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BREXIT

Dechert Partners Outline Post-Brexit Cross-Border Marketing Options and the Viability of Domiciling Funds in Luxembourg (Part One of Two)

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The Hedge Fund Law Report

The likelihood of a "hard" Brexit poses many challenges for fund managers launching, marketing and distributing fund products in Europe. Nonetheless, funds have many options when it comes to cross-border transactions. Redomiciling a fund is far from the sole – or even the most obvious – choice. With a nuanced grasp of several structuring and regulatory options available in Europe, fund managers can make good use of opportunities available in Ireland, Luxembourg, Germany and other jurisdictions. For additional Brexit analysis, see our two-part series: "Effect of Hard vs. Soft Brexit on Hedge Fund Managers" (Jul. 7, 2016); and "Hedge Fund Marketing and Distribution Opportunities in a Post-Brexit World" (Jul. 14, 2016).

These points were highlighted during a seminar presented on October 13, 2016, by Dechert's financial services group, entitled "Current and Future Developments: UCITS, AIFs, Brexit and Global Fund Distribution." Moderated by U.S.-based partner Chris D. Christian, the seminar featured U.K.-based partners Richard L. Heffner, Jr. and Karen L. Anderberg; Luxembourg-based partner Marc Seimetz; Ireland-based partner Mark Browne; and Germany-based partner Angelo Lercara.

This article, the first in a two-part series, presents the points raised during the seminar concerning structuring considerations in light of the impending Brexit, as well as the viability of Luxembourg as a domicile for managers to access E.U. markets. The second article will discuss the viability of domiciling a fund in Ireland or Germany to market in the E.U., as well as the rising prominence of Undertakings for Collective Investment inTransferable Securities (UCITS) structures.

For additional commentary from Dechert attorneys, see "Recent Hedge Fund Fee and Liquidity Terms, the Growth of Direct Lending and Demands of Institutional Investors" (Jun. 14, 2016); "Dechert Global Alternative Funds Symposium Evaluates Liquid Alternative Funds and Fund Governance Trends" (Jun. 25, 2015); and "Key Deal Points and Tactics in Negotiations Between Hedge Fund Managers and Futures Commission Merchants Regarding Cleared Derivative Agreements" (Apr. 18, 2013).

Opportunities Abound in Europe

Christian described opportunity and promise for investment funds in Europe, noting that the continent currently accounts for roughly 30 percent of the $74 trillion of assets under management (AUM) across the globe. (North America, with 50 percent, has the greatest share of any region.)

Tracing Europe's growth as a funds region over time, Christian pointed out that Europe's AUM has climbed to $12 trillion – in a range of products, including regulated funds, registered public funds (*i.e.*, UCITS) and alternative investment funds (AIFs) – from a mere $1 trillion prior to 2000.

A number of asset categories are surging according to Christian, including bonds, equities and real estate, with particular emphasis on alternative products – which he described as the fastest-growing sector of the UCITS space (albeit still a niche market). A general shift is underway, he noted, as large institutions are moving from investing in non-European domiciled investment funds, to seeking regulated products in Europe.

With so much capital available in Europe, Christian postulated, the question is how to raise capital and overcome some of the obstacles that fund managers will encounter. "There is tremendous opportunity to raise assets in Europe, tempered by Brexit, of course," he stated.

Grappling with Brexit

Historically, the first step for non-E.U. managers has been to set up a marketing operation in London as a platform to market throughout Europe, Christian explained. "Obviously that practice will be changed with

Brexit," he anticipated.

Heffner proceeded to describe the process and issues surrounding Brexit that have created uncertainty for fund managers. Under Article 50 of the E.U.'s charter, the U.K.'s exit from the E.U. involves submitting notice to the E.U. of the country's intent to leave. This notice will trigger two years of negotiations over the terms of the country's exit, after which the nation will automatically be out of the union unless the European Commission members unanimously vote to extend the two-year period.

Britain's prime minister, Theresa May, recently announced that she expects to submit notice and trigger the Article 50 negotiations by the end of March 2017, Heffner noted. If the notice is delivered in accordance with May's timeframe, the U.K. will be on its way to leaving the E.U. by March 2019. One factor driving this timing, he postulated, is the desire by some within the Conservative Party to get the Brexit issue out of the way in advance of Britain's general election in May 2020. (Since the date of the conference, however, a U.K. legal decision may have complicated this timeline.)

Uncertainty for Cross-Border Structures

While acknowledging that it is impossible to know in advance what course negotiations will take, Heffner said that certain things are likely to happen given the existing legal structure.

Once the U.K. leaves the E.U., it will no longer be subject to European laws and will be a third-country jurisdiction – similar to the U.S. – unless it voluntarily subjects itself to those laws by joining the European Economic Area (EEA) or entering into another similar special arrangement with the E.U.

A hard Brexit – where the U.K. leaves the E.U. altogether – would cause E.U. management companies to lose their passports into the U.K., Heffner anticipated, as would also happen with U.K. advisers currently passporting into E.U. member states. The U.K. might permit those foreign firms to continue managing U.K. funds, he noted, but that would depend to a great extent on the treatment U.K. firms received.

Heffner surmised that U.K. companies serving as management companies to European UCITS funds will need to make other arrangements. He described ways to minimize the impact of a hard Brexit on those funds by, for example, having them appoint a new European management company. Another option would be to convert the funds into self-managed funds operating as their own management companies and delegating some functions back to the U.K.

UCITS Passporting Rights

The treatment of UCITS structures will be interesting, Heffner noted, as UCITS is an E.U. directive, offering a couple of different passports between E.U. member states. One of them, which is not widely used, enables a company to passport its UCITS management company services all over Europe. The other, which is widely used, is a passport to other E.U. member states to market the fund products themselves, he added. See our two-part series addressing considerations for hedge fund managers launching UCITS funds: "Liquidity, Transparency and Performance Considerations" (Dec. 10, 2015); and "Distribution and Operational Due Diligence Considerations" (Dec. 17, 2015).

Heffner predicted that U.K.-domiciled UCITS funds would lose their ability to be passported into the rest of Europe in the absence of EEA membership or a special deal. By contrast, he highlighted the Alternative Investment Fund Managers Directive (AIFMD), which has the potential for a third-country passport actually built into its legislation, although this passport has not yet been "turned on." Because no such provisions exist for UCITS funds, primary legislation would be necessary to make this possible for British UCITS vehicles on a Europe-wide level, he noted. See our two-part series on the latest ESMA recommendation concerning the extension of the AIFMD passport: "ESMA Limits Positive Recommendation for AIFMD Passport Extension to Only Five Non-E.U. Countries; Excludes U.S., Citing Uneven Playing Field" (Aug. 4, 2016); and "Causes of ESMA's Recommended Delay to Extend AIFMD Passport and Its Impact on Non-E.U. Fund Managers" (Aug. 11, 2016).

"U.K. funds would therefore need to be privately placed as alternative investment funds (AIFs), because upon the U.K.'s exit they would convert – from an E.U. perspective – from UCITS to AIFs," Heffner noted. To avoid having this occur, U.K. UCITS vehicles could redomicile or establish an E.U. clone.

MiFID II

Under the revised E.U. Markets in Financial Instruments Directive (commonly referred to as "MiFID II"), Heffner noted, there is a new third-country regime that may prove highly useful in this context. MiFID II is set to come into effect on January 3, 2018, well in advance of even the earliest possible Brexit. See "FCA Acting Chief Calls for Hedge Fund Managers to Take Greater Responsibility for Implementing MiFID II" (Feb. 18, 2016).

Under MiFID II, if the European Securities and Markets Authority (ESMA) declares the U.K. equivalent to the E.U. in terms of its regulatory framework, then U.K. firms will be able to register with ESMA on a one-time basis and market their services to professional – but not retail – clients. It will effectively be similar to operating with a passport, and the firms will be in basically the same position they are in now with regard to cross-border marketing.

Politics may factor into ESMA's decision to agree to such concessions, Heffner cautioned. "I think that one of the Brexit negotiating points may be ensuring that ESMA reaches its appropriate determination," he commented, adding "it would not require any change in law, but it would make a big difference in terms of the UCITS distribution landscape, among others."

See "ESMA Chair Outlines Rulemaking Authority and Implementation of MiFID II" (Jul. 14, 2016); and "MiFID II Will Affect Market Structure, Registration and Soft Dollars for Hedge Funds Trading in Europe" (May 19, 2016).

Marketing E.U. Funds in the U.K.

With regard to E.U. fund access to the U.K. market, passporting rights would be lost following Brexit, unless U.K. law is amended to allow marketing of non-U.K. UCITS funds to continue. However, Heffner noted that the U.K. has traditionally been generous when it comes to allowing foreign funds to be marketed to professional and institutional investors within its borders. Even under current U.K. law, it is possible for some foreign funds to register with the U.K. Financial Conduct Authority for marketing to the general public in the U.K. if it has certain investment restrictions in place, goes through an approval process and pays a filing fee.

UCITS funds would almost automatically meet the U.K. access restrictions, Heffner noted.

Heffner concluded on a positive note, predicting that European UCITS funds – many of which are managed by U.K. firms – should be able to continue to be marketed in the U.K. following Brexit. "We frankly expect that the U.K. government would allow E.U. UCITS funds to continue to be marketed in the U.K.," he said.

Operating in Luxembourg

Seimetz described how some fund managers are already choosing to establish operations – including their management companies and funds – in Luxembourg in order to ensure access to the E.U. markets. With that said, he acknowledged that some may find the process of redomiciliation of a U.K. entity to Luxembourg to be too complicated and therefore rather opt to set up a new Luxembourg entity, which he estimated would be considerably easier than redomiciliation. Depending on how the Brexit negotiations go, he added, some fund managers may opt to keep their existing U.K. entities and continue using them, probably in a delegation model from the E.U. (using a third-party E.U. management company in case the manager will not establish its own E.U. management company) to the U.K. – thus avoiding having their own Luxembourg solution.

See our two-part series on the Luxembourg RAIF Structure: "Access to AIFMD Passport and Marketing to E.U. Investors for Non-E.U. Hedge Fund Managers" (Apr. 21, 2016); and "Marketing Options and Tax Benefits for Non-E.U. Hedge Fund Managers" (Apr. 28, 2016).

Another option is for a fund manager to establish a "portfolio manager" in Luxembourg. "A portfolio manager is in the category of what we call the MiFID firm," he commented, adding that a portfolio manager license permits a manager to also act as a broker and an investment adviser. It is also possible to add a license for fund distribution, he noted. Seimetz did, however, caution that pursuing only the portfolio manager approach subject to MiFID will not allow those entities to act as UCITS management companies or alternative investment fund managers (AIFMs).

See "Luxembourg Fund Structures Evolve to Meet the Needs of the Private Fund Industry" (Oct. 13, 2016); and "Luxembourg Funds Offer Options for Hedge Fund Managers to Access European and Global Investors" (Feb. 11, 2016)

A preferred solution, Seimetz highlighted, would be to obtain a UCITS management company license (with AIFM extension) that would permit the recipient to manage both UCITS and non-UCITS vehicles. This may be comparatively easier and more efficient, he noted, than trying to use an AIFM license (with UCITS extension). However, either approach will subject the fund manager to fewer requirements than if it established an operation to act as a third-party AIFM or UCITS management company. These third-party approaches involve much higher levels of detail, he cautioned, as well as having more employees and infrastructure in place.

Seimetz acknowledged once again the possibility of keeping the U.K. operations in place as at least a part of the operation, for instance through a sub-delegation of portfolio management to the U.K. entity. He pointed to recent visits to the U.K. by Luxembourg's top officials, who have emphasized their wish to cooperate on cross-border funds matters. Luxembourg's leaders want to ensure that Brexit happens as smoothly as possible and is not too painful for businesses, because cooperation between the U.K. and continental Europe in the business realm is generally preferable to non-cooperation.