Hard BREXIT: implications and practical solutions

At 11 pm on 29 March 2019, the United Kingdom will leave the European Union. In the absence of a material change of trajectory in the Brexit negotiations, it is likely that the investment management industry will find itself grappling with the consequences of a "hard" Brexit. But what does this mean in practice, what are the implications for investment managers and how can they mitigate them?

This Regulatory Spotlight discusses the consequences of a hard Brexit for alternative investment fund managers (although it will also be of relevance to investment managers more broadly). It then explores some practical solutions to assist in the mitigation of the risks associated with a hard Brexit.

What is a "hard" Brexit?

For the purposes of the briefing, hard Brexit refers to a scenario where either no withdrawal agreement is reached and therefore the "implementation period" agreed in principle as part of the withdrawal agreement in March 2018 (see here) does not come into effect or a withdrawal agreement is reached but is deemed insufficient to trigger the "implementation period". In this scenario, from 11 pm on 29 March 2019, all EU law (directives, regulations and so on) would cease to have the force of law in the UK. The UK is preparing for this eventuality by making statutory instruments that will effectively turn existing EU legislation into domestic UK law although this is not a silver bullet. This briefing assumes that no grandfathering agreement is put in place to allow the current state of affairs to continue post-Brexit.

Implications for Investment Managers

The main implications of a hard Brexit on the investment management sector include**:**

- **Asset allocation:** many professional investors are bound by certain asset allocation requirements. As UK financial instruments and markets will no longer be EEA financial instruments and markets, investment managers may need to rebalance their holdings in order to meet their investors' asset allocation requirements. Similarly, interests in UK funds would themselves no longer be considered EEA financial instruments, which could lead to significant redemptions over a short time horizon.
- **Delegation:** the management of a large number of EEA-based funds have historically been delegated to UK based managers. It is unclear how this delegation model will continue to function post-Brexit, although it is interesting to note that HM Treasury, in its 23 August 2018 Guidance (available here), suggests that "*asset management firms can continue to plan on the basis that the delegation model will continue*". There have been some media reports that the UK Financial Conduct Authority (**FCA**) is currently negotiating new cooperation agreements with certain EEA jurisdictions (notably Ireland and Luxembourg) to allow the present system of delegation to continue.
- **Distribution:** at present, under the Alternative Investment Fund Managers Directive (**AIFMD**, text available here), an EU based alternative investment fund manager (**AIFM**) may market its alternative investment funds (**AIFs**) cross border into other Member States. Post-Brexit this so-called marketing passport will no longer be available, UK based AIFMs will therefore be required to market funds under the existing National Private Placement Regimes (**NPPR**). Given, however that UK managers will not be able to apply to market their funds in a Member State until Brexit has occurred and that it can in some cases take several months or longer to be granted permission to market under the NPPR, there will potentially be a period of several months (or potentially considerably longer if the necessary cooperation agreements are not yet in place with the Member State in question) immediately post-Brexit where UK based managers will need to suspend marketing of their funds.
- **Market liquidity:** the landscape for capital markets and trading venues will likely change post-Brexit. For example, it may be that Euro denominated financial instruments will need to be cleared within the Eurozone and/or regulators will require capital to be held in a Member State, which may lead to a fragmentation of the capital markets. The potential restrictions and/or added cost of UK based broker-dealers to access EEA-based markets may have an impact of the front offices of investment managers who may have to change the way in which they access the capital markets.
- **People:** the UK investment management industry employs professional staff from a large number of overseas jurisdictions, many of them from the EEA. It remains unclear how existing EEA nationals currently working and residing in the UK and those wishing to do so in the future will be treated post-Brexit.

There are a number of other issues that investment managers should be mindful of. These include, for example, tax (how will post-Brexit VAT arrangements work and query whether there will be an impact on the process for tax treaty claims) and data processing (how will data routing work under the GDPR post-Brexit).

Some practical solutions

There are a number of practical solutions to mitigate some, but not all, of the risks outlined above. These include:

- **Distribution I (EEA to UK)**: EEA-domiciled funds (both AIFs and UCITS) will be able to use the UK's Temporary Permissions Regime (**TPR**) provided that they have notified the FCA of their intention to do so prior to exit day. The FCA currently expects the notification window to open in early January 2019 and close prior to exit day, after which it will no longer be possible to make new notifications under the TPR. Investment managers should take these timeframes into consideration when planning their fund raising activities over the next 12-24 months.
- **Distribution II (UK to EEA)**: UK-based investment managers should start to map out their fundraising activities over the next 12-24 months with a view to determining where they will be raising funds. There are several potential solutions for those looking to continue to distribute their funds in the EEA post-Brexit:
  - For access to the AIFMD marketing passport: a parallel fund could be established in a Member State with a third party EEA-based service provider appointed to act as AIFM with a contractual obligation on the fund to co-invest alongside the UK-based fund. This would of course, be open to challenge under the anti-letter box provisions in Article 20(7)(b) of the AIFMD.
  - For immediate access to the Member States via the NPPR: a Guernsey/Jersey manager could be established (both have cooperation agreements in place with most, but not all, EEA Member States for marketing under the NPPR). The Guernsey/Jersey manager can then delegate portfolio management back to the UK based investment manager. It is worth noting that real estate funds tend to gravitate towards Jersey and private equity funds Guernsey.
- **Delegation**: under the Guernsey-Luxembourg cooperation agreement, a Luxembourg investment manager could technically delegate portfolio management to a Guernsey manager who could in turn take investment advice from a UK based investment advisor. The Luxembourg regulator may object to such schemes however, as not being in the spirit of the cooperation agreement. Where the manager does not already have a presence in Guernsey, such arrangements would likely add a significant layer of operational costs and professional fees.

Other points to consider

Investment Managers can begin to prepare for a hard Brexit by taking the following steps:

- **Asset allocation:** review requirements at a fund level and draft contingency plans to address the rebalancing of portfolios and/or amending fund documentation to allow UK assets to be counted as EEA assets;
- **Delegation:** are there delegation arrangements in place? Investment managers should consider how these will function post-Brexit and explore potential solutions (as set out above);
- **Review distribution arrangements**: consider the economics of establishing a parallel fund or, in the absence of cooperation agreements, accessing the EEA Member States via the NPPR from Guernsey/Jersey;
- **Review trading arrangements**: do current arrangements allow the manager to continue accessing EEA-based markets and if not, explore new trading arrangements for seamless trading post-Brexit; and
- **Key person risk:** identify key staff, query whether they are a flight risk and how that can be mitigated. Put in place a contingency plan for the loss of key employees.

If you have any questions, please do not hesitate to contact your usual AG contact or one of the lawyers listed below:

Graham Cross, Partner (Private Equity)	020 7160 3081	graham.cross@addleshawgoddard.com
Lorna Finlayson, Partner (Regulatory)	0131 222 9579	lorna.finlayson@addleshawgoddard.com
Lee Sheldon, Partner (Funds)	020 7160 3247	lee.sheldon@addleshawgoddard.com
Richard Small, Partner (Regulatory)	020 7160 3004	richard.small@addleshawgoddard.com
Lisa Dinwiddy, Legal Director (Funds)	020 7160 3179	lisa.dinwiddy@addleshawgoddard.com
Cara Phillips, Managing Associate (Regulatory)	020 7788 5065	cara.phillips@addleshawgoddard.com
William Robertson, Managing Associate (Regulatory)	020 7160 3398	william.robertson@addleshawgoddard.com