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## Brexit for Fund Managers: Time for Cool Heads

The UK electorate voted to leave the European Union (EU) in the “Brexit” referendum held on 23 June 2016. This note looks at the practical impact of a Brexit for fund managers, including possible solutions in the event that the UK ceases to form part of the European Economic Area.

### Introduction

Despite the results of the UK referendum, the UK has not yet formally made the so-called “Article 50 notification” triggering exit negotiations. The outcome of those exit negotiations, which could take several years, is uncertain. Ultimately, the UK may, or may not, end up remaining in a modified European Union relationship, or the European Economic Area (the “EEA”), and continue to be part of the single market. But there is reason for optimism, even if the eventual result is that the UK ceases to form part of the EEA. Although it is sensible to make contingency plans, from a regulatory perspective at least there are potential workarounds for managers in the UK and elsewhere, which could avoid any need to dramatically restructure offerings or relocate businesses.

There are mechanisms in place in the Alternative Investment Fund Managers Directive<sup>1</sup> (“AIFMD”) which could potentially be utilized in order for UK-based managers to continue to have access to professional investors across the EEA—and which presuppose that EEA-based managers would continue to have access to UK investors. A number of other pieces of European legislation, such as MiFID II<sup>2</sup>, contain “equivalence” regimes or similar systems which could lead to reciprocal arrangements between the UK and the EEA covering areas such as advice, portfolio management and custody.

### Background

This note does not discuss the multiple possible models of relationship which the UK may have with the EEA post-Brexit. We have previously written in detail on those models in a note that is available [here](#), and have separately analyzed in detail the potential impact of a Brexit on various legal areas (available [here](#)). We also do not focus further in this note on MiFID II, since we have previously discussed that—and the possibility of equivalence determinations—in a note available [here](#).

Instead, this note focuses on the AIFMD and the UCITS Directive for fund managers in the context of the two possible overarching outcomes: (1) the UK remains a member of the EEA and (2) the UK is no longer part of the EEA (regardless of what that the relationship looks like once the UK is “out” of the EEA).

<sup>1</sup> Directive 2011/61/EU

<sup>2</sup> Directive 2014/65/EU

## Executive Summary

This summary assumes that no special 'deal' is negotiated between the UK and the EU.

- *UK remains a member of the EEA:* very little changes for fund managers (wherever located). Hypothetically, the UK would have less of a say in future European legislation affecting managers.
- *UK leaves the EEA and is a "third country":*
  - *AIFMD for UK fund managers of UK/EEA funds:*
    - Strong possibility of passports being extended to the UK as a third country.
    - Marketing under EEA private placement regimes an alternative.
    - Marketing to UK investors likely not adversely affected (within the UK's power).
    - If passports not extended to the UK, managers of EEA funds may consider operating under delegation from an EEA-based AIFM/self-managed fund, enabling them to carry on day-to-day management as sub-managers, while also benefitting from the passports.
  - *AIFMD for EEA fund managers of UK/EEA funds:*
    - Marketing to UK investors – any changes are within the UK's power. Presents an opportunity for reciprocal access arrangements to be agreed with the EEA.
    - Management of UK funds – any changes are within the UK's power. Presents an opportunity for reciprocal access arrangements to be agreed with the EEA.
  - *AIFMD for non-EEA fund managers:*
    - Marketing to UK investors – any changes are within the UK's power. We would not expect adverse changes as a result of Brexit.
    - Management of UK funds – any changes are within the UK's power. We would not expect adverse changes as a result of Brexit.
  - *UCITS for UK managers:*
    - UK-domiciled UCITS funds cease to be UCITS and are instead treated by the EEA as funds that are subject to the AIFMD (as to which, for marketing, see above).
    - Marketing of UK funds to UK investors – any changes are within the UK's power. We would not expect adverse changes as a result of Brexit.
    - Marketing of EEA funds to UK investors – any changes are within the UK's power. It presents an opportunity for reciprocal access arrangements to be agreed with the EEA.
    - UK management companies of EEA funds may consider operating under delegation from an EEA-based management company/self-managed fund, enabling them to carry on day-to-day management as sub-managers, while also benefitting from the marketing passport.

- *UCITS for EEA managers:*
  - Marketing to UK investors – in principle, EEA UCITS funds would not benefit from the UCITS marketing passport in order to access UK investors (unless the UK agreed to continue this arrangement). Changes are within the UK’s power. Presents an opportunity for reciprocal access arrangements to be agreed with the EEA.
  - Management of UK funds – any changes are within the UK’s power. Presents an opportunity for reciprocal access arrangements to be agreed with the EEA.
- *UCITS for non-EEA managers:* Any such managers will already be operating under delegation from an EEA-based management company or from a self-managed UCITS. Depending on where that management company and the UCITS are based, see above under “UCITS for UK managers” or under “UCITS for EEA managers”, as applicable.

### **The Negotiated Exit – UK Remains a Member of the EEA**

Unless the relationship between the EU and the EEA was to vary considerably from the current set-up, as a member of the EEA, the UK would continue to have access to the single market and managers would still be subject to the AIFMD, the UCITS Directive and MiFID/MiFID II (as applicable). Essentially, very little would change for fund managers—whether those managers are located in the UK, in Europe more widely, or are based outside of the EEA.

In theory, though, the UK would be less involved in the development of future legislation promulgated at the EU level (and which then applies to EEA managers by virtue of the EEA framework agreement). This is the argument that the UK loses its ‘seat at the table’ by leaving the EU but remains part of the EEA. That future legislation potentially would include any that comes out of the holistic review of AIFMD currently scheduled to start in 2017, but in respect of which final legislative acts (AIFMD 2) could take a number of years to come to fruition.

But the extent to which, if at all, any such future laws are problematic for the UK, or for fund managers more generally, is impossible to predict at this stage. Similarly it cannot be known whether the laws and regulations ultimately passed would have been any more favorable for fund managers had the UK remained part of the EU, or whether as an EEA member the UK would be able to have an informal role in the development of those laws and regulations.

### **The Negotiated Exit – the UK is out of the EEA**

#### **1. AIFMD**

The starting position is that, in a worst-case scenario where the UK is outside of the EEA and in the absence of some sort of special deal, the UK would be treated as a “third country” like the US, Singapore, Hong Kong or any other non-EEA country. As a result, UK managers of EEA funds would no longer be able to automatically utilize the marketing and management passports which the AIFMD provides to EEA managers. That includes the extended Article 6(4) MiFID-type services passport, which MiFID II formalized through an amendment to the AIFMD.

Equally though, EEA managers of EEA funds also would not automatically have a right to passport into the UK or to access UK investors under AIFMD, and could potentially have to work around national UK marketing restrictions such as the “overseas persons exclusion” (if continued).

*Private Placement Regimes*

Unless and until the passports are extended to the UK (discussed below), UK fund managers seeking to raise capital from EEA investors would need to rely on the various private placement regimes that exist across the EEA. In some countries such as Luxembourg, Ireland and the Netherlands, those regimes are relatively benign and, given that UK fund managers are already well-used to the AIFMD's disclosure and reporting obligations, would not impose any material burden on those managers. In some other countries, such as France, Germany and Italy, marketing by way of private placement is more difficult or is practically impossible. UK managers would either need to go through the process of making applications to local regulators—which if possible at all can take time, and be burdensome—or rely on reverse solicitation or other exemptions.

The UK would, in principle, be able to change its own private placement regime to make it easier or harder for non-UK fund managers to market their funds into the UK. It seems unlikely that the UK would unilaterally elect to limit the marketing of funds into the UK further, in the absence of some tit-for-tat political reasons for doing so, although some softening of the rules is possible (and would be welcomed by many US and other non-EEA fund managers).

*AIFM in an EEA Member State*

An alternative to relying on private placement regimes, for UK managers of EEA-domiciled funds, would be to establish a new entity in an EEA member state (such as Ireland or Luxembourg), or use an existing entity in an EEA member state, to act as alternative investment fund manager ("AIFM") of the EEA-domiciled fund. Depending on its legal form, the EEA-domiciled fund may even be capable of becoming the AIFM itself, by becoming a self-managed fund. That AIFM could then, in principle, delegate much of the day-to-day management of the fund back to the UK manager (now a sub-manager). Provided that the AIFM does not delegate so much that it becomes a so-called "letter-box entity," the fund would be capable of benefitting from the marketing passport.

A variation of this approach is for the fund to appoint an independent third party as AIFM, with that independent third party then delegating much of the fund management back out to the non-EEA manager. This is a model that already exists and is used by a number of managers located outside of the EEA. One downside of this approach for some third country managers arises from the fact that they operate under delegation; the fund is not "their" fund, at least legally. The AIFM must, for example, be able to terminate any sub-manager where necessary in the interests of the fund to do so. There are, therefore, contractual risks in such an arrangement.

In addition, a UK fund manager's regulatory permissions may need to change (since it would, as a delegate, be carrying on a number of MiFID-regulated activities that it may not currently have permissions for as part of its FCA authorisation). The rules to which such a manager is subject in the UK may change as a consequence. But in terms of overall regulatory impact, a UK fund manager would, as a delegate, not be subject to any materially different level of burden to which it is not already subject. Indeed, it may find itself subject to a less burdensome regime.

*Extension of Passports to the UK – a Likely Solution?*

The UK—like all non-EEA countries—would, in principle, be able to have the AIFMD marketing and management passports extended to it. In order for that to happen, ESMA would need to provide positive advice

in relation to the UK, and the Commission would then have to adopt a delegated act in order to extend the passport to the UK.<sup>3</sup>

To issue positive advice in relation to the UK, ESMA would need to be of the view that there are no significant obstacles regarding investor protection, market disruption, competition or the monitoring of systemic risk, which would impede extending the passport to the UK<sup>4</sup>. It is a similar—but not identical—approach to that of “equivalence” under MiFID II.

Importantly, if ESMA concludes there are no significant obstacles to extending the passport, it must issue positive advice to the Commission. The Commission, for its part, is required to adopt a delegated act having received positive advice from ESMA, but taking into account itself the circumstances and criteria to extend the passport.

ESMA has already issued positive advice in relation to Guernsey and Jersey, and has essentially also given positive advice in relation to Switzerland (subject to certain legislative steps being taken). Further advice on nine other countries was expected by June 30, 2016, although at the time of writing such advice has not been published.

Were the AIFMD to be retained in the UK as implemented, it seems improbable that the UK would not qualify for the passport extension. Its rules would essentially be identical, in pertinent part, to those in EEA jurisdictions. Even if the UK were to fine-tune aspects of the AIFMD as implemented in the UK, regulation of fund managers in the UK would still likely be more closely aligned to regulation in the EU than other countries which may benefit from the passport extension. So, again, one might reasonably expect positive advice to be forthcoming.

#### *Extension of Passports to the UK – Timing*

There is a question of timing, since it has taken some time for ESMA to research and provide positive advice in relation to other third countries. To date, the AIFMD passports have not been extended to any third countries.

Yet the UK should be an easy jurisdiction for ESMA to assess and provide advice for. As Steven Maijor, Chair of ESMA, noted in October 2015 in relation to ESMA’s assessments of third countries, ESMA considers it important to “make a distinction between the very different situations of non-EU countries in terms of such factors as the demand for the passport, the access to the market of these non-EU countries for EU funds and managers, and their regulatory framework as compared to the AIFMD.”<sup>5</sup> Assuming that the UK does not change its laws to restrict access to UK investors of EEA funds and managers, the UK would presumably score very highly on each of these criteria: the demand would be expected to be high, the UK would offer reciprocal access and the UK’s regulatory framework would have implemented the AIFMD.

<sup>3</sup> Article 37, AIFMD

<sup>4</sup> Article 67(4), AIFMD

<sup>5</sup> At the time of writing, available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1535\\_econ\\_scrutiny\\_hearing\\_aifmd\\_passport\\_opening\\_statement\\_steven\\_maijor.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1535_econ_scrutiny_hearing_aifmd_passport_opening_statement_steven_maijor.pdf)

*Extension of Passports to the UK – Member State of Reference*

Were the passports to be extended to the UK, it is worth noting that the AIFMD envisages that each UK manager would be required to have a “Member State of Reference,” being one of the EEA Member States. In order to obtain the passport, the UK fund manager would need to apply to the regulator in that EEA Member State for authorisation. The manager would also need to have a legal representative established in that Member State in order to act as the interface between the regulator and the manager, and between EEA investors and the manager.

The need for a separate regulatory application, and the legal representative requirement, would impose additional burden on UK fund managers which would not exist if the UK remained in the EEA. But one would hope that EEA regulators would look favorably on applications from FCA-regulated fund managers in light of the equivalent rules that apply to such fund managers. The impact of the legal representative requirement is hard to assess at this stage since it does not yet exist (because the passport has yet to be extended), although it is similar in concept to a regime which exists in Switzerland for marketing and which has not proven particularly painful or expensive for most fund managers. But this additional burden may be considered a pill worth swallowing for the passport, if the alternative is re-structuring fund products and re-locating businesses and staff.

**2. UCITS**

Many UK fund managers currently manage Undertakings for Collective Investment in Transferable Securities (UCITS) funds, which are governed by the UCITS Directive<sup>6</sup>.

*Two Key Requirements*

UK managers may manage UK or other EEA-domiciled UCITS funds. A UCITS fund is subject to a number of requirements but two are of critical importance for the purposes of this note: first, a UCITS fund must itself be domiciled in the EEA. Second, a UCITS fund must have a management company which is regulated as such in the EEA, assuming that it is not self-managed. The majority of management companies are located in the same EEA country as the UCITS funds that they manage. Unlike under the AIFMD, there is no mechanism in the UCITS Directive for extending the regime, or passports, to third countries. The UCITS Directive is legislation for, and only for, EEA funds and management companies.

*Managers of UK UCITS*

In the absence of a negotiated special deal or status, if the UK exits the EEA then what were previously known as UK UCITS funds will cease to be governed by the UCITS Directive. They will no longer be UCITS funds for EU law purposes. While for UK purposes those funds are very likely to continue to be capable of being marketed in the UK (and we note that the majority of UK UCITS funds are marketed largely to UK investors), they will lose the ability to be marketed across the EEA by virtue of—relatively—straightforward notifications, regulator-to-regulator. Instead, what was previously a UCITS fund will now be treated in other EEA countries as an AIF that is subject to the AIFMD (as to which, see above).

Equally, though, EEA UCITS funds will in principle lose the ability to be marketed into the UK under the UCITS Directive, unless the UK decides to continue to allow access to the UK market and agrees to receive UCITS-

<sup>6</sup> Directive 2009/65/EC

based notifications from EEA regulators. Although by no means guaranteed, one would hope that reciprocal arrangements could be reached by the EU and the UK in this regard to facilitate continued cross-border marketing of UCITS funds.

#### *UK Managers of EEA UCITS*

It is currently possible, although relatively uncommon, for a UK fund manager to act as management company of an EEA (non-UK) UCITS. Once the UK ceases to be part of the EEA, such a UCITS fund would need to have an EEA-domiciled management company or be self-managed (if possible according to its legal form). The considerations that apply here are very similar to those discussed above in the context of AIFMD (under “*AIFM in an EEA Member State*”). The UK manager could form a local EEA entity to act as management company, use an existing entity to act as such or look to a third party to act as management company. The UK manager would then continue to carry on the day-to-day management of the fund as a delegate.

Again, these structures exist now and are used by many US and other non-EEA managers, where most of the day-to-day management of the UCITS takes place outside of the EEA. In each case, the fund would remain a UCITS, and the marketing passport would continue to be available. While some level of re-structuring and work on documentation may be required, it may be considered by many managers to be considerably less intrusive than significant re-locations of staff and businesses into other Member States, pending the results of the UK’s negotiated exit.

For UK managers currently operating under delegation from an EEA management company of an EEA UCITS, or from a self-managed EEA UCITS, nothing changes.

### **Conclusion**

Much has been made, including by politicians, of the potential consequences for fund managers should the UK exit the EEA without any sort of special “deal.” The loss of automatic passporting rights for UK fund managers, and the possible impacts on EEA fund managers accessing the UK investor base, are real issues for fund managers that require careful analysis on a business-by-business basis.

However, it is worth considering the mechanisms and structures that already exist, under both AIFMD and UCITS, which should be of considerable use to fund managers in the UK, in the EEA and more broadly. For capital-raising of private funds, the AIFMD offers the possibility of the passport being extended to non-EEA countries, subject to an assessment of the non-EEA country’s rules and regulations. The UK would surely be a prime candidate for an extension, assuming that it does not pare back too many material elements of the AIFMD.

Furthermore, under both UCITS and AIFMD, structures have been used for some time by non-EEA managers which satisfy the requirements in form and substance for a local EEA AIFM/management company, yet allow a non-EEA manager to conduct most of the day-to-day management, and there is no reason to think that UK managers could not adopt a similar approach. Admittedly, that will not be an ideal outcome for a number of managers. It is possible that some will feel, on balance, that relocating significant numbers of staff to another EEA country will ultimately be worthwhile. But there is reason to be optimistic regardless of the results of the UK’s negotiated exit; there are already potential solutions in structures being used now, and in the legislation itself.

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