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Brexit and European Financial Services Regulation

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Following the United Kingdom's decision to leave the European Union last year, many private equity and venture capital fund managers are in limbo—they are planning for all contingencies, while still anxiously awaiting a concrete indication of the eventual relationship between the United Kingdom and the rest of the European Union.

Meanwhile, with the United Kingdom likely to leave the European Union in March 2019, regulators across Europe have also been thinking about the consequences of Brexit. For them, the task has been to forestall some of the anticipated regulatory competition that may ensue as the remaining European Union member states seek to attract London's migrating asset managers—making it even harder for fund managers to plan their post-Brexit structure.

However, although Brexit discussions will defer consideration of some regulatory initiatives, including the scheduled review of the Alternative Investment Fund Managers Directive and introduction of a third country passport, regulators have also been progressing other, more positive, reforms—some of which are aimed at improving access to private equity and venture capital across the European Union.

This short update considers some of the most important developments in recent months.

The New UK/EU Deal

It remains hard to predict how Brexit will affect the regulatory position of private equity fund managers and advisers based in the United Kingdom. It is now clear that the United Kingdom will seek to maintain the status quo, to the extent possible, for a transitional period after March 2019, but it will want any such transitional arrangement to end within 2-3 years. Whether the rest of the European Union will agree to such an arrangement, however, remains uncertain, and how much of the status quo can be preserved during this interim period will be a subject for negotiation.

Even if (as seems more likely than not) a transitional arrangement can be agreed upon, there is still likely to be some short-term disruption for private equity fund managers. For example, accessing funding from the European Investment Bank is already proving tougher for funds based in, or making significant investments in, the United Kingdom—a particular issue for venture capital and growth equity funds. At the same time, there may be questions about the continuation of the full marketing and management passport for alternative investment funds during any transitional period, unless the United Kingdom agrees to implement regulatory reforms coming from Brussels during that period.

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Beyond any transitional arrangement, the ultimate outcome is still far from clear. Firms therefore have to plan their future fund structures on a conservative basis, and most are now actively doing that.

Relocation Following Brexit

Any such planning was made even more complicated when the European Securities and Markets Authority (ESMA) published its views on Brexit this summer in an attempt to prevent EU regulators from engaging in a "race to the bottom." ESMA's opinions focused on the position of UK investment firms and managers (AIFMs) seeking to relocate to a remaining EU member state after, or in anticipation of, Brexit. In practice, however, ESMA's guidelines will also impact investment firms and AIFMs that are already based in, and remain in, another EU country. It appears that ESMA is using this opportunity to push for more stringent rules and establish supervisory standards for matters such as corporate governance, substance and delegation throughout the European Union.

The main thrust of the opinions is that an AIFM's choice of location should be objectively justified. Accordingly, ESMA suggests that a competent national regulator should refuse a license application if it thinks that the applicant opted for its jurisdiction in order to evade stricter standards in another member state. ESMA also stipulates that a minimum of two senior managers should be required to obtain an authorization, that the use of any third-party services (including from affiliates) will be considered a delegation, and that, for each fund the AIFM manages, portfolio and risk management may not be delegated to an extent that substantially exceeds the retained, internally-performed functions. When engaging advisors, for example, in relation to portfolio management decision-making, ESMA stresses that the AIFM must have sufficient competence to review the substance of the advice.

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While ESMA's opinions are not binding, they carry significant weight and are likely to have a particular impact on post-Brexit planning. (Further details are available at http://www.debevoise.com/insights/publications/2017/07/esmas-guidelines-on-relocations.)

The European Commission has subsequently gone even further, proposing to increase ESMA's oversight of AIFMs that seek to delegate functions outside the European Union. If these proposals are endorsed by Europe's co-legislators, it will signal a desire to move even further towards a centralized system of financial supervision, making regulatory arbitrage even harder. (More information is available at http://www.debevoise.com/insights/publications/2017/07/esmas-guidelines-on-relocations.)

MiFID II

Regulatory developments already in progress will continue and will be implemented in the United Kingdom even as it prepares to leave the European Union. The most notable example is the new Markets in Financial Instruments Directive and corresponding regulation (MiFID II), which will take effect across the European Union in January 2018 (more information is available at http://www.debevoise.com/insights/publications/2017/07/mifid-ii-reshapes-fundraising). The new regime will add complexity to the launch and marketing of investment funds and other financial products to investors in Europe, including new rules designed to ensure that financial products sponsored or recommended and marketed to investors in the European Union are tailored to the

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targeted investor base. There will also be requirements to record certain communications with clients, as well as increased disclosure requirements. Adjustment to the new rules will be moderately painful.

However, MiFID II will also make it easier for non-EU financial intermediaries to provide regulated services to clients in Europe. Indeed, the introduction of a passport for non-EU investment firms could help some UK firms following Brexit. The cross-border model will allow some firms to conduct business from their home country on a cross-border basis in the European Union.

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Reducing Barriers to Cross-border Distribution of Investment Funds

Meanwhile, in an effort to improve the cross-border distribution of funds within the European Union, the European Commission is seeking to improve the EU marketing passport regime, in particular, by easing burdensome registration and administration procedures and making marketing requirements more consistent across member states. Further legislation is therefore expected and likely to cover, among other things, the definitions of marketing and pre-marketing and the charging of fees by national regulators. This legislation will hopefully improve the passport process, which, with its long blackout and waiting periods that often hold up closings, is currently burdensome and poorly adapted to negotiated private funds.

Other Developments

Against this big picture backdrop, European fund managers continue to face a number of significant regulatory changes in specific areas. For example, this past June saw the deadline to implement the 4th Anti-Money Laundering Directive, which introduced a risk-based approach to customer due diligence and monitoring and mandated a transparency register in each EU member state. Although the United Kingdom already had similar rules, some modifications were necessary to conform to the new EU Directive. The differing approaches to implementation of these regulatory changes in different countries will inevitably pose challenges for compliance professionals. (More information on the UK implementation is available at http://www.debevoise.com/insights/publications/2017/06/uk-implements-new-anti-money-laundering-rules.)

Heralding another change that will pose challenges for UK-based firms, the UK regulator, the Financial Conduct Authority, recently confirmed that it will roll out its Senior Managers & Certification Regime to all UK-authorized firms (further information available at http://www.debevoise.com/insights/publications/2017/07/uk-financial-conduct-authority). This marks a break with the actions of other EU regulators, who tend to focus on technical competence rather than conduct. Undoubtedly, the United Kingdom's new approach to the regulation of individuals who work in private equity funds will require some organizational changes, or at the very least, greater clarity on individual responsibilities.

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