The UK’s vote to leave the EU
How will investment managers be affected?

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The UK’s vote to leave the European Union has created significant uncertainty for investment managers, with implications for their investment strategies, their cross-border business, and potentially their ability to retain and attract staff. Firms will need to think ahead and be prepared to take some decisions in an uncertain environment.
The UK’s widely unexpected Leave vote has introduced uncertainty over the country’s economic growth prospects and has resulted in both tactical and strategic challenges for investment managers. Preparing for Brexit will be complicated by considerable uncertainty over the timing of the UK’s invoking Article 50, the negotiating stances of both the UK and the EU, and the ultimate outcome.

The UK’s most likely options range from: staying in the European Economic Area (EEA), which would mean the UK would retain access to the free trade area and the so-called “passporting” regime; joining the European Free Trade Area, which would mean staying in the free trade area but losing automatic access to passporting; to going it alone on a World Trade Organization (WTO) basis, which would mean both leaving the free trade area and losing automatic access to passporting. Given the wide range of outcomes as well as the potential negative impacts on UK (and possibly EU) growth from a long drawn out negotiation process, irrespective of the outcome, firms should start making some detailed preparations now.

UK and global financial markets have (so far) been resilient post-Brexit vote, after an initial stumble. US stock markets have reached new highs and the main UK and European indices have recovered from their post-Brexit losses, with a fall in Sterling particularly helping UK multinationals to outperform relative to domestic companies. A £170 billion stimulus package from the Bank of England, together with a cut in interest rates, has seen UK government and corporate bond yields fall sharply, while expectations of more central bank stimulus in Europe and a more benign interest rate outlook in the US have combined to boost the value of many fixed income instruments across the globe.

Nevertheless, the Brexit referendum has negatively affected some asset classes in the UK, such as open-ended property funds. These witnessed sizeable redemptions and sparked a number of fund suspensions. Similarly, shares of many domestically focused UK businesses, such as housebuilders and banks, remain well below pre-referendum levels. Sterling has taken the brunt of the impact of the uncertainty of the UK’s economic prospects, down more than 10 percent against the dollar and the euro. There is a concern that slower economic growth could also lower fund sales in the UK. Following the Leave vote, investors in Europe switched into “risk-off” mode with equity funds hardest hit with redemptions. Investment managers experiencing sizeable redemptions may see margin pressures, as well as those with Sterling-based fees and international costs. Conversely, those with international fees and Sterling costs are likely to benefit. Investment managers also need to be alert to pressures on fund liquidity in the event of significant client redemptions.

The medium and long-term implications of Brexit are unclear. While financial markets have been resilient, uncertainty during the renegotiation period will probably weigh on economic growth prospects both in the UK and the wider EU, as well as spark periods of market volatility. Brexit could also lead to similar referenda in other Member States, and raise questions about
the future of the EU. If other Member States decided to leave, this could have a significant impact on global economic activity and ultimately hurt asset values, given Europe’s role as the largest trading bloc in the world. In such an uncertain environment, investment managers will need to update their contingency plans with a renewed focus on potential future impacts on revenues and on fund liquidity, as well as considering the potential impact on their operating model and staff.

Foremost among operational challenges is uncertainty over passporting, which allows EEA investment managers to provide services in any EEA country through a branch or without a physical presence. While the potential loss of access to EEA passports could be a very significant problem for many UK financial services firms, many investment managers are comparatively well placed if they needed to access the EEA without the passports. Nevertheless, the impact would be far from insignificant.

Under the current regulatory regime, UK investment managers can market UCITS retail funds across the EEA without needing to have a UCITS management company or UCITS funds outside the UK. In practice, many UK investment managers already have an EEA UCITS management company or companies and EEA UCITS funds, with appointed local depositaries. Luxembourg and Ireland have typically been the preferred non-UK fund domiciles of UK investment managers in part due to the substantial asset servicing and funds infrastructure businesses in these countries. Firms typically delegate the portfolio management back to a UK entity, which is similar to the model of many global investment managers. Under this setup, firms need to ensure that their EEA management company can provide sufficient oversight of the UK portfolio manager.

As an illustration, the Luxembourg investment funds industry does not expect UK investment managers to shift asset management divisions out of the UK. Rather, the objective is to provide UK investment managers with pragmatic solutions, avoiding disruption to the operating model, and mitigating additional cost as much as possible. For example, asset managers could be looking to set up or re-domicile fund structures to continental Europe working with third-party providers in an initial stage.

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1 In August, the Bank of England cut its GDP forecast for 2017 from +2.3% to +0.8%.
2 Morningstar DirectSM Asset Flows Commentary: Europe, Morningstar, July 2016
3 Undertakings for Collective Investment in Transferable Securities
If the UK loses access to the UCITS passport, firms marketing UK-domiciled funds to EEA retail investors will need to set up a UCITS management company and funds in the EEA (or expand their existing setups) if they want to continue marketing to these investors. Where EEA investors in UK funds move to non-UK funds, or where UK funds re-domicile, there are a number of issues to consider, including whether there could be a tax impact for investors. For EEA investment managers who want to market to UK retail investors, they could set up UK funds or apply for their non-UK funds to become “recognized” by the FCA under the existing UK rules. For the latter option, they would need to demonstrate equivalent consumer protection to the FCA through its funds authorization process.

For non-retail funds, the loss of the AIFMD passport would mean that UK funds, or funds managed by UK alternative investment fund managers, could only be marketed in the EEA where this is allowed under country-specific rules (so-called “national private placement regimes”). EEA countries vary significantly in the extent to which they allow non-EEA funds to be marketed. The UK is relatively open, but some countries are very restrictive. To access the existing AIFMD passport, UK firms would need to have funds and an alternative investment fund manager based in the EEA, although portfolio management could still be delegated to a UK entity. However, in the future, the UK could be granted an AIFMD third country passport if the EU considers that the UK regulatory regime poses no significant obstacles regarding investor protection, market disruption, competition, and the monitoring of systemic risk. The EU is currently considering extending passports to five jurisdictions (Switzerland, Canada, Jersey, Guernsey, and Japan). If the EU were to grant an AIFMD passport to UK firms, it would allow them to access professional investors across the EEA directly, provided they obtain authorization in the EEA and fully comply with the AIFMD.

UK firms managing institutional mandates currently benefit from a MiFID passport, which allows them to access clients across the EEA. If UK firms lose this passport, they will only be able to manage individual mandates for EEA investors where this is allowed under country-specific rules, so may need to establish a greater EEA presence. However, MiFID II, which is due to be implemented in January 2018, introduces an equivalence regime for non-EEA countries. If the UK is deemed by the European Commission to have equivalent prudential and conduct regulation, UK firms will be able to obtain a “third country passport” to provide investment services to professional investors across the EEA without a branch or subsidiary following registration with ESMA. To obtain equivalence, the UK will need to provide an equivalent level of access to the UK for EEA firms. Currently, the UK allows third country investment managers to provide certain services to some types of UK clients under its “overseas persons exclusion.”

Investment managers will also need to consider their distribution networks, as UK-based distributors will only be able to sell funds to EEA retail clients where this is permitted in the relevant country, and MiFID II does not provide any third country passport for distributing to retail investors. UK-based distributors may need to set up EEA branches (if this is allowed in the relevant countries) or an EEA subsidiary (which could access retail clients across the EEA through a MiFID passport). It is also possible that EEA-based distributors serving UK clients may need to set up a UK branch or subsidiary.
If the UK loses its existing passporting rights, investment managers will need to re-evaluate their current EEA and UK footprints. UK firms will need to ensure they have a sufficient EEA presence, with appropriate levels of capital and staff to support any planned expansion of their EEA businesses. The operational restructuring required will vary significantly between firms, depending on the extent of their existing EEA presence. For non-retail business, the operational impact will be reduced if the UK is granted third country passports under MiFID II and AIFMD. However, there could be a time gap between the UK leaving the EU and the passports being granted, and the EU would be able to withdraw the passports in the future if the UK no longer met the criteria. European firms seeking to access UK clients will also need to review the extent of their UK presence. Currently, the UK is more open to non-EEA business than many EEA countries are, so it is possible that European firms seeking to access the UK market may face fewer barriers than UK firms seeking to access the EEA market. However, the UK is likely to want to push for reciprocity as part of its negotiations.

Talent management is another critical operational challenge for UK firms. Workforces in the investment management sector tend to be very international, reflecting in part the globalization of markets. Since the Brexit vote, firms have been reassuring EEA staff based in the UK (and indeed UK nationals based in the EEA) and they will need to continue to do so to the extent that they can. For the UK to retain its central role in the European investment management business and for UK-based investment managers to thrive, access to top-level talent, including that from the EU, will be vital. Firms will no doubt continue to lobby the UK authorities for this cause.

Finally, there will also be operational challenges with respect to taxation for both the corporate group and fund vehicles. Historically, there has been increasing harmonization of tax rules across Member States, resulting in both the benefits and drawbacks of establishing an entity in a particular EEA state being reduced. The impact of EU law, treaty freedoms, and potential domestic law changes could increase tax drag on both corporate entities and funds.

In the face of the operational and strategic challenges that Brexit has raised, firms will need to be forward thinking and consider all the possible scenarios. They will need to be prepared to make some decisions in an uncertain environment, as the details of the UK’s future relationship with the EU may not be known for some time and any changes to the business may take time.

**To the point:**

- The UK’s Leave vote creates significant uncertainty, which could weigh on economic growth prospects for the UK and the wider EU. Indeed, the UK’s future relationship with the EU, and the extent of barriers to cross-border business, will not be known for some time. Against this uncertain backdrop, firms will need to make some important decisions.
- The impact on cross-border business will be most significant for firms providing services to retail clients. For non-retail business, the impact of Brexit is likely to be partly mitigated if the UK is granted third country passports under MiFID II and AIFMD. To achieve that, the UK regulatory regime must be deemed sufficiently robust compared to that in the EU. If these passports are not granted, UK firms may need to establish a greater presence in the EEA to continue providing services to EEA clients.
- Given that the UK is relatively open to international business, EEA-based investment managers may face fewer barriers accessing the UK market than their UK counterparts face accessing the EEA markets, if passporting rights are withdrawn. However, the UK government is likely to push for reciprocity as part of its negotiations.
- Firms will need to continue to reassure existing employees about their futures, to the extent they can. UK investment managers will want to do as much as they can to ensure access to top-level talent, both from within the UK and globally.