Proskauer

6 Months to Brexit: Implications and Contingency Planning For Fund Managers

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Introduction

The United Kingdom ("**UK**") formally notified the European Union ("**EU**") of its intention to leave the EU under Article 50 of the EU's Lisbon Treaty in March 2017. This triggered a two-year period during which the terms of the UK's exit from the EU are to be agreed. This two-year period ends on 29 March 2019.

The UK and the EU agreed on guidelines for a proposed 21-month transitional period following the 29 March 2019 exit date. Under the terms of the proposed transitional arrangements, most EU legislation (including the AIFMD) would continue to apply to the UK in the same way as it does currently until 31 December 2020. In such a scenario the short-term impact of Brexit on the UK and EU financial services sector should be minimal.

However, owing to the nature of the Brexit negotiations, nothing is agreed until everything is agreed. Consequently, there is no certainty at this time that the transitional arrangement will come into effect. In light of this possibility, it is important for fund managers that utilise the cross-border passport to take the necessary steps to ensure they have contingency plans in place to minimize the negative consequences and disruption caused from Brexit in circumstances where no transitional agreement has been agreed. Equally, irrespective of whether the transitional arrangement is agreed, firms that currently utilise the financial services passport into or out of the UK should be considering their longer-term plans on the basis that the passport would not be available after 2020.

Background to marketing under the AIFMD

Under the AIFMD, there are three broad categories of fund manager:

- full-scope alternative investment fund managers ("**AIFMs**") established in the EU;

- a sub-threshold AIFM established in the EU; and
- AIFMs not established in the EU (i.e., AIFMs whose registered office is in a country outside the EU), such AIFMs are referred to as 'third-country AIFMs' under the AIFMD.

Full-scope EU AIFMs

Full scope EU AIFMs currently benefit from the cross-border AIFMD "passport". This allows such AIFMs to manage alternative investment funds ("**AIFs**") established in any other EU Member State (as well as their own) or to market such EU AIFs in any other EU Member State. Such activities can be carried out on a cross-border services basis (i.e., from the registered office of the AIFM) or *via* a branch established in another EU Member State.

If a full-scope EU AIFM manages an AIF established in a country outside the EU then it will not be able to market that AIF in the EU under the marketing passport but would need to market the AIF in other EU Member States under the national private placement regime ("**NPPR**").[1] This process requires making notifications (and triggers ongoing reporting requirements) in each Member State into which the AIFM wishes to market its AIF.

Owing to the way in which some Member States have transposed the AIFMD into their national law, it is not always feasible to obtain NPPR approval for marketing in certain Member States; for example, in Italy, the domestic law does not allow for the making of NPPR notifications and so the only way of marketing in this jurisdiction is *via* the AIFMD marketing passport (which requires an EU AIFM marketing an EU AIF). There is also a possibility that Member States which currently permit NPPR approval for marketing in their jurisdictions change their domestic rules such that NPPR approval would no longer be feasible in the future. In circumstances where an investor in a non-feasible NPPR Member State (e.g., Italy) has requested information on a particular fund at its own initiative (i.e., there is a reverse solicitation) then it would be permissible to provide fund information to such an investor and allow the investor to invest in the fund as there would have been no "marketing" to that investor for the purposes of AIFMD.

Sub-threshold EU AIFMs

Broadly, a sub-threshold EU AIFM is a fund manager established in the EU and which has total funds under management of either less than EUR500 million (assuming all the funds managed are unleveraged); or less than EUR100 million funds under management (if any of the funds managed are leveraged).

Subject to the exception outlined in the paragraph below, sub-threshold EU AIFMs do not have the benefit of the cross-border passport and so the ability of such AIFMs to market their funds in other EU Member States is dependent on the national law of these Member States.

The exception to this general provision is where a sub-threshold EU AIFM registers its EU AIF under the European Venture Capital Funds Regulation (EuVECA) or the European Social Entrepreneurship Funds Regulation (EuSEF). In these circumstances, the AIFM will be able to market its registered AIF across the EU *via* the EuVECA or EuSEF passport respectively.

Third-country AIFMs

Third-country AIFMs are AIFMs which have their registered office outside the EU and European Economic Area[2] ("**EEA**"). These AIFMs do not have access to the AIFMD passport nor do they have access to the EuVECA or EuSEF passport (as they are not EU AIFMs managing EU AIFs). Consequently, these AIFMs can only market their funds in the EU under the NPPR regime.[3]

Impact of Brexit on Fund Managers

Following Brexit, and subject to any transitional arrangement being agreed which allows for the passport to be utilised into and out of the UK for a transitional period (potentially envisaged to be until the end of 2020), it is widely expected that the UK would become a "third-country" (i.e., a non-EEA country) and the provisions applicable to third-countries under EU legislation would therefore become applicable to UK AIFMs.

The impact of Brexit, either from 30 March 2019 (if no transitional arrangement is agreed) or from 1 January 2021 (if a transitional arrangement is agreed), on each of the three types of AIFM is set out below.

Full-scope AIFMs – impact of Brexit

UK full-scope AIFMs would no longer be able to use the AIFMD management passport nor the marketing passport. Instead the default position for such UK AIFMs is that they would need to market into other EEA Member States (where feasible) through the NPPR notifications as third-country firms. There are ways in which fund structures could be reorganised to allow greater access to the EU post-Brexit; these are summarised in the next section.

A pre-condition for marketing under the NPPR regime is the need for so-called supervisory "cooperation agreements" to be agreed between the competent financial services regulatory authority where the third-country AIFM is established (in the case of the UK the relevant competent authority is the Financial Conduct Authority ("**FCA**")) and competent authority of the EEA Member State where marketing is to be directed. If the AIF is established in a different country to that of its AIFM, then cooperation agreements need to also be agreed between the competent authority in the AIF's country and the EEA Member State where marketing is to be directed. The UK FCA has yet to agree such cooperation agreements with regulators in other EEA Member States. If this was to remain the case and if the UK was to become a third-country, then UK AIFMs would not be able to market under the NPPR process until such relevant cooperations agreements are agreed. Fortunately, the form and contents of these cooperation agreements themselves are not particularly long or complicated, so there should not be much of a delay in getting them agreed, as long as there is willingness on both sides to do so.

Full-scope AIFMs in other EU Member States would not be permitted to market in the UK or manage AIFs in the UK under the cross-border AIFMD passport because the UK would become a third-country. Such firms would need to wait to see what regime the UK Government would put in place for EU firms seeking to carry on activities into or in the UK. The UK government has proposed the introduction of a post-Brexit "Temporary Permissions Regime" for EU firms which currently passport into the UK. If such a regime was introduced it would allow EU AIFMs to continue to carry out activities in the UK for a further period of time (which is yet to be confirmed, but likely to be for a maximum of three years), without the risk of the sudden loss of access rights to the UK. This would be attractive to EU AIFMs that currently market AIFs into the UK or which currently manage UK AIFs. Further details in relation to the proposed "Temporary Permissions Regime" are set out later in this note and developments on this proposal should be monitored closely.

Sub-threshold EU AIFMs – impact of Brexit

Sub-threshold EU AIFMs do not have access to the AIFMD passport for cross-border marketing or cross-border management. Consequently, there would be no significant impact of Brexit on such AIFMs unless they had registered (or planned to register) their AIF for marketing under the EuVECA or EuSEF regimes.

For those AIFMs registered under the EuVECA or EuSEF regime, the cross-border marketing passport would no longer be available from or into the UK. If the UK Government introduced its proposed "Temporary Permissions Regime" then this may allow EU AIFMs to continue to market AIFs into the UK under the EuVECA or EuSEF regimes. However, the EU Commission has not indicated that there would be any such equivalent temporary passport offered to UK EuVECA or EuSEF AIFMs and, as such, the marketing passport rights of EuVECA or EuSEF-registered UK AIFMs would be lost.

As noted earlier, a number of EU Member States do not have any mechanism to allow sub-threshold EU AIFMs to market their AIFs in their countries. When the UK leaves the EU and becomes a third-country, UK sub-threshold AIFMs would be able to market in EU Member States under the NPPR regime currently available to third-country AIFMs. This would result in the rather strange outcome that UK sub-threshold AIFMs will gain greater access for marketing into other EEA Member States as third-country firms than it had when the UK was a member of the EU.

Third-country firms – impact of Brexit

After Brexit, the UK will (at least for the short-term) continue to apply AIFMD as implemented into its national regime. Consequently, third-country AIFMs would still need to make NPPR notifications in order to market AIFs in the UK. Brexit will therefore have little to no impact on third-country AIFMs.

Contingency Planning for Brexit for fund managers

UK full-scope AIFMs

The AIFMs that are likely to be impacted most by Brexit are UK full-scope AIFMs managing and marketing EU AIFs. To minimise the disruption caused, these UK AIFMs should be establishing appropriate Brexit contingency plans.

For the marketing of AIFs post-Brexit, the contingency planning options available to UK full-scope AIFMs are:

- Rely on NPPR regime
  - Subject to the relevant cooperation agreements being agreed, a UK full-scope AIFM should be able to market into some EU Member States under the NPPR regime.
  - As noted earlier, it is not feasible to market under the NPPR regime in some EU Member States and UK AIFM would essentially be 'shutout' from marketing in these countries under the NPPR regime. The UK AIFM would therefore need to be comfortable that future marketing activities would be restricted to those where NPPR notifications are feasible.
- Establish an AIFM in an EU 27 Member State and delegate portfolio management back to the UK
  - The UK AIFM could establish an AIFM in an EU jurisdiction (e.g., Luxembourg) and have this become authorised as a full-scope AIFM in its country of establishment.
  - The process for obtaining authorisation would vary on the characteristics of the particular AIFM, the AIFs it would manage and the EU Member State in which the AIFM will be established. Generally, the authorisation process takes approximately 6-9 months.
  - In order to receive authorisation the new AIFM would need to have sufficient personnel and resources to carry out the duties and obligations of an AIFM. In Luxembourg, for example, an AIFM would generally be required to have at least two full-time conducting officers (i.e. those responsible for the key functions carried out by the AIFM) and at least one or two additional staff members.
  - Upon authorisation, this EU AIFM would be able to market an EU AIF under the AIFMD passport going forward.
  - The EU AIFM could carry out the risk management function in relation to the AIF under management and delegate portfolio management back to the UK AIFM. This delegation arrangement would only be permitted under the AIFMD if the competent authority of the delegate portfolio manager has entered into cooperation agreements (as described earlier) with the competent authority of the AIFM. The UK would need to enter into such cooperation agreements with relevant EU competent authorities prior to the delegation arrangement being permissible.
  - Although delegation of portfolio management to third-country firms is expressly recognised under AIFMD, advice on the local law of the AIFM should be obtained to ensure that there was no additional requirements triggered by

the provision of delegated portfolio management by a third-country firm (as the UK AIFM would be post-Brexit) to the EU AIFM.

    - As the delegate portfolio manager, the UK AIFM may need to vary its regulatory permissions to allow it to carry on portfolio management activities as a standalone service.

- Establish an AIFM in an EU 27 Member State and provide investment advice to this EU AIFM
    - An alternative to delegating portfolio management to the UK AIFM would be for the EU AIFM to maintain responsibility for both risk and portfolio management of the relevant AIF and for the UK AIFM to only provide investment advice (i.e. investment recommendations) to the EU AIFM in relation to the AIF.
    - The advantage of this option is that the AIFMD does not require there to be cooperation agreements in place between the competent authorities of the AIFM and of the firm providing the investment advice. However, as the EU AIFM would be carrying on both portfolio management and risk management it is likely that more substance would be required at the AIFM compared to an arrangement where portfolio management is delegated.
    - Under this option, the UK AIFM may need to vary its UK regulatory permissions so that it is permitted to provide investment advice to the EU AIFM. Equally, advice on the local law of the AIFM should be obtained to ensure that there was no additional requirements triggered by the provision of advice by a third-country firm (as the UK AIFM would be post-Brexit) to the EU AIFM.

- Appoint a third-party AIFM in an EU 27 Member State
    - Rather than establishing its own AIFM in an EU Member State, the UK AIFM could appoint a third-party EU AIFM to manage its EU AIFs. This will allow for access to the AIFMD marketing passport for these AIFs.
    - The third-party AIFM could delegate portfolio management back to the UK AIFM or the UK AIFM could provide investment advice to the third-party AIFM which then carries out risk and portfolio management in relation to the AIF.
    - The advantage of this option is that the third-party AIFM would already be authorised to carry out the role – so the option could be implemented on relatively short notice (i.e. no need to wait 6-9 months for the EU AIFM to become authorised). Equally, the UK AIFM would not have to incur the costs associated with establishing a new AIFM another EU Member State.

- A key disadvantage to this option is that the overall management and oversight of the AIF would be carried out by the third-party AIFM (albeit in co-ordination with the fund sponsor). Equally, there would be the extra cost of the third-party AIFM's fees and certain tax and VAT-related issues to consider.

In relation to cross-border management activities, UK full-scope AIFMs that currently manage EU AIFs under the cross-border management passport would need to consider the legal regime of Member State in which the AIF is established to determine whether or not it is permissible for a third-country AIFM (as the UK AIFM will be post-Brexit) to manage AIFs in that country. For some EU Member States e.g. Luxembourg, this is currently possible; for other Member States it is not. If the cross-border AIF management is not possible post-Brexit, then a UK AIFM would need to either establish its own EU AIFM to which management of the AIF would be transferred or the UK AIFM could engage a third-party AIFM to carry out the management of the AIF post-Brexit.

Full-scope AIFM based in an EU 27 Member State

A full-scope EU AIFM managing an EU AIF can currently market in the UK under the AIFMD passport. Similarly, it can provide cross-border management services to UK AIF using the AIFMD management passport.

After Brexit, such EU AIFMs will no longer be able to use the AIFMD passport to market to investors in the UK. Such EU AIFMs would need to wait to see what regime the UK Government would put in place for EU AIFMs seeking to carry on activities in the UK. If the UK Government was to introduce its proposed post-Brexit "Temporary Permissions Regime" regime, this would allow EU AIFMs to continue to passport into the UK for a further period of time (most likely up to three years). This proposed regime is explained in more detail below.

To the extent that an EU 27 AIFM manages UK AIFs under the cross-border AIFMD management passport, this would not be possible under the AIFMD passport post-Brexit. On the basis of current legislation, in order to continue to manage AIFs in the UK, the EU AIFM would need to either:

- establish an AIFM in the UK; or
- appoint a third-party AIFM in the UK to act as UK AIFM to the UK AIF.

The above position would change if the UK government introduced a "Temporary Permissions Regime" allowing EU AIFMs to carry out managing activities in the UK for a period post-Brexit.

Proposed "Temporary Permissions Regime"

As mentioned above, the UK Government has started the legislative process for putting in place a "Temporary Permissions Regime" which would allow EEA firms and funds which respectively use a passport to access the UK market to continue to do so for a period of time after Brexit. Details of the proposed regime were published on the FCA's website[4] in July this year.

The FCA expects the Temporary Permissions Regime to be in place for a maximum of three years from the date the UK leaves the EU on 29 March 2019, within which timeframe firms and/or funds would be required to obtain authorisation or recognition in the UK.

Under the proposed regime, EEA AIFMs which currently passport into the UK and which notify the FCA of their activities will be given UK regulatory permission to carry out their activities in the UK on a temporary basis as if they were authorised in the UK. The scope of the relevant firm's permission would mirror its passporting permissions pre-Brexit and would appear on the FCA register as such. It is expected that separate legislation would be enacted in order to enable EEA AIFs to continue to be marketed in the UK during this period.

EEA AIFMs would be required to notify the FCA of their intention to use the Temporary Permissions Regime prior to the date the UK leaves the EU. Under the current proposals, it is expected that the notification window would open in early January 2019. If a notification is not submitted to the FCA prior to the UK's withdrawal from the EU, the AIFM would not be able to use the Temporary Permissions Regime. Firms which would intend to use the regime would also be allocated a "landing slot" between the date of the UK's exit from the EU and March 2021, during which they would need to submit their application for authorisation to the FCA.

The FCA intends to consult on the rules and fees applicable in respect of the Temporary Permissions Regime during autumn 2018, with the final rules published early 2019. Should there be agreement on the transitional arrangement such that the current passporting regime effectively remains in place until the end of 2020, it is not anticipated that the UK Government would take forward its proposal for a Temporary Permissions Regime.

UK Government initiatives in advance of Brexit

Brexit White Paper, a post-Brexit free trade agreement

In July 2018, the UK Government published its Brexit White Paper.[5] This called for "new economic and regulatory arrangements for financial services", which it argues would "preserve the mutual benefits of integrated markets and protect financial stability". However, the Government did acknowledge "that these could not replicate the EU's passporting regimes", meaning "the UK and the EU are not expected to have current levels of access to each other's markets".

Based on the White Paper, it is clear that the UK Government will not seek to have the passporting regime apply to the UK and to UK firms post the end of a transitional arrangement but rather would seek to agree an expanded third-country equivalence regime to apply from this time (i.e., post 31 December 2020). Such an equivalence regime could see UK and EU AIFMs being granted similar access rights to their respective markets as is currently the case under the AIFMD passport. However, such an outcome is speculation at this stage.

Publication of the UK Government's 'No Deal' Guidance

In August 2018, the UK Government published a series of technical notices setting out information to allow businesses and citizens to understand what they would need to do in a 'no deal' scenario, so that they can make informed plans. Despite the publication of these notices, the UK Government reiterated its view that a scenario in which the UK leaves the EU without a transitional arrangement in place remains unlikely, given, among other things, the mutual interests of the UK and the EU in securing a negotiated outcome.

The technical notice of particular interest to AIFMs was the "Banking, insurance and other financial services if there's no Brexit deal" notice,[6] a sub-section of which specifically covers "Financial Services Firms and Funds". This section did not set out anything particularly new for AIFMs planning for Brexit, although the UK Government did acknowledge that the need for cooperation agreements between the FCA and its counterparties in the other EEA Member States was a key requirement in order for delegated portfolio management arrangements between UK firms and EEA AIFMs to be put in place. The notice went on to state that "*the UK authorities are ready to agree cooperation arrangements with their EU counter parts as soon as possible*". It is encouraging that the UK Government has appreciated the importance of the cooperation agreements under EU legislation and is working to put them in place.

Hope for the best but prepare for the worst

While AIFMs in the UK and the rest of the EU may hope for agreement on the proposed transitional arrangement, as well as a longer-term free trade agreement in the future that would allow for a continuation of the cross-border access as is currently enjoyed by the UK and EU respectively; they should be making contingency plans to cover all potential scenarios, including a worst-case, no-deal Brexit scenario.

[1] This NPPR notification is made under Article 36 of the AIFMD.

[2] The European Economic Area is made up of all 28 EU Member States plus Iceland, Liechtenstein and Norway.

[3] The NPPR notification utilised by third-country AIFMs is made under Article 42 of the AIFMD.

[4] https://www.fca.org.uk/markets/eu-withdrawal/temporary-permissions-regime

[5] https://www.gov.uk/government/publications/the-future-relationship-between-the-united-kingdom-and-the-european-union

[6] https://www.gov.uk/government/publications/banking-insurance-and-other-financial-services-if-theres-no-brexit-deal/banking-insurance-and-other-financial-services-if-theres-no-brexit-deal#purpose

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