

## OPINION

### **to support supervisory convergence in the area of secondary markets 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')<sup>1</sup>. In accordance with Article 44(1) of the ESMA Regulation, the Board of Supervisors has adopted this opinion.

#### **II. Background**

2. On 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 2019.<sup>2</sup> This opinion takes into account the European Parliament resolution<sup>3</sup> and the European Council guidelines<sup>4</sup>.
3. As the UK plays a prominent role in the EU Single Market, the relocation 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 opinion (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<sup>5</sup> within a relatively short period of time. That opinion is primarily addressed to the national competent authorities (NCAs)<sup>6</sup> of the 27 EU Member States remaining in the EU and covers all legislation referred to in Article 1(2) and (3) of the ESMA

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<sup>1</sup> 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.

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

<sup>3</sup> European Parliament resolution of 5 April 2017 on negotiations with the United Kingdom following its notification that it intends to withdraw from the European Union (2017/2593(RSP)).

<sup>4</sup> European Council guidelines of 29 April following the United Kingdom's notification under Article 50 TEU (EUCO XT 20004/17).  
<sup>5</sup> The reference to EU27 should be read as also capturing Norway, Iceland and Lichtenstein (members of the European Economic Area (EEA)).

<sup>6</sup> National Competent Authorities as defined under Article 4 of the ESMA Regulation.

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').

5. In the course of the UK withdrawing from the EU, trading venues relocating from the UK may seek to minimise the transfer of the effective performance of activities in the EU27, i.e. by relying on the outsourcing of certain activities to a UK-based entity, including affiliates. ESMA considers it necessary that conditions for outsourcing activities to UK-based entities do not generate regulatory and supervisory arbitrage risks.
6. This opinion addresses, in particular, regulatory and supervisory arbitrage risks stemming from third country trading venues relocating in the EU27 seeking to outsource activities to their jurisdiction of origin. The principles on the outsourcing of activities by third country trading venues relocating in the EU27 elaborate on the requirements set out in Article 13 of MiFID and Articles 16 and 48 of MiFID II<sup>7</sup>.
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 supervisory consistency of decision-making by NCAs.
8. This opinion should be read in conjunction with the ESMA opinion in the area of investment firms.<sup>8</sup> The principles set out in that opinion should apply in parallel, where relevant.
9. Until the UK has withdrawn from the EU, the EU legislative framework applicable to financial markets will remain in force in the UK. The opinion assumes that the UK will become a third country after its withdrawal from the EU. This is without prejudice to any specific arrangements that may be reached between the UK and the EU.
10. This opinion does not prejudice any future opinions or other convergence tools issued by ESMA.

### **III. Outsourcing of activities by trading venues**

11. The MiFID II/MiFIR establishes three types of multilateral trading venues: regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs). While regulated markets are operated by a market operator, MTFs and OTFs may be operated by investment firms or market operators. The rules and requirements for the different types of trading venues are closely aligned, in MiFID II/MiFIR, to establish a level playing field

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<sup>7</sup> The requirements on outsourcing under MiFID II are further set out in Article 6 of Commission Delegated Regulation (EU) 2017/584 of 14 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying organisational requirements of trading venues and Articles 30-32 of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

<sup>8</sup> [ESMA35-43-762 Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union.](#)

between different venues offering multilateral trading. NCAs should therefore apply the same conditions and standards as concerns the outsourcing of activities by each type of trading venue.

12. The use of outsourcing arrangements by trading venues may be an efficient way to perform some activities. However, such arrangements (in particular when the service provider is outside the EU) are not without their risks both for trading venues and their NCAs, especially when the activities outsourced are critical to the functioning of the trading venue, and must be subject to appropriate oversight; points which this opinion seeks to address.
13. When assessing outsourcing arrangements NCAs should take into account the scale, scope and type of the outsourced activity based on the documents provided by trading venues.
14. Outsourcing of activities to service providers outside of the EU27 could make the oversight and supervision of the outsourced activity more difficult. The proximity to the EU27 and the size and interconnectedness of the financial sector of a third country may make it appear more attractive to outsource significant activities to service providers based in that jurisdiction, thereby resulting in a high concentration of outsourced activities in that jurisdiction. Such developments may increase the likelihood of materialisation of risks to investor protection, orderly markets and financial stability, something which may expose the EU27 to high risks in case of sudden and unexpected developments in that third country jurisdiction.
15. In their assessment, NCAs should take into account outsourcing arrangements with long or complex operational chains and/or with a large number of parties involved which may result in additional risks for trading venues and therefore supervisory challenges for NCAs. In addition, the use of cumulative outsourcing arrangements for various activities may impact the conditions for authorisation and increase concentration risks as well as the risk of letter-box entities.
16. In the case of relocation to the EU27, ESMA expects NCAs to assess outsourcing arrangements with third-country service providers in order to ensure that there are no potential detrimental effects to investor protection, orderly markets or financial stability. Where the NCA considers that such detrimental effects do exist, the trading venue should not be allowed to outsource the activity.

#### Clarification regarding outsourcing arrangements

17. Under the MiFID framework, the outsourcing of key and important activities is subject to strict requirements. It is important that outsourcing arrangements do not undermine the sound governance of trading venues.
18. Trading venues that outsource activities remain fully responsible for discharging all of their obligations under the MiFID framework. Furthermore, board members and senior managers of trading venues in the EU27 need to have effective decision-making powers

in relation to compliance of the EU27 trading venue with Union law, including where the trading venue is part of a corporate group.

19. NCAs should therefore ascertain that outsourcing arrangements do not alter the responsibilities of board members and senior management in relation to compliance of the EU27 trading venue with Union law. Any outsourcing that results in the delegation by senior management of its responsibility, alters the relationship and obligations of the trading venue to its members and participants, removes or significantly modifies the conditions subject to which the trading venue's authorisation was granted should not be allowed.
20. In order to ensure that the trading venue has effective decision-making to allow it to comply with Union law, NCAs should require that key executives and senior managers of a trading venue dedicate a sufficient amount of their time to the operation of the trading venue.
21. Outsourcing arrangements may be concluded with service providers within the same group/entity or with independent/non-affiliated third-party service providers. In order to ascertain that all outsourcing arrangements (whether within the same group or not) effectively comply with Union law, NCAs should assess information on the expected benefits and costs, including risks, of the envisaged outsourcing arrangement, and in particular the extent to which the trading venue has the capacity and means to control the service provider's actions and decisions in relation to outsourced activities.

#### Due diligence

22. NCAs should ensure that trading venues exercise due care, skill and diligence in the selection of service providers and in monitoring the ongoing performance of outsourced activities. NCAs should therefore require that the trading venues' policies and procedures ensure they select service providers based on an adequate decision-making process and that trading venues continuously comply with their obligations under Union law. NCAs should be satisfied that trading venues have and maintain effective due diligence processes, something only feasible to do on the basis of written due diligence by the trading venue on the service provider. Such due diligence should contain, inter alia, an analysis of all the benefits and costs (knowledge, experience, reputation, track-record, technical capabilities, effective oversight and supervision, legal system of the relevant jurisdiction, financial soundness, country and concentration risks, efficiency, pricing etc.) including potential conflicts of interest.
23. With respect to trading venues relocating in the EU27, NCAs should examine any existing, as well as any planned, outsourcing arrangements. This process takes time and in order to ensure efficiency, NCAs should advise trading venues seeking to relocate to the EU27 to approach them as early as possible.
24. When outsourcing activities to third country service providers additional issues may arise that may significantly impact the ability of trading venues and NCAs to control and supervise the outsourcing arrangement. For example, in the event of a security breach, it may be more difficult to monitor and control the function that was outsourced to a third

country service provider, or to take appropriate measures addressing the problem in a timely manner. NCAs should therefore verify outsourcing arrangements, as well as significant changes thereof, with third country services providers having regard to the additional risks arising from them.

25. NCAs should ensure that trading venues establish and implement effective policies and procedures to monitor the performance of the outsourced activities and their compliance with the MiFID framework on an ongoing basis. The compliance and internal audit functions should carry out regular controls with respect to the compliance and effectiveness of outsourcing arrangements and monitoring mechanisms with Union law and report their findings to the management body. NCAs should require trading venues, and the service providers to which the trading venues outsource activities, to establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities, where that is necessary having regard to the outsourced activity.
26. The outsourcing of certain activities to third country service providers should not result in a situation where the scope and independence of the internal control function is impaired, for instance where trading venues carry out less intense oversight or conduct less frequently on-site visits due to the geographical location of, or close links with, the service provider.

#### Substance of outsourcing of key and important activities to third countries

27. Outsourcing arrangements with third country service providers must not involve the delegation of activities to an extent that the trading venue becomes a letter-box entity and should not allow for a circumvention of the MiFID framework or the responsibilities of the trading venue. NCAs should carefully assess the detailed descriptions, explanations and evidence provided by trading venues as to outsourcing arrangements and be satisfied that trading venues exercise due skill, care and diligence before concluding outsourcing arrangements and throughout their duration.
28. The operation of the trading system is a key activity of a trading venue. This includes activities directly linked to the operation of the trading system such as running the trading engine to match orders, and the following: upstream connectivity, order submission capacity, throttling capacities, downstream connectivity, co-location and proximity services and any other type of operation in relation to market data feeds.
29. The proper functioning of the trading venue depends on the design, calibration, control, and monitoring of this key activity. In order to ensure that NCAs can effectively supervise the trading venue, and take supervisory action in case of an emergency, the decision-making for designing, controlling and monitoring the operation of the trading system should not be outsourced outside the EU27.
30. The admission to trading of financial instruments, the establishment of and any subsequent changes to the rulebook of the trading venue as well as the suspension and removal of financial instruments from trading and mechanisms to halt trading are key activities to

ensure the orderly functioning of markets and an appropriate level of investor protection. More specifically, since in certain cases NCAs may require trading venues to suspend or remove from trading certain instruments (Article 52(2) of MiFID II) or coordinate a market-wide trading halt (Article 48(5) of MiFID II), it has to be ensured that trading venues can immediately implement the instructions of NCAs. Therefore, NCAs should not allow the outsourcing of these activities outside the EU27. As far as suspensions and removals of financial instruments and trading halts are concerned, NCAs should ensure that the primary persons responsible are available in the EU while the technical arrangements for triggering suspensions, removals and trading halts can be located outside the EU27.

31. Furthermore, the outsourcing of important activities (such as market surveillance, enforcement, compliance and internal audit, IT control and risk assessment) to third-country service providers can threaten the activity of the trading venue and undermine its effective supervision. NCAs should therefore verify the outsourcing of such important activities to third country service providers.
32. NCAs should oppose any outsourcing arrangement that would undermine the effective supervision of the trading venue.

#### Performance of key and important activities in the EU27 and the third country

33. NCAs should pay particular attention to situations where trading venues would perform substantially more key and important activities from a third country by using outsourcing arrangements and in consequence maintain more relevant human and technical resources in that third country than in the EU. NCAs should therefore require that trading venues do not outsource activities to an extent that exceeds by a substantial margin the activities performed within the EU27.
34. A significant proportion of staff with significant expertise performing key and important activities in accordance with paragraphs 28 to 31 should be based in the EU27 to ensure familiarity with and sufficient competence of applicable rules and regulations.

#### Non-EU branches

35. For the avoidance of doubt, 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 trading venues use non-EU branches for the performance of activities with respect to trading activity in the EU 27. NCAs should therefore consider following the same outsourcing principles set out above.

#### Effective supervision of outsourcing arrangements with third-country service providers

36. NCAs should have the capacity and adequate resources to effectively supervise trading venues and ensure compliance with Union law, including for outsourced activities. NCAs must ensure that outsourcing does not impact their ability to enforce Union law. NCAs should require the cooperation of the third country service provider in connection with the outsourced activity.

37. ESMA expects that NCAs only accept outsourcing arrangements where the trading venue outsourcing the activity, its auditors and its NCA have effective access to any relevant information including books and records of the third country service providers concerning the outsourced activity, as well as effective access to the relevant business premises of the service provider for on-site visits for the performance of their respective responsibilities.
38. Concerning the outsourcing of the operation of the trading system and of important activities, NCAs should consider entering into a cooperation agreement with the third country authority of the service provider performing the outsourced activity to ensure effective supervision, where applicable.
39. NCAs should raise awareness that current outsourcing arrangements with service providers based in the UK will need to be reassessed once the UK withdraws from the EU.