The impact of Brexit on non-European Hedge Funds

"Good morning everyone, the country has just taken part in a giant democratic exercise, perhaps the biggest in our history…The British people have voted to leave the European Union and their will must be respected,"

David Cameron, 24th June 2016

With the Brexit referendum decided and David Cameron's resignation announced, we look at the key impact of the referendum decision on the non-European fund industry.

In the short term the markets and currencies will see significant movements. The Bank of England Governor, Mark Carney has already gone on record to assure investors and pledge billons of extra funds for the financial system as they seek calm the market volatility. What the duration and consequences of this volatility will be remains to be seen.

From an operational infrastructure perspective, there should be no immediate impact on the day to day operations of the funds industry. EU law specifies that a country wishing to leave the EU must invoke Article 50 under the Lisbon Treaty, which would lead to a two year transition period whereby the UK government, headed by a new Prime Minister would negotiate their exit terms. However, whether this timeframe is realistic is uncertain with many market participants suggesting that this timeframe is not reasonable. As previously highlighted on our pre referendum article, there are three principle exit models; the EEA model, the Swiss model, the World Trade Organisation model.

The EEA model

Should the UK agree to remain as a European Economic Area (EEA) country, rules such as the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive II (MIFID II) would continue to apply although UK policymakers would have less say in their formulation.

The Swiss model

The UK could adopt the 'Swiss model', whereby they would apply to join the EFTA, the European Free Trade Association (constituted of Switzerland, Iceland, Norway and Liechtenstein) and negotiate access to the single market on a sector by sector basis. The UK would be bound to follow the regulation in the covered sectors but would otherwise negotiate Free Trade Agreements (FTAs).

The World Trade model

A complete withdrawal would designate the UK as a third country. This would have a more noticeable impact as Britain may have to rely on its World Trade Organisation (WTO) membership to negotiate additional trade deals going forward. However, this model is fraught with potential complications.

Depending on the transition arrangements, the non EU funds industry would be affected in three principle areas, namely marketing, operations and legal.

Marketing

Reverse solicitation

Reverse solicitation is when EU investors actively solicit the manager about their product rather than the manager directly marketing to them. There is a fine line managers must tread when relying on reverse solicitation and the punishments for breaching the rules can be serious. Whilst this is one potential mechanism by which to gain European investment, there are a number of global hedge fund managers for whom the European market is not a primary interest. They are therefore happy to just field calls from EU investors through the reverse solicitation framework. Clearly the impact of BREXIT on these managers will be negligible.

National Private Placement Regime (NPPR)

General reliance on the reverse solicitation framework appears to have shifted as many lawyers warn US hedge funds that the consequences of breaching the rules can be severe. A number of these managers are electing to use NPPR in markets where they are confident of raising meaningful capital. This subjects managers to aspects of AIFMD but not the obligation to appoint a full depositary subject to strict liability for loss of assets. While some hope the UK will scrap aspects of AIFMD in the event of the UK becoming a third country, this is unlikely for both political and practical reasons. The UK – should full BREXIT occur – would want to still benefit from the pan-EU passport regime and having equivalent rules is key to attaining this. Scrapping unpopular elements of AIFMD is a sure-fire way in which to scupper that ambition.

Passporting

The European Securities and Markets Authority (ESMA) is assessing third countries' regulatory equivalence with the EU. Jurisdictions, including the US and Cayman Islands, the latter of which has made regulatory changes to bring its rules more into line with the EU, could very well be granted AIFMD regulatory equivalence by 2018. This would enable managers in these jurisdictions to freely passport into the EU once National Private Placement Regimes (NPPR) expire. It should be noted that both the jurisdiction of the manager ***and*** the fund must be deemed equivalent before they can passport. However, if the US and Cayman Islands received equivalence, it could be argued a New York manager of a Caymanian fund would be in a better position to market to EU institutions come 2018 than a UK counterpart if BREXIT actually happens.

Operational Issues

BREXIT will have undeniable operational consequences for managers with EU interests. US managers which are fully AIFMD or UCITS compliant through management companies or by basing their AIFMs or UCITS managers inside the EU, specifically the UK, could have operational issues. If the UK becomes a third country, UK-based AIFMs and UCITS could be forced to reorganise their business structures with a greater presence in Ireland or Luxembourg. This could be an administrative headache. Simultaneously, those non-EU managers which have structured their businesses through an Irish or Luxembourg management company may be unable to passport their Alternative Investment Fund (AIF) to the UK if the latter became a third country. While NPPR marketing options would remain for the UK, utilising an EU management company to access the UK alongside the EU may not be viable.

US managers using NPPR in certain EU countries (Germany and Denmark) are obliged to appoint a depositary-lite, some of which are domiciled and regulated in the UK. Other managers have appointed full-scope depositaries, which are part of UK custodian banks. A legal briefing by Ashurst highlighted that AIFMD restricts providers that can act as depositary to EC credit institutions. If the UK became a third country, its custodians would not qualify as EC credit institutions. The banks could in theory apply for third country recognition, although Ashurst highlighted this could be “politically fraught.” As such, it could force banks and depositary-lites to relocate more of their UK operations to EU jurisdictions such as Ireland or Luxembourg.

The legal consequences are therefore very complicated. The interim period – depending on the nature of BREXIT – could result in the UK setting legal precedents on a number of issues affecting financial services which would not necessarily be bound by the EU legislature. This could cause confusion, particularly if the UK took diverging views to the EU, which could result in practical problems for managers with UK and EU interests or locations.

Conclusion

BREXIT could have an impact on the marketing and operational structures at non-EU hedge funds. Non-EU hedge funds should be considering the implications a BREXIT could have on their European interests.

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About the author

Trinity is an independent global specialist hedge fund solutions company servicing the asset management industry for over two decades, with offices in New York, Dublin, Cayman, and Cyprus.

Trinity provides incorporation, administration, investor, corporate governance and risk and regulatory reporting services to a diverse range of clients and bespoke investment strategies, across various international jurisdictions (onshore and offshore).

We pride ourselves on delivering the service that our clients deserve. Trinity's success has been built upon the stability and the global proficiency of a large organisation coupled with the flexibility, autonomy and adaptability of a specialist boutique firm.