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Brexit

How Hard Is Brexit Expected to Impact Alternative Fund Managers?

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Brexit has created significant uncertainty for alternative fund managers. It remains unclear whether the E.U. and U.K. can reach a mutually acceptable agreement for a smooth transition or whether there will be a "hard" Brexit.

A recent program sponsored by the New York Alternative Investment Roundtable (NY-AIR) and the Chartered Alternative Investment Analyst (CAIA) Association, entitled "Brexit Impact on Alternative Managers: Views From Europe and the U.S.," delved into Brexit's impact on consumers and financial markets; U.K. access to the E.U.; and future regulation. Andrew Saunders, head of the New York chapter of the CAIA Association and founder of Castle Hill Capital Partners, LLC; and Adam B. Weinstein, president of NY-AIR, introduced the program and the panel. Marianne Scordel, founder of Bougeville Consulting, moderated the discussion, which featured Mikhael Ayache, Economic Counselor and Deputy Financial Counselor of the French Treasury in the U.S.; Raymond Mouhadeb, U.S. general counsel of Lombard Odier Asset Management (Lombard); and Barbara G. Novick, vice chairman and co-founder of BlackRock. This article summarizes the key takeaways from the program.

See our two-part series on the potential impact of Brexit: "Effect of Hard vs. Soft Brexit on Hedge Fund Managers" (Jul. 7, 2016); and "Hedge Fund Marketing and Distribution Opportunities in a Post-Brexit World" (Jul. 14, 2016).

Brexit – The Big Picture

The U.K. joined the E.U. on January 1, 1973, and its relationship with the bloc has always been complicated. In a June 23, 2016, referendum, U.K. citizens voted to leave the union. On March 29, 2019, at 11:00 p.m., the U.K. will have officially left the E.U. There is a surprising lack of certainty at this late date, Novick said. The situation changes day by day and hour by hour. BlackRock is looking at the Brexit process from a "deal-or-no-deal" perspective and preparing to be able to serve clients under both scenarios.

A primary goal of regulation is to ensure that products are safe and well-managed; markets are able to function smoothly; and innovation is fostered for the benefit of consumers, Novick continued. By coordinating and streamlining regulation, and creating a single market, the E.U. has benefited end investors. Regardless of jurisdiction, "what is good for the consumers at the end of the day should be paramount" in the Brexit process, Novick said.

Brexit, however, could harm investors and consumers in several ways:

- *Central Clearing of Derivatives*: E.U. participants have benefited from the London-based liquidity pool. Proposals issued by the European Commission (EC) could fracture those pools, adversely affecting investors in both the E.U. and the U.K.
- *Contract Continuity*: The Bank of England recently estimated that £41 trillion of derivatives contracts will mature after Brexit. Under current rules, counterparties would be unable to clear in the U.K. after Brexit. Similarly, it is unclear whether insurers will be able to deliver for consumers after the breakup.
- *Fund Marketing*: After Brexit, U.K. funds formed under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive will become alternative investment funds (AIFs) in the remaining 27 member states of the E.U. (E.U.27), and vice versa, which could affect all areas of fund operation and reporting depending on how the respective authorities decide to deal with this.

See "FCA Executive Director Outlines Regulator's Brexit Preparations and Expectations for Fund Managers "(Aug. 2, 2018).

The U.K. is enacting legislation to permit E.U.27 funds to continue to be sold into the U.K. on a temporary basis, but the E.U.27 has not yet reciprocated nor has the U.K. decided on its own long-term approach, Novick continued.

Fragmentation of investment pools will result in less diversity and higher costs. "It just isn't going to end well for the investors," Novick lamented. Protectionism will reduce competition and product availability and increase costs to end investors globally. The E.U. funds industry has taken great strides to broaden its reach. UCITS funds are marketed worldwide, and many foreign jurisdictions have copied the E.U. regulations that govern UCITS funds. This has resulted in economies of scale and better investor outcomes. Policymakers should look through politics and focus on what is best for end investors, she enjoined.

See our two-part series on options for post-Brexit access to the E.U.: "Cross-Border Marketing Options and the Viability of Domiciling Funds in Luxembourg" (Nov. 10, 2016); and "Domiciling Funds in Germany or Ireland, PRIIPs and UCITS Structures" (Nov. 17, 2016).

Neither the French government nor its Treasury have a direct role in Brexit negotiations, which is in the hands of the EC, Ayache noted, adding that the views he expressed are his own, not those of the French Treasury. Those negotiations, which most people expected to be far more advanced at this point, are now at a critical stage. The parties appear to be closer to agreement on the financial services industry than on other issues, such as transportation, agriculture and trade.

Following Brexit, U.K. firms will lose their passports to conduct business in the E.U.27. The only two viable options will be for the U.K. to seek an equivalency determination or for investors to choose between the E.U.27 and the U.K. in the short term, Ayache added.

See "Dechert Partners Discuss How Cross-Border European Fund Managers Can Prepare for Brexit's Momentous Regulatory Effect" (Apr. 6, 2017).

Lombard has navigated the global regulatory landscape, which has evolved over many years, developing a robust and compliant infrastructure to enable the firm to service clients through investment funds that are established in the Cayman Islands, Luxembourg and other jurisdictions from investment management offices located in the U.S., the E.U. and Switzerland, Mouhadeb said.

A U.S. fund manager should have little to worry about post-Brexit, Mouhadeb opined. There are already cooperation agreements between the U.S. and Luxembourg. The private placement regimes in the E.U. will remain available. The wider question is what happens to trading with major counterparties who have desks in London. Those counterparties will be faced with deciding whether to move to an E.U.27 jurisdiction to service E.U. business or, more likely, to balance out their businesses by establishing desks in the E.U. while maintaining their presences in the U.K.

"We should expect the end result to be that all trading relationships from a U.S. perspective remain as status quo," Mouhadeb continued. Brexit will result, however, in some fragmentation of liquidity pools. In the end, firms will have to ask if they will be able to continue trading with their counterparties and whether E.U.27 funds or investors will be able to trade through U.K. broker counterparties.

See "Navigating the Patchwork of National Private Placement Regimes: A Roadmap for Marketing in Europe by Non-E.U. Hedge Fund Managers That Are Not Authorized Under the AIFMD" (Jul. 24, 2014).

Ayache underlined that financial services were just one topic among a variety of other issues of critical importance that date to the very formation of the E.U. For example, there is significant concern over the potential creation of a new border between Ireland and the U.K. Maintenance of the peace agreement between Northern Ireland and Ireland is also a very high priority, Novick added. In addition, U.K. citizens residing in E.U.27 nations are in limbo, and vice versa, Scordel noted.

There is significant support in the U.K. for trying to reverse the decision to leave the E.U., but reversal is very unlikely, Scordel opined. E.U. leaders expect Brexit to occur, Ayache added. They see it as a matter of when and how, not if. He would not opine on whether, if the U.K. did ask to come back, the E.U. would say "yes" or "no."

End of Passporting

A firm registered in one E.U. jurisdiction is entitled to engage in certain activities throughout the E.U. through what is commonly known as a "passport," Scordel explained. The concept is embedded in both the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD). After Brexit, passporting between the E.U.27 and the U.K. will no longer be available. E.U.27 nations are now competing to attract firms that wish to leave the U.K. There is a reshuffling in progress, she said.

See "Passports, Platforms and Private Placement: Options for Marketing Funds in Europe in the Post-AIFMD Era" (Apr. 30, 2015).

Some companies, especially financial firms, are planning to leave the U.K. and move their headquarters or operations to places like Paris, Amsterdam and Frankfurt, Ayache noted. By one estimate, about 5,000 financial industry jobs are being moved. After Brexit, U.K. firms will not have automatic access to E.U.27 clients through their U.K. headquarters. "There is no uncertainty" on this result, he cautioned.

Ayache touted Paris as a good alternative for financial firms. It has a variety of financial firms with access to many clients, available liquidity and good resources, he said. The present government has taken several business-friendly measures. The corporate tax rate will decrease to 25 percent by 2022. France is also adapting its legal framework by adding a specialized court with experience in Anglo-Saxon types of contracts and offering a fast-track application process for investment firms. In addition, the International Swaps and Derivatives Association has created contract forms in French.

See "France Welcomes Foreign Asset Managers With Softened Tax Treatment of Carried Interest" (Dec. 6, 2018).

About a decade ago, BlackRock decided to increase its local presence throughout the globe, not just in Europe, Novick said. It now has 70 offices in 34 countries, including 14 in the E.U.27. It has about 1,000 employees in the E.U.27 engaged in asset management, fund administration, risk management, compliance, marketing and client services. It has funds registered in Ireland, Luxembourg, Germany and Switzerland. Despite its preference for bigger pools, local and jurisdictional issues made registration in multiple countries desirable. Because it does not use a passport to sell from the U.K. into the E.U.27, it is avoiding much of the Brexit angst. As part of its strategy to get "more local" worldwide, it will be adding an additional license and staff to an existing E.U. office.

One of Lombard's main offices is in Switzerland, which is not part of the E.U., Mouhadeb explained. It also has an office in London, where it conducts investment management activities for AIFs and UCITS funds. The funds it manages from London cannot easily be relocated because they are specific to the portfolio managers who have raised them. The portfolio managers cannot simply pick up and move to Switzerland, and in turn, Lombard cannot force investors to accept a different portfolio manager.

That said, Mouhadeb opined that inevitably either there will be cooperation agreements in place with the U.K., or in a worst-case scenario, firms will be required to repaper contracts by establishing delegation agreements between firms in the U.K. and in jurisdictions that have cooperation agreements in place, such as Switzerland or the U.S. This would enable U.K. portfolio managers to continue to manage funds from within the U.K.

See "Post-Brexit Environment Requires Fund Managers to Combine Granular Knowledge of Europe's Varied Funds Markets With Appropriately Targeted Marketing Campaigns" (Mar. 2, 2017).

Will the Swiss Model Work for the U.K.?

Switzerland has hundreds of agreements with the E.U. that offer access to the E.U. single market, easier product distribution and mutual recognition by regulators, Ayache explained. Switzerland recognizes and implements E.U. regulation and respects the so-called "four freedoms" of movement of goods, services, capital and people. It also contributes to the E.U. budget, even though it is not a member. It recently signed a €1 billion, ten-year deal with the E.U. That is "exactly what the U.K. does not want to do," he said. Therefore, it is unlikely that the U.K.'s arrangement with the E.U.27 will replicate the Swiss deal.

The E.U. also has "strong red lines" on certain aspects of its future relationship with the U.K. and will not allow the U.K. to have the best of both worlds, Ayache observed. It was the U.K.'s decision to leave, and its businesses and investors will not be entitled to the same benefits as before. There is also concern that, if the E.U. treats the U.K. differently from other third countries, it could send a message to other E.U. countries that leaving the union is not so bad.

U.S. firms establishing presences in the U.K. or in the E.U. should be concerned about the cross-border implications of Brexit, including how they will be able to transact with the U.K. or between the U.K. and the E.U.27, Mouhadeb said. Replication of E.U. rules in the U.K. to maintain the status quo is vital from a U.K. perspective. It is not clear, however, whether the U.K. will be able to cooperate with the E.U.27 in the same way that Switzerland has cooperated.

The U.K.'s short-term plan is full replication of E.U. regulation, Novick said. The real issue concerns how much the U.K. will deviate from those regulations over time and how it will react as the E.U. adopts new rules over the longer term. Switzerland is essentially a rule taker because of its decision to preserve access to the single market. The U.K. may not wish to remain a rule taker when it no longer has a seat at the table. If the E.U. does grant equivalency to the U.K., any significant deviation by the U.K. from existing regulations could jeopardize that status, Ayache added.

U.K. regulators have often blamed regulatory burdens on the fact that they are subject to the E.U. process, Scordel noted. Future rulemaking will now be entirely their own problem. Brexit could give the financial services industry a new opportunity to influence the regulatory environment in the U.K., Mouhadeb said.

See "The Changing Face of Alternative Asset Management in Switzerland" (Feb. 2, 2012).

Mutual Recognition and Equivalence

The U.K. is not asking for a mutual recognition arrangement, under which the E.U.27 would acknowledge that the U.K.'s existing regulatory regime provides adequate protections for E.U.27 firms and investors, and vice versa, Novick observed. Instead, it is asking for equivalence or "enhanced" equivalence. The U.K. is now in the process of replicating all the E.U. rules, but it is not clear whether all the rules will match as of the effective date of Brexit or whether the E.U.27 will grant equivalence.

For example, the AIFMD equivalence passport for third countries has never been used, and it is not clear whether this will be available, Novick continued. Similarly, the European Market Infrastructure Regulation permits jurisdiction by jurisdiction equivalence determinations for clearinghouses. The U.S. has already been approved, but it is not clear whether the U.K. will be approved. The process "seems to be going in reverse," she observed.

Finally, there is no equivalence regime under the UCITS Directive. All funds formed outside of the E.U. are automatically deemed to be AIFs. Therefore, after Brexit, any fund formed in the U.K. will be treated as an AIF when marketed into the E.U., as will funds created in Luxembourg or Ireland that are marketed into the U.K. During this intense regulatory process, there is "so little focus on what is good for the investors, either in the U.K. or in the E.U.27," Novick lamented.

See "What Are the Implications for Investment Managers of the Revised Prudential Framework for E.U. Investment Firms?" (Mar. 22, 2018); and "ESMA Strives to Prepare Markets As MiFID II, MiFIR and Brexit Approach" (Oct. 12, 2017).

See also our two-part series on the AIFMD passport extension: "ESMA Limits Positive Recommendation for AIFMD Passport Extension to Only Five Non-E.U. Countries; Excludes U.S., Citing Uneven Playing Field" (Aug. 4, 2016); and "Causes of ESMA's Recommended Delay to Extend AIFMD Passport and Its Impact on Non-E.U. Fund Managers" (Aug. 11, 2016).

Impact on Alternative Investments

Going forward, AIFs may have an advantage over UCITS funds because they are already more complicated and have to live by many diverse rules, Novick noted. Previously, some managers favored setting up funds in E.U. jurisdictions like Luxembourg, Ireland and Malta, rather than in the Cayman Islands, because of the E.U.'s more stable regulatory environment, Mouhadeb noted. Now, given the new complexities in the E.U., U.S. firms may be more inclined to look toward the Caymans.

Because many qualified investors are based in the U.K., a smaller manager may want to have a base in the U.K. and a presence in the E.U.27, Scordel noted. It still makes sense for a manager to set up in London and use the E.U. member state private placement regimes in jurisdictions where the manager hopes to find investors, in Mouhadeb's view.

London will remain a major financial center, including for business in the E.U.27, Ayache added. Nevertheless, given that the E.U. makes up about one-third of the alternatives market, managers should think about setting up funds there. Some firms may consider delegating fund management from the E.U.27 to the U.K. The European Securities and Markets Authority has made clear, however, that it expects firms that delegate to have "substantial activities" in the E.U. There will be no "free lunch" following Brexit, he said. It will not be possible simply to rely on London-based teams.

See "How Fund Managers Can Navigate Establishing Parallel and Debt Funds in Luxembourg in the Shadow of Brexit and Proposed E.U. Delegation Rules" (Jun. 14, 2018); and "How ESMA's Opinions on the Relocation of U.K. Financial Market Participants to the E.U. May Affect Fund Managers Post-Brexit" (Nov. 16, 2017).

Studies have already shown that U.K. domestic output is lower than it would have been had the country voted to remain in the E.U., Ayache continued. No one expects Brexit to provide an overall economic benefit to either the U.K. or the E.U.27. It is not possible to predict how it will affect the profitability of financial firms. The impact will be company specific and will depend on how it changes business models and cost structures, Novick added. Lombard is not expecting its costs to increase, as it already has sufficient infrastructure in place, Mouhadeb noted.