



ICLG

The International Comparative Legal Guide to:

Public Investment Funds 2018

1st Edition

A practical cross-border insight into public investment funds

Published by Global Legal Group, with contributions from:

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Published by
Global Legal Group Ltd.
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London SE1 3PL, UK
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Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
iStockphoto

Printed by
Ashford Colour Press Ltd
April 2018

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ISBN 978-1-912509-00-3
ISSN 2516-4821

Strategic Partners



General Chapters:

| | | |
|---|---|----|
| 1 | U.S. Regulatory Reforms and Proposals Regarding Registered Funds Post-Financial Crisis – Gregory S. Rowland & Sarah E. Kim, Davis Polk & Wardwell LLP | 1 |
| 2 | Registered Investment Companies – Commercial Considerations for First Timers – Marc Ponchione & Sheena Paul, Allen & Overy LLP | 8 |
| 3 | Credit Facilities for Registered Investment Funds – Alyson Gal & Tom Draper, Ropes & Gray LLP | 12 |
| 4 | Brexit – Implications for the Asset Management Sector – Cormac Commins, Arthur Cox | 17 |

Country Question and Answer Chapters:

| | | | |
|----|-----------------------|---|-----|
| 5 | Andorra | Cases & Lacambra: Marc Ambrós Pujol & Pablo José Asensio Torres | 20 |
| 6 | Australia | Johnson Winter & Slattery: Shelley Hemmings & Andy Milidoni | 26 |
| 7 | Brazil | Pinheiro Neto Advogados: Fernando J. Prado Ferreira & José Paulo Pimentel Duarte | 33 |
| 8 | Canada | McCarthy Tétrault LLP: Sean D. Sadler & Nigel P. J. Johnston | 37 |
| 9 | Cyprus | PricewaterhouseCoopers Ltd: Andreas Yiasemides & Christophoros Soteriou | 43 |
| 10 | Denmark | Kromann Reumert: Jacob Høeg Madsen & Christian U. Weiss Bruhn | 49 |
| 11 | Germany | Bödecker Ernst & Partner mbB: Dr. Carsten Bödecker & Harald Kuhn | 56 |
| 12 | Hong Kong | Deacons: Alwyn Li & Lawson Tam | 61 |
| 13 | Ireland | Arthur Cox: Ian Dillon & Cormac Commins | 67 |
| 14 | Japan | Nishimura & Asahi: Yusuke Motoyanagi & Takuya Wada | 71 |
| 15 | Korea | Dikaion Law Group: Weon Eui Hong & Chiyoon Oh | 76 |
| 16 | Luxembourg | Wildgen: Samia Rabia & Antonios Nezeritis | 80 |
| 17 | Malta | WH Partners: Gabriella Zammit & Rachel Vella Baldacchino | 85 |
| 18 | Netherlands | Allen & Overy LLP: Ellen Cramer-de Jong & Jochem Kin | 91 |
| 19 | Norway | Advokatfirmaet Grette AS: Karl Rosén & Elin Haugen | 97 |
| 20 | Spain | Cases & Lacambra: Miguel Cases & Galo Juan Sastre | 103 |
| 21 | Sweden | Harvest Advokatbyrå AB: Björn Wendleby & Rakey Renström Secka | 109 |
| 22 | Switzerland | Lenz & Staehelin: Shelby R. du Pasquier & Maria Chiriaeva | 114 |
| 23 | United Kingdom | Burges Salmon LLP: Tom Dunn & Gareth Malna | 120 |
| 24 | USA | Davis Polk & Wardwell LLP: Gregory S. Rowland & Sarah E. Kim | 126 |

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Brexit – Implications for the Asset Management Sector

Arthur Cox

Cormac Commins



Introduction

When the United Kingdom (the “UK”) voted to leave the European Union (the “EU”) on 23 June 2016, the decision triggered unprecedented uncertainty around the future relationship between the EU and one of its largest members. The referendum was followed on 29 March 2017 by the UK’s formal notification of its intention to withdraw from the EU pursuant to Article 50 of the Treaty on European Union.

Given the challenges of untangling over 40 years of UK-EU affairs, developed through treaties, agreements, delegation and cooperation, it is not surprising that significant doubt remains over the impact Brexit will have. What is certain, however, is that in the absence of a withdrawal agreement, all EU law will cease to apply to the UK from 30 March 2019. From that point on, the UK will no longer be a member of the EU and will become a “third country”. From an asset management perspective, this means that EU rules on the management of investment funds, including Directive 2009/65/EC on Undertakings for Collective Investment in Transferable Securities (the “UCITS Directive”), Directive 2011/61/EU on Alternative Investment Fund Managers (the “AIFM Directive”) and Directive 2014/65/EU on Markets in Financial Instruments (the “MiFID Directive”), will no longer apply to the UK (other than to the extent that any third-country provisions may apply).

Regulatory Regime for Asset Management

Each of the UCITS, AIFM and MiFID Directives regulates the provision of asset management services in the EU. The UCITS Directive sets out a regulatory regime for retail investment funds with strict rules on the types of asset classes in which a UCITS may invest. The AIFM Directive regulates alternative investment funds (“AIFs”) (such as hedge funds and private equity funds), while the MiFID Directive regulates the provision of investment services where assets are not managed using a fund structure. Each of the three Directives also grants EU “passporting” rights to the asset management firms, which enables firms authorised in any EU Member State to operate freely in another EU Member State with minimal additional authorisation. In a post-Brexit world, the single biggest challenge which UK asset managers will have is the loss of this EU passport.

The UK – a Leading Global Asset Management Centre

UK asset management firms manage the long-term savings and pension needs of millions of investors. It is estimated that there is

approximately £8.1 trillion worth of assets being managed in the UK, making it the largest centre for asset management in Europe, and the second largest globally after the US. Clients and investors of these firms are located in the UK, the EU and around the world. The asset management industry is a significant contributor to the UK economy, and plays a key role in the UK’s financial services sector. Brexit has clear consequences for the UK asset management industry, and UK asset management firms are actively analysing their existing corporate and investment fund structures with a view to developing contingency plans in preparation for the impact of Brexit.

Potential Implications for UCITS

In December 2017, the UK government published its Investment Management Strategy II Report, setting out the UK government’s plans to further develop the UK’s investment management industry. This report stated that the UK government intends to establish a fund structure based on UCITS in the UK, with the intention of enabling the UK asset management industry to continue to work under a globally-recognised regulatory framework. Whether or not such a structure is created, how it might operate and the mechanisms by which it might interact with the EU UCITS regime, are currently unknown and will depend on the direction which future negotiations may take. In the meantime, the current position is that the UCITS Directive mandates that both the UCITS fund and its management company must be domiciled in the EU. This leads to a number of issues from the perspective of the UK asset management sector.

Firstly, UK-based funds which had previously been classified as UCITS will be viewed from an EU law perspective as non-EU AIFs. UCITS are prohibited from investing more than 30% of their assets in non-UCITS collective investment schemes. Non-UK based UCITS will therefore have to reconsider their investments to take account of the fact that UK UCITS will now be classified as non-UCITS funds.

Secondly, UK-based UCITS management companies will be treated as third-country AIF managers and will not be authorised to manage and market UCITS funds within the EU. For a UCITS with a UK management company to continue to market the fund within the EU, it will have to move the domicile of the UK management company to an EU jurisdiction, choose an EU management company instead or become a self-managed fund and domicile itself in an EU jurisdiction. Where a former UK-based UCITS is managed by an EU UCITS management company, the management company will need to be authorised under the AIFM Directive to manage a non-EU AIF (see further below).

Thirdly, non-UK UCITS which are sold or marketed into the UK under the current UCITS cross-border registration process will be subject to local rules which the UK may impose on such funds post-Brexit. Non-UK UCITS and non-UK UCITS managers will also have to assess the extent to which they delegate services (e.g. investment management) to UK-based entities and whether or not any cooperation agreements exist between the home regulator of the non-UK UCITS manager and the UK.

Potential Implications for AIFs

As noted above, if the UK leaves the EU without an agreement on asset management, the AIFM Directive may no longer apply to UK-based AIF managers. This will lead to a number of considerations, including an assessment of delegation arrangements into and out of the UK. However, unlike the UCITS Directive, the AIFM Directive does seek to address the position of non-EU AIFs or non-EU AIF managers in a manner which goes some way to provide clarity on the position of UK AIFs (which will include UK UCITS post-Brexit) or UK AIF managers post-Brexit, including the following:

1. The AIFM Directive would not apply to a UK AIF manager managing a UK AIF which is not marketed within the EU.
2. Member States may permit non-EU AIF managers (e.g. a UK AIF manager) to market AIFs (non-EU AIFs or EU AIFs) in their territory under the National Private Placement Regime (“NPPR”). It is at the discretion of each Member State whether or not to apply this regime or what rules should operate under the NPPR within a Member State. The NPPR therefore varies from Member State to Member State and indeed some Member States do not allow for the NPPR.
3. An authorised EU AIF manager would be able to manage a UK AIF which is not marketed in the EU, provided that the EU AIF manager complies with particular provisions of the AIFM Directive and provided that there are cooperation arrangements between the AIF manager’s regulator and the UK regulator.
4. An authorised EU AIF manager would be able to market a UK AIF in accordance with the NPPR noted above.

The foregoing reflects how UK AIFs and UK AIF managers may be impacted by Brexit given the current state of play of the AIFM Directive. Importantly, however, for UK AIF managers, the AIFM Directive contemplates the introduction of an EU passport for non-EU AIF managers and non-EU AIFs. This would replace the NPPR and would allow a qualifying non-EU AIF manager to manage and market AIFs within the EU under an EU passport. A number of conditions are set out in the AIFM Directive for this, including that:

- the AIF manager must comply with the AIFM Directive;
- the AIF manager must receive a prior authorisation from the regulator of an EU Member State known as the Member State of Reference;
- the jurisdiction in which the AIF manager is established must have sufficient cooperation arrangements in place with the Member State of Reference; and
- where a non-EU AIF is being marketed, the AIF’s jurisdiction must have sufficient cooperation arrangements in place with the Member States in which it is marketed.

The extension of the EU passport to non-EU AIF managers and non-EU AIFs is contingent on positive advice from the European Securities and Markets Authority (“ESMA”) and approval from the European Commission. Under the AIFM Directive, ESMA may only issue positive advice in relation to a non-EU country where it is satisfied that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. Any decision on the extension of the EU passport

to non-EU AIF managers and non-UK AIFs will depend on future ESMA advice on a country-by-country assessment and consequential European Commission approval. However, it would be expected that, provided UK AIF regulation remains similar in a post-Brexit environment, no significant obstacles would exist which might prevent the UK from being part of any future third-country extension of the EU passport.

Pending the outcome of a possible extension of the EU passport to UK AIFM’s and UK AIFs and given the limitations of the NPPR, many UK AIF managers and their investors are looking for a greater degree of certainty. This is particularly so in light of the uncertainty around the terms and future shape of a UK withdrawal from the EU. One option under consideration is the obtaining of an EU AIFM authorisation and the establishment of EU-domiciled AIFs in order to avail of the current full passport rights (see further below).

Potential Implications for MiFID Firms

As noted above, the MiFID Directive regulates the manner in which asset managers provide investment services (largely portfolio management) to clients across the EU. The provision of such portfolio management services may be to UCITS and AIF managers and their funds under management in other Member States, but may also be to clients who hold assets other than through a fund structure, i.e. on a segregated account basis. In order for UK groups with MiFID firms to continue to benefit from the EU passport to sell their services across the EU, consideration is being given as to how such groups may structure their operations to ensure that they maintain an EU MiFID-authorised entity.

Ireland as a Solution

As UK groups assess their options in this regard, Ireland appears high on the list of jurisdictions which UK financial institutions are considering as part of their Brexit contingency plans – with some already having made the decision to establish a regulated entity in Ireland. Ireland has long-standing and close ties to the UK including a common language and time zone, as well as a comparable legal system and culture. These are all very attractive features, as operational and personnel relocations are being considered. One of its other significant advantages is that many of the investment funds managed out of the UK are already domiciled in Ireland, where close to €2.4 trillion worth of fund assets are currently administered. Having the ability to add the provision of MiFID services to an existing UCITS management company and/or AIFM company authorisation, rather than establish a standalone and separate MiFID entity, also makes Ireland an attractive location. Many groups already have existing UCITS management companies and/or AIFM companies in Ireland which act as managers to the funds they have domiciled in Ireland. The Central Bank of Ireland has also resourced up to manage in an efficient and considered manner the approval processes required for the various authorisations.

Conclusion

There is no doubt that Brexit poses significant challenges for the UK’s asset management industry. The level of uncertainty around the future relationship between the EU and the UK is forcing UK-based asset managers to critically assess their operations and investment product offerings. They must do so in order to provide certainty and continuity of service to their investors. Ireland is best placed and ready to support the UK asset management community as it prepares for a post-Brexit world.

**Cormac Commins**

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Cormac is a past member of the Irish Funds Trustee Committee, a past Chair of the Irish Funds Marketing Committee and is actively involved on a number of industry working groups.

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