



**CHAMBERS**  
Global Practice Guides

# Legal Brexit

Investment Funds

Contributed by Travers Smith LLP

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# INVESTMENT FUNDS

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Each chapter provides easily accessible information on the impact of the UK's vote to leave the European Union.

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**Travers Smith LLP** is a leading corporate, financial and commercial UK law firm, with offices in London and Paris. The investment funds group consists of nine partners and 19 fee earners and brings together fund formation, regulatory and tax expertise in an integrated practice focusing on work within the private equity, real estate, alternative credit,

infrastructure and listed equities sectors. The investment funds group is working closely with the Travers Smith's cross-disciplinary 'Brexiteer market impact group,' drawn from legal specialists who are all leaders in their fields and have first-hand experience in advising clients in the financial sector at times of market stress.

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## 1. Current Legislative Framework

This overview sets out the legal implications of Brexit in relation to closed-ended investment funds, particularly those funds structured to pursue a private equity strategy. The information set out in this overview could equally apply to other closed-ended private funds, for example real estate funds, infrastructure funds and private alternative credit funds.

For the purposes of this overview, it is assumed that the fund is structured as an onshore UK-based alternative investment fund with an onshore UK-based alternative investment fund manager. Other structures exist (such as a UK manager or adviser of an EU-based fund or portfolio), but are beyond the scope of this overview.

There has already been much debate on how Brexit will affect the financial services market in the UK, and the City of London in particular. The appointment of Michel Barnier (who repeatedly clashed with the City over financial services reform when he was the EU's internal markets and services commissioner) as the European Commission's chief negotiator on Brexit is likely to make a deal on the UK maintaining access to the Single Market for financial services more of a challenge. The private equity industry is part of the wider financial services market and these issues will be important in

determining the future legal framework in which UK private equity funds will operate.

This overview focuses on the legal and regulatory implications of Brexit in connection with the structuring, establishment and operation of an investment fund. When structuring an investment fund, there are other considerations that should also be taken into account, including tax structuring issues, which are not directly considered here. The day-to-day investment activity of the fund may also be impacted (for example, deal structuring, advising on and arranging deals), especially if there is a cross-border element.

The UK has the longest-established, and deepest, private equity market in Europe, attracting investors from across the globe. The strength of the UK market, and the expertise developed by UK private equity firms, has, in turn, triggered significant outward expansion, with many UK houses now implementing their investment strategies on a pan-European or global basis.

The fact that there has been an active private equity market in the UK for over 30 years means that the legislative and regulatory framework governing the industry has evolved rather than being subject to a single implementing process; in fact, there has been remarkable stability in the structures

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routinely used by the industry over this period. For example, it has always been the case under UK domestic legislation that it is the management vehicle of a private equity fund, rather than the fund vehicle itself, which has been subject to regulation; something which was not historically the case across much of continental Europe but a principle which has underpinned recent EU legislative initiatives in the sector.

That being said, many of the recent developments have been driven by EU legislation. In particular, the Alternative Investment Fund Managers Directive (“AIFMD”), supplemented by its Level 2 Delegated Regulation and guidelines from the European Securities and Markets Authority (“ESMA”), has ushered in a new regulatory environment for private equity firms. The driver behind AIFMD was the pan-European harmonisation of the regulatory and supervisory framework for the non-UCITS fund sector, together with the freedom to passport management and marketing activities on a cross-border basis. The European Venture Capital Funds Regulation (“EuVECA”) provides what is essentially “AIFMD-lite” for venture capital fund managers.

AIFMD has been implemented in the UK by various implementing measures – primarily the Alternative Investment Fund Managers Regulations 2013, the Alternative Investment Fund Managers (Amendment) Regulation 2013 and the Alternative Investment Fund Managers Order 2014, as well as changes to the UK Financial Conduct Authority’s (“FCA”) rulebook. These have added an additional component to the domestic regulatory regime set out under the Financial Services and Markets Act 2000 (“FSMA”).

Under the legislation implementing AIFMD and under FSMA, the management vehicle (the “AIFM”) of any alternative investment fund (the “AIF”) will need to be authorised and regulated by the FCA. There are significant costs and burdens of compliance with AIFMD (including operational requirements which affect the AIF itself) over those historically imposed; the quid pro quo of enhanced regulatory scrutiny is the fact that private equity firms fully within the scope of AIFMD are able freely to market their AIFs on a cross-border basis within the European Economic Area (“EEA”) using the marketing passport. An AIFM which conducts all of its activities in its capacity as the manager of AIFs based in the UK will be exempt from the Markets in Financial Instruments Directive (“MiFID”).

Despite the availability of the marketing passport, the AIFMD framework does devolve significant authority to national Member States – for example, the ability to market private equity funds to retail investors is a matter for domestic legislation. In this regard, the UK has retained a flexible and open approach to encourage wide investor participation in the industry.

AIFMD does contain a partial exemption for AIFMs whose total assets under management do not exceed certain thresholds. These “sub-threshold” AIFMs will not need to comply with the full provisions of AIFMD (unless they elect to opt in) but equally will not be able to take advantage of the marketing passport and will therefore need to access European investors on the basis of the national private placement regimes (“NPPRs”), to the extent that any such regime is available, of the jurisdictions they are targeting. UK mid-market firms will have undertaken a cost-benefit analysis to understand whether the advantages offered by the marketing passport outweigh the costs of full compliance with AIFMD; many have come down on the side of avoiding full compliance with AIFMD and therefore the impact of Brexit on the industry will not be homogeneous but will depend on a particular private equity firm’s regulatory profile.

As noted above, there has been relative stability in the structuring of private equity funds, with the majority of funds established in the UK being structured as limited partnerships. Because, both under domestic and European legislation, it is the AIFM rather than the fund itself which is subject to regulation, the governance of limited partnerships has largely been a matter for domestic legislation. The Limited Partnerships Act 1907 (the “1907 Act”) has not been influenced by EU legislation and therefore will not need to be amended by virtue of Brexit, and whilst the Partnership Accounts Regulations are derived from an EU directive, domestic implementation of the European legislation has meant that the majority of private equity firms can avoid becoming subject to the rules.

Tax legislation is also largely a matter of Member State sovereignty (subject to some notable exemptions such as VAT). As limited partnerships are tax transparent, relevant tax legislation largely revolves around the tax profile of the AIFM (and its executives) or the tax position of the underlying investor. Relevant domestic tax legislation such as the recent rules relating to disguised investment management fees and the rules determining when carried interest arising to an individual from an investment scheme is “income-based carried interest” should not be significantly impacted by Brexit (assuming the UK government maintains its support for the initiatives on policy grounds), nor should international tax initiatives impacting on private equity investment funds and whose applicability stretches further than the EU such as the OECD’s measures to counter base erosion and profit shifting (“BEPS”) or the automatic exchange of tax and financial information be affected.

## 2. Transitional Framework

During the transitional period between the vote to leave and the UK’s formal exit from the EU, it is important to note that the UK remains a part of the EU and there is no immediate

change in status or the applicability of existing EU legislation. Due to the complexity of the Brexit negotiations, this transitional period may last a significant time, with most commentators suggesting a period of between two to four years at least. Because of the fundraising cycle that private equity firms usually follow, it is possible (likely, even) that the next fundraising undertaken by most firms will take place during this transitional period. As the legal and regulatory framework within which private equity firms operate will not change until the point of formal exit from the EU, during the transitional period it will largely be a case of 'business as usual' for the structuring, marketing and operation of existing and new AIFs (for example, the marketing passport available to UK-based full-scope AIFMs that permit marketing activities across the EU will continue to be available).

However, there are certain implications for AIFs that private equity AIFMs should take into account.

### **Impact on legislative developments**

(i) The AIFMD includes a framework for "third country" provisions, to allow AIFMs established in non-EU countries (ie "third countries") the right to apply for passports to enable marketing of AIFs across the EU, with various milestones that need to be passed before the provisions come into force. On 19 July 2016, ESMA published its advice to the EU institutions on implementing these "third country" provisions. In theory, the European Commission should now publish delegated legislation by mid-October 2016 setting a date for the "third country" provisions of the AIFMD to be switched on. However, in its advice ESMA also suggested that the Commission may wish to wait until ESMA "has delivered positive advice on a sufficient number of non-EU countries." Whether or not the Commission wishes to delay could be affected by the significance of third-country issues to Brexit negotiations, in particular because, following Brexit, the UK may become a "third country" (this is set out in more detail below).

(ii) It is likely that the UK's influence on EU legislative developments will diminish during the transitional period: UK MEPs may not be appointed as frequently (if at all) as rapporteurs in the European Parliament, and other Member States may not pay as much attention to UK government representatives during the negotiation of new EU legislation. This reduction in influence may have implications for private equity funds. For example, the UK will have little credibility when discussing changes to the ESMA guidelines on particular AIFMD topics, or on the review of AIFMD itself (due to take place from mid-2017) but will still be obliged to have regard to them during the transitional period.

(iii) The UK private equity industry has been working with the government to bring about a number of reforms and updates to the 1907 Act. For example, it is proposed that safe harbours be introduced so it is clear what types of activity may be carried out by limited partners without being regarded as taking part in the management of the limited partnership, the requirement for limited partners to make capital contributions is removed and, to the extent that a capital contribution has been made, the prohibition on the repayment of that capital contribution is also removed. Whilst draft regulations have been published, there are a number of final amendments being discussed and a date has not yet been set for the regulations to come into force. These proposed changes relate to domestic law, so are not directly impacted by Brexit. However, it would be an unfortunate side-effect if the project of reforming the 1907 Act is delayed because the UK's focus is now redirected to analysing, considering and negotiating the numerous issues connected to the UK's departure from the EU. An alternative outcome to be encouraged is that the UK takes the opportunity to make more radical reforms to domestic law (including the 1907 Act) to increase the competitiveness of the UK when compared to other funds jurisdictions.

### **Other considerations**

(i) Clearly, during the transitional period, the fundraising environment will be more uncertain as fund managers and investors assess the implications of Brexit. This issue is likely to be more acute for UK AIFMs. To give two examples of a potential negative impact: (a) the EIF (which is part of the EIB) is a significant investor in private equity funds targeting European companies and European SMEs. Because of its strategy, there is a strong possibility that the aggregate level of investment made by the EIF into UK-focused funds will reduce during the transitional period and/or it may be more selective with the UK funds that it invests into; and (b) German pension funds that are subject to the German Insurance Ordinance may find it less attractive to invest into certain UK investment funds because their specific asset class quotas may come to be impacted by Brexit. If an investment falls within the 'private equity quota', the impact may be less because the German Insurance Ordinance only requires that the AIF and the AIFM have their seat in an OECD country; however, if the investment falls within the 'real estate funds quota' (which may be the case for a PERE fund) or the 'alternative investment funds quota' (which may be the case for a private debt fund), the AIF and the AIFM must have their seat in the EEA. Because of these increased difficulties, some German pension funds may decide to reduce their exposure to the UK market.

Of course, there could also be positive fundraising consequences that arise from Brexit: the fall in the value of sterling

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has made UK assets (including private equity funds investing in UK assets) relatively cheaper compared to the pre-Brexit vote; and the difficulty in predicting what EU marketing rights the UK will hold following a formal exit from the EU may push some private equity firms to accelerate their fundraising plans to ensure they are completed during the transitional period.

- (ii) The uncertainty and related risks during the transitional period will prompt some private equity firms to consider possible reorganisations of their business as early as possible in order to hedge against the risks of adverse effects. For example, a UK-based AIFM that wants to ensure a continuance of its financial markets passporting rights may look to create an authorised AIFM in a remaining EU jurisdiction to act as a toehold within the EU as a precaution against the UK losing access to the European markets upon exit from the EU.
- (iii) During the transitional period, the documentation for private equity funds may be modified to add flexibility following Brexit. For example, some firms may want to permit a change in domicile of the AIF and/or the AIFM from the UK to an EU jurisdiction on the UK ceasing to be part of the EU or the EEA; certain investment restrictions may need to be amended to clarify whether a fund is able to invest into the UK even after it ceases to form part of the EU; and additional risk factors will be needed in marketing documents for new funds.

### 3. Post EU Exit

As noted above, the private equity funds industry in the UK has developed over the years so that it has a pre-eminent position in Europe and is a significant participant in the global private equity market. Maintaining this status following the UK's formal exit from the EU, in contrast to reverting to a largely domestic market, is dependent on a number of broad principles:

- (i) The free movement of capital into and out of the EU is guaranteed under EU law, even for third countries, so investments into EU target companies from private equity funds domiciled in the UK will not be affected.
- (ii) Access to the EU Single Market for financial services has been an important principle in the development of the private equity industry in the UK; however, it is unclear if or how this access will be restricted as part of the withdrawal negotiations.
- (iii) The development of passporting regimes within European financial services legislation is a key factor in the UK becoming a hub for European private equity activity. The continued availability of these passports (or the

availability of a "third country" passport, in particular for marketing) will be important for UK private equity funds post-Brexit.

- (iv) Finally, London is an attractive financial centre for a range of reasons: the breadth and depth of the financial services sector, the effectiveness of the UK legal system, the use of the English language, the ability to attract high-quality personnel both domestically and internationally, the extensive network of financial and professional services, and the flexibility of the law-makers to adapt the law and keep the market competitive. Whether London loses its lustre and so has a diminished significance as a financial centre will also affect the status of the UK private equity funds industry.

How the broad principles referred to above will be impacted by the UK's future relationship with the EU will largely determine how the private equity funds industry in the UK is affected by Brexit. Also relevant will be any reforms the UK makes to domestic law alongside the untangling of EU-derived law and regulation.

Three scenarios are examined below.

#### 3.1 The UK leaves the EU but remains a part of the EEA

Under this model (often referred to as the "Norway model"), the UK will leave the EU but remain a part of the EEA. In broad terms, this will mean the UK retains access to the Single Market, which provides for free movement of goods, services, persons and capital within the EEA.

If the UK remains a part of the EEA, it will operate within broadly the same regulatory framework that is currently in place. As a result, it will still be subject to EU laws and there would only be limited changes in the laws and regulations that apply to private equity funds and managers to reflect the change in status from being a member of the EU to a member of the EEA. This provides the key advantage of the EEA membership model: in principle (but subject to important caveats below) there would be continued access for UK firms to the Single Market passports to conduct business across EEA borders, including the marketing passport under AIFMD.

However, this ignores a number of challenges with the EEA route:

- (i) As a member of the EEA, the UK would be bound by the EEA Agreement, which is a living document that incorporates EU legislation in the policy areas of the Single Market covering the four freedoms (ie free movement of goods, services, persons and capital). Before EU legislation can be incorporated into the EEA Agreement there



is a lengthy approval process, which can only start once the legislation is adopted by the EU. This approval process essentially requires unanimity between all the EEA members (currently Norway, Iceland and Liechtenstein). In practice, this process means there is often a considerable delay in implementing EU legislation before it is effective in the EEA. For example, at the time of writing, three years after AIFMD came into force it has not yet been incorporated into the EEA Agreement, meaning the ability to obtain a passport for the management or marketing of an AIF throughout Europe is still not available to EEA members. There have also been challenges with how the European Supervisory Authorities operate and impose sanction in the EEA member states.

- (ii) Notwithstanding the above, as an EEA member the UK would be bound to adopt almost all EU financial services and markets legislation. This would be the case even though the UK would have no direct representation and no vote on whether such legislation is appropriate: the UK would be a rule-taker, not a rule-maker. This would place the UK in an extraordinary position of having a significantly larger financial services industry than other member states of the EU or EEA but with very little control over the EU legislation that implements changes to the financial markets, with the consequential challenges that this would create for both the economy and the financial markets (including the private equity funds industry) in the UK.
- (iii) There are also clear political challenges, such as the UK being required to make a significant financial contribution to the EU and the UK having to accept the free movement of people.

### 3.2 The UK leaves the EU but joins EFTA

Two separate models have been widely discussed: (1) the “Swiss model,” under which the UK leaves the EU but joins the European Free Trade Association (EFTA) and so has partial access to the Single Market provided through bilateral agreements; and (2) the “Canadian model,” under which the UK leaves the EU and trades with the EU pursuant to a bilateral trade agreement.

For the UK private equity funds industry, the effectiveness of both of these models will depend on the bilateral agreement(s) that are put in place. In particular, and as noted above, the UK private equity funds industry would ideally want access to the Single Market for financial services. Switzerland has over 100 bilateral agreements with the EU but, significantly, none of these covers financial services. Similarly, the Canadian deal covers trade but does not cover financial services. If similar arrangements were implemented for the UK, the UK would not have access to the Single Market for financial services and UK private equity firms would

be treated as “third country” firms for the purposes of EU financial services regulation.

AIFMD already has a framework for AIFMs in third countries to market their funds into the EEA. Currently, this is based on Article 42 of AIFMD and on NPPRs (if applicable) but, as noted above, the EU institutions are working on a future entitlement for a third-country passport. This marketing passport could prove very useful to the UK following its formal exit from the EU, but whether private equity firms are able to operate with such a passport will depend on ESMA’s assessment of the equivalence of the future UK regime. If the UK does not amend its existing legislation (which is, obviously, AIFMD-compliant), one assumes that ESMA and the Commission would deem the UK regime to be equivalent. However, this is an important point that the UK should confirm as part of the withdrawal negotiations, to ensure there is no gap between the UK leaving the EU and having the right to use a marketing passport.

Whilst helpful, the third-country marketing passport is not a panacea for all issues that may arise for UK private equity funds as a result of the UK’s formal exit from the EU:

- (i) To obtain the marketing passport, the UK private equity firm will need one EU Member State to be its “Member State of reference” (this is not a matter of choice but is determined by a relatively complicated set of rules). It will then need to become dual-authorized by the regulator in that Member State of reference (such as BaFin in Germany or the AMF in France) and will also need to establish a legal representative in the EU. This process could take time and give rise to additional costs for a UK private equity firm.
- (ii) Before a firm in a third country is granted a marketing passport, the third country must have signed an agreement with other EU Member States on the exchange of tax information and an agreement on the exchange of information between regulatory authorities in the relevant third country and other EU Member States. When the UK becomes a third country, for most EU Member States both of these requirements are covered by existing agreements and treaties, but there are likely to be gaps that need to be addressed. The tax treaties that the UK has with certain EU Member States will need updating to ensure each is fully compliant with the OECD Model Tax Convention of Income and on Capital (for example, the tax treaty with Finland dates from 1970 and it may not fully comply). In respect of the agreement between regulators, the FCA has not entered into ESMA’s model MoU for use with third countries, but it (along with ESMA and other EU regulatory authorities) has entered into the IOSCO Multilateral MoU, which should be sufficient. Confirmation will need to be sought during the

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withdrawal negotiations that the UK is fully compliant with these requirements (or any missing agreements are entered into) to avoid any unnecessary hiccups post-exit.

- (iii) The marketing of funds across the EU is potentially only one of the cross-border activities that a private equity firm may be engaged in. Any private equity firm that is subject to MiFID should note that there is currently no harmonisation of rights for third-country firms to provide investment services into the EU on a cross-border basis. Under MiFID II (which it is assumed will come into force, along with MiFIR, in January 2018), there may be an ability to provide investment services to professional clients (as opposed to retail clients), but only if the Commission has adopted an equivalence determination in respect of the UK's regime and the firm has registered with ESMA.

Under this option, the EuVECA regulations (and the similar EuSEF regulations for social entrepreneurship funds) will cease to have direct effect in the UK, so UK fund managers will no longer be able to either use these designations or make use of the corresponding marketing benefits.

Even though this option means that EU legislation will cease to apply in the UK, for the reasons set out above some laws and regulations that derive from EU legislation may be retained for passporting or equivalency purposes. However, although not strictly required as a result of a formal exit to leave the EU, there are a number of other laws that the UK government should consider amending to improve the competitiveness of the UK investment funds market:

- (i) The reforms of the 1907 Act referred to above should be implemented as a matter of priority. The UK government should even go further: for example, the private equity funds industry has been pushing for a number of years to give English limited partnerships the option to elect to have separate legal personality. Now would be a good time to increase the flexibility of the UK funds industry by making this change.

(ii) VAT is a tax that derives from EU directives. In the context of the structuring of investment funds, the potential imposition of VAT on portfolio management services causes a number of structuring headaches. It would be useful if HMRC could reconsider this, especially in the light of the recent *Fiscale Eenheid* case in the ECJ, to ensure the UK fund structuring options are as tax-efficient as in other EU jurisdictions that will now be competing directly with the UK.

(iii) It would be useful if the FCA could examine its rulebook to determine whether any provisions could be reasonably viewed either as 'gold-plating' or as redundant and, if so, to try to streamline the rules. Without certain constraints of EU law, it may also be possible to make the financial promotion regime for the marketing of private equity funds in the UK more attractive to the investor community. In a similar vein, the Partnership Accounts Regulations derive from EU legislation and so could now be repealed.

### 3.3 The UK leaves the EU and trades with the EU

When the UK leaves the EU (and assuming that it does not stay in the EEA), it will no longer be required to comply with EU legislation. As noted above, complying with some EU laws may be beneficial to demonstrate equivalence and therefore have certain passporting rights. However, a final option to consider is the UK putting in place a dual-track regime: the UK could keep the current AIFMD rules to allow access to the third-country marketing passport; and it could also use the opportunity of being outside the EU to implement an alternative, more tailored regime for those private equity fund managers (and other fund managers) who do not require the EU marketing passport.

If a dual approach were pursued, the alternative regime would be attractive for those fund managers who are only seeking domestic or international (non-EU) access. Even for such a fund manager, access to EU investors may not be completely ruled out if there is a reverse solicitation or to the extent that NPPRs remain available. Also, if the UK domestic financial promotion regime can be made relatively attractive, this may encourage certain investors (including EU investors) to establish a base in the UK for marketing purposes. As well as the points described above to improve the competitiveness of the UK investment funds market, a more tailored dual regime could make the UK into a more attractive destination for non-UK managers. For example, this alternative regime could have less onerous pay regulations than those currently imposed under EU law, or the authorisation process could be made more straightforward if the relevant fund manager were already authorised and regulated by a supervisory body in another jurisdiction (such as the SEC in the USA).

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