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Brexit: what might change
Investment Management

Introduction

On 23 June 2016 the UK population voted for the UK's exit from the European Union (EU). The applicable exit procedure and certain possible legal consequences of Brexit for Investment Management will be discussed below in the form of a Q&A.

In the short term, we do not identify material changes for the legal practice. The European law and regulations will remain in force until the negotiations between the EU and the UK have been completed and the withdrawal procedure has come to an end. To which extent European law and regulations will also apply following the UK's exit from the EU, will largely depend on the outcome of the negotiations. One of the fundamentals of the EU is the internal market, allowing for the free movement of goods, services, workers and capital (Internal Market). In this context we note that in January 2017, Prime Minister May announced that the UK will opt for a "hard Brexit", meaning that the UK will no longer maintain membership of the Internal Market, nor accede to any associated status. Instead, the UK will seek a free-trade deal with the EU outside the Internal Market.

Brexit – background

Since 2007 (Treaty of Lisbon), the EU Treaty offers a Member State an explicit legal basis to leave the EU (Article 50 TEU). Pursuant to Article 50(2) TEU, the UK can start the exit procedure by giving notice to the European Council. The exit agreement will be concluded on behalf of the EU by the Council[1], acting upon a qualified majority[2] and after having obtained the consent of the European Parliament. The agreement must set out the arrangements for the UK's exit and take account of the framework for the UK's future relationship with the EU. The UK cannot participate in the relevant discussions or decisions of the European Council or Council.

The EU Treaties cease to apply to the UK from the date of entry into force of the exit agreement or, if there is no such agreement, 2 years after the date of notice under Article 50 TEU, unless the European Council, in agreement with the UK, unanimously decides to extend this period. The exit procedure has never been called for and the way forward is full of uncertainties. Apart from Article 50 TEU, no further provisions or guidelines apply.

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1 The Council consists of a representative of each Member State at ministerial level, who may bind the government of the Member State in question and cast its vote (Article 16 TEU).

2 The qualified majority shall be defined as at least 72 % of the members of the Council representing the participating Member States, comprising at least 65 % of the population of these States (Article 238(3)(b) TFEU).

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Q&A – Investment Management

How can UK AIFMs access the EU market post-Brexit?

Option A: Access on the basis of NPPRs
First of all, the AIFMD provides for a third-country private placement regime. Pursuant to Article 42 of the AIFMD, Member States may, on the basis of their national private placement regimes (**NPPRs**), allow non-EU AIFMs to market interests in AIFs they manage to professional investors, provided that such non-EU AIFMs must at least comply with the AIFMD related transparency rules. Other applicable conditions would not be controversial from a UK angle as they relate to not being listed as a non-cooperative country by FATF and having cooperation agreement in place between financial regulators (i.e. between the UK Financial Conduct Authority (**FCA**) and the regulator of the Member States in which the relevant AIF is to be marketed). That being said, some EU countries (e.g. Germany and France) pose additional conditions to those set out above (such as appointment of a depositary and/or local paying agents) while others (like Italy) simply ban the marketing of non-AIFMD compliant funds. Only a fairly limited number of European countries (Belgium, Luxembourg, the Netherlands and Ireland) have adopted a NPPR without gold plating any of the terms of Article 42 of the AIFMD. The knock-on effect for a UK AIFM post-Brexit would therefore be that it would have to review for each country what the conditions are for marketing.

Option B: Access on the basis of an EU marketing passport
The second option is that UK AIFMs will obtain an EU marketing passport for non-EU AIFMs. This requires however a positive decision to that extent by the European Commission (the **Commission**) based on a prior “equivalence test” carried out by the European Securities and Markets Authority (**ESMA**). So far ESMA has assessed 12 countries, and delivered positive advice for 5 of these. In its most recent advice of 18 July last, ESMA however suggested that the Commission may wish to wait with taking a decision on the EU marketing passport until ESMA has delivered positive advice on a sufficient number of non-EU countries. It is quite likely that the Commission will follow ESMA’s suggestion and will request a further review by ESMA. So, as of yet, it cannot be ascertained if and when the EU marketing passport will be available. If an EU marketing passport is introduced for non-EU AIFMs, we would expect that such passport will also be afforded to UK managers as long as the UK keeps the AIFMD implementation framework in place or introduces very similar legislation. It is good to note that a UK AIFM that would like to market on the basis of an EU marketing passport (once available) will still need to be authorized by the local regulator in its “Member State of Reference” (to be determined on the basis of a number of factors), will have to comply with the AIFMD (including the depositary requirements) and will have to establish a legal representative in its Member State of Reference to act as a contact point for the relevant regulator. Lastly, any disputes between the UK AIFM or the AIF managed by it and EU investors will have to be settled in accordance with the law of, and made subject to the jurisdiction of, a Member State.

Remaining question is whether UK managers can still opt to market interests in AIFs on the basis of NPPRs, once the EU marketing passport is available. ESMA's understanding is that this would be possible, at least during a certain transitional period. However, it has indicated that it sees merit in clarifying this issue.

Option C: Authorised EU subsidiary
If marketing on the basis of NPPRs or EU marketing passport is too cumbersome or not available, UK AIFMS may set up an EU domiciled affiliate and have such affiliate AIFMD authorized. Such authorised affiliate obviously has full access to the EU on the basis of the AIFMD passport and in its turn could delegate the portfolio management to the UK AIFM. As an alternative for setting up an authorised affiliate one could retain the services of an authorised third party EU AIFM under a so-called “rent a ManCo strategy”. These structures are becoming increasingly popular for non-EU AIFMs that wish to have pan-EU access but lack the resources for setting up their own authorised EU AIFM.

How can EU AIFMs access the UK market post-Brexit?

This again depends on what form Brexit will take. If the UK becomes part of the EEA, access will be immediate but, if not, it will depend on future national UK law whether or not EU AIFMs are allowed to raise funds in the UK and if so, under what conditions. However, given that the UK has clearly indicated that it is keen to keep access to the EU market, it seems unlikely that the UK will unilaterally block access to the UK for authorised EU AIFMs. This of course may be different if the EU marketing passport for non-EU AIFMs will ultimately not be introduced.

Q&A – UCITS

Post-Brexit, a UK UCITS manager would lose its pass porting rights under the UCITS directive. As a result, UK licensed UCITS management companies/managers would not be able to manage and market UCITS freely throughout the EU.

Will UK UCITS lose their UCITS status post-Brexit?

Under the UCITS Directive, a UCITS must be EU domiciled and can only be managed by an authorised EU UCITS manager. Hence, if the UK leaves the EU, any UCITS managed by UK managers will lose their UCITS status (and will be treated as AIFs) and hence will no longer be marketable to retail investors on the basis of a passport. From a marketing standpoint, the requalification as an AIF has the effect that those funds will only be marketable in the EU on the basis of NPPRs or, when available, the EU marketing passport for non-EU AIFMs (please be referred to ‘*How can UK AIFMs access the EU market post-Brexit?*’).

The loss of the UCITS status is also likely to result in those funds being no longer marketable in non-EU jurisdictions, where they have so far been accepted for marketing on the basis of a NPPR which grants access to UCITS funds.

Another notable knock-on effect of a requalification of UK UCITS to AIFs is a potential breach of investment restrictions by parties that are invested in such UCITS. This is particularly relevant for regulated investors, such as insurance companies and UCITS that in their turn are invested in such former UK UCITS. As these investors

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are subject to strict asset allocation requirements, such requalification will require them to most likely have their interests in any such funds redeemed.

A way around to the above adverse effects would be a mutual recognition of UK funds being deemed “UCITS compliant” in return for the UK retail market being accessible for EU UCITS. This is likely to be on the negotiation table between the EU and the UK.

How can UK managers access the EU market post-Brexit?

In contrast to AIFMs, a third country regime extending the passport to third country managers is not available for UCITS. Therefore, a UK UCITS manager wishing to operate under an EU passport would need to set up an EU domiciled selfmanaged UCITS or a UCITS managed by an EU management company (with potential delegation of portfolio management to the UK investment manager). As most UCITS are set up as either Luxembourgish or Irish structures the fact that the fund must be EU domiciled is not the most pressing. For those funds that are set up as a UK entity a cross-border merger with an EU UCITS would be a possible solution.

As to the management of the UCITS, setting up a regulated EU domiciled UCITS management company and delegating back portfolio management back to the UK entity would be a sound solution. Alternatively, also for UCITS managers one could make use of the services of third party management companies under a “rent a ManCo strategy”, similarly to those as for AIFMs as described in paragraph *‘How can UK AIFMs access the EU market post-Brexit?’* (Option C) above.

How can EU managers access the UK market post-Brexit?

The possible marketing of UCITS funds to UK based retail investors will entirely be left to UK law (with expected guidance from the FCA). That being said, with the UK being the largest European market for distribution of Irish, Luxembourgish and other EU UCITS funds, one could expect that the EU and the UK will agree on mutual recognition of UK funds being deemed UCITS compliant in return for the UK allowing EU UCITS to be marketed in the UK to retail investors.

Q&A – MIFID

MiFID will be replaced by a new set of harmonized rules (known as **MiFID II/MiFIR**). MiFID II/MiFIR is due to be implemented by the Member States by January 2018 which is most likely well before Brexit becoming effective. Under MIFID II/MiFIR, non-EU investment firms, providing investment services, such as investment advisory or individual portfolio management services, to investors in the EU, will be able to benefit from a third-country regime. Below, we will set out the possibilities for UK firms to provide investment services to clients in the EU under such third-country regime.

How can UK firms provide investment services to clients in the EU post-Brexit?

Option A: registration with ESMA (only for investment services to professional clients)
After a Brexit, UK firms will be able to provide investment services to eligible counterparties and per se professional clients (hereinafter: professional clients) in the EU, if the

Commission has taken an equivalence decision in respect to the UK (please be referred to 3.2 for our expectations in that respect). In that case, UK firms can register themselves with ESMA. Once the UK firm has been registered by ESMA, it may provide investment services to professional clients throughout the EU. UK firms that are registered with ESMA no longer come within the scope of MiFID II/MiFIR and CRD IV/CRR. They should inform their clients that they are not authorized to provide services to clients other than professional clients and that they are not subject to supervision in the EU. In addition, they must offer to submit any disputes in relation to their services to the jurisdiction of a court or arbitral tribunal in a Member State.

Option B: establish a branch (only for investment services to retail clients, but EU passport for investment services to professional clients)
Whether or not UK firms can establish a branch to provide investment services to retail clients (including opt up professional clients, i.e. clients who may be treated as professional clients on request) will depend on the Member States in which such retail clients reside. If such Member State has implemented the branch requirement (as intended by the Netherlands), the UK firm can open a branch in such Member State after having obtained an authorization from such Member State. The authorization does not provide for an EU passport for the provision of investment services to retail clients. It does however provide for an EU passport for the provision of investment services to professional clients, but only if the Commission has taken an equivalence decision in respect to the UK.

Option C: in accordance with national regimes
In the absence of an equivalence decision in relation to the UK, the conditions upon which a UK firm may provide investment services to professional clients continue to depend on the national regimes of the Member States. Even so, if a Member State has not implemented the branch requirement (as intended by Germany), it will depend on the national regime of such Member State whether or not the UK firm may provide investment services to retail clients in such Member State.

Option D: set up of EU subsidiary
A UK firm can choose to set up a EU subsidiary that will obtain a MiFID II authorization from the competent authority in the Member State in which it is established. The EU subsidiary will subsequently be able to provide investment services to professional and retail clients throughout the EU based on an EU passport. The EU subsidiary can delegate certain tasks and responsibilities, e.g. portfolio management decisions, to the UK firm without such UK firm coming in scope of MiFID II/MiFIR. The EU subsidiary and UK firm should only enter into a delegation agreement in accordance with the provisions under MiFID II (e.g. the UK firm should have the knowledge and capacity to conduct the tasks and responsibilities, the EU subsidiary should have possibilities to monitor the outsourced activities, etc.). If the outsourced activities concern portfolio management for retail clients, certain additional requirements apply, unless the competent authority does not object to the outsourcing arrangement following notification of such arrangement.

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Will the Commission ever take an equivalence decision in relation to the UK?

The Commission can take an equivalence decision if the legal and supervisory arrangements of a third country are equivalent and such third country provides for an effective equivalent system for recognition of EU firms. Given that it is quite unlikely that the UK will have left the EU before the implementation deadline of MiFID II, the UK will still be required to implement MiFID II. We therefore expect UK law to be equivalent (if not entirely similar) to EU law by the time a UK break up from the EU materializes. A minor remark in that respect is that MiFIR does not have to be implemented, since MiFIR is a regulation that has direct effect in all Member States. After a break up, MiFIR will no longer have direct effect in the UK, as a result of which the UK may have to introduce legislation in order to ensure that its legislation is equivalent to MiFIR. It is difficult to predict at this stage, whether the UK will provide for an effective equivalent system for recognition of EU firms. It will depend on future national UK law whether or not EU firms are allowed to provide investment services in the UK and if so, under what conditions. Even if equivalence and reciprocity can be established in relation to the UK, it will still be the Commission that has to initiate the equivalence and reciprocity assessment.

Member States can indicate their interest that a certain third country is subject to such assessment, but such indications are not binding on the Commission. We would however expect that the Commission prioritizes the equivalence and reciprocity assessment in relation to the UK, if pragmatism prevails.

What next?

Once the UK invokes Article 50 TEU, the UK and the EU will negotiate the terms of Brexit. It will be a highly political process and the outcome is as yet unclear. Therefore it is of the utmost importance to monitor the developments and the potential impact on your company's position closely. We will keep you informed about further developments.

Please contact your trusted adviser at Loyens & Loeff or send an e-mail to Brexit@loyensloeff.com if you have any queries.

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