ALLEN & OVERY

Brexit day 1 readiness for European asset and fund managers

We examine some of the ways in which a hard Brexit will affect the EU legal and regulatory obligations of EU asset and fund managers if there is a hard Brexit.

OCTOBER 2019

As we near a potential hard Brexit, UK, EU and international asset and fund managers continue to plan for the exit of the UK from the EU single market. From a legal and regulatory perspective, the primary order of change is the loss of passporting. In our experience EU firms are now generally well prepared for this.

Second order issues then follow in two areas.

– The first is changes to UK legal and regulatory obligations arising from Brexit – these primarily derive from the UK legal and regulatory regime arising from Brexit. The UK authorities have prepared a considerable volume of materials 'onshoring' and making various changes to EU law: as a result EU firms with UK branches are generally aware of the UK legal and regulatory changes that will occur on Brexit date and have been putting in place implementation plans. Our experience is that EU firms which provide cross-border services into the UK without a branch are generally a little less well-prepared.

– The second is changes to EU legal and regulatory obligations arising from Brexit. Here, unlike in the UK, there is very little legislative change associated with Brexit – the EU has limited itself to the passing of legislation providing transitional relief in specific areas only (eg for UK CCPs and CSDs and limited changes to EMIR).

This paper draws attention to a few of the major areas of change we have identified that will affect EU asset and fund managers, focusing on EU legal and regulatory obligations.

GENERAL POINTS

As a general matter references to the EU or the EEA in European legislation will no longer include the UK, so investment objectives/restrictions and disclosures may need to be amended.

Prospectuses and other key fund documentation may need to be checked to ensure they are not stale – eg firms should consider if new disclosures are required in respect of sales to UK investors (in line with disclosures included for investors in other jurisdictions such as the US, Hong Kong etc), to reflect the impact of the UK temporary permission regime where relevant, and to reflect the changed status of UK markets and funds. The Irish regulator in particular has flagged that it may be necessary to amend the list of regulated markets in a prospectus to remove references to the UK being an EU market, or policy updates as required to clarify the geographical focus of a UCITS or retail AIF.

EU firms should consider how they can transfer personal data into the UK where relevant, given the restrictions in place under GDPR. As flagged by the FCA: "*The UK Government has taken action to ensure that if the UK leaves the EU after 31 October with no deal UK firms will continue to be able to legally send personal data from the UK to the EEA and 13 countries deemed adequate by the EU. However, the position for transfers of personal data from the EEA to the UK has not been made clear. The EU Commission stated on 13 November 2018 that an adequacy decision of the UK data protection regime is not part of its contingency planning*." [1]

International groups, as well as fund managers of EU funds, should consider if any changes need to be made to their distribution arrangements if they are currently using a UK firm to market relevant funds in their group throughout the EU – and check both new and ongoing distribution agreements to ensure any risks are mitigated (eg warranties as to a firm holding all certain licences).

Dual hatting and secondment arrangements (if any) as between an EU27 and UK firm in the same group should also be checked to ensure they are in line with local expectations.[2]

Where an EU regulator (such as the regulator in Ireland) currently accepts in practice some of an EU firm's directors or management team being located elsewhere in the EU rather than locally, it must be considered whether this position will change as regards staff in the UK once it becomes a third country.[3]

There is likely to be a step change in the focus on local substance requirements by EU regulators – including where an EU fund manager delegates day to day portfolio management to a UK firm. This is also an area of focus for ESMA, which has flagged that firms should not delegate investment management functions to an extent that exceeds by a substantial margin the investment management function performed internally.[4] It remains unclear how this point will be interpreted in practice across the EU. There are also concerns about outsourcings in respect of internal control functions, IT control infrastructure, risk assessment, compliance functions, and key management functions at minimum.

The European Commission has flagged that UCITS management companies and AIF managers may need to inform investors of the consequences of the withdrawal of the UK from the EU in certain circumstances.[5]

For example:

– In accordance with Article 22 of AIFMD, an AIFM must include in the annual report of a relevant AIF any material change to the information to be disclosed to investors.

– In accordance with Article 78 of the UCITS Directive, UCITS management companies must prepare a key investor information document or KIID whose essential elements must be kept up to date. This includes information on member states in which the UCITS manager is authorised, where the UCITS is managed or marketed cross-border.

According to Article 21 of AIFMD and Article 23 of the UCITS Directive, the depository of an EU AIF or UCITS must be located in the home member state of the fund. This rules out the use of a UK domiciled depositary, as well as an EU branch of such a depositary. For a non-EU AIF, it will only be possible to use a UK domiciled depositary if the AIF is also located in the UK and certain other conditions are met. If UK depositaries are used for other AIFs, changes may be required.

Further specific points for certain types of funds are set out below.

UCITS

Key points of impact resulting from the UK becoming a third country are as follows:

- UK UCITS funds will become AIFs under EU (and presumably national) law. This will have a number of knock on impacts such as the following:[6]
  - It will result in new restrictions on the marketing and sale of such funds in the EU.
  - Filings under local national private placement regimes (**NPPRs**) may be necessary.
  - AIFMD includes a minimum set of conditions under an NPPR for (i) third country entities (eg non-EU managers should comply with certain requirements of AIFMD such as an annual report, disclosure to investors and reporting), and (ii) for the third country (eg cooperation agreements). These would in principle need to be complied with for a UK UCITS that continues to be sold into the EU post Brexit.
  - Agreements with EU distributors and platforms may need to be revisited – eg if a relevant UK UCITS is currently listed under a particular distribution agreement as available for sale to retail throughout the EU, and/or if warranties are given as to all relevant passports being in place.
  - It may be useful to obtain local advice as to the impact on existing investors – eg how they should be dealt with in relation to future corporate actions such as a merger with another UK fund.
- EU UCITS funds will become AIFs under UK law, unless the relevant manager has joined the UK temporary permission regime. New EU UCITS funds launched in the UK post a hard Brexit will in any event need to comply with the UK AIFMD regime.
- Sales of UK UCITS to EU retail investors will become subject to the PRIIPs regime – eg from an EU perspective, they will cease to benefit from the exemption to PRIIPs for EU UCITS funds.
- Query whether it will also affect the tax treatment of holdings of UK UCITS by EU nationals under national laws.
- EU UCITS' relationships with UK securities, counterparties and service providers will need to change. Eg the Irish regulator is considering whether UK MiFID firms should be a category of eligible financial derivative counterparty for UCITS, but in the interim, it appears they will be eligible.
- Investment limits in some cases prefer EU assets and counterparties. These will cease to apply to UK assets and counterparties. In particular:
  - absent specific mention of UK markets in the prospectus, approval by national competent authorities or mention in national law, UK-listed transferable securities and money market instruments become ineligible;
  - absent an assessment of equivalence by the national competent authority UK UCITS will become ineligible "other collective investment undertakings" and even after such potential assessment will be subject to the 30% limit of a EU UCITS' investment into non-UCITS compliant funds;
  - absent a national equivalence decision relating to UK banks, deposits with UK banks will become ineligible;
  - absent inclusion of UK counterparties in the categories approved by national competent authorities, financial derivatives with UK counterparties will become ineligible; and
  - UK covered bonds will no longer be treated as covered bonds under Article 52(4), resulting in a lowering of exposure limit from 25% to 5%.

In April 2019, the Luxembourg legislator introduced a grace period of twelve months in respect of potential exclusively Brexit-related breaches of investment policies by Luxembourg UCITS and regulated AIFs. "Breaches" will not be considered as such but must nevertheless be remedied as quickly as possible taking into account the stability of the financial markets and the interests of investors. The grace period only applies to positions taken prior to the hard Brexit taking place.

In terms of UCITS funds-of-funds, in Ireland, the regulator has clarified that (at least initially) it will consider UK AIFs as eligible investments for a UCITS.[7] However, a UCITS fund will need to ensure that no more than 30% of relevant assets are invested in eligible AIFs (including UK funds). If not, it may be necessary to rebalance the UCITS' investment portfolio to ensure it continues to comply with this investment restriction.

MONEY MARKET FUNDS (MMFS)

- EU MMFs will be unable to invest in deposits with UK banks (art 12). This is because under the applicable EU regulations, EU MMFs can only deposit cash with a credit institution that has a registered office in an EU member state or a third country considered equivalent. It does not appear that any equivalence decision will be made in advance of a hard Brexit.
- EU MMFs will be unable to invest in UK STS (art 11)
- UK covered bonds will no longer be treated as covered bonds under Article 17, resulting in a lowering of exposure limit from 10% to 5%
- Reverse repos with UK counterparties will no longer benefit from the disapplication of haircut requirements under Article 2 of Commission Delegated Regulation (EU) 2018/990.

AIFS

The AIFMD requirements applicable to asset stripping will no longer apply with respect to UK investments.

The examples above are intended to illustrate that firms have work to do to enable them to meet their – largely unchanged – EU law obligations post-Brexit in connection with activities which may in some way involve the UK. This paper does not purport to give a complete overview of all relevant points.

We have prepared a separate note looking at changes in other areas, such as credit ratings and benchmarks, securitisations, MiFID II and MiFIR. If you would like a copy of this please ask your usual A&O contact.

1_https://www.fca.org.uk/firms/preparing-for-brexit

2_Eg see the Irish regulator's FAQs - https://www.centralbank.ie/regulation/how-we-regulate/brexit-faq

3_Eg see the Irish regulator's position at https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/notice-of-intention-in-relation-to-the-location-requirement-for-directors-and-designated-persons-of-irish-fund-management-companies.pdf?sfvrsn=2

4_https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf and https://www.esma.europa.eu/sites/default/files/library/esma34-45-344_opinion_to_support_supervisory_convergence_in_the_area_of_investment_management_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf. See also the Irish regulator's FAQs at https://www.centralbank.ie/regulation/how-we-regulate/brexit-faq

5_https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-asset-management_en.pdf

6_See also https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-asset-management_en.pdf

7_https://www.centralbank.ie/regulation/markets-update/issue/markets-update-issue-3-2019