Brexit
Potential Impact on Funds and Practical Steps
The news that the UK has voted to leave the European Union (EU) has begun to sink in and it is time to start taking practical steps to address the issues facing your business and engaging with contingency planning. Brexit, if and when it happens, will affect funds, managers and investors both in the UK and the EU and the impact on the funds industry has the potential to be significant.

The terms upon which the UK might leave the EU are currently unclear and will depend on the trading terms which the UK is able to negotiate with the EU and/or the rest of the world. For example, it is not clear if the UK, like Norway, will be a member of the European Economic Area (EEA), will have a trade arrangement with the EU similar to Switzerland or will have a different arrangement with the EU.
Business as usual until Brexit?

EU laws and regulations currently in place or implemented before Brexit takes effect will still be binding in the UK until Brexit, which is unlikely to occur until late 2018 at the earliest. In the longer term, Brexit will mean an overhaul of the legal and regulatory environment in which funds and their managers operate. However, the most likely short term effects of the result of the Brexit referendum on funds will be economic, rather than legal or regulatory.

Changes in the value of sterling, inflation, interest rates, yields on gilts and corporate bonds, property values, rises and falls in the stock market and increased market uncertainty leading to volatility will impact funds in a variety of ways. The post-referendum economic environment will provide challenges, risks and opportunities for funds. The performance of underlying portfolios and the ability of funds to raise money in both the private and public equity capital markets are likely to be impacted.

Brexit Planning

Whilst the terms of Brexit are unclear and this makes long term planning challenging, there are a number of short and medium term actions that funds and their managers should be taking. Key elements of Brexit planning to be considered include:

- **Impact analysis** – Funds and their managers need to assess the short, medium and longer term potential impacts of Brexit and develop strategies to manage these impacts. Funds should assess the extent to which they are reliant on access to the single market. Those funds whose business model is reliant on being able to access the single market, either for capital (i.e. EU investors) or for services (i.e. EU AIFM, investment adviser or other financial services provider), will be more impacted than funds whose investors and operations are predominantly domestic UK.

- **Documentation review** – Fund documentation should be reviewed to check references to the EU, and whether these references will work as intended post-Brexit. Examples include references to the EU in investment policies (e.g. if an allocation to UK was previously included in an EU bucket), territorial grants of fund distribution rights, non-competition covenants, and so on.

- **Investor Communications** – Managers need to ensure that investors are informed of potential Brexit impacts and potential Brexit risks are properly disclosed in offering materials. Particular care should be taken when issuing “it’s business as usual” communications in view of the potentially unquantifiable and unknown consequences that Brexit may have.

- **Market volatility planning** – The cocktail of domestic and EU politics that will determine the duration and destination of the Brexit journey, will inevitably impact the markets over the next couple of years. In many cases, the lessons of the global financial crisis were learnt the hard way. Managers should try to anticipate the possible effects of market volatility on their funds and implement currency hedging, takeover defence and other strategies to mitigate these risks.

- **Redemptions** – managers of open-ended funds will need to prepare for a potential increase in redemption requests. Redemption provisions should be reviewed to ascertain whether redemption gates, suspensions or side pockets can be used and any necessary investor communications will need to be drafted.

- **Valuations** – funds should keep their valuation policies under review and should consider the need for pricing oversight committees and possible increases in valuation frequency. They should also consider strategies for dealing with hard-to-value assets.

- **Lobbying** – It will be crucial for industry participants to contribute to any relevant government consultations.
Once the shape of the post-Brexit relationship becomes clearer, funds will need to consider whether they will need to restructure their operations for any of the following reasons:

– to ensure that they can raise capital from their target investor base;
– to ensure that they can continue to receive services from service providers such as AIFMs, investment advisers, depositaries and other financial services providers; and
– to ensure that their current domicile continues to provide the optimum tax and regulatory treatment when balanced with the operating costs of the jurisdiction.

Please get in touch with us if you would like to discuss the impact on any potential fund structures.

**Potential General Impact on Funds**

Depending on the exact terms negotiated for a Brexit (and assuming that the UK would not remain in the EEA) the impact on UK funds and managers has the potential to be significant. As much of the relevant regulation is based on international initiatives, Brexit would not necessarily mean that the regulatory requirements on funds and managers would differ significantly from current requirements but certain associated benefits may be lost.

Much would depend to what extent (and when) UK implementing legislation would be repealed, for example in relation to the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, and whether the UK could negotiate to retain the benefits of the EU based regulation in the form of marketing and management passports (which allow UK fund managers to market to investors based in the EU and provide services to entities in the EU).

Also, several fund vehicles such as UCITS, European Long Term Investment Funds (ELTIFs), European Venture Capital Funds (EuVECAs) and European Social Enterprise Funds (EuSEFs) must be EU domiciled and managed by an EU-based manager, which would prevent UK domiciles and managers for such funds unless these requirements are re-negotiated with the EU.
Impact on Alternative Investment Fund Managers

Depending on the exit terms, post Brexit, UK alternative investment fund managers (AIFMs) would be treated as non-EEA AIFMs and would only be able to market alternative investment funds (AIFs, i.e. broadly non-UCITS funds) to EEA investors under private placement arrangements if the member states where the investors are based permit such marketing. Under the AIFMD, a non-EEA “third countries” passport may be introduced. This would allow non-EEA domiciled and managed funds to be marketed within the EEA if the manager is authorised and certain other conditions are met. However, at present, the introduction (and timing) of such a third countries passport is not certain.

It would also be important to ascertain whether a UK portfolio manager can act under delegation from an EEA based AIFM. In such a case, the AIFMD letter box considerations would be relevant, and the AIFM must have sufficient oversight over risk management and portfolio management. The ability to adopt this business model will also depend in part on whether UK portfolio managers will be treated as “EU equivalent” under the “third country” regime that is foreseen in MiFID II.

Impact on UCITS Funds and Managers Based in the UK

A Brexit would fundamentally impact UK domiciled UCITS as, based on current requirements, these would need to be EU domiciled and self-managed or managed by an EU management company (ManCo). As the precise terms of a Brexit are uncertain we cannot yet fully know whether the UK will be permitted to remain a domicile for UCITS or ManCos. If this would not be the case, current UK UCITS or ManCos will have to be migrated/relocated to an EU member state (and re-authorised) or cease being a UCITS. Currently a vast majority of UCITS are domiciled in Luxembourg or Ireland, which means that, in many cases, Brexit might not be a major practical impediment to these managers being able to continue in business. That said it would be important to ensure that any UK ManCos would be able to manage UCITS under delegation arrangements.

Impact on Investment Mandates and Investment Policies

Mandates in Investment Management Agreements and investment policies in fund documentation, plus retail investment products, will likely need to be amended to allow for investment in both the EU without the UK (a Brexited EU) and the UK (instead of the current EU). This will require consideration of the relevant variation terms and is likely to require agreement of the investors as well as regulatory notifications.

Investors will have to review their internal procedures and investment guidelines to accommodate investment in a Brexited EU and UK. For example, pension fund trustees may have to amend their Statements of Investment Principles.

Impact on Listed Funds

A post-Brexit world would see the LSE’s Main Market and the Specialist Funds Market lose their status as EU regulated markets. It is likely that the UK would try to negotiate equivalent market status for these markets on the basis that the disclosure obligations applicable to funds and other issuers traded on those markets are equivalent to other EU regulated markets.

Equivalence status is likely to help maintain the competitiveness of London’s markets and would minimise the impact on listed funds whose investors require them to be traded on a market that has a certain regulatory status. However, equivalent market status is likely to restrict the ability of the UKLA and HM Treasury to remove defunct provisions or unnecessary ‘red-tape’ laws, rules and regulations that have originated in Europe, so many of the Prospectus Rules and DTRs are likely to continue to apply to listed funds (even the bits that don’t make any sense!).

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