Navigable Challenges for Private Funds

Skadden

03 / 02 / 21

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Greg P. Norman
Counsel / London
44.20.7519.7192
greg.p.norman@skadden.com

Elena Faloutsou
Associate / London
44.20.7519.7180
elena.faloutsou@skadden.com

Abigail B. Reeves
Associate / London
44.20.7519.7282
abigail.reeves@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Manhattan West
New York, NY 10001
212.735.3000

40 Bank St., Canary Wharf
London, E14 5DS, UK
44.20.7519.7000

The negotiations that culminated in the establishment of the Trade and Cooperation Agreement (TCA) at the end of 2020 concluded with no meaningful agreement in relation to the provision of financial services between the United Kingdom and the European Economic Area (EEA). For the private funds community operating in the UK, this result was disappointing but not unexpected. Private fund sponsors and managers have implemented different solutions since the 2016 Brexit referendum to address this outcome. In this article, we explore some of those solutions and what may follow now that the transition period has concluded.

Takeaways

- The TCA failed to provide any meaningful cooperation regarding financial services.
- UK-based alternative investment fund managers (AIFMs) remain subject to the same rules as before Brexit, but without the benefit of the marketing passport.
- UK divergence from the EU rules on private funds and their managers seems possible but limited in scope.
- The UK fund industry continues to lobby to improve the UK as a destination for both fund vehicles and fund managers.

Background

In the UK, the regulations applicable to the management and marketing of private funds have largely stemmed from Directive 2011/61/EU, or the Alternative Investment Fund Managers Directive (AIFMD), which was transposed into the national laws of the EEA member states in 2013. The AIFMD was a reaction to the global financial crisis, and the EU sought to increase and harmonise consumer protection in, and regulatory oversight of, the private funds industry, which had been implicated as a sector that helped cause the crisis. Since its implementation, the AIFMD has not generally been well received in the private funds industry. In an attempt to produce rules applicable to such a wide range of products, the AIFMD created various obligations that are unduly burdensome for certain parts of the industry. For example, the AIFMD remuneration rules include an obligation to impose retention requirements in respect of the variable remuneration of all in-scope employees, regardless of the type of fund. As a result, managers of funds which investors have agreed should pay incentive compensation on the basis of rolling 12-month performance periods are limited in their ability to distribute such incentive compensation to the employees, even though there is no requirement or expectation that such amounts should be impacted by future performance. However, the AIFMD did introduce passporting for alternative investment fund managers in the EEA, allowing suitably authorised EU AIFMs to manage and market funds within other EEA member states with relative ease. The AIFMD also established rules for fund managers outside the EEA that wish to market alternative investment funds within the EEA.

© Skadden, Arps, Slate, Meagher & Flom LLP. All rights reserved.

Navigable Challenges for Private Funds

Despite the benefits of the marketing passport, a significant number of managers took the view that the obligations under the AIFMD were too onerous, and structures were implemented to shift the regulatory burden to third parties (*i.e.*, "host AIFMs"), with advisory services being provided from the UK or elsewhere. In such a model, fund managers engage with a third party that is fully authorised as an AIFM in an EEA member state and is responsible for compliance with the AIFMD. That third party then appoints the fund manager as a delegate or an adviser, which typically carries a lighter set of regulatory obligations. However, many private fund managers adapted to the requirements under the AIFMD and were able to utilise the marketing passport to access EEA investors in jurisdictions in which marketing otherwise would have been difficult.

Post-Brexit

As noted above, most private fund managers have been planning for Brexit for some time, implementing different solutions depending on commercial need and preference. In this regard, their planning largely mirrors solutions that non-EU managers have been using for some time, with some utilising structures that should be unaffected by the immediate change. One example of this is managers that have established fund vehicles in the UK or an offshore jurisdiction, such as Jersey. Larger managers who wished to maintain access to the passport established affiliate presences in EU jurisdictions, with Luxembourg as their preferred location. Other managers opted to use the "host" AIFM solution, summarised above. Although these solutions are fairly well utilised, they have not come without administrative burden and cost.

Pending any agreement between the UK and the EU on financial services, UK-based AIFMs remain subject to the same rules as before Brexit, but without the benefit of the passport. As a result, managers which have not already adopted one of the solutions outlined above will only be able to market products in the EU on the basis of the national private placement regimes, which stem from the AIFMD but vary among EEA member states. Therefore, non-EU managers will have to navigate the different rules of each regime, which impose varying organisational and structural requirements, in order to access the relevant EEA jurisdiction. In some EEA jurisdictions, the marketing of non-EU alternative investment funds is practically impossible.

For those UK managers seeking to access investors based in EEA jurisdictions, it seems unlikely that the rules will become any easier to navigate. In 2020, the EU kicked off an overdue review of the AIFMD. This appeared to have been delayed due to Brexit but now looks to be gathering momentum, with proposed changes to the AIFMD framework expected to be in final form in 2021. As noted in our 12 October 2020 client alert, the European Securities and Markets Authority (ESMA) issued a letter to the European Commission (EC) in August 2020 identifying 19 topics ESMA had identified for consideration in the AIFMD review. Of those topics, the focus on delegation is likely to be the area of most concern for UK managers that have utilised the host AIFM solution or other delegation-based models. If the EC chooses to adopt ESMA's suggestions, it seems likely that the host AIFM solution, in particular, will become more difficult to utilise for a number of managers. This is because ESMA's recommendation is that host AIFMs should be required to retain a level of control and independence, which would arguably shift the balance of investment decision-making too far from the appointed portfolio manager.

Given that these changes were proposed in the heat of the Brexit negotiations, it seems likely that the proposals were at least partly driven by the EU's desire to boost the EEA internal market for private funds. However, these changes would impact not only UK managers but also any other private fund managers located outside the EU. While this could benefit managers located in the EEA, it could conversely be a detriment to EEA investors by reducing their access to non-EU fund managers. This would seem to be contradictory to the investor protection aims of the AIFMD, resulting in many hoping that the delegation model is left largely unchanged.

Future UK Regulation

Closer to home, the UK fund industry is closely engaged with lobbying the government to improve the UK as a jurisdiction for funds and their related vehicles, as well as looking for enhancements to the tax, legal and regulatory regime from a manager perspective.

There is little doubt that London remains a centre of talent for investment management and should continue to be so in the near term. The UK Treasury has made numerous public statements about the importance of the UK asset management industry and various consultations are already underway to consider matters such as the regulatory and tax regimes applicable to UK-domiciled funds and asset-holding companies. At a time when the tax efficiencies previously provided by cross-border structures seem to be under scrutiny as a result of initiatives such as base erosion and profit shifting and the Organisation for Economic Co-operation and Development's draft Pillars discussed in our 2 November 2020 alert, having a viable UK asset-holding vehicle could be a valuable solution for UK private funds.

There also is hope amongst some in the industry that the UK may seek to diverge from the EU regarding the regulation of private fund managers, for example in areas of reporting and certain organisational requirements. While for some financial services industries, continued alignment may be important should the UK

and the EU agree on any equivalence measures, this is unlikely to be relevant to private fund managers. The AIFMD does not recognise equivalence, and although the AIFMD contemplates non-EU-authorised AIFMs obtaining a passport equivalent to EU AIFMs, the process for implementing an extension of the AIFMD passport to non-EU jurisdictions started but then stopped several years ago. There appears to be little appetite from the EC or ESMA to restart this process, meaning there are limited advantages for UK private fund managers to remain subject to equivalent regulations to their EU counterparts.

That being said, the UK was heavily involved in the creation of the AIFMD, and it seems likely that many aspects of the regime will remain. For instance, the Financial Conduct Authority already applies a proportionality test to the remuneration rules that has made them far more palatable for many private fund managers. Other areas, such as reporting, may be refined, but since fund managers have generally adapted well to the requirements since 2013, there may be little impetus for radical change at this stage.

One of the key strengths of the private funds sector is its flexibility and adaptability. Our expectation is that well-advised managers will be able to navigate the challenges posed by Brexit and maintain the UK's standing as a leading asset management jurisdiction.