Brexit: Impact on asset managers and investment funds

June 2018
The industry faces potentially the single biggest impact on cross-border financial services in a generation — Brexit. Considered an unlikely event in early 2016, the UK’s exit from the EU is now fast approaching.

Brexit is not just about the future of London as a financial centre or of the UK-based asset and fund management industry. Firms within other EU Member States (“EU27”) and elsewhere will be affected.

Progress has recently been made in the political negotiations, but key issues remain to be resolved. However, the regulatory analysis for asset managers and investment funds, and the attendant Brexit risks to their operations remain largely unchanged from our analysis in 2016. Indeed, the European Commission issued papers in February 2018 that confirmed our analysis.

Much business takes place from and to the UK via EU regulatory passports. For funds and management companies (ManCos) the key passports are in the UCITS(1) Directive and the AIFMD(2). For the provision of asset management services, the MiFID II(3) passport is king. It also regulates the distribution of fund and asset management services. The passports work differently in all three directives and their loss would have different impacts in the retail and professional market places.

**Equivalence — a poor substitute**

There is a diversity of “third country” provisions under different pieces of EU legislation and some have no formal “equivalence” regime. The provisions in MiFID II, AIFMD and the UCITS Directive are all quite different, for example.

Equivalence regimes cover only a subset of the activities that currently benefit from passports for EU firms. Therefore, unless the final trade agreement between the EU and the UK includes arrangements for UK firms to continue to benefit from all EU passports (which, politically, seems unlikely), Brexit will result in EU27-UK cross-border business being prohibited or restricted.

Moreover, gaining equivalence status is neither a singular nor a one-off process for a third country — it requires a different judgment for each piece of legislation and those judgments are subject to review at any time.

ESMA(4) has said that the EU framework for third countries is not fit for purpose and requires overhaul. In fact, there is no generic framework, with different arrangements in different pieces of legislation — which are a mixture of equivalence, endorsement, recognition or passporting — or no arrangement at all. Also, it is time- and resource-intensive, requiring detailed assessments of third countries’ regimes and lengthy negotiations if a country is not initially judged equivalent.

A number of MEPs(5) have joined the call for a fundamental review of third country provisions.

It will though, be a major drafting and practical task to bring about greater consistency of approach. In the meantime, firms and market entities will wish to factor into their business planning that the third-country provisions of today may look rather different in a few years.

---

**Implications of the loss of the three key EU passports:**

**UCITS**

UCITS are by definition EU-domiciled funds with EU-domiciled ManCos. Therefore, absent a specially negotiated deal and changes to UCITS legislation, UK UCITS will no longer be UCITS and UK ManCos will no longer be able to be ManCos for EU27 UCITS.

EU27 UCITS invested in UK UCITS may have to divest, unless UK-ex-UCITS are accepted as “equivalent”.

There is no obvious regulatory reason why EU27 UCITS should be prevented from marketing to UK retail investors. However, if UK UCITS can no longer be sold into the EU, there is a political risk that EU27 UCITS will no longer be able to access UK retail investors.

**AIFs**

Unlike the UCITS Directive, both AIFs and AIFMs may be EU or non-EU. Therefore, in theory, there is nothing at EU level to prevent EU27 AIFs continuing to be sold into the UK (and vice versa), or for EU27 AIFMs to manage UK AIFs (and vice versa).

However, the AIFMD non-EU passports have not been introduced and a number of the EU27 do not have, or have very restrictive, private placement regimes. If UK AIFs cannot be sold into these countries, there is a political risk, albeit small, that AIFs domiciled in those countries will not be able to be marketed into the UK.

Some Member States allow UK retail AIFs to be sold to retail investors in their country, and vice versa. Again, there is a political risk of these arrangements being disrupted.

**Investment management of funds**

Both the UCITS Directive and AIFMD allow the investment management function to be delegated, provided there is still “substance” in the home Member State.

ESMA is promoting a common understanding of the substance requirements for UCITS ManCos and AIFMs. It has also called for the disparate third country regimes in EU legislation to move to a common approach. Brexit adds political momentum to both these debates.

**Investment management of separately-managed accounts**

Under MiFID II, UK firms should be able to continue to provide investment management services to EU professional clients. However, the client may itself be subject to national rules that restrict its choice of investment manager (e.g., some pension funds). This is mainly an issue for UK-based investment managers, but, again, there is a political risk of similar issues for EU27 firms that provide investment management services to UK professional clients.

In the wealth management arena, EU27 firms may not be able to market their services to UK clients, and vice versa.

**Distribution**

MiFID II also regulates the distribution of funds and investment management services. The common practice of sales people moving freely between UK and EU27 will be curtailed.
Delegation practices under scrutiny

With the issuing of an opinion by ESMA in May 2017 on principles for the supervisory approach to the relocation of activities from the UK to elsewhere in the EU, followed in July 2017 by more detailed sector-specific opinions, a further and significant issue has arisen: the future regulatory approach to delegation.

ESMA says that no reliance should be placed on firms’ existing authorisations and there should be no derogations or exemptions.

The European Commission says that “the future departure of the EU’s currently largest financial centre means that supervisory arrangements must be strengthened to ensure that financial markets continue to support the economy on an adequate and sound basis.”

The Commission proposes to mandate ESMA to review the arrangements of firms that intend to make extensive use of delegation or outsourcing to third countries. It would amount to second guessing national regulators’ views and has moved to centre stage the practice of domiciling a fund in one EU member state and delegating the investment management function to the UK or elsewhere. For further details on the proposals and their progress, see EAMR Chapter 5.

ESMA has sought to reassure the industry. Its chair, Steven Maijoor, said in March 2018 “we are not looking to question, undermine or put in doubt the delegation model. We know that this is a key feature of the investment funds industry and that the flexibility to organise centres of excellence in different jurisdictions has contributed to the industry’s success.” He said that ESMA is seeking to address the risk of letterbox entities and that the opinions “simply clarified what this means in practice and what factors have to be taken into account when assessing whether there is sufficient substance.”

Neither is there is any indication that ESMA’s new powers would be applied retrospectively, but it seems inevitable that the detailed rules on delegation under the AIFMD will be extended to UCITS. The Commission said the lack of harmonisation between AIFMD and the UCITS Directive makes it challenging to interpret the two directives “with the same spirit”.

When coupled with the upcoming review of AIFMD and consideration of the future shape of the EU’s third country regimes, fund managers around Europe may have to reconfigure their business models.

UK trade agreements with non-EEA(6) countries

The day of Brexit will not be the end of the story. The UK will need to negotiate new trade agreements with non-EEA countries where it currently benefits from EU agreements. The time gap in securing these agreements will impact firms in the UK, across Europe and more widely.

For example, business is currently done between the UK and Switzerland under Switzerland’s trade agreement with the EU. Post-Brexit, this business will be uncertain until the UK agrees a new trade deal with Switzerland. Not only will UK and Swiss firms be affected: other firms (within the EEA or elsewhere) with operations in both the UK and Switzerland, and which depend on that border remaining open, will be impacted too.

Many other Brexit issues to navigate

In addition to the three main regulatory passports, EU investment and fund managers benefit from a number of other passports, protections and activities that will be impacted by Brexit. Here are just a few:

Post-Brexit, UK financial instruments and UK regulated markets will no longer be EU/EEA instruments and markets.

A number of professional clients are required to be predominantly invested in EU/EEA financial instruments or to trade via EU/EEA regulated markets.

Investment managers will have to adjust these clients’ portfolios.

As the investment banks adjust their operations, so the capital markets, market liquidity and trading venues will change and evolve. The front offices of investment managers will have to adapt to these changes and they may have to change their internal dealing support systems.

Even if firms do not relocate any of their operations (from or to the UK), they will have to navigate contract law, employment law and tax law issues: for example, what will happen to VAT arrangements for EU27 members with operations in the UK? What impact will there be on the process for tax treaty claims?

Some EU27 members route data via the UK and then on to other destinations (e.g. the US). How will this work post-Brexit under the EU General Data Protection Regulation, which includes specific extra-territoriality provisions?
To read the full Evolving Asset Management Regulations report visit kpmg.com/eamr