Brexit

What alternative asset managers can expect

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On 23 June 2016, the British public voted to leave the European Union after 43 years of membership. Although the results of the referendum are not binding in law and there remains a possibility of a constitutional challenge, the early indications from Prime Minister Theresa May and leading figures within the ruling Conservative Party are that the United Kingdom will proceed with the so-called Brexit. This article considers how Brexit might affect alternative asset managers in the United Kingdom and the US.

Article 50 procedure

The process for a member state exiting the EU is set out in Article 50 of the Treaty of the European Union. Article 50 prescribes that a member state that decides to withdraw must first formally notify the European Council (‘Article 50 Notice’). Following the Article 50 Notice, the European Council will draw up the guidelines for the negotiations of the withdrawal agreement between the EU and the United Kingdom. Once negotiated, the withdrawal agreement must be adopted by a qualified majority of government ministers representing the remaining EU member states after obtaining consent of the European Parliament. The Article 50 Notice also sets a two-year period running, so that an eventual Brexit will occur at the earlier of: (1) the conclusion of the withdrawal agreement; or (2) two years following the Article 50 Notice.

If no agreement has been reached by the end of the two-year period, the negotiations can be extended for a further two years, but only with the unanimous consent of the remaining member states. Alternatively, the United Kingdom will leave the EU with no separation terms in place. The United Kingdom has not yet given the Article 50 Notice, but EU officials have indicated that 1 Jan. 2019 should be the target date for Brexit.

Future financial services regulation

Much of the UK financial services legislation, including the regulatory regime for asset managers, is derived from EU Directives. As an EU member state, the United Kingdom is also subject to a number of EU Regulations which have a direct effect in all member states. During the negotiation process, the United Kingdom will remain a member state of the EU and will continue to be bound by EU law (including the domestic legislation incorporating EU Directives). To this end, the UK Financial Conduct Authority (‘FCA’) has emphasised that it expects FCA-regulated firms to abide by their obligations derived from EU law and continue with their implementation plans for EU legislation that is not yet in effect. Such implementation plans would include, for example, compliance with the revised Markets in Financial Instruments Directive (‘MiFID’) framework known as MiFID II, due to take effect from January 2018.

Exactly how the future UK legal and regulatory landscape might be impacted by Brexit will only become clear once a formal approach to exit negotiations has been drawn up and the nature of the relationship that the United Kingdom will seek to maintain with the EU post-Brexit is known. If, as some commentators suggest, the United Kingdom were to opt to become a member of the European Free Trade Association (‘EFTA’) and part of the European Economic Area (‘EEA’), similar to Norway, it would be required to comply with any existing and future EU financial services legislation (without the ability to formally influence such legislation) in return for the right to benefit from the access to the common market for financial services.

Another alternative might be some form of ‘equivalence’ status for the purposes of certain aspects of EU financial services legislation. In this scenario, the United Kingdom would likely retain the overwhelming majority of existing EU-derived legislation and implement the key elements of any relevant future EU legislation.

As a major financial centre, the UK has historically contributed significantly to the shaping of EU financial services legislation. Moreover, a large proportion of recent EU financial legislation originates from G20 commitments made in the wake of the financial crisis. Accordingly, it is doubtful that the United Kingdom would rush to repeal material portions of existing EU-derived legislation regardless of what relationship (if any) it negotiates with the EU. At the same time, a full separation or a new relationship with the EU might present the United Kingdom with both an opportunity to repeal or replace unwanted legislation and greater flexibility to tailor current regulations to the interests of the UK financial services industry post-Brexit.

Impact on UK asset managers

Two key EU Directives shape the regulatory regime applicable to UK alternative asset managers: Alternative Investment Fund Managers Directive (‘AIFMD’) and MiFID. Both Directives contain a passporting regime for cross-border services within the EU and establishment of branches in other member states based on the principle of common market access embedded in EU legislation. The AIFMD and, from 2018, MiFID II also include a so-called ‘third country’ regime which gives access to EU markets to non-EU firms on the basis of an equivalence determination (that is, where such firms are subject to equivalent regulatory supervision in a non-EU jurisdiction).

Position of UK AIFMs

The AIFMD contains two types of passporting regimes: a management passport and a marketing passport. A UK manager may currently utilise the management passport to act as the alternative investment fund manager (‘AIFM’) of, for example, an Irish or Luxembourg fund. The marketing passport is currently only available in respect of EU-domiciled funds managed by an EU manager and has not been used widely by the alternative management community, as most alternative investment funds (‘AIFs’) are established outside the EU (e.g., Cayman Islands). The European Securities and Markets Authority (‘ESMA’) has been charged with advising the European Commission on the

possible extension of the marketing passport to third countries. To this end, ESMA continues to work on its equivalence assessments of various third countries and is expected to produce further advice on a number of key fund jurisdictions (including the Cayman Islands) this year.

If the Brexit negotiations result in the United Kingdom having continued access to the common market (and, accordingly, retention of the passporting rights), there will be no post-separation change for alternative investment managers. If UK managers lose passport rights as a result of Brexit, the United Kingdom should be in the position to secure a third country equivalence status for the purposes of both management and marketing passports. Specifically, if the Commission chooses to extend the marketing passport to AIFs established in the Cayman Islands and also agrees to grant UK (as the domicile of the AIFM) equivalence status, UK AIFMs will have access to the third country marketing passport for their Cayman AIFs in the same way as managers from other non-EU jurisdictions which may be deemed 'equivalent' by the Commission (e.g., US managers marketing Cayman funds). Equally, if UK AIFMs are deemed subject to equivalent supervision, they will be able to continue acting as AIFMs of Irish and Luxembourg AIFs.

The third country regime under AIFMD would effectively put UK managers in the same position as now, including compliance with the whole of AIFMD. To benefit from the third country regime, a UK manager will also need to register with a regulator of another EU member state (e.g., Ireland) as its 'member state of reference'. It is unlikely that other aspects of the third country regime, including the appointment of a full depositary for the Cayman AIF, would present a significant challenge given that both UK AIFMs and depositaries are currently subject to the UK law implementing the provisions of AIFMD.

MiFID investment services

UK managers authorised to provide MiFID services (e.g., portfolio management, and reception and transmission of orders) typically utilise the MiFID cross-border passport to offer managed account services to institutional investors in those EU member states where the local regime does not exclude activities of overseas firms from the scope of the licensing requirements. Some MiFID authorised firms also utilise the MiFID passport to provide distribution services in respect of UCITS and AIFs in countries where such passport is required as an alternative to local licensing as a broker or placement agent.

As with AIFMD, there would be no change to MiFID passporting rights if the United Kingdom were to retain access to the common market post-Brexit (e.g., as an EEA member). If the United Kingdom loses its passporting rights following the withdrawal, UK managers may be able to provide MiFID services to professional clients in the EEA based on an equivalence determination made by the Commission and subject to a requirement to register with ESMA. As noted above, the United Kingdom will be required to implement MiFID II during the withdrawal negotiation period and, accordingly, the regulatory regime applicable to investment firms in the United Kingdom will be the same as in the remaining EU member states.

UCITS and AIFM platforms

Post-Brexit, it is likely that UK managers will also be able to continue providing portfolio management services to UCITS and AIFM platforms based in Ireland and Luxembourg, even if the United Kingdom does not become an EEA member and does not benefit from equivalence status under the third country provisions. Such platforms are typically structured as either an Irish or Luxembourg self-managed fund (e.g., an Irish ICAV) or a fund with a regulated Irish or Luxembourg management company. Both jurisdictions currently allow non-EU managers to provide such services, subject to the approval of the local regulator. Continued access to such platforms will also secure the ability of UK managers to distribute UCITS funds and AIFs to EU investors under the passporting provisions contained in the UCITS Directive and AIFMD.

Impact on US managers

It is unlikely that Brexit will have a direct impact on US managers that do not have UK-based affiliates. US managers who have registered their AIFs under the national private placement regime in the United Kingdom will be required to continue complying with its conditions, such as initial investor disclosures (e.g., an AIFMD disclosure supplement to the private placement memorandum), periodic reporting (including annual reports with remuneration disclosures), and Annex IV reporting. Depending on the terms of Brexit (i.e., whether it retains access to the common market), the United Kingdom may be in the position to relax its marketing restrictions in the future and revert to the pre-AIFMD marketing regime.

The ability of US managers to provide portfolio management services to UCITS and AIFM platforms established in the remaining EU member states will depend, as now, on the local regulatory regime of the relevant EU member state, as described above (i.e., there will be no change).

Impact on UK and US CLO managers

Potential Brexit has also raised concerns about the continued ability to offer CLOs to investors in the EU. Under the current EU securitisation framework, certain EU-regulated investors (such as banks, fund managers and insurance companies) are unable to invest in CLOs unless the risk retention requirements contained in the relevant EU Directives have been met.

There are two permissible options for a compliant risk retention vehicle in the context of CLOs. The first option is the 'originator' model which has been utilised widely by UK and US CLO managers. For these purposes, an originator of a CLO structure is a person that acquires credit exposures from a third party and then securitises them, subject to certain conditions being met.

The second option is the 'sponsor' model. A sponsor is, broadly, an investment firm established in the EU and authorised under MiFID to conduct certain types of investment activities. Although the 'sponsor' model has been utilised widely by European financial institutions, the applicable MiFID authorisation and regulatory capital requirements have made this structure less feasible for US managers and UK managers not affiliated with large financial institutions.

Unless the withdrawal negotiations result in the United Kingdom remaining a member of the EEA, UK collateral managers will no longer be eligible to act as 'sponsors'. Conversely, the 'originator' does not need to be an entity established in the EU and, as such, the 'originator' model would continue to be available to UK and US CLO managers under the current EU securitisation regime.

That being said, the EU securitisation framework is being revised. The current legislative proposals

tighten the eligibility conditions applicable to originators, including a possible requirement for the originator to be an EU entity subject to some form of regulatory oversight. If implemented, these changes will have a significant impact on the structuring of future CLO transactions and may also affect existing deals sold to EU investors.

Derivatives documentation

Until further details of the post-Brexit regulatory framework are known, it would be difficult to predict the impact on the ISDA Master Agreement and OTC derivatives trades. It is unlikely that Brexit would directly trigger an Event of Default in the standard 1992 or 2002 versions of the ISDA Master Agreement. At the time of writing, we are not aware of any Brexit termination events being negotiated into ISDA Master Agreements. However, the likely economic ripple effect of Brexit (e.g., credit downgrade termination events in relation to rated institutions, such as prime brokers) could trigger termination events.

The Governing Law and Jurisdiction provisions of the now more common 2002 version of the ISDA Master Agreement provides an exclusive jurisdiction clause to English-law-governed agreements entered into between EU counterparties and the reciprocal recognition of judgments handed down by a court in an EU member, including UK court judgments, across the EU. This position is unlikely to change in the event of Brexit, even if the United Kingdom does not become an EFTA/EEA member. EU courts will continue to give effect to the contractual parties' choice of law in accordance with the Rome Regulations. English courts have historically respected contractual choice of law and jurisdiction, and this approach is not likely to change in the future.

OTC derivatives regulation emanated from a global G20 initiative and has been implemented in the United States under Dodd-Frank and the EU under the European Market Infrastructure Regulation ('EMIR'). As an EU Regulation, EMIR takes direct effect in the United Kingdom. Post-Brexit, it is uncertain what elements of this regulation would remain applicable or adopted as UK law. As with other EU legislation, parts of EMIR rely on cross-border recognition and authorise the European Commission to recognise the arrangements and legal framework of non-EU countries as being 'equivalent'. Given the global regulatory initiative and the nature of the derivatives market which relies on cross-border recognition, it is expected that such recognition would be a part of EU and UK exit negotiations, as both sides would be keen to address regulatory inconsistency and potential jurisdictional arbitrage.

Taxation

Membership of the EU has had a substantial influence on the development of UK tax law. EU Directives and Regulations have been incorporated into UK domestic law and so become part of the UK tax system, most notably in the case of the United Kingdom's participation in a common European VAT regime for cross-border supplies of goods and services. The United Kingdom has also transposed a number of EU Directives related to cross-border payments and the provision of financial information, such as the Interest and Royalties Directive, the Parent/Subsidiary Directive and the EU Savings Directive.

Decisions of the European Court of Justice have also brought about changes in UK tax law to ensure its compliance with EU fundamental freedoms, such as the free movement of workers and capital and freedom of establishment. UK law in the areas of group loss relief, double tax relief and controlled foreign companies ('CFCs') has been significantly altered by the need to ensure its compatibility with these fundamental principles of the EU.

In considering the impact of Brexit, however, it should be recognised that rules derived from EU tax law are only a part of the UK tax system. The UK has an extensive network of bilateral double tax treaties (including with those countries that remain EU member states) and is also subject to other international agreements in the area of tax information reporting, such as FATCA and the OECD Common Reporting Standard.

The immediate UK tax impact of Brexit is therefore likely to be limited. In principle, the non-applicability of the Interest and Royalties Directive and the Parent/Subsidiary Directive might lead to the imposition of withholding taxes on cross-border payments made to or by UK companies, but this will remain dependent on the terms of any applicable double tax treaty.

What may be more significant is the flexibility that Brexit will give for the United Kingdom to diverge from EU tax law in the future. For example, whilst the United Kingdom will clearly need to maintain a UK VAT system (or at least an equivalent sales tax), Brexit will give the United Kingdom the freedom to set its own VAT rates and determine which supplies should be treated as exempt or zero-rated. Brexit should also permit the United Kingdom to adopt its own rules in areas such as transfer-pricing and CFCs in ways that might have been struck down as discriminatory and contrary to the fundamental freedoms had the United Kingdom remained subject to the jurisdiction of the EU.

The fact that the United Kingdom will now have a much diminished role in the development of EU tax law and policy should also not be forgotten. In the past the United Kingdom has been very active in seeking to influence EU tax measures in defence of the United Kingdom's interests — one notable instance being the negotiations on the proposals for an EU financial transactions tax — and will lose that influence following Brexit.

Conclusion

The full impact of the potential Brexit on the UK legal and regulatory regime will remain unknown until the terms of the United Kingdom's future relationship with the EU have been defined. What is clear is that there will be no overnight changes. Once the negotiations on the separation have commenced, it is likely to be a slowly evolving process. This will allow asset managers sufficient time to plan, mitigate any risks and adapt to the forthcoming changes well before they come into effect. The negotiation process is also likely to present asset managers with unparalleled opportunities to engage with trade bodies and UK policy makers and to contribute to the shaping of the future legal and regulatory environment in which the alternative asset manager community operates. **THFJ**

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