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Brexit: What does it mean for asset managers?

A Legal Update from Dechert

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The European Union (EU) is made up of 28 member states committed, through a series of treaties, to ever closer economic and political union. As such it exercises considerable power, both internally and internationally. It is also very bureaucratic and its policies are often influenced by the agendas of individual member states. Over the years, this has caused a good deal of controversy and in the 2015 UK general election the Conservative party promised (i) to renegotiate the terms of the UK's membership of the EU and (ii) thereafter to hold a referendum in which the UK public would be asked to vote on whether they wished to remain in the EU.

The Conservatives were re-elected on 7 May 2015 and on 19 February 2016 Prime Minister David Cameron duly announced that (i) he had reached an agreement with the other 27 leaders of the EU (the Agreement) for a revised relationship between the EU and the UK, and (ii) the promised referendum would be held on 23 June 2016.

This OnPoint looks at the legal basis for David Cameron's agreement and the legal process for a UK withdrawal in the event of a "no" vote. It goes on to look at the implications of such a withdrawal for asset managers (wherever located) and their sales of products and services.

David Cameron's proposed agreement

The Agreement reached between David Cameron and the other 27 leaders on 19 February will come into effect only if the UK votes to remains in the EU. Among other things it includes declarations that the objective of ever-closer union does not apply to the UK, that the UK will not be liable to contribute to future euro-zone bail-outs, a right for any non-Eurozone state to require a review of problem Eurozone laws and a promise to make EU laws simpler and reduce the regulatory burden on EU businesses.

The Agreement is between the leaders of the member states of the EU and is legally binding between those states as a matter of international law. Such international agreements can be taken into account when interpreting existing treaties and so the European Court of Justice should have regard to the Agreement in interpreting EU treaties as they currently stand. Yes, that's right. The European Court of Justice should, but is not legally obliged to, follow the Agreement. The Agreement will not be binding on the European Court of Justice until the Treaties and any relevant EU law are updated in accordance with the provisions of the Agreement.

The process for agreeing a new settlement in the event of a no vote

There is no precedent for a member state leaving the EU so how this will unfold is far from certain. The procedure is laid out in article 50 of the Treaty on European Union (the Lisbon Treaty), the text of which is set out in the Appendix to this update.

Article 50 provides that, following a decision by the UK to withdraw, there will be a negotiation between the UK and the EU Council (i.e. the other 27 Member States) to reach agreement on the terms of that withdrawal, including the framework for the future relationship between the UK and EU and any transitional arrangements. The Council will negotiate on the basis of a proposal put forward by the Commission. The Treaty sets a long-stop of two years for negotiation, but this can be extended with the agreement of all 28 countries.

The final agreement will be concluded on the basis of the agreement of the UK plus a qualified majority of the Council (this requires at least 72% of the members of the Council representing Member States other than the UK and comprising at least 65% of the population to vote in favour). It also requires the consent of the European Parliament. If no agreement is reached, the UK exit becomes effective two years after the UK's notification to the EU that it wishes to leave.

In the absence of such an agreement existing international treaties, including the General Agreement on Tariffs and Trade (GATT), would govern the future trading relationship between the UK and EU. These offer no material preferential access for financial services akin to the "passporting" rights that exist under the EU financial services legislation discussed below. Negotiations might seek to include preferential access for certain financial services, but the discussion below assumes that no special access for financial services will be included in any UK-EU agreement.

At the same time the UK will need to address fundamental issues about how EU legislation presently incorporated into UK law will be treated going forward. A wholesale disapplication of EU law is probably unlikely since so much law comprises or is derived from EU rules. EU Directives have been transposed into UK law and will, in principle, remain unless changed by UK statute. Regulations, however, are EU laws which have direct effect and it is less clear whether they would continue as part of UK law or would need to be readopted.

None of this will be easy, given the number of matters to be agreed and the number of parties whose agreement must be obtained.

Anyone looking to influence the final deal terms will need to consider how best to go about this and start identifying the key players within the UK, the Commission, the European Parliament and other Member States.

Of course a vote to remain in the EU will make it more important for asset managers and others to consider how to best track and reference the ever increasing array of EU requirements going forward.

Some timing issues

The two year timetable means that nothing will change in the short term and the fears that plagued the Grexit crisis of 2012 – redenomination of the local euro into drachma, capital, currency controls to avoid a run on the banks and flight of capital, banks stopping payment and counterparty defaults - should not be relevant to the UK position. However, while the exit deal is being negotiated, there is likely to be considerable business and investor uncertainty and it would be advisable for firms to plan their strategies in advance.

Could the UK be asked to vote a second time? Most commentators are saying a no vote must mean no, and there is no formal procedure for revisiting the results of the UK referendum. However, a two year negotiation would certainly give scope for formulating a revised set of proposals to be put to the UK in a second referendum, and might be easier to agree than the terms of a full Brexit.

The EU asset management regime

The main EU asset management regime is contained in the Markets in Financial Instruments Directive (MiFID), the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities Directive (UCITS). In addition, OTC derivative transactions by asset managers are regulated under the European Market Infrastructure Regulation (EMIR).

These apply a series of very detailed regulatory requirements to firms based in EU member states which, in return, are given passporting rights elsewhere in the EU.

In general, UK based investment managers access fees from clients or investors through the sale of UCITS, the sale of AIFs and the provision of segregated account services. It follows that, in assessing the risk of Brexit for investment managers, we should assess the continuing ability of UK based investment managers to access the EU market in each of these three areas.

In the case of the first two, access to the rest of the EU is often already structured through European centres like Dublin, Luxembourg and Malta (EU Gateway Hubs). These arrangements can be expected to remain largely

unchanged after any Brexit. Those who do not have this infrastructure are likely to have ample time, during the two-year negotiating period, to put such arrangements in place. The continued provision of segregated account services should not be too difficult as explained below.

As indicated above, the following discussion assumes that no special access deals are struck as part of the exit arrangements, but that existing legislation broadly remains in place in both the EU and the UK (although the UK would now be outside the EU and have no special EU position).

As such and post Brexit, UK managers would, in EU parlance, become “third country firms” and would cease to benefit directly from the MiFID, AIFMD and UCITS passporting regimes. However, the UK’s existing EU-based laws should be fully equivalent to those of the EU. Therefore the UK would be well placed to take advantage of EU Gateway Hubs and concessions available to third countries, as many non-EU countries already do.

There would be some transitional issues - for example, would the UK (and indeed the EU) continue to implement MiFID II post Brexit? Also some currently passported services, such as the MiFID/AIFMD branch passports and cross-border UCITS manco services, are not designed to extend to third countries and might need to be terminated or replaced with an EU-authorised service provider.

As for UK groups with continental affiliates, the fact that the continental affiliates are in the same group as a UK manager should not affect their position as EU firms, apart from certain requirements that apply on a UK group consolidated basis. For example, for a group headed by a UK bank, the continental affiliate could fall outside the scope of the onerous remuneration restrictions that might otherwise apply under the new Capital Requirements Directive. Funds and managers in EU Gateway Hubs would continue to operate within the EU regime and should be able to continue to delegate portfolio management to UK based investment managers (see further under “portfolio management” below).

UCITS management and marketing

UK managers

Post Brexit, an existing UK UCITS and its UK manager would continue to be UK-authorised and their activities would be unaffected in the UK domestic market.

However, the fund would cease to qualify for the UCITS marketing passport. As already noted, UK managers often use funds set up in EU Gateway Hubs for their EU marketing so there would be little or no change here. If this was important there should be ample time and limited expense for a UK fund to be re-domiciled, or a UCITS clone fund established in an appropriate EU member state.

A UK manager would still be able to set up a UCITS in an EU Gateway Hub whether using a local affiliate as a ‘self-managed’ fund or by hiring a local contractor to act as the UCITS management company. The new fund could then appoint the UK manager as its delegated investment manager. According to ESMA’s UCITS V draft guidelines, the UCITS management company would need to ensure that the delegated UK investment manager was subject to remuneration policies equivalent to those in UCITS V or agree to meet them on a contractual basis.

Non-UK managers

A third country manager is usually able to set up a UCITS and act as its delegated manager in the way described above.

UK rules similarly permit EU and non EU managers to act as delegates for a UK retail fund provided certain standards are achieved.

As for marketing, assuming the UK's existing UCITS inward passporting regime dropped away, an EU UCITS would no longer have automatic access to the UK retail markets. It is likely to be relatively easy for such a fund to obtain approval as a UK recognised scheme which would give it equivalent marketing rights, at least where the fund has a UK investment manager. EU Gateway Hubs, in particular, would be well-placed to obtain general recognised status for their UCITS funds.

EU UCITS management companies may also be permitted to continue to manage a UK UCITS after a Brexit.

Non-EU retail funds, such as US registered funds, would continue to be treated as AIFs subject to AIFMD marketing restrictions in the UK, including the UK's implementation of AIFMD article 42 discussed below. Post Brexit, the UK Government could permit these funds to be marketed in the UK under its less onerous pre-AIFMD private placement regime.

AIF management and marketing

As with UCITS, a UK-authorised AIFM managing a UK or non-EU AIF could continue to do so post Brexit under whatever UK domestic rules applied for management and marketing.

UK AIFM with an EU AIF

A UK AIFM managing an EU AIF would no longer be able to do so as an authorised EU AIFM. Whether it could continue to manage the AIF would depend on the AIF's home state rules.

The UK AIFM would not be able to market its EU AIF in the EU under the AIFMD passport unless the passport was extended to the UK as a third country operating regulations "equivalent" to the AIFMD. ESMA is tasked under article 67(1) of the AIFMD to make recommendations to the Commission for such extensions. Given that the UK already has the AIFMD regime in place it should not be difficult for it to establish equivalence. To complete the process the UK AIFM would then need to reapply for EU authorisation through an EU "member state of reference" such as an EU Gateway Hub. Alternatively the UK could rely on private placement under the national private placement regimes (NPPRs) of individual member states where available.

Another, probably simpler, option would be to establish a self-managed AIF, or contract with an AIFM service provider in an EU Gateway Hub, with the portfolio management function delegated to the UK manager. Indeed many UK managers will have already set up this infrastructure.

UK AIFM with a non-EU AIF

Currently a UK AIFM managing a third country AIF such as a Cayman fund must comply with the so called article 36 regime. In practice this applies many of the AIFMD requirements, plus a "depo-light" version of the depositary requirements. Post Brexit, it would be open to the UK to suspend some or all of these requirements and revert to its simpler pre-AIFMD private placement regime.

Post Brexit the marketing of a non-EU AIF in the EU would continue to be subject to the various NPPRs but for a UK AIFM the applicable AIFMD provision would switch from article 36 to article 42, thus relieving the UK AIFM and its AIF from full AIFMD compliance, including the article 36-specific depo-light requirement, and requiring it to comply only with certain AIFMD transparency obligations to investors and regulators.

Again, the continuation of the NPPRs would be subject to any extension of the EU passport regime to the UK and to any third country where the AIF is based and any related discontinuation of the article 42 regime.

Other third country AIFMs

As discussed above, it would be open to the UK Government to permit other third country AIFMs to market their AIFs in the UK under the UK's pre-AIFMD private placement regime, or at least under article 42 in the same way as they do at present. The marketing of AIFs by third country AIFMs into the rest of the EU should not be affected by a Brexit.

Portfolio management and marketing

Management of individual client portfolios is a MiFID service which normally requires authorisation under MiFID when the service is provided in an EU member state.

Under international law the general rule is that a discretionary portfolio managed service is "provided" in the location where the relevant investment decisions are made. On this basis a UK manager (or a third country manager based outside Europe) managing a portfolio belonging to a client based in the EU would not be carrying on a MiFID service that required authorisation in the EU client's home state. However, if an EU state takes the view that, under its national law, the service is provided in the location of the client, the portfolio manager would need to comply with the home state rules of the relevant client. We would expect this positon to continue under the new MiFID II regime.

The current MiFID regime does not prescribe how MiFID services may be provided into the EU. Regulation of such activities is left to the home states of the relevant investors. Portfolio management can be passported and national regulators are often more relaxed where the marketing is carried out by a MiFID-authorised firm, and some third country managers maintain a MiFID-authorised entity in the UK specifically for this purpose.

MiFID II, due to come into force in January 2018 and thus within the two-year negotiation period discussed above, will for the first time introduce a new, EU-wide regime for third country MiFID services, including portfolio management.

Under MiFID II, EU member states will be able to require third country portfolio managers who provide their services to retail and elective professional clients in that member state to establish a branch and obtain local authorisation in that member state. If the manager's third country meets the relevant equivalence tests prescribed in MiFID II, the branch will be able to passport its services to *per se* professional clients in other EU jurisdictions.

A third-country firm providing portfolio management to professional clients whose home state meets the equivalence test will be subject to a light touch registration regime which will allow it to market its MiFID services in the EU provided it registers with ESMA. National regulators are not allowed to impose additional requirements. Where no equivalence finding has been made the individual national private placement regimes will continue to apply.

The UK should be well-placed to meet the equivalence test, enabling its authorised investment firms (investment managers and marketing entities alike) to continue to market to professional clients on substantially the same basis they do currently under MiFID passports.

A third country firm may also provide MiFID services without any EU authorisation or registration provided its services were solicited at the "exclusive initiative" of the client.

The distribution of funds (whether AIFs or UCITS) from the UK into the EU may also involve the MiFID activities of reception and transmission of orders and in some cases investment advice. Accordingly, UK firms currently often rely on their MiFID passporting rights when distributing funds in other EU member states. Post Brexit, these passporting rights will no longer apply. However, the firms concerned should be able to take advantage of the MiFID II marketing regime discussed above to distribute to professional clients in the EU.

In summary, post Brexit, it may be more difficult for a UK portfolio manager or other third country MiFID firm to market to retail clients in the EU, but it should be relatively easy for a UK MiFID firm to market and provide services to professional clients. In practice, retail customers are likely to be sourced through a UCITS product rather than a discretionary investment management service so the negative impact here should be limited.

As for EU and third country managers doing business into the UK, the likelihood is that marketing would continue to be subject to the UK financial promotion regime and their portfolio management carried on from outside the UK would continue to be treated as not requiring UK authorisation. The UK has, and could be expected to retain, one of the more liberal regimes for non UK parties to access the UK market.

EMIR

The EMIR rules apply to the counterparty to a derivatives transaction (the manager's client) rather than to the manager itself. Counterparties are categorised as financial or non-financial counterparties, with financial counterparties subject to tougher rules. Counterparties based outside the EU are third country counterparties and are not generally subject to EMIR though they may be indirectly subject to some of its provisions where they deal with EU-based counterparties.

If the UK leaves the EU:

- Whether a counterparty is or is not a third country entity will continue to be judged by the location of the client rather than the location of its investment manager so this will not (for the most part) be affected by the UK manager ceasing to be an EU-authorised firm.
- However UK-authorised UCITS, and AIFs managed by UK-authorised AIFMs, will become third country counterparties.
- Third country clients/counterparties will be subject to the EMIR regime on a limited basis. They will not be subject to the reporting requirement. Where they are dealing with an EU-based dealer or other counterparty they will be subject to (i) certain risk mitigation requirements insofar as the EU dealer considers this necessary to meet its own EMIR obligations and (ii) to the EMIR clearing obligation where they would have been subject to the clearing obligation had they been based in the EU.
- If a third country client deals with a non-EU-counterparty – and post Brexit at least some London-based dealers are likely to be non-EU counterparties – they will now be outside the scope of EMIR and not subject to its requirements.

In summary, the EMIR rules for OTC derivatives could prove to be less onerous for UK-based managers and clients if they were classified as third country firms.

Other options

As noted, the above discussions assume that on a Brexit the UK would leave the EU but that legislation in both the UK and EU would remain largely the same. There are however many potential variations on this.

One option would be for the UK to retain its existing EU-compliant regime to assist firms marketing and providing services in the EU, while introducing a second, lighter regime available to firms dealing with third country clients. There are various precedents for this including Jersey which, in anticipation of the extension of the AIFMD third country passport, offers side by side AIFMD and non-AIFMD compliant regimes.

Establishing a separate, non-EU equivalent regime could give UK firms an opportunity to regain lost US and Asian business and support smaller asset managers who do not have the resources to cope with the overheads generated by EU regulation.

The UK Government would have to decide how “light” such a regime would be. One target might be those areas where bank rules on capital and remuneration have been applied to asset managers on the basis of maximum harmonisation. In the alternative funds area a lighter regime might include reduced capital, disclosure, depositary and reporting requirements.

Going forward, the UK would be able to make its own decisions on whether to participate in new EU regulatory initiatives.

Appendix - The text of Article 50 of the Treaty of Lisbon

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.

A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

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This update was authored by:

Peter Astleford
Partner
T: +44 20 7184 7860
peter.astleford@dechert.com

Dick Frase
Partner
T: +44 20 7184 7692
richard.frase@dechert.com

Richard Heffner
Partner
T: +44 20 7184 7665
richard.heffner@dechert.com

Stuart Martin
Partner
T: +44 20 7184 7542
stuart.martin@dechert.com

Andrew Hood
Partner
T: +44 20 7184 7315
andrew.hood@dechert.com

dechert.com

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