Brexit : Times are changing (again)

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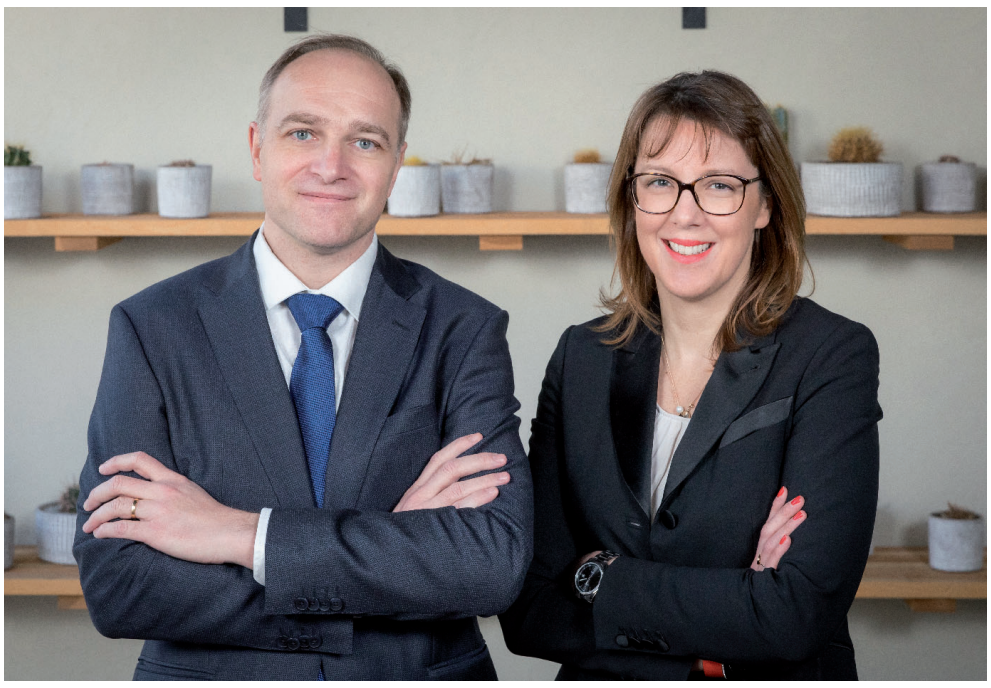
Four months after the triggering of the article 50 of the Treaty of the European Union («EU») by Theresa May, negotiations for the exit of the United Kingdom («UK») from the EU do not seem to have made significant progress given that the respective delegates on both sides of the negotiation table have very differing views on the matters of priority to be discussed and agreed upon. Unless the parties can reach agreement on the numerous pertinent items that remain to be dealt within the limited two year period for which the clock has already started, it has to be said that the very idea of having either a «hard» or «soft» Brexit (which was the main point of discussion up until a few weeks ago) may itself begin to appear an impossibility.



The inefficient progresses and delays are currently affecting the asset management industry despite a promising global trend for increased investment in alternative assets. Only very recently have fund managers had to adapt to the new regulatory paradigm created by the alternative investment fund manager directive («AIFMD») which many have already experienced as being a burdensome transition.

UK licensed AIFMs, UCITS management companies and MiFID firms who are accustomed to the EU-wide passporting available under the various EU Directives, will again have brace themselves for change and adapt to the change in their status vis-à-vis their EU based funds under management and investor base.

What will change for an authorized alternative investment manager?

From the options that were available to asset managers at the time of the adoption of the AIFMD, many have chosen to benefit from the management and marketing passport which enables an AIFM licenced in any EU Member State to passport their management services and market their funds across EU Member States via a simplified notification process with their home state regulator.

A removal of the UK's access to the single market will mean that UK licensed AIFMs will no longer benefit from this EU-wide passport with respect to their cross-border operations in any other EU Member States. Similarly, AIFMs established in any EU Member State who have been availing of the passport to manage UK funds or to access UK based investors with their EU based funds.

It must be remembered however, that for the licensed AIFMs that are domiciled in any of the 27 remaining EU Member States, there will be limited impact and these managers will be able to continue availing of the EU-wide passport with respect to the remaining 27 EU Member States.

If they are managing UK funds or marketing their EU based funds into the UK however, they will need to obtain the requisite authorization in the UK, according to new rules that are expected to be adopted by the UK Parliament and in such cases, will become subject to newly applicable regulatory and private placement requirements as far as cross-border operations with the UK are concerned. The burning question is whether the UK regulatory regime (which were quite flexible prior to the introduction of the AIFMD) will revert to the previous «light-touch» regime or indeed become more restrictive and protectionist in favour of UK products and investors.

In the case of licensed AIFMs domiciled in the UK they will be able to continue their activities in the UK but they will no longer be authorized to manage EU funds or to market UK or EU funds in the 27 remaining EU Member States on the sole basis of their previous UK AIFM authorization.

These managers, if they wish to continue accessing the single market, may need to consider a restructure which itself must be thought through in detail in light of the operational infrastructure and human resources that will need to be in place before a new AIFM authorization can be obtained from any of the 27 remaining EU Member State regulators.

What are the most favourable options for UK authorized AIFMs?

Relying on the third-country regime? Since 2008, the EU permita non-EU based firms to access the single market provided that they can be recognized as subject to an equivalent prudential regime in their home country. This regime is known as the 'third country regime' («TCR»). While not all EU legislation contains TCR provisions, the AIFMD does. One possible option for the UK based AIFMs would thus be to remain operating from the UK on the basis of the TCR. However, the TCR also comes with a number of drawbacks.

First, the equivalence test referred to above will not be an automatic or stream-lined process and will be carried out by the EU regulators that will rely entirely on their judgment and will have ultimate discretion in their final decision-making.

Secondly, the TCR as it will apply in the UK will need to be aligned with the AIFMD will continue to evolve over time and will thus need to adapt to ensure sure that the prudential framework (notably the enforcement rules) remain equivalent.

Thirdly, a cooperation agreement will need to be signed between the relevant market authorities ensuring reciprocity in favour of the EU based AIFMs will need to be ensured in the UK and any dispute will always need to be submitted to the jurisdictions of the EU based courts. It must also be said that the equivalence test can be withdrawn at any time and is therefore not a certainty. Last but by no means least, the TCR is limited in scope meaning that the UK asset managers would be limited to marketing and/or managing EU based AIFs with the exclusion of UCITS since the UCITS Directives do not foresee TCR provisions.

Alternative? UK based managers could begin the process of relocating their operations to Europe by first opening a branch in the EU. Commencing with such a worst-case scenario is the safest approach in light of Brexit because it paves the way for a clear and certain restructuring plan for fund managers and their marketing strategy. There is now less than a two-year window (which will close on 30 March 2019) remaining for those UK asset managers who wish to run operations in continental Europe to leverage on the cross-border EU passport by setting up a permanent establishment in an EU member state availing of the still-existing passporting possibility.

This option offers the advantage of a gradual relocation thereby minimizing related costs and resources required to operate AIFM activities in the EU to a minimum. At a later stage, when «hard» Brexit looms large, it would then advisable to convert the EU based branch into an EU subsidiary. Again, the conversion of the branch into a subsidiary can be undertaken in a smooth manner thanks to EU merger rules that would avoid any adverse legal, regulatory or tax impact.

Once settled within the territory of the EU, is there a possibility to continue interacting with the UK-based teams and business units? The asset management industry is familiar with organizational structures operating from different places in the world where global asset management firms create «centres of expertise».

Multiple allocation of functions with cross-border delegation of certain functions is therefore already very common. The EU representatives are conscious of the critical need of those expertise centres but warn against the risk of EU regime circumvention based on the multiple delegation of asset management functions to UK-based business units. Indeed, the UK based asset managers may be tempted to open up a structure in the EU territory which would delegate back most of the functions to the UK parent in order to alleviate the structural costs of the re-domiciliation.

It would be a common sense approach for those groups to continue performing investment management or investment advisory functions in and from the UK pursuant to delegation arrangements. Over the summer, ESMA (13 July 2017 ESMA 34-45-344) issued guidance in the form of principles that will support regulatory convergence between all the 27 remaining EU Member States in the context of UK firms relocating in Europe.

The aim is to avoid potential regulatory arbitrage that could arise from UK asset managers seeking to minimize the transfer of effective performance of their AIFM activities in the EU by continuing to rely heavily on the staff and resources remaining in the UK based on delegation and outsourcing arrangements. ESMA urges the EU National Competent Authorities to pay special attention to the potential proliferation of letter box entities within the EU in order to continue to perform the core activities of the AIFM/UCITS management in the UK.

The ESMA guidance *dedicated to the supervisory convergence in the area of investment management in the context of the UK withdrawing from the EU* provides very comprehensive details on the manner in which asset management functions are relocated to Europe in the wake of Brexit. Notably, ESMA encourages the National Competent Authorities to place particular scrutiny on the UK-based investment advisers. One statement that has drawn our particular attention is the risk of advisory functions being re-qualified as pure investment management functions.

ESMA is of the view that «*where authorized entities appoint third party to provide investment advice and base their investment decision on the advice provided by a third party without carrying out their own qualifies analysis before concluding a transaction, such arrangements are to be considered as delegation of investment management activities(…)It is not sufficient to check whether the investment proposed by the investment advisers would breach investment restrictions*» and ESMA concludes that an own qualified analysis should be carried by the EU authorized UCITS/AIFM manager after the receipt of the investment advice.

ESMA further insists on on-going monitoring, on-site due diligence visits, the existence of written policies and reporting lines and ESMA even provides an example of where it would be objectively questionable to authorize delegation of investment advisory to a UK-based advisers when the real estate properties of the AIF are located within the EU territory.

Conclusion

Ironically, Theresa May's Lancaster House speech of 17 January 2017 provided a lot of relief to the asset management industry which was eager to start working on the possible options. The famous «*better no deal than a bad deal*» sets a goal for the Brexit project managers.

Working on the basis of a hard Brexit by drawing up business plans and projected forecasts is the most tangible way to move forward. There are structural options available and to some extent, Brexit will give the whole asset management industry a better picture on the level of tolerance of the EU supervising authorities on cross-border delegation arrangements notably on the boundaries of investment management *versus* investment advisory.

We expect that the impact for investors of the AIFM restructures should be minimal as the burden of the reorganization will in any case be borne by the AIFM. It is likely that the investor protection provisions under the AIFMD and other current EU regulations will continue to apply in a similar manner for UK funds, especially as current UK legislation will continue in force until such time as it is repealed and replaced by new national laws adopted by the UK Parliament.