

UK-based alternative investment fund managers: This is how Brexit impacts your cross-border distribution and management business

Brexit negotiations have dominated the headlines for the past four years and at the eleventh hour a deal was struck...but not for financial services. The UK's "golden goose" was conspicuous by its absence in the deal, and confusion and uncertainty over the true impact of Brexit on the UK's thriving funds industry has reigned ever since.

So, with what information we do have to hand, and having spoken to our clients, lawyers and other leading industry experts on the matter, here are our thoughts on how UK-based alternative investment fund managers ("managers") should navigate the post-Brexit world.

Ignore the hot air around "equivalence" - it's no deal (for now at least)

We've heard plenty of talk about trade and cooperation agreements and assurance that an agreement on financial services will be reached, but talk is obviously no good to anyone. From a legal perspective - and that's what matters - it's no deal (for now at least).

Under the terms of the Joint Declaration, the UK and the EU have committed to work towards agreeing a Memorandum of Understanding to establish a framework for cooperation on equivalence decisions. While the intention was to wrap any discussions up by the end of March, at the time of writing, there's no sign of an agreement being reached any time soon.

Assume the UK is on a different path

The early signs for a shiny deal on equivalence are not promising. Commissioner Mairead McGuinness has publicly stated that any talks '*...will not be about restoring market access rights that the UK lost, nor will...[they]...constrain the EU's unilateral equivalence process.*'

In the UK, opening salvos can hardly be construed as friendly either. Andrew Bailey (Governor of the Bank of England) has recently accused Brussels of double standards by blocking the City from European financial markets and warned it against picking a fight that could harm economic recovery. Lord Jonathan Hill, the UK's former financial services commissioner to the EU also stated that the EU would '*not do us any favours*' and that it was certain Brussels will not grant equivalence for British firms.

In addition, the UK still has a right of centre Conservative government who were arguably and, likely, remain uninterested in ongoing alignment with the European rulebook. From a financial services perspective, this is clear from current consultation processes covering both the UK funds regime (albeit, excluding AIFMD and UCITS) and the alternative asset holding company regime, with the Treasury signaling their desire to reform and improve the UK's current offering.

On the face of it, equivalence seems a long way off and regulatory divergence from the European rule book seems very much on the cards, and, as a result, for the foreseeable future at least, the UK will have to get used to operating as a third country with all the complexities that this creates when looking to operate in Europe.

Prepare for life after AIFMD and MiFID

Up until the "deal" was announced it was business as usual for UK managers as far as European market access was concerned. Under the Alternative Investment Fund Managers Directive ("**AIFMD**") and the Markets in Financial Instruments Directive ("**MiFID**"), UK managers had the ability to both market interests in, and provide management services to, funds in any EU member state.

Post Brexit, passporting rights under both AIFMD and MiFID have been lost, leaving UK managers reliant on more traditional third country market access

routes. In theory under both AIFMD and MiFID, there are provisions in place to grant passport-based access to third country firms but, in practice, due to arguably politicised delays in European Commission processes, at European level such market access routes remain unavailable.

Cross-border management: These are your options:

Without the availability of passporting rights in connection with the cross-border supply of management or marketing services within Europe, you have a couple of options:

Option A: Establish an entity within Europe which can be authorised as a manager:

While an option, the costs associated with doing this are likely to exceed €500,000 depending on whether any kind of European operating platform is in place, so for many managers this isn't a cost effective solution. Additionally, minimum substance requirements will need to be met in the jurisdiction in which the manager chooses to establish, which tend to be in the region of three to five individuals, some of whom need to assume specific regulatory positions.

Option B: Rely on a third party AIFM:

An alternative solution to maintain cross-border management capabilities is to appoint a third-party manager that is based in Europe. While this is generally cheaper than establishing a European presence, it doesn't come without cost and notwithstanding the fact that portfolio management can be delegated away from the manager, it effectively shifts the centre of operations for managing a structure to the third party manager which can be operationally challenging.

In practice, it's unlikely that large numbers of managers will have been adversely affected by Brexit from a cross-border management perspective as, in general, the location of the manager tends to follow the location of the fund. Therefore, for UK based managers, cross-border management issues on Brexit will only be an issue where the associated funds are located outside the UK but within Europe (Luxembourg, for example).

Cross-border distribution: How your advisors may suggest you proceed:

Cross-border distribution in connection with AIFMD and MiFID is perhaps the biggest challenge to emerge from Brexit, although not an insurmountable one. This is how your advisors may propose you approach cross-border distribution in the post-Brexit world:

AIFMD rules: Undertake distribution through a combination of reverse solicitation and Article 42 registrations/notifications:

In practice, specified Article 42 marketing routes exist in most northern European jurisdictions, so these are not generally considered problematic. It's worth noting that when marketing in Germany and Denmark, local legislation requires the appointment of a depositary, but as this is not directly required under AIFMD, the higher threshold of strict liability for any listed assets that are subsequently acquired by the fund does not apply. Southern Europe (including France) remains somewhat of a conundrum in connection with Article 42 marketing, with no routes specified in France, Spain or Italy and, as a result of this, reverse solicitation has generally been relied on.

Alternative MiFID II rules

While MiFID is not always considered directly relevant to UK based managers in terms of fund distribution, many of the more institutional UK based managers do have MiFID permissions (in standalone entities or under the AIFMD top up provisions) and UK based placement agents have historically been regulated under this legislation and collectively have conducted a range of distribution activities under the associated passporting regime.

As a result of Brexit, this passporting has been lost with UK based firms now having to rely on a mix of extended transitional relief, domestic third country regimes, exemptions and scoping arguments to continue their activities on a cross-border basis. Tied agency solutions involving European principals are also available but in practice, these suffer from a range of operational difficulties. UK MiFID firms can continue to operate in the majority of key European investor

jurisdictions, but for France, Germany and Spain, certain difficulties arise.

Given that there is no specified marketing route under AIFMD for managers in France and Spain (absent a passport), reverse solicitation has historically been relied on for firms looking to source capital from these jurisdictions, so the loss of MiFID passporting is more of a theoretical issue. Germany, however, has always been an open market and its effective closure to UK MiFID firms does create a distribution wrinkle that has an indirect effect on firms bringing funds to market.

Additional new rules

The forthcoming pre-marketing rules will cause further disruption in connection with cross-border distribution by UK based placement agents once in force (August 2021) as any such agent will require a MiFID authorisation to complete pre-marketing for a manager. Although this will only be applicable in connection with pre-marketing activity on behalf of authorised European managers (who paradoxically will have an AIFMD marketing passport), it remains to be seen whether this will form the basis of pre-marketing restrictions for sub-threshold European and non-European managers in due course.

The end of an era, but the beginning of a new one?

It seems unlikely that a meaningful equivalence deal will be struck any time soon, if at all, so UK managers will really have no choice but to adapt to their new regulatory surroundings. It won't be without its challenges, but it's by no means disastrous. And perhaps there may be a silver lining from all of this after all - a more favourable UK regulatory environment for alternative investment funds and their associated holding structures, but that's one for another article!