How will Brexit affect financial centers of excellence?

On 29 March 2017, UK Prime Minister Theresa May officially triggered the process that will lead to the United Kingdom’s exit from the European Union. This marks the beginning of what is likely to be an in-depth two-year negotiation period that will re-draw the relationship between the UK and the EU. These negotiations will be complex and touch many areas.
Speculations over the last nine months have led to talks of a hard Brexit. It has now become clear that the EU and the UK have converging interests in reaching an agreement that would minimize disruption to businesses, investors, and citizens; in May’s own words, in her letter triggering Article 50 of the EU’s Lisbon Treaty, “... as the UK is an existing EU Member State, both sides have regulatory frameworks and standards that already match,” and this should greatly facilitate the process.

Given the number of technical aspects that need to be covered, however, the criticality of certain topics and the necessary links to be drawn between them for the sake of fruitful negotiations, it may well take more than two years for the players to be able to draw comfort from a clear, stabilized situation and make definitive plans for the future. Since very few players can afford uncertainty, many have already initiated steps to plan remediation actions in order to secure business continuity in a worst case scenario until they eventually discover how much relief they can draw from successful negotiations. Since Thursday 23 June 2016, there is still a great deal of uncertainty as to the terms and conditions of the negotiations, with a marked contrast between the views of the UK and the EU.

In response to Theresa May’s urging to “build an ambitious free trade agreement” between the UK and the EU, saying it is “necessary to agree on the terms of our future partnership alongside those of our withdrawal from the EU,” Angela Merkel countered that “the negotiations must first clarify how we will disentangle our interlinked relationships.”

Yet now is the time to realize that there is much more at stake than just trying to mitigate the impacts of the UK and the EU no longer having free access to each other’s markets. Brexit also creates opportunities for accelerating the creation of pan-EU product and service distribution centers of excellence. This article analyzes the impact and options at stake for UK players, and how this will drive new development opportunities for traditional cross-border centers in the EU.

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UK firms with EU-centered interests can no longer afford to live with this constant uncertainty, and have already initiated remediation plans to ensure continuity of their pan-EU distribution models.

From the moment the referendum result became clear, UK fund firms with strong interests in Continental Europe had to contend with redemptions, driven by retail investors’ irrational fears, although this situation appears to have stabilized for the time being. Alternative fund managers also encountered certain challenges in raising cross-border capital for their new projects in the UK; the prospect of potentially being locked into an investment vehicle for several years, with no certainty on the ultimate tax treatment applicable upon exiting, appeared to become a challenge for qualified investors. This scenario pushed various UK-based fund initiators to start replicating their existing UK-based products in the EU. Similarly, third country managers, who traditionally used the UK as their entry point into the EU, have been considering alternatives for their new projects.

For fund managers and MiFID firms with generally strong local anchors and interests in the UK, the key challenge is trying to sustain the balance of securing both continuity and future business development on both sides of the Atlantic. Typical future target operating models for UK management companies and MiFID entities will be to establish themselves in another EU jurisdiction of choice and to delegate portfolio management and other value-added functions back to the UK, to the largest extent possible. This setup is based on the strong assumption that the UK will benefit from minimal recognition of equivalence. This being said, it is worth noting that only AIFMD and MiFID mention the possibility of third country regimes, so businesses should not solely rely on equivalence as a strong future business model.

Many actors can already rely on the footprints they have established on the continent to support other businesses; others see benefits, at least in the short
term, in partnering with a local player or even “renting” a third party management company to help cement their EU link and access to a single direct market. While proximity to star investor pools or to real assets might be considered as key criteria in relation to the choice of the target location, all players will need to consider multiple dimensions including taxation, infrastructure, and costs when conducting their detailed comparison exercise between possible candidate host jurisdictions.

**Arbitrage between jurisdictions—an opportunity to redistribute cards inside the EU?**

The perspective of drawing some benefits from the UK’s exit has stimulated certain EU country challengers and led other, mainly cross-border, jurisdictions to intensify their campaigns on their undisputed merits. While Ireland and Luxembourg, having both built their growth on catering to non-local actors and cross-border distribution, are taking a more subtle approach to future opportunities, France is active in promoting ad-hoc toolboxes designed to incentivize relocation to its territory. Although EU regulatory environments are generally harmonized, there are still rather unequal practices between member states. Ease of doing business, excellence in supporting cross-border dimensions, and linguistic compatibilities will undoubtedly be one of the critical differentiators between best candidates in this race.

Beyond the free competition element, however, the EU should not forget looming threats of growing fragmentation. The EU’s ability to grasp this opportunity to accelerate the series of reforms initiated through the Capital Markets Union Action Plan might well be critical for its potential to capitalize on its strengths in the future. Actors seeking to relocate pan-EU distribution activities to a single EU member state still seem to face inconsistent approaches from one member state to another. Asset management firms performing both fund and MiFID activities often operate client-facing activities through branches established in the EU and are contemplating transferring their branches to other EU- or EEA-based entities. Large asset management firms may seek to benefit by grouping these activities under the umbrella of their management companies. Yet at this point in time, it still seems difficult to streamline this type of setup across member states.
UK center of excellence as the new gateway to Eastern Europe and the rest of the world?

Over the last nine months, it has become clear that Brexit will also provide the UK with an opportunity to position itself as a center of excellence to support development in other world regions. If the UK is successful in negotiating balanced agreements with the EU, this venture may well turn into a win-win situation for Britain as a leading financial center.

A recent idea consists in implementing a dual fund regime, with standard EU products on one hand and lighter regimes for products aimed at clients outside the EU on the other. According to Jamie Carter, deputy chairman of the New City Initiative, “A dual fund regime would allow UK managers with EU interests to continue complying with EU laws and directives and retain favorable access to their EU investors, while simultaneously letting others market ‘ex-EU’ to the rest of the world and avoid the worst excesses of EU regulation. This type of regime could also enable fund managers to avoid relocating their businesses to onshore EU locations such as Ireland and Luxembourg, provided equivalence for the UK is granted.”

It will take months before the consequences of Brexit for the financial industry are fully realized, and to what extent this event will trigger a restructuring, or even creation, of financial centers of excellence on a global level. If a member state no longer wishes to recognize the jurisdiction of the European Court of Justice, how can it expect to still have access to the single market? Considering President Trump’s stated intention to deregulate, the EU will need to quickly figure out how much longer it can afford to continue leveraging its label of excellence when external competition on the cost of compliance is becoming a general threat.

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