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Brexit: issues for asset managers

July 2016

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Asset management should be a key area for consideration for the UK as Brexit discussions are developed, as it is one of the financial services areas most likely to be severely affected by Brexit.

It is important that those in the industry who understand the real challenges put forward their views and ideas to all relevant stakeholders, once we know who they are, particularly on the Single Market issues, prior to the negotiations on any exit progressing.

This is particularly important because this is a diverse sector: the approach which might best suit some managers may not suit others. What is the best way forward post Brexit to suit managers generally, ranging from long-established household-name fund managers with fund ranges already established in at least two of the three main European jurisdictions, to some of the alternative fund managers, such as the hedge fund managers, to new entrants into the marketplace?

We set out below some preliminary thoughts on some key topics for UK based asset managers.

Post the "leave" vote on 23 June, UK asset managers, along with all other financial institutions and businesses in the UK, are now having to address the potential consequences for their businesses, and their products and services:

- At first glance there might be an attraction to Brexit, because the UK could apply a regulatory brake to the never ending deluge of regulation from the EU Commission.
- On the other hand there seems to be much to lose, particularly if we cannot participate in the Single Market place, and with the potential for further UK business operations or product to move to other EU jurisdictions.

Business as usual, initially

The FCA's statement on the European Union referendum issued on 24 June indicates what one might expect: in the short term, on a day to day basis, it should be business as usual:

> "*Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament.*
>
> *Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect.*
>
> *Consumers' rights and protections, including any derived from EU legislation, are unaffected by the result of the referendum and will remain unchanged unless and until the Government changes the applicable legislation.*"

However, this is an expected initial position. It will in all likelihood remain only a short term approach pending developments on some of the considerations raised below.

Dealing with market volatility

There are of course immediate concerns resulting from the consequences of market volatility.

Fund managers need over the forthcoming weeks and months to maintain vigilance in monitoring both liquidity positions and the ability to fair price investment funds, particularly open-ended funds. We have, to date, only seen serious issues arise for open-ended property funds and, to be fair, these have always been susceptible to challenges which arise from market volatility and particularly where a reduction in asset values is anticipated. (On 8 July the FCA issued general guidance on fund suspensions in response to the higher than normal levels of redemption requests experienced by open-ended property funds.)

In this area, one is considering application of long established regulations for UK authorised funds designed to deal appropriately with situations where this might have consequences for those funds.

- ### Valuation and pricing

  The basic question is whether you can do the pricing exercise at the relevant valuation point and in accordance with the relevant prospectus document. The position will vary across a fund range.

  Clearly if the relevant eligible markets are not functioning such that there is no quoted price for fund assets available this would cause a difficulty. This analysis should not just be "is a market open" but about a wider set of issues regarding whether fair value pricing can be achieved, accurately reflecting market developments.

- ### Suspension of dealing

  In the event of difficulties for a particular Fund such that you cannot price shares, the next question to consider is suspension of dealings under COLL 7.1.

  The current guidance at COLL 7.1.3 states that this chapter is intended to help *"to achieve the statutory objective of protecting investors by ensuring that they do not buy or sell units at a price that cannot be calculated accurately. For instance due to unforeseen circumstances it may be impossible to value, or to dispose of and obtain payment for, all or some of the scheme property of an authorised fund or sub fund."* The rule in COLL 7.2.1 refers to *"exceptional circumstances"* where it is in the interests of all of the unitholders in the fund to suspend.

Suspension is a last resort – as indicated in the Guidance at COLL 7.3.2, the Manager and Depositary should ensure that any alternative courses of action have been discounted before determining that it is in the best interests of unitholders to suspend dealing. Difficulties in realising scheme assets or temporary shortfalls in liquidity may not, on their own, be sufficient justification – the Manager and Depositary need to be confident that suspension could in those circumstances be demonstrated genuinely to be in the best interests of the unitholders.

The guidance at COLL 7.2.2(2) indicates that the Manager needs to ensure that any suspension, while maintaining unitholders' interest, is temporary, of minimal duration and is consistent with the provisions of the prospectus and instrument constituting the Fund.

- ### Liquidity management tools

Thankfully, in the initial week or so, suspensions, other than in the property funds sector, have not been necessary.

Markets have been volatile but not so as to prevent markets functioning and securities pricing therefore being undertaken. Obviously firms have been monitoring the position in accordance with their liquidity management procedures but it seems that managers have not yet needed to deploy some of their liquidity management tools.

As for the risk of a large number of redemptions occurring, these will not materialise if investors generally maintain their unit holdings. Where bulk redemptions requests are to be made, the general deferred redemption power in place for funds might assist, but only to a limited degree. In addition to being difficult to operate, this tool is of more use when seeking to reduce the impact of dilution on a fund (for which it was designed) and generally dealing with liquidity management than it is as a practical tool for dealing with a major flood of redemptions.

For other types of funds, the valuation, pricing and liquidity issues will similarly require review in the light of the specific provisions which apply under their constitutive documents and applicable regulation.

Potential loss of passports

Thinking ahead to how negotiations for Brexit might progress, the main focus for asset managers is of course on the issue of potential loss of passports for products and services.

Clearly there is interest in maintaining participation in the Single Market from most in the asset management sector – certainly those with established businesses in the UCITS space and utilising passports for investment purposes. However, whatever the wishes and needs of the asset management industry, if (as at present seems likely) the corollary of having access to the Single Market will be having to agree to continuation of the right for free movement of EU citizens, continued participation in a Single Market might not be an achievable outcome within the Brexit negotiations.

- ### Passport for MiFID investment services

Investment managers benefit from MiFID I and prospectively MiFID II passports. MiFID I already enables a wide range of businesses to passport on a branch or services basis throughout the EU for investment management and advisory services, and the scope of MiFID is to be widened with effect from 3 January 2018.

If and when the UK becomes a "third country", UK firms would have limited options. There are three main options:

- **keep outside the scope of MiFID**

  Assuming services currently come within the scope of MiFID, there is little scope for new ideas here.

  Under Article 42 of MiFID there is a general exemption, which is applicable across the EU, allowing for provision of services at the exclusive initiative of the client in an EU Member State. However, whilst relying on arrangements like this may allow some degree of activity to be undertaken from the UK into Europe, this is not likely to provide a sound basis for operating a business.

- **establish a branch, utilising Article 39 of MiFID II**

  Article 39 of MiFID II allows each individual Member State to opt into a regime under which the Member State may require a third country firm that intends to provide investment services, or perform investment activities (with or without any ancillary services) **to retail clients or to professional clients**, to establish a branch in that Member State which would be authorised by the relevant regulator in that Member State.

  This route would be available only where the conditions in Article 39 are fulfilled regarding:

- AML status,
- co-operation arrangements being in place between competent authorities,
- sufficient initial capital being at free disposal of the branch,
- one or more persons being appointed to be responsible for management of the branch,
- the third country having signed an agreement with a Member State where the branch is to be established which complies with the standards laid down in Article 26 of the OECD Model Tax Convention on income and on capital and ensures an effective exchange of information on tax matters; and
- the firm belonging to an investor compensation scheme authorised or recognised in accordance with Directive 97/9/EC.

The branch of the third country firm would be obliged to comply with the provisions to which Article 41(2) refers, which would apply various provisions of MiFID II and MIFIR such as organisational requirements, conflicts of interest and various investor protection measures. A Member State though would not be able to impose any additional requirements on the organisation and operation of the branch in respect of matters covered by MiFID. It would also be obliged not to treat any branch of third country firms more favourably than EU firms.

This option involves the extra cost of running a branch but allows the head office of the branch still to be run from the UK. It does not however provide any passporting rights from the selected Member State into other Member States. Also, in order to follow the Chapter IV provisions, it will be necessary for the other EU Member States to decide to opt in to the Article 39 MiFID II regime and then for the various conditions to be met, so it would not be an automatic route.

- **establish a branch, utilising Article 46 of MiFIR**

The second practicable option to consider would be to explore utilising Article 46 MiFIR and other provisions of Title VIII within MiFIR.

These would apply if the Commission makes an equivalence decision in respect of the UK. In theory, the UK could easily meet the equivalence requirements, but it is possible that this decision could be politicised and slow in coming.

If the UK is deemed to meet the equivalence requirements, UK firms could seek registration with ESMA. If a UK firm has established a branch under MiFID II Article 39, they might also benefit from a limited passport. A third country firm can provide investment services or perform investment activities with or without any ancillary services to **eligible counterparties** and to **per se professional clients** (but not opt up professional clients) without the establishment of a branch, where it is registered in the register of third country firms kept by ESMA in accordance with Article 47.

Article 47 provides for the Commission to adopt a decision in relation to a third country stating that the legal and supervisory arrangements of that third country ensure that firms authorised in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in MiFID II and MiFIR, the CRD IV Directive, and implementing measures adopted under those measures, and that the legal framework of that third country provides for an effective equivalent system for the recognition of investment firms authorised under third country legal regimes. ESMA is to establish co-operation arrangements with the relevant competent authorities whose legal and supervisory frameworks have been recognised as effectively equivalent in accordance with this provision.

If eligible, ESMA shall register a third country firm that has applied for a provision of investment services or performance activities throughout the union in accordance with Article 46(1) where the following conditions are met:

- the Commission has adopted a decision in accordance with Article 47(1);
- the firm is authorised in the jurisdiction where its head office is established to provide the investment services or activities to be provided in the EU and it is subject to effective supervision and enforcement ensuring full compliance with the requirements applicable in that third country; and
- co-operation arrangements have been established pursuant to Article 47(2).

Where a third country firm is registered in accordance with Article 46 MiFIR, Member States would not be able to impose any additional requirements on the third country firm in respect of matters covered by MiFIR or by MiFID II, and will not be able to treat third country firms more favourably than EU firms.

Where a third country firm established in a country whose legal and supervisory framework had been recognised to be effectively equivalent, and would be authorised in accordance with Article 39 of MiFID II, it would then be able to provide the services and activities covered by the authorisation **to eligible counterparties and per se professional clients in other Member States of the EU without the establishment of new branches**.

It would however need to comply with the information requirements for cross border provision of services and activities in Article 34 of MiFID II. Note that the branch would remain subject to the supervision of the Member State in which a branch was established in accordance with Article 39 of MiFID – although the relevant regulators of the Member State where the branch is established and the regulators of the host Member State could establish proportionate co-operation agreements in order to ensure that the branch of the third country firm providing investment services within the EU delivers an appropriate level of investor protection.

Establishing therefore whether the Commission will make an equivalence decision under Article 47 of MiFIR will be an important item for the exit negotiations: One cannot assume that the Chapter IV MiFID II regime will be utilised by all Member States. The idea of utilising Article 42, so that there would be a business built on providing services only at the exclusive initiative of the client, would be unrealistic.

These options are currently being debated – and of course are preferable to the alternative of the UK investment management firms establishing MiFID scope investment management firms in an EU Member State. This final alternative would involve establishing a separate subsidiary or sister firm in a Member State that obtains full authorisation in that Member State and runs EU-facing activities through that new firm. For UK based investment management businesses, this would involve extra cost and duplication of activities but the new subsidiary would enjoy full passporting rights across the EU. The main concern of course with this final alternative is the possible need to relocate portfolio managers and core investment management type activities. Hence the focus on pursuing the options explained above.

- **Passporting investment funds in the EU**

For fund managers, the two types of funds, as defined for EU Directive purposes, have their related passports:

- for UCITS the retail passport and
- for AIFs the passport for professional investors.

The various consequences of Brexit will depend on the nature of the nature of the funds business:

- The likelihood is that the UK authorised funds would continue in a very similar vein and be suitable for promotion as they are now within the UK – it is simply their labels, and the loss of the passports which might affect UK based funds.

- For those few asset management groups which have used the product passports for promoting UK authorised funds into Europe, they would need to consider other options and most likely set up additional fund ranges in Dublin or Luxembourg which would be UCITS funds benefiting from the passport.

- Many larger asset managers have Dublin and/or Luxembourg fund ranges even if there is management from the UK for these products. The management arrangements in respect of these funds would need to be considered carefully should the passports no longer be available.

- Using a UK-based management company, whether a UCITS management company or an AIFM as appropriate, would no longer be an option. Given the predominance of investment management firms being within London, even though they might operate UCITS fund ranges in two out of the three main jurisdictions of UK, Luxembourg and Dublin, the notion of having a UK based management company would no longer be available. This will lead most asset management groups to consider whether to have a Dublin or Luxembourg based management company or companies.

- There would be new issues to consider, with the investment management from the UK now being regarded as third country investment management, and consideration of whether this is still practicable and meets the relevant conditions. (This should be practicable but would need to be reviewed in the light of developments, notably in Dublin regarding looking at governance of Dublin based funds.)

- Indeed any delegation terms would need to be checked where there is use of UK resource.

- **Passporting into the UK**

Note of course this is not a one-way street. In addition to looking at passporting out into Europe, there is also the issue of what happens on passporting *into* the UK.

Many firms currently use European passports for passporting in both products and services from other entities based in other EU jurisdictions. There would be a need to review how these arrangements could continue to work – or how they might be reinvented.

Restructuring of groups

Having only recently completed the restructuring of all of their non-UCITS fund business with the implementation of AIFMD, UK fund managers may now be faced with the prospect of restructuring their groups in order to maintain their business activities in Europe, and potentially wider. This would be likely to result in the focus of even more of their business in non-UK firms within their groups, in particular those established in other EU Member States.

This may be seen as simply an inconvenient evolvement of the position for major asset management firms: many have already long established operations in other EU Member States and indeed utilise Luxembourg and Dublin based funds for the majority of markets. It would however pose more of a challenge for smaller firms and new entrants into the market place – and certainly new entrants would be discouraged from considering having their main establishment in the UK.

Wider UCITS and AIF marketing issues

There are also much wider marketing issues.

UCITS has become a global brand and notably in the Asian markets and South American markets, the UCITS label is itself valuable. The AIFs label is now developing similarly, although not quite in the same way as UCITS as yet.

If UK authorised funds lose their relevant label, this might prejudice business wider than just selling within Europe. The innate preference might well be to ensure that funds are set up in a domicile which offers the EU label. Even the loss of the label could be viewed as important.

Third country issues for AIFMs

For all alternative investment fund managers (AIFMs), there is an additional issue which is that the position regarding third country firms – which the UK would become – is itself uncertain. The position varies depending on the sector in which the AIFM is operating – whether hedge funds, private equity funds, property funds etc – and the location of their investor base.

- If the current regime for utilising the national private placement regime were to continue, many AIFMs based in London might well welcome this because it would take them out of a regime from which they essentially did not benefit.

  Many in the offshore fund world are currently lobbying against Article 37 AIFMD being switched on so as to benefit from the third country provisions in the Level 1 Directive. Instead, they wish to keep the NPPR regimes in operation as they currently work relatively well, and on the basis which keeps the AIFs concerned out of the scope of most AIFMD regulations. They just need to cope with limited disclosure requirements, and a notification. If a similar position were in the future to apply to UK based fund managers of some AIFs, this might similarly suit them.

- For UK based investment funds such as private equity or property limited partnerships, they could go back to their long-accustomed basis for operating unregulated collective investment schemes which work well for the institutional markets, subject to discussion as to how they might be made more generally available under UK regulation.

- For investment trusts, they could have removed the unwelcome discussions encountered over the last couple of years as to who is really in charge – the investment trust's board or the AIFM.

- For non UCITS retail schemes, it would remove an unwelcome hurdle so full regulation would apply under the original COLL Rules without the imposition of FUND Rules.

Nonetheless, UK-based AIFMs with UK-based AIFs may experience various teething problems and in particular uncertainty regarding how they could promote their products outside of the UK.

Further, there may be a general perception issue that, for new products, the fund domicile of choice would be an EU Member State in order to benefit from the AIF label as mentioned above. It could simply mean that, whether technically better or worse, products might be structured so as to use an EU-domiciled AIF product and so out of the UK in future.

Self-determination of UK regulation?

One considerable advantage of Brexit is the expectation that the UK could be free from EU regulation – with the UK determining its own regulation going forwards. UK regulators could resist some of the initiatives in the European Commission with which both regulators and the industry might disagree.

There are however good reasons for doubting this perceived advantage of Brexit. There are a few inhibitors to the UK determining its own regulation going forwards.

Known for providing a prudent regulatory environment with close attention to investor protection concerns, the UK's general approach is unlikely to change. Indeed, we should not be expected to change given that UK regulators will still be expecting to take a lead within the wider global regulatory environment – the IOSCO framework etc. And the Government and the PRA and FCA will be expecting to pursue their independent and progressive approach in any new post-Brexit environment.

Certainly, we might expect the UK regulators to follow through on their own specific initiatives such as the senior managers regime and the outcome from the Fair and Effective Markets Review, RDR, regulatory sandbox, embracing innovation, etc.

Many of the initiatives now coming through from the EU are in fact in areas where the UK was the first to establish the relevant regulation, and indeed where the UK in some instances still maintains gold plating. It would be unrealistic to expect initiatives regarding costs and charges transparency, transaction reporting, inducements or provisions on investment research not to continue to be pursued. It would also be unrealistic to look for a lighter regulation of authorised investment funds. Given that many EU Directives, for example, the UCITS regime, have had strong support from the UK the UK is highly likely to choose to continue much existing EU-driven existing regulation. We see little, if no, prospect of a lighter regulatory burden for UK authorised firms.

No doubt there might be some examples where there might be an improvement. Whilst most of the over regulation which you might mention might have been driven by the UK regulators, there are some examples where European regulation has been unwelcome and the UK might prefer to revert to the old provisions - for example fund mergers rather than UCITS IV mergers, and methods for doing the disclosures required in pre‐sale disclosure documents. In the main though, the advantage (were it to be free to do so) would be the UK determining its position rather than having to accept the composite EU view.

Depending though on the nature of the deal with the EU, it may be that the UK still needs to maintain some equivalence to the EU legislation.

- If the UK were to adopt the Norway model, in order to benefit from the single market, it would be subject to the EU Rules although not able to influence them.

- If, as is more to be expected, the UK may need to maintain a comparable regime in order to benefit from some third country provisions such as those mentioned in respect of investment services above, the UK regulators would need to retain an eye on the EU position in order that this is achieved. Where EU legislation provides for institutions authorised in countries with equivalent levels of legislation to enjoy special access rights, no doubt the UK would look to obtain status as such a country. The UK having an equivalent financial services regulatory regime, would be a precondition to benefitting from these although this is not a given, notwithstanding the UK being stricter in several regulated areas or conforming with international regulatory standards that are followed by most major financial centres (including the EU).

Regardless of the position negotiated with the EU, generally freedom for the UK to determine its own position will not necessarily be entirely feasible. The potential for this being practicable would rather depend on there being more of a domestic focus on the UK market place than a global one. Given the globalisation of asset management businesses, this would not seem to us to be practicable.

Consequently it will take some time to see how UK regulation might develop if self standing. As the Chairman of the FCA has expressed it in a speech on 30th June: ***"the need for "better regulation"*** and not just ***"bulkier regulation"."***

The legislative position

What happens to existing EU related laws in the UK?

On all fronts, in the short term, simply allowing all UK domestic law derived from the EU to lapse or revoking would be unworkable. It will be a complicated process to work through how to move towards a new UK regime.

EU laws are deeply embedded in the UK. Certainly Regulations which are directly applicable in Members States but would presumably cease to apply on Brexit unless replicated or preserved by new legislation (which might well in any event be the likely outcome, at least as a stop gap until tailored legislation can be put in place). EU Directives are mostly required to be transposed and so implemented in the Member States, and so the UK could reverse its previous primary legislation or sometimes secondary legislation pursuant to the European Communities Act 1972 insofar as it wished to do so.

We think it is highly likely that the UK Government will introduce some form of overarching legislation to address the fundamental legal uncertainties caused by Brexit. An obvious parallel (ironically) is the position at the time the UK was considering adopting the Euro where it seemed likely that legislation would be required to avoid any doubts about the continuity of contracts notwithstanding the change of currency. Quite though how this will be devised will depend on how the Brexit negotiations develop.

Many now seem to think that the likelihood – or perhaps hope? - is that the UK will end up with its own special new regime which does not follow any particular model currently enjoyed by another European country. At this point, it is too early to tell what this might look like.

Process and timing

Given the fact that no Member State has so far left the EU, there is uncertainty regarding the way in which the procedure and the negotiations involved will be progressed. A period of intensive negotiation is likely once the UK's Government position becomes clearer, one hopes by September. It is conceivable that the EU will offer further concessions in an attempt to head off Brexit but it is difficult to see how this would be compatible with the Brexit vote and with the nervousness of the EU in discouraging further countries from leaving the EU.

The UK Government is likely to use Article 50 of the Treaty on European Union under which a Member State wishing to leave the EU must give two years' notice of its intention to withdraw, although that period may be extended with the agreement of all 27 remaining Member States. Reaching the end of the two year period without reaching such an agreement, and without all 27 Member States accepting an extension, would result in the UK leaving the EU with no immediate replacement position agreed.

Uncertainty as to the scope of the Article 50 negotiations is also a point of interest – there is a need for some certainty as to the post Brexit environment rather than simply the details of how the UK might exit. We understand that the EU Commission is deputing two separate teams to work on the Article 50 and the post Brexit UK regime as separate matters. The very fact that the exit process could of itself work on an unsatisfactory basis is a negative issue. This might be one reason informing the UK Government's reluctance to give the Article 50 notice prematurely.

The timing is tricky. It looks at the moment as though, in theory at least, several major initiatives - most relevant to asset managers, MiFID II and PRIIPs, which are in the process of being implemented by the EU will come into force before the UK can negotiate its exit terms. The impact of these measures and how they might be modified will themselves be items for negotiation.

Dealing with uncertainty

With the well-established EU framework for asset managers and the particular perceived strengths of the EU UCITS and AIF products, the impact of Brexit may be particularly marked for UK based asset managers.

With the current lack of specifics as to how the process will work through and what the end result might be, in reality, the most important issues for the moment still remain the intangible ones – the lack of certainty, and perception problems which the UK will face when out of the EU.

We should hope that there is a speedy negotiation of whatever the basic shape of "out" looks like so that UK based asset managers can decide how best to move forwards.

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