KPMG

Brexit - UK decision, global issue

Evolving Investment Management Regulation

June 2017

KPMG International

kpmg.com

The industry now faces potentially the single biggest impact on cross-border financial services in a generation — Brexit. Considered an unlikely event in early 2016, here we are in 2017 with Article 50 triggered and a two-year timetable in place for the UK's exit from the EU.

Brexit is not just about the future of London as a financial center or of the UK-based investment and fund management industry. Firms within other EU Member States ("EU27") and elsewhere will be impacted.

Much business takes place from and to the UK via EU regulatory passports. For funds and management companies (ManCos) the key passports are in the UCITS[1] Directive and the AIFMD[2]. For the provision of investment management services, the MiFID II[3] passport is king. The passports work differently in all three directives and their loss would have different impacts in the retail and professional market places.

Equivalence — a poor substitute

There is a diversity of "third country" provisions under different pieces of EU legislation and some have no formal "equivalence" regime. The provisions in MiFID II, AIFMD and the UCITS Directive are all quite different, for example.

Equivalence regimes cover only a subset of the activities that currently benefit from passports for EU firms. Therefore, unless the final trade agreement between the EU and the UK includes arrangements for UK firms to continue to benefit from all EU passports (which, politically, seems unlikely), Brexit will result in EU27-UK cross-border business being prohibited or restricted.

Moreover, gaining equivalence status is neither a singular nor a one-off process for a third country — it requires a different judgment for each piece of legislation and those judgments are subject to review at any time.

ESMA has said that the EU framework for third countries is not fit for purpose and requires overhaul. In fact, there is no generic framework, with different arrangements in different pieces of legislation — which are a mixture of equivalence, endorsement, recognition or passporting — or no arrangement at all. Also, it is time- and resource-intensive, requiring detailed assessments of third countries' regimes and lengthy negotiations if a country is not initially judged equivalent.

Mr. Maijoor cited the equivalence system under EMIR[4]: "The EU is an island of third-country reliance in a world that has mostly opted for individual registration of CCPs[5] that want to do cross-border business." ESMA has limited opportunities to see the specific risks that third-country CCPs might be creating in the EU as it has limited powers regarding information collection and risk assessment, and no regular supervision and enforcement tools.

It remains to be seen how quickly and in what ways the co-legislators will respond to this call for an overhaul of the system. Certainly, it would be a major drafting and practical task to bring about greater consistency of approach. Political pressures, in Europe and beyond, may provide momentum behind the task. In the meantime, firms and market entities will wish to factor into their business planning that the third-country provisions of today may look rather different in a few years.

Implications of the loss of the three key EU passports:

UCITS

UCITS are by definition EU domiciled funds with EU domiciled ManCos. Therefore, absent a specially negotiated deal and changes to UCITS legislation, UK UCITS will no longer be UCITS and UK ManCos will no longer be able to be ManCos for EU27 UCITS.

EU27 UCITS invested in UK UCITS may have to divest, unless UK UCITS are accepted as "equivalent".

There is no obvious regulatory reason why EU27 UCITS should be prevented from marketing to UK retail investors. However, if UK UCITS can no longer be sold into the EU, there is a political risk that EU27 UCITS will no longer be able to access UK retail investors.

AIFs

Unlike the UCITS Directive, both AIFs and AIFMs may be EU or non EU. Therefore, in theory, there is nothing at EU level to prevent EU27 AIFs continuing to be sold into the UK (and vice versa), or for EU27 AIFMs to manage UK AIFs (and vice versa).

However, the AIFMD non EU passports have not been introduced and a number of the EU27 do not have, or have very restrictive, private placement regimes. If UK AIFs cannot be sold into these countries, there is a political risk that AIFs domiciled in those countries will not be able to be marketed into the UK.

Some Member States allow UK retail AIFs to be sold to retail investors in their country, and vice versa. Again, there is a political risk of these arrangements being disrupted.

Investment management of funds

Both the UCITS Directive and AIFMD allow the investment management function to be delegated, provided there is still "substance" in the home Member State.

ESMA is promoting a common understanding of the substance requirements for UCITS ManCos and AIFMs. It has also called for the disparate third country regimes in EU legislation to move to a common approach. Brexit adds political momentum to both these debates.

Investment management of separately managed accounts

Under MiFID II, UK firms should be able to continue to provide investment management services to EU professional clients. However, the client may itself be subject to national rules that restrict its choice of investment manager (e.g. some pension funds). This is mainly an issue for UK based investment managers, but, again, there is a political risk of similar issues for EU27 firms that provide investment management services to UK professional clients.

In the wealth management arena, EU27 firms may not be able to market their services to UK clients, and vice versa.

Note (1) Undertaking in Collective Investment in Transferable Securities
(2) Alternative Investment Fund Managers Directive
(3) Markets in Financial Instruments Directive, revised
(4) European Market Infrastructure Regulation
(5) central counterparty

UK trade agreements with non-EEA[6] countries

The day of Brexit will not be the end of the story. The UK will need to negotiate new trade agreements with non-EEA countries where it currently benefits from EU agreements. The time gap in securing these agreements will impact firms in the UK, across Europe and more widely.

For example, business is currently done between the UK and Switzerland under Switzerland's trade agreement with the EU. Post-Brexit, this business will be uncertain until the UK agrees a new trade deal with Switzerland. Not only will UK and Swiss firms be affected: other firms (within the EEA or elsewhere) with operations in both the UK and Switzerland, and which depend on that border remaining open, will be impacted too.

Many other Brexit issues to navigate

In addition to the three main regulatory passports, EU investment and fund managers benefit from a number of other passports, protections and activities that will be impacted by Brexit. Here are just a few:

Post-Brexit, UK financial instruments and UK regulated markets will no longer be EU/EEA instruments and markets. A number of professional clients are required to be predominantly invested in EU/EEA financial instruments or to trade via EU/EEA regulated markets. Investment managers will have to adjust these clients' portfolios.

As the investment banks adjust their operations, so the capital markets, market liquidity and trading venues will change and evolve. The front offices of investment managers will have to adapt to these changes and they may have to change their internal dealing support systems.

Even if firms do not relocate any of their operations (from or to the UK), they will have to navigate contract law, employment law and tax law issues: for example, what will happen to VAT arrangements for EU27 members with operations in the UK? What impact will there be on the process for tax treaty claims?

Some EU27 members route data via the UK and then on to other destinations (e.g. the US). How will this work post-Brexit under the new EU General Data Protection Regulation (GDPR), which includes specific extra-territoriality provisions?

Increased competition to London may also lie outside the EU. The government of **Switzerland** said in a federal council report, "Financial Market Policy for a Competitive Swiss Financial Centre", that Switzerland's investment and wealth management industry should be able to capitalize on Brexit. "While asset management and investment banking are well-established strengths of London's financial center and are likely to remain so, Switzerland can build on its strong position in the area of cross-border asset management."

ESMA takes aim at delegation practices

Would-be rivals to London within the EU have been warned that unfair practices to attract business will not be welcomed. ESMA said, in March 2017, that it was investigating risks of "regulatory arbitrage", whereby national regulators try to attract jobs and tax revenue by offering lighter regulatory supervision.

Mr. Maijoor observed that the UK's decision to leave the EU results in increased risks to consistent supervision. He urged national regulators not to compete on regulatory and supervisory treatment, citing the ability for EU firms to delegate or outsource to a UK entity while being registered and supervised by one of the EU27 regulators. In May 2017, ESMA issued nine principles on how to deal with firms that are relocating, with the aim of ensuring a consistent approach to authorisation and supervision, including that the firms must have "substance".

When coupled with the upcoming review of AIFMD and consideration of the future shape of the EU's third country regimes, fund managers around Europe may have to reconfigure their business models. The common practice of domiciling a fund in one Member State and delegating the investment management function back to the UK is likely to come under increasing scrutiny and regulatory restriction.

> "... the UK's decision to leave the EU results in increased risks to consistent supervision."

(6) European Economic Area

Contacts

Jeremy Anderson
Chairman
Global Financial Services
KPMG International
T: +44 20 7311 5800
E: jeremy.anderson@kpmg.co.uk

Tom Brown
Global Head of Investment Management
KPMG International
T: +44 20 7694 2011
E: tom.brown@kpmg.co.uk

Fiona Fry
Head of Financial Services Regulatory Center of Excellence
EMA region
Partner
KPMG in the UK
T: +44 20 76942364
E: fiona.fry@kpmg.co.uk

Julie Patterson
Investment Management Director
Financial Services Regulatory Center of Excellence
EMA region
T: +44 20 73112201
E: julie.patterson@kpmg.co.uk

Simon Topping
Head of Financial Services Regulatory Center of Excellence
ASPAC region
T: +85 2 2826 7283
E: simon.topping@kpmg.com

Bonn Liu
Head of Investment Management
ASPAC region
T: +85 2 2826 7241
E: bonn.liu@kpmg.com

Deborah Bailey
Head of Financial Services Regulatory Center of Excellence
Americas region
Managing Director
KPMG in the US
T: +1 202 533 3443
E: bcmatthews@kpmg.com

James Suglia
National Sector Leader Alternative Investments
KPMG in the US
T: +1 617 988 5607
E: jsuglia@kpmg.com

Larry Godin
Principal
Advisory, Regulatory Risk
KPMG in the US
T: +1 212 954 1939
E: lgodin@kpmg.com

To read the full Evolving Investment Management Regulations report visit kpmg.com/eimr

kpmg.com/socialmedia

Designed by Evalueserve.
Publication name: Evolving Investment Management Regulation
Publication number: 134427-G
Publication date: June 2017