Continental Drift? Brexit's Potential Impact on International Investment Managers

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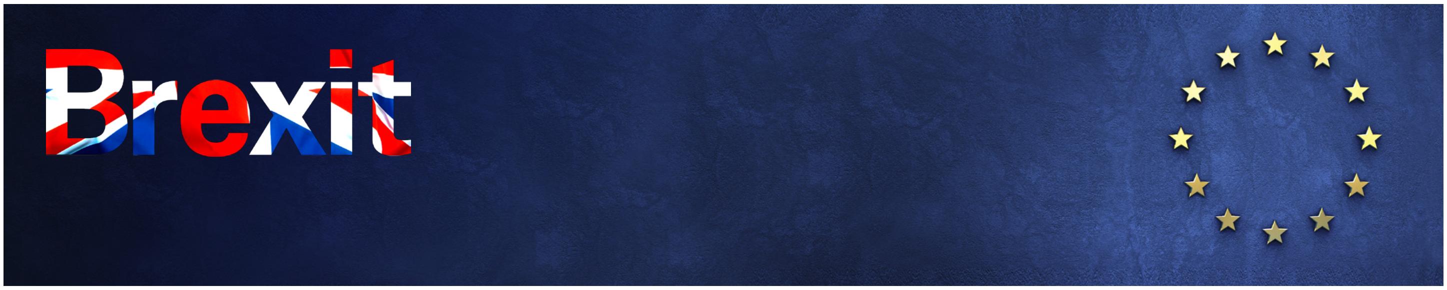

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Introduction

The U.K. referendum vote to leave the European Union has focussed attention on Brexit's potential impact on the U.K.'s financial services industry. The U.K. is home to a wide array of asset managers, banks, insurers, investment exchanges and clearinghouses, most of which access the EU's single market through "passporting" or other automatic access rights granted under EU law.[1]

This note considers Brexit's potential impact on non-EU investment management groups that access EU investors and clients or use U.K. group members to perform investment management business in the EU.

The Brexit Process

The U.K. must begin the Brexit process by submitting a formal notice of intention to withdraw to the EU Council under Article 50 of the Lisbon Treaty. This will in turn begin a two-year process during which U.K. and EU negotiators will attempt to agree to the terms of separation. The U.K. will remain an EU member during that time. If no separation agreement is reached within two years, and the negotiation time period is not extended, the U.K. will still exit the EU but without an agreement that governs separation terms or any parameters for establishing a future framework. When exactly the U.K. will submit its notice of intention to withdraw is currently unclear, although recent unconfirmed press reports suggest that no notice will be delivered before the end of this year.

EU treaties envisage that the separation agreement will be distinct from the agreement governing the U.K.'s future relationship with the EU. It remains to be seen to what extent U.K. negotiators are able to ensure that the separation agreement contains significant terms governing the U.K.'s future relationship with the EU.

Two main questions have emerged from the uncertainty of the Brexit process:

1. *Will U.K. financial institutions be able to use a passport to access the EU single market post-Brexit?*

The ability of U.K. financial institutions to passport into and access the EU single market could be lost unless the U.K. agrees to the free movement of EU workers in its territory. However, U.K. government control over immigration was one of the "leave" campaign's key promises. Therefore, unless the U.K.

[1] Passporting allows a financial institution headquartered and licensed in one EU member state (the home state) to provide services/market funds in another (the host state) without having to get separately licensed in the host state. Those financial institutions need merely to notify their home state of their intention to provide services/market funds in the host state. Some EU laws give even more automatic access to some EU investment exchanges and clearinghouses.

and the EU are able to compromise on this issue, the so-called "Norway model" that allows non-EU European countries to access the EU single market if they join the European Economic Area (EEA), pay into the EU budget and comply with EU single market laws is unlikely to be available to the U.K. post-Brexit. If the U.K. does not retain the passport, U.K. financial institutions would only be able to use passport rights to access the EU single market until the U.K. exited the EU. Post-Brexit, the U.K. would need to use other mechanisms or arrangements to continue to have access.

2. *If passporting is unavailable post-Brexit, will the U.K. be considered "equivalent", allowing U.K. financial institutions to access the EU single market?*

Some EU financial services laws contain an "equivalence" concept that allows some financial institutions headquartered in non-EU countries (Third Countries) to access EU institutional clients as long as (1) the EU determines that the Third Country's regulatory arrangements are equivalent to the EU's, (2) the Third Country gives reciprocal access to similar EU financial institutions, and (3) the EU and Third Country have entered into regulator cooperation agreements. Technically, formal equivalence as defined in the relevant laws does not cover all financial services[2] and can take a number of years to negotiate separately. However, the general equivalence concept could provide a framework for a relatively quick agreement between the U.K. and EU, since both sides have an interest in their financial institutions continuing to access each other's markets, even if on a transitional basis pending conclusion of a wider future relationship agreement. Politics aside, the equivalence criteria should be relatively easy to meet because of the current close links between the U.K. and the EU, which use the same type of regulatory system and whose regulators cooperate with each other on a frequent basis.[3]

Potential Impact on Non-EU Investment Managers That Use a UK Group Member to Conduct Business From the UK

There is a wide range of potential Brexit impacts on non-EU investment managers that use a U.K. group member to conduct investment management business from the U.K. Frequently, these entities are used to provide services or market to investors in the wider EU. Brexit raises issues as to how this access can be maintained.

The five main types of U.K. investment management operations maintained by non-EU investment managers are described below.

UK Alternative Investment Fund Managers

U.K. alternative investment fund managers (AIFMs) act as managers of alternative investment funds (*e.g.*, hedge funds, private equity funds, investment trusts and other non-UCITS investment vehicles). U.K. AIFMs are licensed by the Financial Conduct Authority (FCA) and have to comply with Alternative Investment Fund Managers Directive (AIFMD) requirements that have been in force since July 2013.

U.K. AIFMs can use a marketing passport granted under the AIFMD to sell EU-domiciled alternative investment funds (AIFs) to professional investors in other EU countries. They can also manage AIFs domiciled in other EU countries pursuant to a passport granted (again) under the AIFMD. They cannot, however, currently use a passport to sell non-EU AIFs that they manage to EU investors — such funds must be distributed to EU investors in accordance with private placement regimes that EU member states choose to make available. This can be problematic for some U.K. AIFMs because many AIFs are domiciled outside the EU for tax reasons, and some large EU countries such as France, Spain and Italy have made private placement technically or practically impossible. That means they are effectively closed to efforts to sell non-EU AIFs in their domestic markets (absent reverse solicitation).

Brexit calls into question the ability of U.K. AIFMs to use the AIFMD's marketing and management passports and, in turn, their ability to sell EU AIFs to EU professional investors and manage AIFs domiciled in other EU jurisdictions.

If the U.K. remains in the EEA, U.K. AIFMs' passporting rights should be preserved if the EEA treaties are amended to implement the AIFMD, but as explained above, it is not clear whether EEA membership for the U.K. is a practical possibility.

It may be also possible for the EU to allow U.K. AIFMs to benefit from a marketing passport that will at some point be available to Third Country AIFMs after 2018. However, despite recent positive assessments of several Third Countries, recent experience suggests that this passport is unlikely to be available quickly if the EU follows the procedures set out in the AIFMD.[4]

[2] For example, there is no equivalence concept in the EU's UCITS (Undertakings for Collective Investment in Transferable Securities) legislation, meaning that non-EU investment funds that are UCITS compliant cannot use UCITS directive passporting rights to access the EU single market. Currently, such funds must make use of AIFMD private placement provisions.

[3] Equivalence would be harder to maintain if the U.K. decides to deregulate so that its regulatory system no longer matches the EU's. Deregulation would be a radical departure for U.K. policymakers, especially as it would run counter to the U.K.'s implementation of global (and not just EU) regulatory standards. Equivalence would also be difficult to maintain if the EU amended its regulations in a way the U.K. was unable or unwilling to adopt.

[4] The EU has embarked on a process to identify whether certain managers and AIFs from specific non-EU countries can use the AIFMD passport. At the time of writing, the process began over 18 months ago and is only now beginning to gain traction.

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It is also possible that the U.K. and the EU could negotiate transitional arrangements that effectively "grandfather" existing arrangements so that U.K. and EU AIFMs can continue to sell certain AIFs to investors (and, where relevant, manage AIFs) in the other's jurisdiction.

Whether any of the above options are realistic will become apparent as Brexit negotiations proceed. However, given the uncertainty, U.K. AIFMs are likely to examine the feasibility of using another entity based in another EU country (*e.g.*, Luxembourg and Ireland) to act as the AIFM. A feasibility study would involve an examination of how much infrastructure would need to be put in place in other EU jurisdictions; the number of staff that would need to be based outside the U.K.; whether certain investment management functions could be delegated to, and performed from, the U.K.; tax issues; the impact of the other EU member states' staff compensation requirements; and the time it would take to obtain regulatory licences.

U.K. AIFMs that only manage non-EU AIFs are not currently dependent on passporting rights to market funds to EU professional investors because no such rights are available under the AIFMD. It is possible that such passporting rights could be granted after 2018, but the precise timetable for their introduction is currently unclear. Therefore, those U.K. AIFMs will have to continue to rely post-Brexit on AIFMD national private placement provisions to sell their funds in the EU. They will still be able to do this if the U.K. enters into regulator cooperation agreements with other EU regulators that are in place when the U.K. formally exits the EU. Since EU regulators have entered into cooperation agreements in respect of the AIFMD with regulators across the Americas, the Caribbean and Asia, it is difficult to see — politics aside — why they would not be able to enter into similar agreements with the FCA, with which they already cooperate under existing EU laws and regulations.

UK UCITS Managers

U.K.-based UCITS managers and funds are in a similar position to U.K. AIFMs that manage EU-domiciled AIFs. The EU's UCITS directive makes a widely used marketing passport available to UCITS managers that wish to sell funds to the general public in their chosen EU jurisdictions. Further, it also provides a management passport to U.K. UCITS managers that wish to act as a management company for non-U.K. UCITS funds.

Brexit calls into doubt the ability of U.K. UCITS managers to access EU investors post-Brexit and manage non-U.K. UCITS. These rights will be lost if the U.K. and EU are unable to agree that the U.K. can join the EEA, from which single market passports should still be available, or agree to transitional arrangements, which would allow U.K. and EU UCITS managers to continue to access investors in the other's jurisdiction.

Without a passport or transitionals, U.K. UCITS funds will lose their status under the EU UCITS directive and therefore likely be treated as alternative investment funds under the AIFMD. This would mean that they could only be sold in the EU post-Brexit using national private placement provisions until such time as the AIFMD passport for non-EU AIFMs selling non-EU AIFs comes into effect.[5] Given that many UCITS target retail investors, this could severely limit their marketability, leaving to one side the impact the loss of the UCITS "badge" would cause.

Therefore, it is likely that U.K. UCITS managers will need to examine whether to create a UCITS management platform in other EU countries such as Luxembourg or Ireland, depending on whether their business model requires them to market or manage UCITS in the wider EU. The feasibility of setting up a separate non-U.K. UCITS platform will again depend on infrastructure, staffing, whether delegation of certain functions to the U.K. is possible, tax, local staff compensation requirements and regulatory licence timings.

EU Hosted Solutions

Some non-EU investment managers currently use an "EU hosted solution", which allows them to act as investment adviser to an EU parallel fund that they sponsor and for which a separate third-party EU-based manager acts as management entity. The parallel fund can then be marketed to EU professional investors using the AIFMD marketing passport. The solution has the advantage of allowing the marketing of funds to professional investors in jurisdictions such as France, Italy and Spain, which are very difficult to market to under the AIFMD's national private placement regime, absent reverse solicitation.

Brexit would call into question the viability of that model for any non-EU investment manager that uses a third-party host based in the U.K. should the U.K. alternative investment fund managers lose AIFMD passport rights. Given the uncertainty of the U.K.'s position, as was the case pre-Brexit, we expect that non-EU investment managers interested in using the hosted solution will focus on hosts based in Luxembourg and Ireland until such time as the likely outcome of U.K.-EU negotiations becomes clearer. It is also likely that U.K. hosts will look to develop similar services that can be offered from Luxembourg and Ireland so as to allow those non-EU investment managers that use a U.K. host to transition to a non-U.K. host post-Brexit; doing so would mean any impact would likely fall on the hosts rather than the investment managers.

[5] It is unclear that a U.K. UCITS manager would want to use an AIFMD passport, because that passport may come with conditions for management of the fund that would require operational changes to the way the fund is managed that the manager would be unwilling to make or fund investors would be unwilling to agree to.

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UK Discretionary Portfolio Managers

International investment management groups have established U.K. discretionary portfolio managers that manage segregated accounts delegated to them by a variety of clients, including pension and other investment funds, insurance companies, private client banks, family offices and other discretionary managers.

Such discretionary portfolio managers are subject to Markets in Financial Instruments Directive (MiFID) requirements implemented in the U.K. through FCA rules and frequently use MiFID passports to operate in the EU. This allows them as MiFID investment firms to deal with EU counterparties when executing investment decisions for client portfolios. The MiFID passport is also used to ensure that there are no local licensing issues caused by a U.K. discretionary manager managing accounts in the U.K. for clients based in other EU countries.

U.K. discretionary portfolio managers that do not manage assets belonging to other EU clients and that deal locally in U.K. markets are unlikely to be adversely affected by Brexit from a regulatory perspective, irrespective of the outcome of the Brexit negotiations. It is possible that such managers will be content to manage local U.K. institutional accounts and deal with or work through other U.K. broker-dealers in the U.K.'s deep and liquid financial markets.

However, those discretionary portfolio managers that do manage other EU clients' money and deal in EU markets are dependent on access to the EU single market. If the U.K. joins the EEA, the MiFID passports that discretionary portfolio managers currently use would ideally be preserved, and access to EU clients would remain in place. However, if passporting rights are lost post-Brexit, matters become more complicated.

Recent commentary has focussed on the Third Country provisions set out in Articles 46 and 47 of MIFID II,[6] which is due to come into force in January 2018 and therefore likely to apply pre-Brexit. In short, these provisions allow Third Country (*i.e.*, non-EU) investment firms to provide investment (and ancillary) services cross-border to EU eligible counterparties and per se professional clients.[7] Standalone U.K. discretionary portfolio managers will be Third Country investment firms post-Brexit. Assuming that the U.K. does not otherwise negotiate access, the Third Country access provisions may only be used once the European Commission makes an equivalence decision on the U.K.'s regulatory arrangements, the U.K. is deemed to give EU investment firms reciprocal access to the U.K. and both sides enter into regulator cooperation agreements. Technically, the equivalence process can only be started once the U.K. leaves the EU — *i.e.*, when it becomes a Third Country after Brexit. However, we expect that U.K. negotiators will be identifying how to persuade the EU to allow an earlier agreement on equivalence.

Politics aside, there is no reason why the U.K.'s regulatory regime should not be deemed equivalent, assuming that the U.K. does not lighten the regulatory load on U.K.-regulated investment firms that wish to access the EU single market. The U.K. is likely to give reciprocal access rights to EU investment firms. It already cooperates with other EU securities regulators through existing EU laws and regulations. However, Articles 46 and 47 of MiFID II are a less sure way of getting access to the EU (absent reverse solicitation) because of timing and political risks.[8] Therefore, it would be preferable if the U.K. and EU agreed to transitional arrangements where each side's investment firms obtain access to each other's markets and the EU agrees that the Third Country process will be expedited for U.K. investment firms.

The MiFID II Third Country provisions also contain a transitional arrangement that allows Third Country firms to continue to have access to a specific EU member state in the absence of an EU equivalence decision. This suggests it may be possible for certain EU countries to agree to give U.K. investment firms access to certain market segments whilst the European Commission considers whether to make the equivalence decision described above. However, it remains to be seen whether any EU country would be willing or feel able to agree on such access with the U.K. at a time when the U.K. is negotiating with the wider EU.[9]

U.K. discretionary portfolio managers with business models requiring access to the EU single market may have to explore whether some operations should be moved to the EU or delegated to EU entities. A closer examination is needed of precisely what licences are required (taking into account possible exemptions) by U.K. discretionary portfolio managers that provide services to EU clients and to execute investment decisions with or through EU counterparties. To the extent that an EU presence may be desirable, a feasibility study of infrastructure and staffing, delegation, tax, local compensation requirements and regulatory licence timings should be performed.

[6] MiFID II is the name given to the EU's reform of its securities and derivatives markets. Essentially a recasting of the current MiFID directive and Markets in Financial Instruments Regulation, the MiFID II reforms represent a radical overhaul of EU financial markets.

[7] "Elective professional clients", retail clients who satisfy sophistication and wealth criteria, are excluded from this treatment. They can only be accessed if the Third Country discretionary investment manager is able to set up a licensed branch in one relevant client's jurisdiction and then uses that branch to offer services in other EU jurisdictions.

[8] For example, the EU may take time to grant equivalence and may decide to wait until after Brexit to start the procedure. The U.K. could also lose an equivalence assessment upon short notice if it changes its investment services laws and regulations so that they are deemed by the European Commission to be no longer equivalent to EU law.

[9] It is possible that the EU will take the view that the negotiation of such access is a trade agreement that only the EU as a whole could negotiate on behalf of all EU member states.

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As mentioned above, it is likely that international investment managers will explore the moving of infrastructure and some staff to fund management entities located in other fund centres such as Ireland and Luxembourg and then look to have those management entities delegate discretionary portfolio management to U.K. discretionary managers. This model will work if the U.K. retains passporting rights or agrees on equivalence on a transitional or permanent basis. It may also work if the U.K. discretionary portfolio manager can show that the management entity initiated at its own exclusive initiative the discretionary management services (*i.e.*, MiFID II's definition of reverse solicitation) that the U.K. discretionary management services will provide. However, in this scenario the U.K. discretionary manager would need to take care to ensure that its trading activities with EU counterparties on behalf of its clients did not breach EU licensing requirements post-Brexit.

UK Entities That Market Funds

A number of non-EU investment managers use U.K. regulated entities to sell fund shares or units. Some of these entities are third-party placement agents, while others (called exempt CAD firms) can provide investment advice to investment fund management entities both within and outside their group. They frequently use MiFID passports that allow them to sell fund shares or units to EU investors.

These entities face the same type of issues as U.K. discretionary portfolio managers that manage money for EU clients. In the absence of EEA passports, MiFID II "equivalence" presents a potential solution. However, timing and politics produces a need for a U.K.-EU agreement on transitional arrangements and the availability of equivalence decisions in order to get a reasonable level of certainty. In the absence of such certainty, non-EU investment management groups should look at whether to use a non-U.K. EU placement agent to market funds post-Brexit in the EU. Investment management groups that make use of an internal group "exempt CAD" firm should examine the feasibility of moving infrastructure and staff to an EU-licensed entity or using a third-party, EU-based placement agent for post-Brexit marketing services.

Potential Impact on Non-EU Investment Managers That Do Not Maintain a UK Place of Business

Brexit is unlikely to significantly impact most non-EU investment managers that do not (or have no plans to) maintain a U.K. place of business.

Non-EU investment managers will still be able to sell the non-EU funds that they manage relatively freely to U.K. institutional investors under the U.K.'s liberal implementation of the AIFMD. There is no current reason to believe that the U.K. will change this general approach post-Brexit.

Some non-EU investment managers provide discretionary and advisory portfolio management (sometimes called managed account) services to U.K. institutional clients such as pension schemes, insurance companies, investment managers and family offices. Brexit is unlikely to affect their ability to continue to perform and offer these services. The U.K. has a long-standing liberal "overseas persons" regime for non-U.K. financial institutions that wish to deal with U.K. institutional investors. There is no current reason to believe that Brexit will result in a change to the U.K.'s existing open approach.

Conclusion

Because of the uncertainty that surrounds Brexit, some international investment management groups with U.K. headquartered operations have begun examining the likely impact of Brexit on their businesses. This may result in a number of groups deciding to move certain parts of their businesses outside the U.K. while preserving a significant U.K. presence. If negotiations go well for the U.K., some of those operations that were moved out of the U.K. may drift back. If negotiations appear to be going poorly for the U.K., international investment management groups will likely scrutinise the viability of a model that relies upon the use of a U.K. based discretionary manager to provide services to EU clients, including UCITS and AIF management entities. This may mean that further investment management functions performed onshore in the U.K. may have to move offshore to the wider EU, although we do not believe there will be wholesale moves from the U.K. to the EU. Rather, we would expect a remodelling of where certain regulatory functions are performed.

International investment managers whose business model includes selling funds and services into the U.K. must also weigh the potential impact of Brexit. Although the U.K. is likely to try and retain a fairly open economy, if negotiations go badly and the principle of reciprocal access is not readily conceded, non-U.K. EU investment managers will need to consider what they have to do to preserve access to U.K. investors, especially pension fund and insurer money. It is far too early to tell whether it is realistic for the U.K. to develop an international asset management market where investment management firms from around the world set up U.K. regulated operations to access U.K. investors. However, the fact that such thoughts are being floated at this stage shows that some are focussing on how U.K. and EU investment managers and investors can retain access to each other and not drift too far apart.