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Brexit – legal consequences for commercial parties

Impact of Brexit on Asset and Fund Managers

Specialist Paper

June 2016

Issue in focus

With the referendum on the UK's continued membership of the EU fast approaching and the increasingly close polls, asset and fund managers are actively considering the impact that Brexit could have on their assets under management, the existing financial services regulatory regime, the ease of conducting their business in the EU through passporting and their access to expertise in financial services.

In this paper, we examine the key risks and legal consequences of Brexit for asset and fund managers and analyse the potential impact of this on the sector as a whole, both in the immediate and in the longer term aftermath of a leave vote. We discuss the various post Brexit models in the context of the asset and fund management industry, and highlight the difficulty in selecting a clear "winner" due to the complex trade-offs and political issues which those models raise. Finally, we discuss what can be done now in terms of contingency planning.

In the event of a leave vote it must be emphasised that only once a post-Brexit model is agreed by the UK and the EU will it be possible to quantify and conclude with certainty the impact of Brexit.

Article 50 of the Treaty on the European Union provides the legal framework for a Member State to exit from the EU. After a leave vote, the UK has to deliver a notice to the EU Council of its intention to withdraw from the EU. That notice triggers a two-year negotiation period. There is likely to be some delay before such a notice is served by the UK Government as it seeks to conduct scoping negotiations. The outcome of the vote is simply advisory and not binding on the UK Government, however it would be politically unthinkable for such a vote not to be acted upon. During the two year negotiation period, the UK and the EU will have the opportunity to conclude an agreement for the withdrawal of the UK and agree a post-Brexit model for how the UK and EU will interact. If no agreement is reached within two years (and no extension agreed), then Brexit will occur with the UK leaving the EU and all EU treaties ceasing to apply to the UK without any replacement regime in place. Any extension to this two year negotiation period before Brexit actually occurs must be agreed by the EU Council (i.e. the remaining EU Member States) unanimously. If the UK and the EU conclude a withdrawal agreement however, the EU treaties should cease to apply to the UK on the date that the withdrawal agreement specifies. Therefore, in considering the impact of a leave vote, it is necessary to consider separately the negotiation period before Brexit and then any post-Brexit model that may have been agreed with the EU.

Our conclusion surmises that Brexit will impact individual firms in different ways depending on whether they are more UK- or EU-focused[1]. Albeit there is no

[1] The term EU as used throughout this paper is to be interpreted as having "EEA relevance" in areas of overlap where it is intended that certain EU Directives be adopted under the agreement constituting the European Economic Area, so that the term EU includes non-EU countries within the EEA (i.e. Iceland, Liechtenstein and Norway), to the extent that these EEA countries have applied the EU legislation which is being discussed in this paper into their domestic legislation. This paper therefore refers to "EU" and "non EU" rather than "EEA" and "non-EEA".

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certainty on the post-Brexit model, a Brexit is likely to be of significant consequence for asset and fund managers who have UK managed funds (whether AIFs or UCITS) offered into the EU and, in the case of UCITS, the rest of the World, and EU funds (whether AIFs or UCITS) managed in the UK and offered into the EU.

Critically for now, there may be significant and rapid sell-offs and out-flows of assets under management by UK asset and fund managers in the immediate aftermath of a leave vote, occurring against the backdrop of significant declines in asset values and Sterling devaluation. Therefore, a key short-term issue for asset and fund managers is taking preparatory steps for handling such capital out-flows, including reviewing the policies in place for handling suspensions or gating of redemptions and drafting the accompanying client communications in advance.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers, please visit: www.allenovery.com/brexit.

Analysis

What will happen next for asset and fund managers in the immediate aftermath of a leave vote?

As the UK Government steers the country through the immediate aftermath of a leave vote, and in view of the robust UK laws and regulations which are already in place governing the asset and fund management sector, it is unlikely that the UK Government will look to overhaul those laws and regulations as a priority at the start of the negotiation period leading up to Brexit. UK asset and fund managers should therefore not expect sudden and drastic changes in the UK regulation of their industry, at least until the development of the post-Brexit model is seriously underway.

What asset and fund managers may expect to see as an economic impact in the short term (and which has already begun to some extent) is eroded general investor confidence and volatility in financial and currency markets.

A key risk in the days and weeks after a leave vote is that there may be a sudden and accelerated out-flow of assets under management from UK asset and fund managers. That may result in funds having to apply gating provisions or suspend investors' redemption rights, which may create legal and reputational risk, particularly if competitors with similar products do not exercise gating or suspensions. It would be sensible for asset and fund managers to revisit, with the directors of their funds (who will usually be responsible for any gating / suspension decision, based on advice from the fund's manager), their redemption processes and the policies they have in place for seeking to protect investors (both those redeeming and those remaining) from allowing normal redemptions to occur. In seeking to manage reputational risk, managers may want to pre-emptively prepare investor communications in case their funds do apply gates or suspensions.

In the months after a leave vote, what will be important in establishing stability during the negotiation period is the UK Government ensuring that its negotiations with the EU as to the post-Brexit model have at their heart the maintenance of access for UK asset and fund managers to continue to manage / advise EU clients and source EU assets under management for their funds and managed accounts. If it becomes apparent during the negotiation period that either UK asset and fund managers will not get the same or substantially similar access to the EU as they have today, or that the negotiation period will end without a workable agreed post-Brexit model, then UK asset and fund managers may be forced to plan for a new or greater presence in the EU through their subsidiaries.

In the case of a leave vote, the scale of the task involved in agreeing a post-Brexit model with the EU (which requires a qualified majority of the EU Council and a majority vote of the EU Parliament) is unprecedented, especially within a two-year timeframe. While the UK controls the start of the negotiation period, once notice is served there is a significant risk that the UK runs out of time to put in place a well-considered model or has no model at all.

Possible models for what a post-Brexit UK / EU relationship could look like in an asset and fund management context

While it is not yet possible to identify with certainty the parameters and exact form of the UK's relationship with the EU post-Brexit, we can contemplate to some degree the possible models based on existing formulations reached by other countries, albeit in different contexts to the UK. For asset and fund managers, the benefits of these various models from the UK's perspective are harder to determine than the known key concerns, and this is likely to remain the case until the likely post-Brexit model is identified. Central to this analysis is whether access to EU financial markets and financial services will be preserved for UK asset and fund managers.

Please refer to our specialist paper "*Brexit –potential mechanisms for a UK exit from the European Union and what follows next* " for a detailed discussion of these post-Brexit models.

Norwegian model

This would entail the UK becoming a non-EU member of the European Economic Area (EEA) and the European Free Trade Association (EFTA) in the same way Norway did, with significant EU single market access and a substantial financial contribution requirement. Free movement of people would continue and the UK would continue to pay into the EU budget almost as much as it does now, while applying single market rules but having no ability to vote on them – all factors which make this model appear less viable from a UK domestic political standpoint. There would be some EU legislation that the UK would no longer be required to apply if it followed this model, which may mean that the UK would have to enact domestic legislation in its place. The UK would also have to resolve its relationship with the EFTA first and obtain the necessary approvals because it is not possible to be a member of the EEA without being a member of either the EU or EFTA.

Swiss model

This would entail the UK negotiating and concluding bespoke sector-specific treaties with the EU, and European free trade agreements with the EFTA member countries in the same way that Switzerland did, with a partial financial contribution requirement. This would enable limited access to specifically defined areas of the EU single market, but would be dependent on the outcome of negotiations (it took Switzerland 16 years), and result in layers of complex sector-by-sector bilateral agreements. It may well also require the UK to accept at least some of the EU's rules on freedom of movement of people and to comply with EU rules when trading within the market, again without a formal seat at the table when those laws are drafted. Also, if the Swiss model was adopted literally, freedom of movement of services would be limited. Because this model involves the UK being part of the single market for goods but not all services, it is not a winner from the perspective of the asset and fund management industry. Further, it is understood that it is not even likely that the EU will accept going through the piecemeal Swiss approach again with the UK because of its complexity.

Customs union (like Turkey)

This would entail the UK entering into a Customs Union with the EU in the same way Turkey did, with no financial contribution required. Under this model, which applies only to the trading of goods and not services, no internal tariffs are applied to trade between Turkey and the EU, and there are common external tariffs for trade with third states. There would be limited access to the EU single market and the UK would lose its current ability to provide services on equal terms with EU Member States, which is not attractive from an asset and fund management standpoint. The UK would not be bound by the majority of EU law and would therefore have to legislate to fill the significant gaps in its national legislation that would be left upon exit.

Free trade agreements (Canadian model)

This would entail the UK finalising an extensive free trade agreement with the EU like the EU-Canada Comprehensive and Economic Trade Agreement (noting that it took seven years to negotiate), with no financial contribution required. While this is often cited as one of

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the more popular models for a leave scenario, any agreement reached with the UK will require ratification by all Member States and other applicable approvals. Under such a model the UK would retain control over tariff arrangements with other (non-EU) countries. From an asset and fund management standpoint, most free trade agreements may not cover certain services or regulatory convergence.

World Trade Organisation (WTO) terms

This would entail the UK being dependent on its membership of the WTO in order to trade with the EU, with no access as such to the EU single market but the application of caps on tariffs applicable to goods traded between the UK and the EU and limits on certain non-tariff barriers in relation to goods and services. It would not apply to services and may well require substantial amounts of new legislation to replicate EU legislation that would fall away on Brexit. The UK would not be required to make any financial contribution to the EU, however, nor would it be bound by EU laws. The current free trade agreements between the EU and third party countries will no longer apply to the UK once it exits the EU and trade with those countries will be on a WTO basis until new arrangements are agreed. From an asset management standpoint, the WTO model does not address non-tariff barriers faced by the financial services industry.

Key issues and risks for asset and fund managers following Brexit

Insider to Outsider – Impact on access to EU single market

The loss or restriction of access to the EU market which is currently enjoyed by UK asset and fund managers, who are established in the UK but manage money sourced across the EU has been cited as one of the most significant consequences of Brexit in this industry. Asset and fund managers may see disrupted access to EU investors resulting in a negative impact on raising new assets under management, but the exact extent of this is difficult to predict at present. What follows are some considerations in the situation where, as a result of Brexit, there is a loss of the existing access to the EU market (i.e. a UK firm's passporting rights cease to exist).

In practice, a number of medium or large UK asset and fund managers have a range of UK UCITS for distributing to UK clients and a range of Luxembourg or Irish UCITS for distributing to continental European / international clients. Brexit should not affect this distribution model from an operational and legal perspective. Where a Luxembourg or Irish UCITS is managed by a delegate firm in the UK, depending on the recognition of the UK regulatory regime as having equivalence by the EU Commission, and assuming the maintenance of the UK's currently EU-compliant regime and appropriate regulator to regulator arrangements, those UK firms should be able to continue to manage such EU UCITS post-Brexit.

Impact on the financial services regulatory regime

The UK has played a primary role for 40 years as the driving force behind the establishment of the EU financial services regulatory framework. Consequently, a high degree of similarity and consistency exists between the EU and the UK when it comes to such regulation and, in so far as the UK retains domestic regimes based on the EU regimes, it is expected (despite the lack of certainty on the timing for this) that the EU Commission will reach a conclusion of equivalence to EU requirements with respect to much of the UK financial services regime once post-Brexit the UK becomes a third country. UK asset and fund managers may face additional licensing and regulatory requirements to service their EU clients however in areas where the EU Commission does not make an equivalence determination.

The points of tension from a regulatory standpoint post-Brexit will be the inability of the UK to continue to successfully drive and influence EU regulation as it has always done in the past, and the move from a single regulatory regime to a dual regime. On the upside, a leave vote may enable the UK to "switch off" provisions under EU directives relating to financial services that are contrary to UK policy and administratively burdensome. Nevertheless, it is expected that there will have to be some "repatriation" of EU laws regardless of the post-Brexit model agreed on in order to ensure that the UK can maintain equivalency as a third country.

Key for UK asset and fund managers during the negotiation period is that the UK remains a Member State during this time and it is assumed, subject to EU laws until a withdrawal agreement is in place. The UK Government must ensure that access to EU markets under the passport system continues undisrupted at least during the negotiation period and, as mentioned above, the level of efforts by the UK Government in this regard are critical but the results cannot be guaranteed. The UK Government should also ensure that any negotiated withdrawal agreement contains transitional provisions stating that EU law in this area is to continue to apply in the UK until all legislative changes have been concluded by the UK, but in the case of this not being successfully addressed, UK asset and fund managers face the significant risk of a regulatory limbo and will need to revisit their group model for engaging with EU investors and perhaps establish or increase the substance of EU subsidiaries under the passport system.

Asset and fund managers should note that a leave vote does mean that the UK's regulatory framework would need to change according to the post-Brexit model chosen, and this could range from the UK maintaining existing UK measures to having the freedom to regulate its own regulatory framework. The UK Government will need to decide which EU measures it would like to retain and will need to legislate where required to do away with any gaps in the legal regime created by Brexit.

Please refer to our specialist paper "*Financial services regulation – what impact will Brexit have on regulated firms established in the UK, Europe and third country jurisdictions?*" for a discussion of these regulatory issues.

Disruption in relation to passport rights

In general

The impact of Brexit on asset and fund managers would depend on the extent to which they are UK-, EU- or non-EU-focused, their range of investment products and the services they offer to investors. When it comes to passporting, which is the ability of financial services firms authorised in one Member State under EU directives to conduct business throughout the EU under the freedom to provide services throughout the EU, the issue is two-fold. There are the outward passporting rights of UK asset and fund managers, and the inward passporting rights of EU asset and fund managers. In short, purely UK-focused asset and fund managers (so UK entities and their UK subsidiaries, as well as UK branches of non-EU entities) will not face any material impacts. If they use a passport however, then the key issue will be the continuity of the passporting system because if this is no longer available post Brexit, it would be necessary to consider obtaining separate licences in the relevant EU jurisdictions to the extent available and revisiting subsidiary group structures. The EU branches of existing UK asset and fund managers will likely lose passporting rights and may be forced to comply with local licensing requirements in the relevant EU jurisdictions or close conversely. For EU asset and fund managers operating in the UK who do not wish to limit their activities, it would be necessary to consider establishing a UK subsidiary, or obtaining UK authorisation if operating on a cross border basis.

The worst case scenario is if the UK fails to agree politically on the issue of passporting rights post Brexit, and the UK financial services industry generally loses all relevant passporting rights. As previously mentioned, a greater European presence through a network of subsidiaries will then need to be planned by UK asset and fund managers and the associated costs and administrative burden of doing this will need to be taken into account.

AIFMD

Asset and fund managers who use the "passport" for market access under AIFMD may have to consider how to re-structure their businesses or re-domicile their funds if the passport system is disrupted or lapses. UK AIFs would become non-EU AIFs and lose their pan-European marketing rights with local private placement regimes applying instead in order to market to EU investors. UK AIFMs would no longer be able to manage AIFs established in other EU Member States. Compliance with the AIFMD transparency and reporting requirements would still be necessary however. The possibility of a third country passport under AIFMD for non-EU financial institutions and approved by ESMA may reduce the impact on UK AIFMs post-Brexit, but this has not yet been granted so remains an area to be watched.

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MiFID

The key issue with MiFID II is whether the UK will fall under a harmonised regime for third country access to enable passporting to professional clients in EU jurisdictions, despite the timing and detail of this currently being very uncertain. It is interesting to consider whether the UK would continue to implement MiFID II post-Brexit, given the concerns of the FCA about certain aspects of MiFID II. Nevertheless, the UK should be in a strong position to meet any equivalence test for the implementation of MiFID/MiFIR from 2018, and this may mitigate market access restrictions facing asset and fund managers in other areas. The major practical issue is the quagmire which asset and fund managers may face as MiFID II comes into force in 2018 before the negotiations on Brexit close, which means having to implement MiFID without certainty on the outcome of the UK's relationship with Europe.

UCITS

The post-Brexit impact of this will depend on the business model of each asset / fund manager as they would not be heavily affected if they marketed primarily within the UK, only if they wished to use the passport to manage UCITS established in other EU Member States, because UK asset and fund managers would no longer be able to manage UCITS established in other EU Member States. UK OEICs and AUTs would no longer be UCITS and so they would lose pan-European marketing rights, and would have to be marketed by firms as non-EU AIFs through individual Member State private placement regimes. Therefore, the impact will be less material for managers who have a Luxembourg or Irish management company (ManCo) or a Luxembourg or Irish UCITS fund range that can still passport post-Brexit, or for managers whose group prefers to use a UK UCITS fund range for clients as opposed to a Luxembourg / Irish UCITS fund range for other EU clients. The difficulties arise where the UK asset / fund manager has a single pan-European ManCo or a single pan-European UCITS fund range, or has a Luxembourg or Irish manager (or MiFID firm) and reliance will have to be placed on their passport and staff to market Luxembourg / Irish funds across the EU post Brexit, rather than being able to use a UK MiFID firm for all EU marketing activities as would normally be the case. In short, if a UK asset or fund manager wants new segregated mandate clients from the EU post-Brexit, they may have to use their Luxembourg / Irish manager and then delegate to their UK firm or try to use local law exemptions.

Impact on talent, on UK counterparties and the potential relocation of UK headquarters

When it comes to a potential talent drain feared by many asset and fund managers as one of the significant impacts of Brexit (depending on the post-Brexit model chosen), it is recognised that it may be harder to recruit or move highly skilled people from the UK to the EU and vice versa, resulting in a skills shortage and additional costs and restrictions in order to meet new immigration criteria even for highly skilled individuals. Employee mobility could potentially be restricted by the impact of a leave vote on the EU-wide recognition of certain professional qualifications and immigration controls which might also impact the labour supply for asset and fund managers.

The impact of Brexit on UK based counterparties including banks, trading venues, clearing houses, settlement systems, depositaries and other service providers in terms of how they can continue to provide services to EU-based firms and EU-based markets is a concern for the asset and fund management industry. For example, UK-incorporated depositaries would no longer be eligible to act as depositary of AIFs or UCITS established in EU Member States. Similarly, firms with UK-based trading venues, clearing or settlement systems will need to reassess how they can continue to service EU-based firms or link-up with EU-based market infrastructure for EMIR-compliant trading.

Depending on the post-Brexit model chosen, the ability to run a Europe-wide business from London would be subject to uncertainty post-Brexit and there may be fewer incentives for some global players to operate international or EU-focused asset and fund management activities from the UK. On the other hand, Brexit could be viewed as an opportunity to win back international business to the UK and perhaps benefit from a more streamlined and lighter regulatory regime. The relocation of the London-based EU headquarters of many large global asset and fund management firms will be driven by two factors. First, the post-Brexit model chosen for implementation between the UK and the EU.

Second, if there is a loss of the passport system – a key feature of the EU single market. The change in status of the UK as a hub to access clients and markets across the EU could lead to considerable loss of prestige for the UK's asset and fund management industry and have a consequential impact on it as an "export industry", an impact which cannot be ignored when considering that nearly half of the UK's assets under management come from outside the UK, split evenly between Europe and the rest of the world.

What you can do now

The events which have led up to the Brexit referendum, and then the immediate aftermath and long term future if there is a leave vote, will significantly impact the asset and fund management sector as outlined in this paper.

What managers in the industry can do at this stage is engage in contingency planning with the involvement of all stakeholders, bearing in mind that a leave vote is unlikely to immediately impact the substance of existing contractual rights and obligations and that the direct impact on individual asset and fund managers is unpredictable for now and at least until a post-Brexit model is being negotiated by the UK Government. Therefore, while detailed long-term planning is not yet feasible, high-level impact analysis can be undertaken by asset and fund managers by reviewing their existing business models to determine impediments to market access arising out of a leave vote, and how these might be shaped in a UK context.

Efforts to engage with industry and trade association work streams and contributing to governmental consultations on this subject will be a crucial tool for determining key priorities. There are anti-trust guidelines which participants need to follow in such lobbying.

Regarding any sudden capital outflows which may be expected if there is a leave vote, asset and fund managers can prepare for this possibility by reviewing their gating and redemption suspension provisions and communicating with investors regarding any changes.

The legal and compliance functions, both internal and external to asset and fund managers, should play a central role in defining the policy and communications strategy of the business in case of a leave vote. This should include an action plan for the business in case of a leave vote and the identification of a key team to formulate such an action plan.

If desired, existing contracts can be reviewed to assess how leaving the EU would impact the scope of existing obligations (e.g. through definitions including EU terms) and whether amendments are necessary – this includes investment management mandates and fund investment policies.

As the post-Brexit model becomes clearer, asset and fund managers can begin detailed planning for a post-Brexit world.

Your Allen & Overy contacts

If you would like to discuss the issues raised in this paper in more detail, please contact your usual Allen & Overy contact.

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