HFMWEEK

Life after Brexit

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Wednesday 18th May, 2016 4:08 AM ET

As the UK's 23 June referendum on continued EU membership creeps closer, many will understandably feel they're as far as they ever were from understanding what a post-Brexit world might look like.

In an *HFMWeek* poll of nearly 100 UK-based hedge fund managers in February, the majority said they would vote to remain in the EU by a margin of 58% to 42%.

Large managers appear equally split with Winton Capital's David Harding and Caxton CEO Andrew Law seen as leading "Remain" campaigners while Odey Asset Management founder Crispin Odey and Marshall Wace co-founder Paul Marshall are advocating a "Leave" vote.

Cutting the red tape

Brexit supporters often have a litany of reasons for their disdain for the EU and in the hedge fund community, the specific regulatory issues that drive Brexit sentiment are familiar to most.

"AIFMD was essentially a land grab by the EU to regulate firms that weren't doing a great deal of European business," says Jacob Rees-

Mogg, a Conservative MP and co-founder of $6.8bn Somerset Capital Management.

“It was not a sensible regulation, it wasn’t well thought through and it wasn’t event ready by the time they wanted to introduce it.”

Aspects of Mifid II, Markets Abuse Regulation and Emir have drawn similar ire from Rees-Mogg and his fellow Brexit supporters.

Christopher Leonard, a partner at law firm Akin Gump warns that Brexit might not alleviate these issues.

“Despite the frustration with red tape that drives Brexit sentiment, the notion that there would be less regulation in a post-Brexit UK is fanciful,” says Leonard.

“Financial regulation post-2008 has been in large part driven by international bodies like the G20, the FSB and Basel.

“The idea the UK would turn its back on those international institutions is very unlikely.”

Experts have also noted that if the UK left the EU, financial firms in the region would still be heavily impacted by European regulations such as AIFMD and MIfid II yet UK policymakers would not have a seat at the table to represent their interests.

Independence Day

If the UK votes to leave the EU on 23 June, there are few certainties about what Brexit will deliver. However, a generally accepted consequence, in the short-term at least, is disruption and volatility.

May has already seen a number of bleak post-Brexit economic forecasts, notably including one from Bank of England governor Mark Carney who said a Brexit vote could trigger a possible “technical recession” in the UK, warning of the impact on growth and jobs, as well as the value of the pound.

Indeed, the impact on the UK’s currency is already being felt as CME Group research shows the pound more vulnerable to the possibility of Brexit than the euro.

“Normally, GBP implied volatility is lower than that for the euro,” explains CME’s report. “This relationship has reversed sharply in recent weeks ahead of the June 23 vote.”

On 13 May the International Monetary Fund said Brexit would lead to a “protracted period of heightened uncertainty, leading to financial market volatility.”

John Rowland, executive director of political consultancy firm Cicero, argues these interventions will be significant in the outcome of the referendum.

“The perception is that the economic argument has been won by the Remain campaign,” he says. “There’s almost been an acceptance from the Leave side in that respect, but this was never just an argument about economics.”

Article 50

Whatever the result of the referendum on 23 June, life for hedge fund managers will probably not be drastically different in the immediate future.

“On 24 June, the law will be exactly the same as it is today, with or without Brexit,” says Akin Gump’s Leonard. “AIFMD won’t suddenly melt away and markets abuse regulation will still come into effect 3 July.”

In accordance with Article 50 of the EU’s Lisbon Treaty, the UK prime minister, whoever that might be post-Brexit, would have to write to the EU Commissioner confirming the country’s decision.

The UK would then have to negotiate the terms of Brexit with the 27 other member states.

The treaty lays down a timescale of two years from the point the UK formally gives notice of its intention to exit, but the overall process could be longer if Article 50 is not immediately engaged.

There are a number of possible blueprints the UK may choose to follow in the event of Brexit, from the Swiss model to UK justice secretary Michael Gove’s so-called “Albanian model”.

“The post-Brexit model that would undoubtedly have the least impact is the so-called Norway model, with the UK joining the European Economic Area (EEA) and retaining the passport to provide services EEA-wide and access the single market,” says William Yonge of legal advisory firm Morgan Lewis. “In this case the UK would still have to make significant financial contributions to the EU but would not have a seat at the table in negotiating legislation.”

However, Cicero’s Rowland warns that the Norway model is an unlikely prospect.

“It’s unlikely because it requires paying heavily into the EU budget for access to the [single] market, without having a say,” he explains.

“The costs will be too high for people who advocate Brexit to accept. It would be politically very difficult.”

Rowland believes the UK would more likely to follow a different path.

“I think we would end up with a uniquely British model that doesn’t exist anywhere else at the moment,” says Rowland “The problem is, even the people who advocate Brexit aren’t sure what that model would look like.”

Ucits

A Ucits fund must be EU domiciled as must its management company to benefit from the directive’s marketing and managing passport. And the Ucits directive does not contain a ‘third country regime’.

Post-Brexit, UK firms would therefore lose managing and marketing passporting rights into the EU.

Funds established as Ucits in the UK would fall outside of the directive and likely be categorised as an 'alternative investment fund' (AIF) under AIFMD.

"The impact of Brexit will largely depend on the nature of your business and where your investor base is located," says Morgan Lewis' Yonge.

Most UK hedge funds operating alternative Ucits funds will already have their funds domiciled in Luxembourg or Dublin but would have to make changes to ensure they have a management company presence within the EU.

The options left to those managers who rely on an investor base in the EU and currently operate their management process entirely in the UK, would involve either leaving the UK or using an EU-based affiliate as a management company and appointing a UK manager as the fund's delegated investment manager.

Here lies opportunity for other European jurisdictions, says Akin Gump's Leonard.

"Dublin, Luxembourg, Paris and Frankfurt would all like a little bit of the pie. They already want it and why wouldn't they?" he says. "If they perceive an opportunity to get bigger slices via Brexit, they will."

He adds: "Dublin is the obvious choice. People often talk about the advantages of London being the language, time zone and educated workforce, Dublin has all of these things.

"What it doesn't have is the same level of infrastructure, which can be built – but not overnight."

Mifid

Similarly Mifid gives EU investment firms authorised in their home jurisdiction a passport to conduct cross-border business and to establish branches in other EU countries, free from additional local authorisation requirements.

UK-regulated firms that undertake Mifid business would no longer be able to rely on the passport to undertake that business in the EU.

Conversely, firms in the remaining countries in the EU firms would no longer be able to undertake Mifid business in the UK.

In this respect, Brexit would have restructuring implications for both UK and non-UK Mifid firms.

"The impact on Mifid and Ucits firms is potentially greater than that on AIFMs because passports are not available for third countries under Mifid and Ucits," says Yonge.

This impact is significant because Mifid II is likely to go ahead in the UK, even if it were to leave the EU.

Although it is an EU regulation, Mifid II is based upon the G20's commitments and reform agenda following the financial crisis, to which the UK as a club member is committed.

In addition, Mifid II is scheduled to be implemented within the two year period the UK has to renegotiate its relationship with the EU.

In order to continue doing business across the EU, UK firms will need a degree of equivalence.

Mifid II introduces an arrangement which would allow Esma-registered non-EU firms from an equivalent jurisdiction a third-country passport to provide cross-border investment services across the EU to eligible counterparties and professional investors.

However, UK managers will not be able to benefit from a passport to provide services to retail and other kinds of professional clients as each member state is permitted to require investment firm's to establish a branch in their country.

AIFMD passport

As key aspect of many hedge funds' business models, how AIFMD is handled would be a crucial aspect of any post-Brexit settlement.

In a non-EEA Brexit scenario, marketing by UK AIFMs of AIFs to EU investors would have to be undertaken on the basis of member state private placement regimes.

UK-based AIFMs would also no longer be able to manage an AIF established in an EU member state without being locally authorised in that member state to do so.

For the UK, an AIFMD third-party passport extension is by no means a given, but the nation's current relationship and synergies with the EU would certainly put it in a better position than other global jurisdictions vying for the passport.

"The UK regime is equivalent because we are in the UK currently, and we have leading regulators in the FCA and the PRA," says Morgan Lewis' Yonge. "However, post-Brexit the UK regime would have to be politically judged equivalent by the European Commission and the other EU authorities.

"It is not clear that we in the UK can rely on that judgement being positive because of political issues that we cannot foresee."

This article was originally published in **HFM Week**

The online version can be found here