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Brexit: Is Equivalence a Solution for Investment Funds?

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Dublin Cork London New York Palo Alto San Francisco www.matheson.com

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We have considered in a broader context whether the European Union ("**EU**") equivalence framework provides an appropriate basis for the future relationship between the EU and the United Kingdom ("**UK**") – see our paper "**Brexit – Is Equivalence a Solution for Financial Services?**". With the prospect of no agreement being reached by the end of the transition period becoming increasingly likely, our view (as outlined in the above paper) with respect to equivalence generally is that the existing equivalence framework does not provide an acceptable, long-term, sustainable solution for the UK-based financial services industry as a whole to access EU markets. Predictability, stability and transparency are key for financial services firms to implement their distribution, marketing and growth planning in the medium to long-term and the existing regime does not offer these benefits.

In this paper, we consider whether equivalence offers any solutions specifically for investment funds and their managers and, if not, how the various implications for investment funds of the UK's withdrawal from the EU might be addressed. We have also prepared papers outlining the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: **insurance**, **derivatives clearing**, **banking**, **MiFID firms**, and **fintech and payments**; together with an analysis of equivalence as a viable or relevant mechanism in each case.

Equivalence and Investment Funds

The short answer to the question posed at the outset is that equivalence currently offers no direct solutions for investment funds, although equivalence decisions in some related areas may have an indirect impact. The investment funds industry in Europe is regulated by two primary regulatory regimes, namely the Alternative Investment Fund Managers Directive ("**AIFMD**") and the Undertakings for Collective Investment in Transferable Securities Directive ("**UCITS Directive**"). Under the AIFMD, EU alternative investment fund managers ("**AIFMs**") can avail of a marketing passport and a management passport to manage and market EU-domiciled alternative investment funds ("**AIFs**") throughout the EU. Under the UCITS Directive, a UCITS established in one EU member state can be marketed on a passported basis throughout the EU with minimal additional regulatory burden in the host countries. A UCITS management company may also manage a UCITS established in any EU member state using the management company passport. The UCITS Directive contains no third country regime or equivalence framework that would allow third country funds structured in a similar way to UCITS and governed by similar rules to be marketed in the EU, or to allow non-EU managers to manage EU UCITS. The AIFMD, on the other hand, contains provisions which would permit the extension of the passports currently available to EU AIFs and EU AIFMs to non-EU AIFs and non-EU AIFMs, but these provisions have not been activated as yet and there is little prospect of the passport being extended in the short to medium term as discussed in further detail below in the section titled "*Particular Impacts under the AIFMD*".

In light of the fact that the equivalence framework does little to address the many issues for investment funds arising from the UK's withdrawal from the EU, we have set out below the implications for investment funds of the UK's withdrawal, how these have been addressed to date and how equivalence decisions in various areas could indirectly impact upon investment funds.

Implications of the UK's Withdrawal for Investment Funds

UK investment managers manage the assets of millions of investors in the EU. As a consequence of the UK's withdrawal from the EU, UK firms risk losing access to such investors but the inverse is also true; such investors risk losing access to those UK firms. Over the past four years, regulators and industry participants have worked to engineer a post-Brexit landscape that represents, in the short term at least, as positive an outcome as could have been hoped for, particularly in light of the ongoing uncertainty relating to other aspects of post-transition period EU-UK relations.

Particular Impacts on UCITS

The UCITS legislative framework requires that the UCITS, its management company and its depositary be domiciled in the EU. Following the transition period, this will have a number of implications for UK and EU UCITS, the most material of which are set out in the table below.

UK UCITS	Marketing Unless it re-domiciles to the EU, a UK UCITS will automatically become a non-EU AIF and lose its passporting rights. For EU investors in such a fund, this may not be acceptable and so the majority of impacted managers have offered those investors an EU-domiciled equivalent UCITS instead (generally in Ireland or Luxembourg). Management Where the UK UCITS has an EU management company, that management company will need to examine its licence to ensure it can manage non-UCITS; an AIFM licence will be required.
UK UCITS management companies	UK UCITS management companies will not be authorised to manage and market non-UK UCITS. Where they manage a non-UK UCITS at present, that UCITS will need to either appoint an EU management company instead of the UK management company or become a self-managed UCITS.

EU UCITS	Marketing EU UCITS will lose access to the UK on a passported basis and their ability to be sold into the UK will instead be subject to local rules which the UK may impose on such funds post-Brexit. Until those rules are put in place, however, the UK has created the Temporary Permissions Regime ("**TPR**"). This will allow EU UCITS to continue to be sold in the UK until the new local rules are applied. The TPR will come into effect at the end of the transition period and is expected to last for a maximum of three years. The window for fund managers to notify the UK Financial Conduct Authority ("**FCA**") that they want to use the TPR reopened on 30 September 2020. Management A UCITS with a UK management company will need to appoint a management company in an EU jurisdiction or become self-managed if possible. Investment Management UCITS are entitled to have non-EU investment managers and therefore UK investment managers are likely to be able to continue to act as the investment manager to a UCITS after the transition period. (See below note on Delegation.) Investment Mandates and Parameters UCITS may not invest more than 30% of their assets in non-UCITS collective investment schemes. Investment mandates and the level of investment in UK UCITS may therefore need to be reassessed to account for the UK not being an EU member state.
EU UCITS management companies	The majority of EU UCITS management companies delegate portfolio management functions to an investment manager, a large number of which are based in the UK. On 1 February 2019, the European Securities and Markets Authority ("**ESMA**") announced that it had entered into the necessary cooperation agreement in the form of a multilateral memorandum of understanding ("**MMoU**") with the FCA. (See below note on Delegation.) A separate point arises for an EU UCITS management company that manages UK UCITS; when those UK UCITS become AIFs, the EU UCITS management company will need to ensure it is appropriately authorised to manage AIFs.

Particular Impacts under the AIFMD

As noted above, unlike the UCITS Directive, the AIFMD provides for a third country regime that would allow the marketing and management passports to be made available to non-EU AIFs and non-EU AIFMs where ESMA issues a positive opinion in relation to the extension of the passport and the European Commission ("**Commission**") adopts the necessary legislation. It had been envisaged that, subject to a positive opinion from ESMA, the passport would be extended in 2015 and that national private placement regimes ("**NPPRs**") would be phased out and replaced by the passport in 2018. However, this timeframe has been delayed, partly in response to altered considerations in light of the UK's decision to withdraw from the EU. ESMA has adopted the approach of assessing each non-EU jurisdiction to determine whether the passport ought to be extended to that jurisdiction and has to date published two opinions on the extension of the passport, concluding that the passport ought to be extended to Canada, Guernsey, Japan, Jersey and Switzerland.[1] However, the Commission has decided to "*wait until ESMA has delivered positive advice on a sufficient number of non-EU countries*" before triggering the legislative procedure to extend the passport. The AIFMD third country regime therefore has not been activated as yet.

Following the transition period, ESMA may assess whether the AIFMD passport ought to be extended to the UK. ESMA may only issue positive advice in relation to a non-EU country where it is satisfied that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. Provided UK AIF regulation remains similar in a post-Brexit environment (which cannot be taken for granted in light of the UK's stated intention to diverge from EU rules in some areas), no significant legal obstacles would exist which might prevent the AIFMD passport being extended to UK AIFMs and UK AIFs.

In the absence of a passport for non-EU AIFMs and non-EU AIFs, the AIFMD also provides for minimum conditions a member state must apply in order to allow third country AIFMs to carry out marketing activities in respect of any AIF without an AIFMD passport, in combination with the discretionary NPPRs member states may adopt. Non-EU AIFMs seeking to privately place non-EU or EU AIFs are subject to AIFMD requirements including annual reporting, mandatory investor disclosure obligations and regulatory reporting to relevant member state authorities with respect to a list of prescribed matters. Cooperation arrangements must be in place between the regulatory authority in the member state where the AIF is marketed, the regulatory authority where the AIF is established and the regulatory authority in the home country of the AIFM. The relevant non-EU jurisdictions concerned must not be listed as a "non-cooperative country" by the Financial Action Task Force ("**FATF**").

NPPRs vary from member state to member state and some member states do not allow for any private placement. As a result, many managers of AIFs currently sold under the passport have decided that reliance on NPPRs is not a viable marketing strategy. Such managers are, depending on their particular circumstances, establishing EU AIFMs and / or EU AIFs to ensure continued access to the passport.

[1] See our update, "**ESMA Advises on the Extension of the AIFMD Passport**"

UK AIFM and AIFs managed by that UK AIFM	The UK AIFM will continue to be able to manage EU AIFs, although they will lose access to the AIFMD management passporting regime. Similarly, any UK AIFs managed by the UK AIFM will also lose access to the marketing passport. Instead, the ability to market in an EU member state will be dependent on the NPPRs applicable in that member state and compliance with the requirements in article 42 AIFMD. However, where such UK AIFs are not marketed in the EU, they will fall entirely outside of the scope of AIFMD (including its most burdensome obligations).
EU AIFM and AIFs managed by that EU AIFM	Any UK AIFs managed by an EU AIFM will lose access to the marketing passport and will have to rely on NPPRs. EU AIFs will be unaffected including, at least in the short term, as regards being sold in the UK because the Temporary Permissions Regime will apply to such AIFs.

Note on Delegation

The Commission is currently undertaking a review of the AIFMD which may lead to amendments to the directive. On 19 August 2020, ESMA sent a letter to the Commission highlighting areas to consider during the Commission's review, with a particular focus on delegation and substance. ESMA has suggested that legislative clarifications in the UCITS Directive and AIFMD frameworks could be provided in line with the ESMA Opinion on supervisory convergence in the area of investment management in the context of the UK withdrawing from the EU. ESMA notes that, in light of the withdrawal of the UK from the EU, delegation of portfolio management functions to non-EU entities is likely to increase further. ESMA suggests that the Commission may wish to provide a list of core critical functions that must always be performed internally and may not be delegated to third parties. This may impact on future delegation to the UK. However, at this stage these proposals are recommendations only and any amendments to the legislation would have to be considered and agreed upon by the Commission, European Parliament and Council of the EU and therefore the recommendations may not be implemented in full or at all.

General Impacts on Investment Funds

If no relevant equivalence decisions are made by the Commission in respect of the UK, fund portfolios will need to be assessed and adjusted in order to address the regulatory consequences of the UK becoming a third country, including in respect of investment in UK securities, trading on UK markets, accessing clearing through UK central counterparties, complying with the MiFIR share trading obligation, using UK-issued credit ratings, investing in UK benchmarks and reporting to UK trade repositories. Equivalence decisions, where provided for under the relevant legislation, will be necessary in some of these areas to avoid disruption. The key regulatory consequences are summarised in the table below.

Investments	
UK funds	The Central Bank of Ireland ("**Central Bank**") has indicated that it will consider whether UK funds should be identified in Central Bank guidance as a category of investment fund in which Irish UCITS and RIAIFs may invest. For the period during which this is under consideration by the Central Bank, the Central Bank does not propose adopting a default position which would treat UK funds as ineligible. Such a determination by the Central Bank is subject to change.
Deposits and ancillary liquid assets held in UK credit institutions	UK credit institutions will be non-EEA "third country" credit institutions post transition period. The Commission has not as yet adopted an equivalence decision under the Capital Requirements Regulation ("**CRR**") in respect of the UK. Therefore, the UCITS eligibility of any UK credit institution will depend on it continuing to be *"a credit institution authorised within a signatory state, other than a Member State of the EEA, to the Basle Capital Convergence Agreement of July 1988"*.
Money market funds – eligibility of deposits with UK credit institutions	Under the Money Market Funds Regulation, EU money market funds ("**MMFs**") can only invest in deposits with credit institutions where such credit institutions have their registered office in a member state or where a third country credit institution is subject to prudential rules considered equivalent to EU rules under the CRR. The Commission has not adopted an equivalence decision in respect of UK in this regard. In the absence of such a decision by the Commission, EU MMFs will not be permitted to invest in the deposits of UK credit institutions.
UK markets as "regulated markets" under MiFID II	The regulatory structure under MiFID enables cross-border access to EU regulated markets. UK markets will be third-country markets and no equivalence decision has been adopted by the Commission under MiFID II in respect of UK markets.
MiFIR share trading obligation	Under MiFID II / MiFIR, EU firms may only undertake trading of EU-traded shares on EU venues or third country venues that have been deemed equivalent (the share trading obligation). UK venues will become third country trading venues and EU firms will not be able to trade a share on UK venues if it is also traded on an EU venue unless the UK venue is assessed as equivalent. No equivalence decision has been adopted by the Commission under MiFID II with respect to UK markets.

Credit ratings	UK credit rating agencies (“**CRAs**”) will become third-country agencies and their registration under the EU CRA Regulation will be withdrawn. Unless a credit rating issued by a UK CRA has been endorsed in accordance with the endorsement regime under the CRA Regulation, it will not be possible to use such credit ratings to comply with EU law requirements requiring the use of a credit rating. The endorsement regime is made available for CRAs that are affiliated or work closely with EU-registered CRAs. When an EU-registered CRA (the endorsing CRA) endorses a credit rating issued by another CRA of the same group established outside the EU, the rating can be used for regulatory purposes in the EU.
Reporting of derivatives investments under EMIR	UK trade repositories currently registered with ESMA will lose their EU registration and no longer be eligible entities to whom derivatives reporting may be made under EMIR. This means that reporting entities will need to identify an alternative EU registered entity for reporting purposes.
Use of a UK benchmark index	UK administrators of benchmarks and third-country benchmarks recognised or endorsed in the UK will be removed from the ESMA register of administrators and third-country benchmarks. From 31 December 2020, UK benchmarks become third country benchmarks under the Benchmarks Regulation. The use of third country benchmarks, where such use commences prior to 31 December 2021, is subject to the adoption of an EU equivalence decision (which is not expected to be available before the end of the transition period) or the benchmark / its administrator being endorsed / recognised under the Benchmarks Regulation.

Clearing

Use of UK central counterparties to meet EMIR central clearing obligations	To continue servicing EU clearing members after the end of the transition period, the UK will require either permanent or temporary equivalence and UK central counterparties (“**CCPs**”) will need to be recognised by ESMA. On 21 September 2020, the Commission adopted a time-limited temporary equivalence decision to give financial market participants 18 months to reduce their exposure to UK CCPs.

Settlement

Settlement of Irish securities (including ETF shares) no longer possible using UK central securities depositary	Settlement of Irish securities will not be possible using the UK central securities depository (“**CSD**”). The UK CSD will no longer be authorised under the EU Central Securities Depositaries Regulation (“**CSDR**”) upon the expiration of the transition period and Irish securities, including ETF shares, currently settled through the UK CSD will need to migrate to a new CSD. Legislation has been enacted to establish a statutory process to allow Irish issuers to migrate to Euroclear Bank. Due to differences between the CSD model operated by the UK CSD and Euroclear Bank, an assessment of the implications for individual issuers will be necessary.

UK Directors / Designated Persons

Ability of Irish funds to appoint UK-resident directors or designated persons	The Central Bank has issued a notice of intention which states that, should the UK become a third country, the Central Bank will consider whether it is a jurisdiction which meets the Central Bank’s effective supervision requirements and its “location rule” requiring a certain percentage of directors / designated persons to be EEA resident. While this is under consideration, the Central Bank does not propose adopting a default position which would treat the UK as not satisfying the effective supervision requirement.

Data Protection

Transfer of personal data to the UK	Any transfer of personal data by Irish funds and fund service providers must take place in accordance with the GDPR. Therefore, there will have to be an adequacy decision in favour of the UK or Commission approved Standard Contractual Clauses will need to be put in place with any UK entities in receipt of data.

Market Impact

In the event that there is no agreement in relation to financial services before the expiration of the transition period, there is the possibility of increased market volatility and reduced liquidity in respect of some securities in the weeks preceding and immediately following the end of the transition period. This may lead to difficulties in producing fund valuations. Firms will need to prepare for potential difficulties in pricing and the possibility of requiring fund boards to sign off on fund valuations. In the event of extreme volatility and liquidity issues, there are likely to be operational issues and fund boards may need to consider the suspension of dealing.

Responding to a No-Deal Scenario

Firms have adopted differing approaches in addressing the challenges presented by the UK's withdrawal from the EU. Assessments of operations and product offerings has led some to establish a fund management presence in Ireland or other EU countries and to extend existing authorisations to include, for example, individual portfolio management top-ups. Investment policies and fund documentation have been reviewed and updated (eg, to update the list of recognised markets) to prevent any inadvertent breaches occurring upon the expiration of the transition period. UK firms that decide not to establish a substantive EU presence may run the risk of falling behind their EU counterparts who can market on a passported basis in the EU, establish super management companies (ie, fund management companies with authorisations under both the UCITS Directive and the AIFMD) and who will benefit from the global recognition of the UCITS brand. The cost implications of the various options will obviously be a significant consideration in considering the appropriate response to a no-deal scenario.

See also: Implications of Brexit for Asset Managers and Investment Funds

The Impact of Brexit on Asset Management

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Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this paper.

Full details of the Asset Management and Investment Funds Department, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com. Further Brexit-related updates, articles and briefing notes may be accessed on our Brexit Forum.

Contacts

Tara Doyle
Partner
T +353 1 232 2221
E tara.doyle@matheson.com

Michael Jackson
Managing Partner
T +353 1 232 2000
E michael.jackson@matheson.com

Dualta Counihan
Partner
T +353 1 232 2451
E dualta.counihan@matheson.com

Anne-Marie Bohan
Partner
T +353 1 232 2212
E anne-marie.bohan@matheson.com

Shay Lydon
Partner
T +353 1 232 2735
E shay.lydon@matheson.com

Liam Collins
Partner
T +353 1 232 2195
E liam.collins@matheson.com

Philip Lovegrove
Partner
T +353 1 232 2538
E philip.lovegrove@matheson.com

Elizabeth Grace
Partner
T +353 1 232 2104
E elizabeth.grace@matheson.com

Oisin McClenaghan
Partner
T +353 1 232 2227
E oisin.mcclenaghan@matheson.com

Michelle Ridge
Partner
T +353 1 232 2758
E michelle.ridge@matheson.com

Barry O'Connor
Partner
T +353 1 232 2488
E barry.oconnor@matheson.com

Donal O'Byrne
Partner
T +353 1 232 2057
E donal.o'byrne@matheson.com

Bronagh Maher
Professional Support Lawyer
T +353 1 232 3757
E bronagh.maher@matheson.com

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