

Reform of the Supervision of EU Financial Services

In September 2017, the European Commission (“**Commission**”) published proposals to reform the EU’s supervisory architecture as part of its Capital Markets Union (“**CMU**”) project. The proposals, if adopted, would introduce changes to the mandates, governance and funding of the European Supervisory Authorities (“**ESAs**”), including the European Securities and Markets Authority (“**ESMA**”), with the intention of enhancing regulatory and supervisory convergence within the European Union (“**EU**”). The timing of the proposals has no doubt been influenced in part by the UK’s vote to withdraw from the EU and the Commission’s press release announcing the proposals noted that the reforms are aimed at promoting:

“... further capital market integration following the UK’s departure from the EU ... [and] ... will introduce changes to the supervisory relations with non-EU countries so as to ensure proper management of all financial-sector risks.”

This briefing note summarises the key elements of the Commission’s proposals, focusing in particular on the proposed changes to ESMA’s powers. The Irish funds industry representative association, Irish Funds, has published a position paper relating to the Commission’s proposals, welcoming many aspects of the proposals that could help reduce barriers to cross-border fund distribution, ensure consistency in the application of EU rules and consolidate data management and reporting. Irish Funds, however, suggests that many of the aims of the proposals could be achieved through a more proportionate response than altering long-standing, well-functioning arrangements, such as using the existing framework of powers and mechanisms to support engagement among NCAs and the development of practical convergence solutions. It is argued that consistency of supervisory approaches could be achieved through the use of opinions and guidance to achieve the practical application and implementation of EU law and the use of standard forms and templates could drive consistent supervisory outcomes.

Supervision of Delegation Arrangements

The Commission has proposed that ESMA would monitor national competent authorities’ (“**NCAs**”) supervision of fund managers delegating and outsourcing business functions to non-EU countries, with the aim of ensuring that risks are properly managed and to prevent circumvention of EU law. Under the new regime, NCAs would be obliged to notify ESMA when they intend to authorise an entity where the business plan of the entity includes the outsourcing or delegation of a material part of its activities or any of its key functions or the risk transfer of a material part of its activities into third countries. ESMA would perform an assessment of that notification and, where ESMA considered it necessary to issue an opinion to the NCA on the non-compliance of the authorisation with EU law, ESMA would inform the NCA of this within 20 days of receipt of the notification. The NCA would then be obliged to await the opinion of ESMA before any further consideration of authorising the entity.

Entities that have already been authorised would be obliged to notify NCAs of any new outsourcing or delegation arrangements to third countries that they enter into. NCAs would inform ESMA of such notifications on a semi-annual basis. ESMA would be empowered to issue recommendations to NCAs, including recommendations to review a decision or to withdraw an authorisation.

Irish Funds set out in their position paper their concerns that these proposals would lead to a more bureaucratic, costly and inefficient process regarding delegation, outsourcing and risk transfers, would unnecessarily restrict access to local expertise and reduce investor choice, ultimately having a detrimental impact on investor outcomes. The proposals would also lengthen the time to market of European fund products, contrary to the core aims of the CMU.

Stakeholder Input on Guidelines and Recommendations

Many of the responses to the spring 2017 public consultation that preceded the publication of the Commission's proposals raised concerns regarding instances in the past where ESMA was perceived to have exceeded its competence in issuing certain guidelines and recommendations.

In a welcome development, the proposed reforms would require that ESMA conduct open public consultations regarding the guidelines and recommendations which it issues and analyse the related potential costs and benefits of issuing such guidelines and recommendations, save in exceptional circumstances.

When two-thirds of members of the Securities and Markets Stakeholder Group ("**SMSG**") deem that ESMA has exceeded its competence by issuing certain guidelines or recommendations, they may send a reasoned opinion to the Commission. Commission may then ask ESMA to withdraw the guidelines or recommendations concerned.

Direct Supervision by ESMA

Under the proposals, ESMA would be the direct supervisor over European Long-Term Investment Funds ("**ELTIFs**"), European Venture Capital Funds ("**EuVEECAs**") and European Social Entrepreneurship Funds ("**EuSEFs**"). The Irish Funds position paper points out that these fund structures are also subject to the Alternative Investment Fund Management Directive ("**AIFMD**"), as each of these funds must be managed by an alternative investment fund manager ("**AIFM**"). Therefore, this proposal would create a dual regulatory regime (eg, ESMA would supervise the ELTIF element while the NCA would supervise the AIFMD element) leading to a more complex, cumbersome and expensive fund authorisation and supervision process.

Further reforms proposed by the Commission would mean that ESMA would authorise and supervise the EU's critical benchmarks and endorse non-EU benchmarks for use in the EU; approve certain EU prospectuses and all non-EU prospectuses drawn up under EU rules; and would be given a greater role in coordinating market abuse investigations.

Product Intervention Powers

The Commission proposals would extend the product intervention powers under the Markets in Financial Instruments Regulation ("**MiFIR**") to managers of UCITS and alternative investment funds ("**AIFs**"). These powers would allow ESMA and NCAs in certain exceptional cases to restrict or prohibit the marketing, sale or distribution of units or shares in UCITS or AIFs.

Governance

The Commission has proposed that the ESAs would have newly created independent executive boards with permanent members, made up of a chairperson and five permanent members in the case of ESMA. The Executive Board would prepare decisions to be taken by the Board of Supervisors, which is made up of representatives from each NCA. The Executive Board would also be in charge of setting out supervisory priorities for NCAs in a new “Strategic Supervisory Plan”, it would check the consistency of national work programmes with EU priorities and would review the implementation of national work programmes. The Executive Board would also be in charge of monitoring delegation, outsourcing and risk transfer arrangements to non-EU countries.

The Irish Funds position paper notes that the current governance arrangements ensuring equal representation of NCAs enables NCAs to actively contribute to and influence policy formation, reflecting the specificities of the EU, the dynamics between member states both large and small and the diversity of markets including non-Euro currencies.

Funding

Currently, ESMA’s activities are financed through a fixed distribution of funding between NCAs (60%) and the EU budget (40%). Under the Commission’s proposals, the funding of the ESAs would be independent from NCAs. While the EU budget would continue to contribute a share of the ESA’s funding, the rest will be funded by contributions from the financial sector. Since the publication of the proposals, it has been found that the proposed funding of the ESAs by industry is not permissible under EU law.

Comment

While we welcome the European Commission’s ambition to progress the CMU project and the potential benefits of that project in reducing barriers to cross-border distribution, harmonising the application of EU law and consolidating data management and reporting, we believe that in many respects the proposed reforms to ESMA’s powers and governance are a step too far. Our Asset Management and Investment Funds partners, through their membership of a number of Irish Funds committees and taskforces, have been involved with the preparation of the Irish Funds position paper and share the concerns expressed in that paper, particularly with regard to ESMA’s role in the supervision of delegation and outsourcing arrangements, ESMA’s direct supervision of certain fund types and the proposed new governance structures. In relation to the oversight of delegation in particular, we would note that the delegation model has served investors and the European industry well to date, ensuring access to best-in-class expertise and operating under clearly defined procedures and rules which ensure that the requirements of the UCITS Directive and AIFMD are not circumvented. We also welcome the introduction of the Supervisory Coordination Network as a constructive means of fostering a common supervisory approach among national regulators.

We will continue to keep our clients informed of further developments as the proposals make their way through the EU legislative process. The Commission’s regulation reforming the EU supervisory framework may be accessed [here](#). The Irish Funds position paper relating to the proposals may be accessed [here](#).

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

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

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