BREXIT – ASSESSING THE IMPACT ON ASSET MANAGERS

On 23 June 2016, the British people voted to leave the European Union. The next step is for the UK government to initiate the procedures under Article 50 of the Treaty of the European Union, leading to the UK's withdrawal from the EU and, ultimately, to the establishment of a new relationship with its former EU partners.

Precisely what this will look like, and when it will come about, is uncertain and there is much debate on whether the consequences will ultimately be positive or negative for the UK. What is certain, however, is that Brexit will have a significant impact across a range of sectors - financial services, trade, employment, tax, competition and others. Asset managers, be they based in the UK, the EU or elsewhere, will be caught up in this, and will find themselves affected by Brexit, albeit to varying degrees.

Key issues

- Loss of EU managing and marketing passporting rights out of and into the UK
- Changes to managing and marketing strategies for UCITS and AIFs
- Changes to the provision of portfolio management and investment advisory services
- Change of domicile and use of delegation arrangements
- Changes to investment mandates and parameters

KEY AREAS OF IMPACT FOR ASSET MANAGERS

Loss of EU passporting rights

One of the key consequences of Brexit is that, on current rules, UK firms would lose managing and marketing passporting rights into the EU. Passports have been used extensively to further the single market and have shaped the way many asset managers conduct their business, for example, enabling funds to concentrate in centres such as Dublin and Luxembourg, or non-EU managers, from the US or Switzerland for example, to establish a hub in London, from which they can 'passport' into other EU Member States. Currently, Brexit will mean that UK firms will no longer qualify for a passport under existing EU legislation, which would have an impact on those asset managers who rely on a passport to conduct their business, for example if they rely on a passport to market and distribute their funds into the EU, or to provide managed account and investor advisory services on a cross-border basis to EU based clients. Conversely, asset managers who do not rely on a passport are unlikely to be significantly affected e.g. if they manage assets from the UK and do not market their funds into the EU or do not provide segregated account portfolio management or investment advisory services to EU clients.

Changes affecting managing and marketing of UCITS and AIFs

A UCITS fund must be EU domiciled and managed by an EU management company. After Brexit, funds established as UCITS in the UK would no longer fall within the scope of the UCITS Directive, and would therefore be unable to use the passport provisions which allow UCITS funds established in one Member State to be managed and marketed in other Member States. As a consequence, asset managers for whom passports are integral to their business model will need to change the way in which they manage and market their funds.

If the fund remains in the UK, it is likely that the UK regulator would regard the fund for UK regulatory purposes as a type of non-UCITS retail fund, which would be categorised as an 'alternative investment fund' (AIF) under AIFMD. Similarly, the EU would treat the UK fund as an AIF. This means that UK UCITS accessing the EU would have to comply with the AIFMD regime and could only be marketed into the EU under the AIFMD's national private Bullet placement regimes for marketing to professional investors. Many EU jurisdictions restrict the marketing of AIFs to retail investors (and some do not permit it at all). Some EU Member States, such as Italy, have not implemented an AIFMD private placement regime and in others, such as Germany, the conditions for the AIFMD regimes are very restrictive. Similarly, assuming the UK does not change its rules, EU UCITS could only be marketed in the UK under the UK national private placement regime. This would require compliance with the UK's financial promotion restrictions and would restrict marketing to retail investors.

Turning to alternative investment funds, the exit of the UK from the EU would mean that UK full scope AIFMs would no longer be full scope EU authorised AIFMs and so would lose the use of the marketing (and management) passport under AIFMD. Instead, they would have to comply with the AIFMD national private placement regimes for marketing into EU jurisdictions. In a similar way, the exit of the UK from the EU would also affect EU AIFMs when marketing into the UK.

Small UK AIFMs may be in a better marketing position, as they would be able to access the AIFMD national private placement regimes (whereas currently other EU Member States may not provide a national private placement route for a small UK AIFM). However, this would introduce fuller AIFMD reporting requirements applicable to the small UK AIFM than it may be subject to currently under UK AIFMD implementation.

UK managers of UCITS and AIFs managing funds elsewhere in the remaining EU (and EU Managers managing UK-based funds) would also have to consider whether they would be subject to local licensing requirements as a result of their managing or marketing activities, particularly if these relate to retail investors, and whether there are any available exemptions to the licensing requirements. EU AIFMs marketing funds into the UK or managing any UK AIFs, for example, would need to consider UK licensing requirements.

Changes to the provision of portfolio management and investment advisory services

Brexit will change the way portfolio management and investment advisory services are provided on a cross-border basis, by both UK and EU firms.

A number of managers provide asset management related services under a MiFID permission, for example delegation of (some or all) portfolio management for a fund to a MiFID investment firm, acting as an advisor to a UCITS manager or AIFM, or separate managed account/discretionary or advisory mandates.

Under the current regime, Brexit would mean a loss of the MiFID investment services passport for UK investment firms, and so it would not be possible for such managers to provide services on a cross-border (or branch) basis across the EU. Provision and marketing of those services would become subject to each EU Member State's national rules.

It may be possible for UK investment firms to continue to provide discretionary management services to existing EU clients on a reverse-enquiry basis (and it is likely that management activity would be characterised as carried on in the UK) which could be helpful for existing structures and mandates. However, services such as the provision of investment advice could be characterised as being carried on in the EU jurisdiction of the client, and would need consideration of local regulatory rules.

Additionally, EU investment firms would lose their investment services passport into the UK, affecting the provision (and marketing) of services to UK clients. EU firms will effectively move into the same position in respect of the provision of investment services into the UK as non-EU firms are in currently. EU firms would then need to consider the availability of exemptions from UK licensing requirements, such as the overseas persons exclusion, at least if the clients are professional clients.

Change of domicile and delegation

Loss of management and marketing passports may lead some funds to consider changing domicile. For example, UK management companies would no longer be able to act as managers of EU UCITS and EU management companies would no longer be able to act as managers of UK UCITS. They may choose to establish new management companies in the EU and the UK for this purpose (or, where there are existing affiliates in the EU, consider some form of group re-organisation to re-domicile in another EU jurisdiction).

Additionally, new management companies should be able to delegate portfolio management to the existing management company, subject to compliance with the requirements of the UCITS Directive on delegation to non-EU managers. Existing delegation arrangements may need to be updated to reflect these requirements and some 're-papering' may be required.

The AIFMD also permits delegation of management activities to non-EU managers, provided certain conditions are satisfied, and again, delegation or sub-advisor arrangements between AIFM and UK managers may need to be updated to satisfy those requirements. AIFMs may also need regulatory approval for the delegation. Note that under AIFMD, EU AIFs would not be able to use UK banks as depositories and UK AIFs would not be able to use EU banks as depositaries.

Finally, EU firms providing portfolio management on a delegated basis from a UK based manager may also need to consider any additional requirements that need to be complied with by the UK manager in respect of a delegation and vice versa, with respect to the non-EU manager.

Changes to investment mandates and parameters

UCITS may not invest more than 30% of their assets in non-UCITS collective investment schemes. This means that investment mandates may need to be re-assessed to take into account the UK not being in the EU. Indeed, more broadly than UCITS, asset managers (both UK and the EU) will need to consider any EU related investment parameters to accommodate investment in the EU (minus the UK) and the UK. This may require managers revisiting and updating investment management agreements and fund documentation.

Investors in funds may also be subject to similar restrictions (both contractual and regulatory), and so will need to review their internal procedures and investment guidelines in the same way (for example, if investors have any restrictions on investment in non-EU funds).

From a documentation perspective, on both current and future structures, fund managers may need to consider the definition of "Investments" to ensure it is as wide as possible (so it is not restricted by the UK's relationship with the EU), as well as ensuring transfer provisions give enough flexibility in case a future restructuring is needed.

It will also be important to check agreements with any service providers, particularly banking documents, to see if any material adverse change clauses could be triggered. It will also be important to talk to service providers who have a cross-EU platform, such as depositories delegating into or out of the UK, to check how their service provision might be affected.

Can the existing legislative framework help manage the impact?

The UK Government is likely to seek alternative Treaty Frameworks for future co-operation with the EU that might preserve some of the benefits of the single market in financial services, for example, through the UK becoming a member of the EEA or by negotiating some other free trade agreement. As well as these options, there are mechanisms in existing financial services legislation that might help manage the impact of Brexit, most notably, by using 'third country regimes', which are a feature of many key pieces of financial services legislation, such as MiFID2/MiFIR and EMIR.

'Third country regimes' allow non-EU entities access to the EU market, usually on condition that they are authorised in a State which has a regulatory regime equivalent to that in the EU and which provides an effective reciprocal mechanism offering access to EU firms. These mechanisms could provide an important means of managing the changes caused by the UK leaving the EU, because - at least at the outset following the UK's exit - the UK could ensure that its regulatory regime is equivalent to the regime in the EU by maintaining its existing regulatory regime implementing EU laws. Similarly, the UK could offer reciprocal access to EU firms.

In particular, the EU Markets in Financial Instruments Directive and Regulation (MiFID2/MiFIR), scheduled to be in force from January 2018, includes a new arrangement which could allow non-EU firms from an equivalent jurisdiction a 'third country entity passport' to provide cross-border investment services to professional clients and eligible counterparties across the EU.

It should be noted, however, that these regimes do not cover all services and activities. For example, there is no third country regime under UCITS, although there is a third country regime under the AIFMD, for non-EU AIFMs marketing into the EU, but this has yet to be 'switched on'. The MiFID2 regime may also not help UCITS managers or AIFMs in respect of additional MiFID activities they carry on.

Many of these third country regimes are not immediately effective and are as yet untested. Perhaps more importantly, it is not certain whether, for political or competition reasons, the UK would be given third county status and when, especially if the UK seeks to abandon or amend other aspects of its current regulatory regime. Therefore, there is likely to be a long period of uncertainty before it becomes clear whether or not these regimes will be available to UK firms.

Finally, third country regimes rely on there being harmonised legal frameworks. If, over time, divergences appear between the regulatory regime in the UK and the EU, this could jeopardise 'regulatory equivalence' and result in third country regimes no longer being available.

CAN 'THIRD COUNTRY REGIMES' HELP ASSET MANAGERS MANAGE THE IMPACT OF BREXIT?

MiFID/MiFIR

MiFID2/MiFIR will introduce a new arrangement which could allow non-EU firms from an equivalent jurisdiction a 'third country entity passport' to provide cross-border investment services to wholesale clients and counterparties across the EU, provided the firm is registered by ESMA. Registration is subject to several 'equivalence' and 'reciprocity' conditions being met. However, UK AIFMs and UCITS managers may not be able to benefit from the MiFIR 'third country entity passport', which may not be available to managers of collective investment undertakings. The MiFIR 'third country entity passport' could be useful in other circumstances though, such as where a UK investment firm provides portfolio management and investment advisory services into other Member States.

UCITS

The UCITS Directive does not contain a 'third country regime'. UK management companies may not be able to benefit from the MiFIR 'third country entity passport'.

AIFMD

If the EU 'switched on' the third country passport regime under AIFMD, a UK full scope AIFM could have the benefit of the AIFMD marketing passport for marketing to professional investors in the EU. However, it would have to be authorised in an EU Member State of reference, comply with the full requirements of AIFMD and maintain a legal representative in the EU. It would also still have to be authorised in the UK and to comply with any requirements of the UK regime, even if duplicative of or going beyond the EU requirements.

Additionally, although it is possible that, following the exit of the UK from the EU, the UK regime regulating AIFMs becomes less burdensome than the AIFMD regime, it is also possible that maintenance of the current regime may be a condition of the marketing passport being available to UK AIFMs – that is, the passport is only 'switched on' in relation to equivalent jurisdictions.

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