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union

I. Legal basis

1. The European Securities and Markets Authority's (ESMA) competence to deliver an opinion is based on Article 29(1)(a) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council (the 'ESMA Regulation')¹. In accordance with Article 44(1) of the ESMA Regulation, the Board of Supervisors has adopted this opinion.

II. Background

2. On the 29 March 2017, the United Kingdom (UK) notified the European Council of its intention to withdraw from the European Union (EU) pursuant to Article 50 of the Treaty on European Union (TEU). The withdrawal will take place on the date of entry into force of a withdrawal agreement or, failing that, two years after the notification on 30 March 2019².
3. As the UK plays a prominent role in the EU Single Market, the relocation³ of entities, activities and functions following the UK's decision to withdraw creates a unique situation which requires a common effort at EU level to ensure a consistent supervisory approach to safeguard investor protection, the orderly functioning of financial markets and financial stability.
4. Against this background, ESMA published an opinion⁴ (hereinafter referred to as 'cross-sectoral opinion') which addresses 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. That opinion is primarily addressed to the national competent authorities (NCAs)⁵ of the 27 EU Member States

¹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84–119).

² Article 50 further allows the European Council, in agreement with the Member States, to extend this period.

³ Relocation as referred to in this opinion should be understood in a broad sense and includes not only situations where an entity seeks authorisation for the first time in the EU27, but also cases where an existing entity in the EU27 is restructured (e.g. through an acquisition of an existing investment firm or even through an increase in the number of personnel of an existing firm) as a result of a transfer of activities and functions from a UK entity.

⁴ ESMA opinion on general principles to support supervisory convergence in light of the United Kingdom withdrawing from the European Union, May 2017 (ESMA42-110-43).

⁵ National Competent Authorities as defined under Art. 4 of the ESMA Regulation.

remaining in the EU (EU27)⁶ and covers all legislation referred to in Article 1(2) and (3) of the ESMA Regulation, including, inter alia, Directive 2004/39/EC (MiFID I), Directive 2014/65/EU (MiFID II) and Regulation (EU) No 600/2014 (MiFIR) (hereafter referred as the “MiFID framework”)⁷.

5. This sector-specific opinion sets out principles based on the objectives and provisions of the MiFID framework, which are applied to the specific case of relocation of entities, activities and functions following the UK’s withdrawal from the EU. It seeks to supplement the principles set out in the cross-sectoral opinion by addressing regulatory and supervisory risks in the area of investment firms, in particular in relation to authorisation (III), substance requirements (including governance and outsourcing) (IV) and effective supervision (V). It should also be read, where appropriate, together with the sector-specific opinion on secondary markets⁸.
6. Similar to the cross-sectoral opinion, this opinion assumes that the UK will become a third country after its withdrawal from the EU and is therefore without prejudice to any specific arrangements that may be agreed between the EU27 and the UK, to any equivalence decisions that may be adopted by the Commission under MiFID II / MiFIR and to any future ESMA opinions or other convergence tools.
7. Through the recently established Supervisory Coordination Network, ESMA is providing a forum for reporting and discussions among NCAs regarding market participants seeking to relocate entities, activities or functions to the EU27. The objective is to promote that consistent decisions are taken by NCAs.

III. Authorisation

8. NCAs should ensure full compliance with the authorisation requirements set out in the MiFID framework⁹.

⁶ The opinion is also addressed to the NCAs of the EEA-EFTA States Norway, Liechtenstein and Iceland as per the EEA Agreement.

⁷ Directive 2004/39/EC (MiFID I) on markets in financial instruments (OJ L 145, 30.4.2004, p.1) to be repealed from January 2018 by Directive 2014/65/EU (OJ L 173, 12.6.2014, p.349) (MiFID II) and Regulation (EU) No 600/2014 (OJ L 173, 12.6.2014, p.84) (MiFIR) as further specified in relevant implementing measures.

⁸ [ESMA70-154-270 Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union.](#)

⁹ NCAs should take into consideration all relevant MiFID requirements (MiFID I, MiFID II, MiFIR as further specified in relevant implementing measures and including the Commission Directive 2006/73/EC implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MiFID I Implementing Directive) (OJ L 241, 2.9.2006, p. 26), MiFID II Delegated Regulation on organisational requirements and operating conditions for investment firms (OJ L 87, 31.3.2017, p.1) or the MiFID II Delegated Regulation with regard to technical standards on information and requirements for authorisation of investment firms (C(2016)4417), as well as ESMA guidance.

This section does not apply to credit institutions that are authorised under Directive 2013/36/EU. When a credit institution decides to provide investment services or perform investment activities the competent authorities, before granting an authorisation under Directive 2013/36/EU, should verify that it complies with the relevant MiFID provisions.

9. Consequently, NCAs should require applicants to provide them with a complete set of information as required under the MiFID framework and should carry out the complete authorisation procedure without any derogations or exemptions¹⁰.
10. The MiFID framework does not provide for any reliance on previous or existing authorisations in other Member States or third countries and NCAs need to ensure, before granting authorisation, that all relevant conditions are met from day one¹¹. In particular, as the MiFID framework does not provide for any transitional provisions in case of relocation of firms, NCAs should not rely on mere confirmation from applicants but require detailed information in order to be satisfied that applicants' organisational set-up and business operations will be in compliance with the MiFID framework from day one.
11. NCAs should pay particular attention to issues affected by relocation and to situations where the applicant is part of a group/has links with non-EU entities and should therefore assess any qualifying shareholders, the group business model/structure, the impact of potential (prudential) consolidated supervision or lack thereof, etc. NCAs should verify how any (in particular non-EU) shareholders or members with qualifying holdings are likely to influence the sound and prudent management of the investment firm and its compliance with the MiFID framework as well as prudential requirements under CRR/CRD IV¹². In particular, NCAs shall carefully assess whether the group structure within which the investment firm will operate constitutes an obstacle to their effective exercise of supervisory functions.
12. NCAs should also assess applications in order to ensure that the choice of Member State for relocation is driven by objective factors (and not by regulatory arbitrage). NCAs should carefully assess the geographical distribution or activities of the applicant (based on e.g. the programme of operations, information on prospective investors, marketing and promotional arrangements, location of development of products or services, the identity and geographical localisation of distributors' activities, language of offering/promotional materials¹³) and 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 firm intends to carry out or carries out the greater part of its activities¹⁴. An NCA's assessment of how an applicant firm plans to oversee its business and manage the risks arising from its cross-border activities should be proportionate to the volume and complexity of the planned cross-border operations. An NCA should also consider, in processing a request for authorisation, the extent to which the applicant's

¹⁰ In particular, NCAs should not design fast-track authorisation processes that provide for more flexible authorisation/supervision approaches compared to approaches adopted in relation to any other EU entity or do not otherwise ensure full compliance with EU legislation.

¹¹ NCAs could, subject to full compliance with Union law and applicable national law in the Member State of establishment, take into consideration for example assessments of fit and proper requirements where appropriate. NCAs should consult each other, and share information, in accordance with the obligations in the MiFID framework.

¹² Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (OJ L 176, 27.6.2013, p.1) and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms OJ L 176, 27.6.2013, p.338).

¹³ See also upcoming MiFID II Delegated Regulation with regard to RTS on authorisation of investment firms (Insert full legislative reference).

¹⁴ See Recital 22 MiFID I and Recital 46 MiFID II.

envisaged operations in other jurisdictions might impact the NCA's resources and ability to effectively supervise the cross-border operations of the firm.

IV. Substance requirements

13. NCAs should mitigate the risk of letter-box entities and ensure that any relocation is effective and complies with the MiFID framework from day one and on an ongoing basis. NCAs should ensure that investment firms dedicate appropriate human and technical resources as well as adequate governance and internal controls for the day-to-day management of firms' business, as well as carefully consider which functions can be outsourced (and in particular whether they can be outsourced to non-EU service providers) without this impacting the substance and the independence of the firm.

A. Governance and internal controls

Sound governance and effective internal control mechanisms

14. The MiFID framework requires investment firms¹⁵ to establish, implement and maintain effective governance structures and internal control mechanisms. NCAs should ensure that the persons effectively directing the business and other senior management and/or key function holders of applicant firms are in the Member State of establishment¹⁶ and that board members and senior managers in the EU27 have effective decision-making powers, even where the investment firm is part of a group. Where the investment firm and/or persons who effectively direct the business have not established a meaningful presence in the chosen jurisdiction, for example where the senior management and/or persons in key compliance and risk functions are not present in the home Member State, such that the NCA believes that the firm is not genuinely operating from the home Member State jurisdiction or that the persons directing the business do not have sufficient control and oversight of the business, this may provide grounds for not granting or withdrawing authorisation.
15. Board members/senior managers/key function holders should have the necessary knowledge and expertise for and should dedicate sufficient time to effectively manage the investment firm. NCAs should therefore carefully assess board members/senior managers/key function holders' long-term commitment to the firm and its relocation as well as links (including non-financial relationships) with any group entities and how that may increase conflicts of interests or impact their time commitment towards the firm.
16. In light of the essential role of board members/senior managers' to carry out independent decision-making, to safeguard the best interests of clients, and to ensure firms' compliance with EU legislation, NCAs should assess and put additional scrutiny on individuals with

¹⁵ The term "investment firms" includes credit institutions providing investment services.

¹⁶ This is particularly important with respect to firms with online business models and which might otherwise have a more limited physical presence in the home Member State. Firms should also bear in mind that in accordance with Article 5 of MiFID I (or MiFID II) the registered and/or the head office must be in the Member State in which the firm actually carries out its business.

high numbers of (executive or non-executive) roles. NCAs should consider their expectation as to appropriate thresholds (in terms of time commitment) and should monitor commitments so as to avoid any potential risk that governance standards may be weakened.

17. At least two persons with the requisite knowledge, experience and sufficient time-commitment conditions should effectively direct the business of the applicant firm¹⁷. Sound governance and internal control mechanisms should provide clarity as to the allocation of responsibilities, documented policies and procedures which foster constructive challenge and the effective involvement of board members/senior managers.
18. NCAs should assess and be satisfied that the designation of specific tasks to individual senior managers does not compromise the ability of the individual senior manager, or the management body as a whole, to have independence of mind. Also, 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.
19. The allocation of functions (in particular relating to risk-taking and independent control) within an investment firm must be organised in a manner that avoids conflicts of interest. Internal control functions should in principle operate independently from operating units¹⁸. Where investment firms are part of a group, NCAs should also be satisfied that any reporting lines to the group do not impair the independence of internal control functions. NCAs should give particular consideration to any conflicts of interest which may arise when investment firms outsource certain functions/services to affiliated service providers. In such cases, one measure to manage conflicts of interest could be to have a sufficient number of non-executive members of the management body¹⁹ and, where it exists, a supervisory function that is independent from the parent undertaking and the group service provider.
20. Effective internal control mechanisms must be in place to ensure compliance with the MiFID framework and any other relevant requirements²⁰. Investment firms should ensure that relevant control functions are discharged properly and independently and NCAs should carefully assess cases where the performance of multiple functions risks preventing relevant persons from discharging any particular function soundly, honestly and professionally. Combining the risk management, compliance or internal audit functions should generally be avoided as this may undermine their effectiveness and independence. In particular, NCAs should 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 the safeguarding of client assets (i.e. one that does not perform any other functions) and ensure that appropriate safeguards are implemented

¹⁷ While Member States may, in accordance with national rules, grant authorisation to investment firms that are natural persons or legal persons managed by a single person meeting the knowledge, skills and time commitment conditions, alternative arrangements must be in place (including the immediate appointment of a substitute manager meeting the conditions) to ensure the sound and prudent management of such firms and the adequate consideration of the interest of clients and the integrity of the market.

¹⁸ In line with proportionality considerations as particularly developed in paragraphs 28-30.

¹⁹ Different governance structures may exist across Member States (e.g. unitary or dual board structure). The terms used in this opinion are functional and intended to embrace all existing structured without advocating any particular structure.

²⁰ See Article 13 MiFID I, Article 16 MiFID II.

by the investment firm so that the effectiveness of such functions is not compromised and to mitigate against any conflicts of interest or impact on firms' overall compliance with the MiFID framework. Moreover, where an investment firm is part of a group, NCAs should ensure that responsibility for the compliance and risk function permanently rests with the investment firm which needs to be in charge of monitoring its own compliance risks.

21. NCAs should also receive detailed information and be satisfied that sufficient human and technical resources are available to each senior manager/key function holder to enable them to effectively discharge their roles. Firms' organisational policies and procedures should ensure the independence and the strong role of internal control functions within the organisation. This is essential in order to ensure the decision-making process includes an appropriate assessment of all relevant risks. Moreover, internal policies and procedures should ensure that significant deficiencies detected by control functions are documented and reported to the management body and NCAs without undue delay.
22. Investment firms' governance structure and configuration of human and technical resources must ensure that NCAs can contact and meet with board members, senior managers and relevant staff during normal business hours, even when carrying out on-site visits of firms' business premises (including when without prior notice).

Appropriate financial and non-financial resources and programme of operations

23. NCAs should ensure that the applicant firm's financial and non-financial resources are appropriate in relation to the activities the firm intends to carry out and that applicant's documents, policies and procedures are tailored to the specific business model and risks of the firm. For example, NCAs should consider firms' policies and systems to ensure compliance with all relevant organisational and conduct of business requirements such as safeguarding of client assets or best execution. NCAs should pay close attention to the risks arising out of the situation where firms choose to execute client orders using a single venue. A firm may not be able to demonstrate that it is acting in clients' best interests if it is reliant on a specific venue for the continuation of its own services. Intra-group links, binding contractual agreements or technology links between an investment firm and a venue should not prevent or make it impractical for the firm to consider executing client orders using an alternative venue if, inter alia, the execution quality deteriorates and/or does not enable the firm to consistently deliver the best results for its clients. Moreover, where the investment firm uses another execution venue to hedge client orders on a back-to-back basis, the selection of the firm's hedging venues is a major factor impacting the delivery of best execution. As the use of one single/affiliated counterparty to hedge client orders impacts the execution offered to EU clients, the NCAs should assess whether the firm can demonstrate consistently delivering best execution.
24. NCAs should also pay 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 orders²¹. If the non-EU execution venue is not subject to similar regulatory

²¹ Where in compliance with any trading obligation requirements under the MiFID framework.

requirements, the NCA 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). Similarly, if a firm, dealing on own account and executing client orders and that is hedging on a back-to-back basis, uses an execution venue based in a non-EU jurisdiction for its hedging activity or to derive prices for its clients' orders, the NCA should require the firm to demonstrate how this enables it to comply with its best execution obligations and to monitor this on an ongoing basis. If an NCA is not satisfied that the firm will be able to meet its MiFID obligations for the execution of client orders or for the firm to execute its hedge orders, the firm should not use the venue.

25. NCAs should particularly assess situations where the firm has similar business models or close links with non-EU entities, given the heightened conflict of interest risks. For instance, where firms hedge trades intra-group, NCAs should consider the proposed hedging arrangements and be satisfied that the firm can demonstrate sufficient oversight of these arrangements and deliver best execution.
26. NCAs should also consider whether the firm is adequately capitalised and whether it is likely to meet own fund requirements on an on-going basis²², taking into account whether the proposed business model is sustainable.
27. Furthermore, where investment firms intend to or carry out cross-border services, NCAs should also consider how the additional complexity and risks arising from the provision of investment services outside the home Member State will be overseen and managed by the firm²³.

Proportionality

28. Taking into consideration the nature, scale and complexity of firms' business (and including the complexity of investment strategies and activities pursued, the geographical distribution of activities, the type and range of functions/services that are performed internally or outsourced, the (expected) number and type of investors), NCAs should carefully consider the appropriate sophistication of the governance structures and internal control mechanisms as well as the human and technical resources expected from each firm.
29. Consequently, NCAs should require firms of significant size and/or with complex business models and/or with a broad range of activities to have appropriate and sufficiently sophisticated governance structures (beyond the minimum two members of the management body) and internal control functions fully independent from operative functions. A prudent assessment of these factors is of the utmost importance as such firms' models entail a broad range of tasks and responsibilities for senior management and internal functions.

²² Article 12 of MiFID; and any applicable provisions under CRD/CRR.

²³ Additional complexity and risks could arise, for example, from the need to deal with marketing or promotional material in a different language or interactions with various legal systems.

30. NCAs should ensure that any exemption or derogation from general requirements to establish internal control functions with dedicated staff independent from operational functions is duly justified based on the principle of proportionality. In any case, NCAs are not expected to grant derogations or exemptions in relation to internal control functions to firms that are of significant size or have a broad or complex range of activities.

B. Outsourcing

Assessment of outsourcing arrangements

31. The use of outsourcing arrangements may be an efficient way to perform some functions or activities. However, such arrangements (in particular when the service provider is outside the EU) are not without their risks both for investment firms and for their NCAs and must be subject to appropriate oversight; points which this opinion seeks to address. Under the MiFID framework, the outsourcing of critical and important functions is subject to strict requirements. Any outsourcing that results in the delegation by senior management of its responsibility, altering of the relationship and obligations of the firm towards its clients, undermining the conditions with which the firm must comply in order to be authorised under MiFID or removing or modifying any of the conditions subject to which the firm's authorisation was granted is not allowed²⁴. Outsourcing arrangements should not create undue operational risks or impair the quality and independence of firms' activities and internal controls or the ability of the investment firm and the relevant NCA to supervise compliance with regulatory requirements.
32. Investment firms' outsourcing arrangements and risk management policies and procedures should detail all functions that are not performed internally and are subject to outsourcing requirements. NCAs should ensure that outsourcing arrangements are properly monitored and fully compliant with the MiFID framework and other relevant regulatory requirements, including EU data protection²⁵ restrictions on data transfer outside the EU and recovery and resolution provisions.
33. NCAs should also ensure that investment firms have organisational policies and procedures in place in order to comply with the MiFID framework at all times. Firms should be able to effectively control and challenge the quality and performance of services outsourced and carry out their own qualified analysis. It is not sufficient if investment firms only undertake formal assessments of whether the functions/services provided would breach regulatory requirements. For instance, in the case of outsourcing of discretionary portfolio management, NCAs should be satisfied that the policies and procedures of investment firms provide for clear documentation and record-keeping of their own qualified analysis on the quality of the service received.

²⁴ See Article 14(1) of the MiFID Implementing Directive, Article 31 of MiFID II Delegated Regulation.

²⁵ The oversight of firms' compliance with data protection requirements may fall outside the remit of MiFID NCAs and may be carried out by separate national authorities.

34. NCAs should carefully assess the detailed descriptions, explanations and evidence provided by investment firms as to the envisaged outsourcing arrangements and be satisfied that there are objective reasons for the outsourcing arrangements and that they do not lead to the creation of letter-box entities or allow for a circumvention of the MiFID framework and the responsibilities of investment firms. This analysis should be based on firms' descriptions about the expected benefits of the envisaged outsourcing arrangement (compared to the estimated costs to perform 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 on-going basis)²⁶. Where investment firms intend to outsource functions/services to entities within the same corporate group, NCAs should assess the due diligence carried out by firms in more detail and be satisfied that the selection of a group entity is based on objective reasons despite the additional conflicts of interest such an outsourcing structure may entail.
35. NCAs should analyse firms' conflicts of interest policies and procedures in order to be satisfied about the effective management of conflicts including the relevant disclosures to clients. Effective conflicts of interest management is of particular importance where EU firms outsource functions/services to entities that are part of the same corporate group. The conflicts of interest policies and procedures should clearly identify all relevant risks arising from such links and detail the mitigation measures and controls to ensure that outsourcing arrangements with affiliated entities do not impair the firms' ability to act in the best interests of clients and comply with the MiFID framework. In such cases, one viable risk mitigation measure could be to have a sufficient number of non-executive members supervising the outsourced functions that are independent from the parent undertaking and other group entities.
36. Outsourcing to non-EU entities could make oversight and supervision of the outsourced functions more difficult. Similarly, outsourcing arrangements with long or complex operational chains and/or with a large number of parties involved are likely to result in additional challenges both for investment firms and NCAs. In addition, the use of cumulative outsourcing of various functions/services is likely to impact the conditions for authorisation and to heighten concentration risks as well as the risk of letter-box entities. NCAs should therefore give special consideration to such outsourcing arrangements and the additional risks arising from them and in particular whether to require (relocating) firms to submit a detailed plan of the phasing out of any such outsourcing arrangements.

Due Diligence

37. NCAs should be satisfied with firms' due diligence processes. To this end, all outsourcing of functions must be preceded by the firm's written due diligence on the service provider and possible substitutes (if any). Firms should, inter alia, analyse all benefits and risks (knowledge, experience, reputation, track-record, technical capabilities, effective oversight

²⁶ See Article 14(2) of the MiFID Implementing Directive, Article 31(2) of MiFID II Delegated Regulation.

and supervision, legal system of the relevant jurisdiction, financial soundness, country and concentration risks, efficiency, pricing etc.) including conflicts of interest.

38. The objective of a due diligence process is to determine whether, having regard to the specific functions to be carried out by the service provider and taking into account all related benefits and risks, the service provider can be considered as most suitable to undertake the outsourced functions/services. NCAs should be satisfied that firms' policies and procedures ensure that they select service providers based on objective reasons to ensure that investment firms continuously comply with their obligations and duty to act in clients' best interests when outsourcing those functions²⁷.
39. The written contractual arrangements between firms and service providers should detail precisely the individual tasks and activities that are outsourced and ensure that firms have the right to inquire, inspect, access and instruct service providers as well as terminate contracts at short notice where this is justified to safeguard the best interests of clients. NCAs should verify and investment firms should 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 protection²⁸, safeguarding of clients assets, etc). While contractual arrangements must ensure that the service provider performs the outsourced functions/services in compliance with the MiFID framework at all times, NCAs and investment firms should carefully assess situations in which the service provider may not be subject to equivalent legal and regulatory obligations and which therefore heighten risks to ongoing/permanent compliance with EU rules. Moreover, the contractual arrangements should ensure that investment firms, their internal control functions, external auditors and NCAs have effective access to data related to the outsourced functions and to the business premises of the service provider as well as require the service provider to cooperate with these parties at all times.
40. Moreover, NCAs should assess whether firms have established and implemented effective methods and procedures to monitor the performance of the outsourced functions and their compliance with the MiFID framework on an ongoing basis and carry out regular on-site visits even where service providers are located outside of the EU. The compliance function and internal audit function should carry out regular controls with respect to the compliance and effectiveness of outsourcing arrangements and monitoring mechanisms and report their findings to the governing body and, where it exists, the supervisory function. The outsourcing of certain functions/services 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 EU firms carry out less intense oversight or conduct less frequent on-site visits due to the geographical location of or the close links with the service provider. Investment firms' policies and procedures should also provide for regular reviews of

²⁷ See Article 14 of MiFID I Implementing Directive, Article 31 of MiFID II Delegated Regulation.

²⁸ The oversight of firms' compliance with data protection requirements may fall outside the remit of MiFID NCAs and may be carried out by separate national authorities.

contracts to ensure that they continue to be in compliance with all applicable EU legislation (and where relevant national law) as it may evolve over time.

41. NCAs should be satisfied that the outsourcing and risk management policies and procedures of investment firms provide for contingency planning and detail all necessary steps and measures in case of a change of service providers. Investment firms should have timely access to the required expertise, technology and data to replace service providers or enable them to perform functions internally at very short notice.
42. NCAs should ensure that they have access to all information (e.g. records of all due diligence and monitoring of outsourcing activities, contractual arrangements and all related documents) to supervise the compliance of the performance of outsourced functions with the MiFID framework.

Substance and outsourcing of critical functions/services

43. As outsourcing arrangements must not involve the delegation of functions/services to an extent that the firm becomes a letter-box entity, NCAs should pay particular attention to situations in which EU firms would continue to perform substantially more investment services functions from the original country using outsourcing and therefore also maintain substantially more relevant human and technical resources there. Firms should therefore not outsource services/functions to an extent that exceeds by a substantial margin the services/functions performed internally²⁹.
44. The performance of investment services or functions in accordance with the high standards set out in the MiFID framework requires appropriate technical and human resources both at staff and senior management level. Where certain investment services/functions are not performed internally, this creates additional risks and workload for investment firms as they have to select service providers diligently and monitor the performance of the outsourced services/functions on an on-going basis. NCAs should therefore ensure that investment firms dedicate appropriate internal human and technical resources and expertise to the selection and ongoing supervision of service providers and that all individuals involved in this process have the required skills, knowledge, experience and time commitment in order to effectively monitor service providers and be able to constructively challenge them. The outsourcing and risk management policies and procedures should therefore clearly allocate due diligence and monitoring responsibilities at all levels of the organisation (operational staff, internal control functions, senior management) and detail the nature and extent of monitoring activities, the number of individuals involved and the time committed to these activities. These policies and procedures should elaborate on function-specific expertise of all individuals and/or units involved. It is unlikely that a single person³⁰ has sufficient knowledge, experience and time to monitor a broader range of services/functions in an effective manner. NCAs should therefore engage with firms that intend to allocate the supervision of a number of outsourced functions to a single person and be satisfied that

²⁹ See also recital 19 MiFID I implementing Directive 2006/73/EC.

³⁰ And taking into account proportionality considerations as appropriate.

this does not raise additional risks to the soundness or continuity of investment services or to investor protection/market integrity. NCAs should pay particular attention to the extent to which investment firms (in particular ones adopting online business models) are reliant on technology and/or bespoke IT systems, to understand whether the use of such IT systems presents a risk to the continuity of services provided by firms. In their ongoing supervision, NCAs should also consider whether investment firms need to adapt these human and technical resources as business operations change.

45. By way of example, where investment firms intend to outsource multiple critical or important client facing functions (such as website design, trading software, financial promotions, client disclosures, and/or client on boarding processes such as “know your client” information gathering and appropriateness testing), the nature of controls needed to effectively oversee and assess the performance of such service providers will be more complex and NCAs should consider withholding authorisation where firms cannot appropriately demonstrate and ensure effective oversight of outsourced functions to meet their regulatory obligations under the MiFID framework. Also, where investment firms intend to outsource portfolio management functions to non-EU entities with respect to portfolios investing in instruments issued by EU issuers or portfolios of collective undertakings located in an EU Member State, NCAs should assess whether, in light of the geographical spread of investments and clients between the EU and non-EU markets, such outsourcing arrangements to non-EU entities are appropriate and objectively justified. The application of this principle does not impair the right of investment firms to provide services on a cross-border basis in accordance with Union law. NCAs should carefully consider whether such outsourcing arrangements, in particular when there are alternative providers located in the EU, ensure compliance with the MiFID framework and firms’ duties towards clients.
46. NCAs should require detailed information and evidence and be satisfied that any outsourcing of internal control and key functions are based on objective reasons and do not impair the independence or the effectiveness of the relevant functions³¹. The vital importance and the required involvement of internal control functions in firms’ operations and key decisions usually necessitate a local presence and NCAs may expect certain roles, such as those exercising significant influence over the investment firm’s conduct³², to not be outsourced or to be performed in the home Member State. Where this is not the case, investment firms should appropriately demonstrate that the EU entity providing such functions has the required knowledge, expertise and experience and is up-to-date with the EU regulatory framework and that the outsourcing will not impair the effectiveness of these functions. NCAs should also give special consideration to reporting lines (and without prejudice to any applicable prudential requirements) and/or outsourcing of internal control functions within the same corporate group and the additional conflicts of interest arising from this.

³¹ See Article 14 of MiFID I Implementing Directive, Article 31 of MiFID II Delegated Regulation.

³² And without prejudice to the fact that senior management responsibilities cannot be delegated.

47. Certain key functions should be outsourced outside the EU only under strict conditions, given that such outsourcing is very likely to endanger robust internal governance and sound and effective risk management or the operational independence of the investment firm³³ and therefore undermine the MiFID passporting regime. For instance, in the case of underwriting and placing activities or respectively execution services provided to EU clients, while certain back-office functions could be outsourced to non-EU entities (subject to full compliance with MiFID requirements on outsourcing), the marketing and the performance of underwriting/placing services or respectively execution services (including client facing and 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. Similarly, investment firms outsourcing safekeeping functions should pay particular attention to the service providers' local laws and how these may impact its duties towards EU clients and their rights to access own assets, especially in case of the insolvency of the service provider (or any sub-contractor).
48. NCAs should ensure that any outsourcing to the cloud is implemented in a manner that complies with applicable European legislation (including data security/data protection rules). The technology used should not alter the regulatory obligations imposed on firms. Moreover, while the use of cryptography may be a secure and reliable method of storing and sharing information, any encryption keys should always be provided, when requested, to the relevant EU27 NCA to allow it to perform its supervisory roles.

C. Non-EU branches

49. NCAs should carefully monitor situations in which the risk of letter-box entities arises not only from the use of outsourcing arrangements but from situations in which EU investment firms use non-EU branches for the performance of functions/services with respect to EU clients. Where investment firms 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 the services provided in the non-EU jurisdiction and does not result in a situation where such non-EU branches perform material functions or provide services back into the EU. The use of non-EU branches may be based on objective reasons, e.g. where firms provide services in the non-EU jurisdiction or require local marketing support. NCAs should require relocating entities to provide them with detailed information relating to, inter alia, the activities (and their geographical distribution) to be performed by the branch, its organisational structure and the persons responsible for the management of the branch and ensure that they can effectively supervise the non-EU branch.

V. Effective supervision

50. NCAs should have the capacity and adequate resources to effectively authorise and supervise any investment firm. NCAs should for instance carefully consider their ability to

³³ NCAs should also carefully assess any intragroup structures that support extensive back-to-back booking.

assess documentation presented in a foreign/non-national language without any appropriate translation.

51. In particular, EU27 NCAs should ensure that firms comply with EU legislation on a continuous basis, including such EU legislation relative to outsourcing. This also implies that NCAs should have (i) effective access to all information related to outsourced functions that is required for the performance of supervisory tasks and (ii) effective access to business premises of service providers for on-site visits at any time in order to effectively supervise compliance with the EU legislation. NCAs should not grant or should withdraw authorisations if the 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 functions³⁴.
52. NCAs should also understand any commercial arrangements between the investment firm and another authorised investment firm in order to assess how the risks arising from such commercial agreements³⁵ will be managed (in particular in the context where, after the UK withdrawing from the EU, the UK investment firm would become a third country firm) 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.
53. NCAs should give special consideration to and raise the attention of investment firms to the fact that, as from the effective date of the UK's withdrawal from the EU, any outsourcing of portfolio management to UK entities will only be permitted where the conditions under Article 32 MiFID II Delegated Regulation are met, including the requirement that cooperation arrangements between NCAs and UK competent authorities are in place. More broadly, NCAs should raise awareness that current outsourcing arrangements with UK service providers will need to be reassessed once the UK withdraws from the EU. Effective and efficient cooperation among NCAs is also of utmost importance in this respect, including with authorities in third countries.
54. Finally, NCAs should also 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 "clients' own exclusive initiative" exemption.

³⁴ See also Article 10(2) MiFID I / MiFID II and MiFID II Delegated Regulation with regard to RTS on authorisation.

³⁵ Such commercial arrangements can operate in different ways, and may be referred to by different names. For instance, an arrangement by which a MiFID investment firm would introduce its clients to use the services offered by another authorised firm.