Lex et Brexit — The Law and Brexit

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POLITICO

As we move to a monthly schedule for the publication of Lex et Brexit, we finally have some idea as to the schedule for the Brexit process. The British Prime Minister indicated in her party conference speech that the UK will begin the exit process and two year negotiation period by the end of March 2017. While this finally provides some clarity on timetable, there remains considerable uncertainty over the terms of Brexit. At the recent meeting of EU heads of state in Brussels, the signals from both sides continue to point towards a so-called 'hard' Brexit meaning, inter alia, materially restricted access to the EU market for UK providers of goods and services.

In this edition of Lex et Brexit, we look at another of the Prime Minister's key announcements made during the Conservative party conference: the proposal for a 'Great Repeal Bill' (the "**Bill**") to repeal the UK legislation which enables membership of the EU and to end the supremacy of EU law in the UK. Paradoxically, the Bill will not repeal any substantive EU law. Instead, the Bill will preserve all pre-Brexit day EU law in force in the UK and carry over into UK law the full body of EU law not already implemented in UK domestic law. The intention is then for the UK to change these laws as necessary over time. We identify a number of legal and policy challenges inherent in these proposals, including the need to accommodate transitional arrangements (if these can be agreed with the rest of the European Union (the "**EU**")) and the prospect of the UK government being able to change the regulatory landscape in the UK with only limited parliamentary scrutiny.

We then examine the impact of Brexit on the regulation of UK fund managers under the Alternative Investment Fund Managers Directive (the "**AIFMD**"). We conclude that the availability of arrangements in AIFMD to allow the passporting of non-EU ("**third country**") fund managers may assist some UK firms, but timing, logistical and political factors mean that many will feel it prudent to consider setting up some form of licensed entity within the EU after a 'hard' Brexit.

The ‘Great Repeal Bill’: the many unanswered questions

Functions of the Bill

The ‘Great’ Repeal

On October 2, 2016, the UK Prime Minister signalled that the next Queen’s Speech (a speech written by the Government outlining the legislative agenda for the coming parliamentary session) will include the Bill. The Bill will seemingly serve two major functions. First, it would repeal the European Communities Act 1972 (the “**ECA**”). The ECA gives effect not only to EU law in the UK, but also priority to EU law over UK law (including over Acts of Parliament) and recognition of the judgments of the Court of Justice of the European Union (“**CJEU**”).

The effects of repeal “will be clear”, the UK Prime Minister told the Conservative Party conference in Birmingham: “[o]ur laws will be made not in Brussels but in Westminster. The judges interpreting those laws will sit not in Luxembourg but in courts in this country. The authority of EU law in Britain will end.” Its purpose would be to make the UK a “fully-independent, sovereign country”.

Indubitably a shrewd political move, the announcement of the ECA’s repeal is, from a legal perspective, considerably less significant than it might at first appear. While it will be on the statute book before Brexit day, repeal will not take effect until Brexit day. As a result, it might be said that repealing the ECA on Brexit day is legally unnecessary. The ECA only gives effect and priority to EU laws that are binding upon the UK by virtue of its international obligations flowing from the EU treaties. Post-Brexit day, the UK will have no such international obligations and the ECA will have no EU law whatsoever on which to bite. That said, a move along the lines of the Bill was always expected in the wake of the Brexit vote, to give the public and business some kind of certainty as to the status of long-established EU laws and rules after Brexit.

Preservation

Second, paradoxically, although the Bill will repeal the ECA, it will not repeal any substantive EU law. Quite the opposite. One of its purposes will be to preserve all pre-Brexit day EU law in force in the UK and carry over into UK law the full body of EU law not already implemented in UK domestic law. The preservation of pre-Brexit day EU law in the UK is sensible. It offers a degree of legal certainty for businesses: there will not suddenly be a legislative vacuum in areas of law such as financial services, data protection and intellectual property, which are areas where EU directives and regulations account for the lion’s share of the legal and regulatory framework. At one level, the format and drafing of the Bill itself could be relatively straightforward, with a provision allowing the necessary definitional changes to EU regulations when they become UK law.

Nevertheless, the prospect of this preservation exercise raises important issues. In her speech to the Conservative Party conference, the Prime Minister stated that “[w]hen the Great Repeal Bill is given Royal Assent, Parliament will be free…to amend, repeal and improve any law it chooses.” But how would this play out? On October 2, the UK Department for Exiting the EU declared that “[t]he Repeal Bill will include powers for ministers to make some changes by secondary legislation, giving the Government the flexibility to take account of the negotiations with the EU as they proceed.” The scope of these proposed powers lacks significant detail. In particular, there is as yet no indication as to whether ministerial powers to change legislation will be limited to EU laws which apply in the form of secondary legislation or, more controversially, EU laws domesticated by way of Acts of Parliament. Endowing the Government with the powers to amend or repeal Acts of Parliament through the use of secondary legislation, known as Henry VIII clauses (after the 1539 legislation which gave that monarch the power to legislate by proclamation), would be particularly ironic: a government wedded to the goal of restoring “full” parliamentary sovereignty would suddenly gain considerable law-making powers which reduce Parliament’s role in constructing the post-Brexit legislative landscape.

Implications for financial services

In the context of financial services, post-Brexit, how will the UK deal with new EU regulations or new detailed secondary measures? Ultimately, this will be a political decision. At its simplest, and as noted above, post-Brexit day, the UK will have no legal obligations flowing from the EU treaties and will not be bound by new EU regulations or new secondary legislation. However, the possibility of transitional arrangements and any desire to be deemed 'equivalent' so as to ensure "third-country" access to the Single Market add layers of complexity. The UK may need to adopt a mechanism to reflect ongoing changes to EU law to a certain extent. In particular, there will inevitably be "in-flight" EU legislation at the date of Brexit, meaning situations where framework legislation has been agreed but where the detailed implementing legislation and regulation still needs to be negotiated. In financial services, examples of these 'in-flight' measures might well include the expected package of measures deriving from the so-called Basel IV proposals, and those designed to reflect TLAC proposals into EU law.

And what of UK laws passed pre-Brexit to implement EU law obligations? It remains unclear whether such rules will, post-Brexit, be subject to the principle that they are required to be interpreted, if possible, so as to comply with those (no longer existing) EU obligations. What happens when those EU directives are amended post-Brexit? Again, it would appear that much will turn on the UK's desire to be deemed equivalent under the various third country regimes.

As mentioned above, the Bill will also have to take account of any transitional measures which are agreed with the EU for financial services (perhaps allowing single market access and passporting for a transitional period). It is expected that the quid pro quo for such arrangements will be that the UK agrees to continue to abide by the EU regulatory rule book and judgments of the CJEU during the transitional arrangements. The Bill may have to incorporate provisions to facilitate this.

Furthermore, the Bill will likely have to "bake-in" some changes to EU law from the beginning. For example, hundreds of references to the EU supervisory authorities[1] will have to be amended when EU directly applicable regulations relating to financial services are adopted as UK law, presumably to be replaced with appropriate references to the Bank of England, PRA and FCA. Furthermore, on Brexit day, the UK will become a third country for the purposes of EU financial services law; changes to existing UK law implementing EU directives and the new UK law reflecting EU regulations will have to be made to reflect this new reality. In order for the law to be consistent and clear, the changes will need to be in place on the day that Brexit occurs. The relative complexity and volume of EU financial services legislation mean that we recommend that the UK Government, together with the UK regulators, begin preparatory work on this as soon as possible.

Further legal questions

The Bill raises wider legal questions too. The UK Department for Exiting the EU has stated that the Bill will "ensure that the Government can establish new domestic regimes in areas where regulation and licensing is currently done at an EU level, and amendments are required to ensure the law operates effectively at a domestic level." Sadly, the simplicity of this statement belies the difficulty in execution. So, for example, the EU rules on medicines give powers to the European Commission and the European Medicines Agency (the "**EMA**") and involve recognizing decisions of those bodies and member state regulators. Since 1995, the EMA has overseen EU-wide drug approvals. Post-Brexit day, would the UK continue to accept decisions of the EMA until a new UK equivalent body had been set up, which could take a significant period of time?

To what extent will UK courts, in interpreting the "preserved" EU legislative provisions, be required or permitted to follow post-Brexit decisions of the CJEU on the meaning of those provisions? The Department for Exiting the EU has indicated that the Bill will end CJEU jurisdiction in the UK but it has said little on how the CJEU's post-Brexit decisions will be treated. On the one hand, following post-Brexit CJEU interpretations amounts, in one sense, to giving continued effect to CJEU decisions. On the other hand, not following them countenances divergences between EU and UK case law on the interpretation of substantially the same statutes. There might be clear benefits for trying to maintain

[1] The European Securities and Markets Authority, the European Banking Authority and the European Insurance and Occupational Pensions Authority.

consistency in order to facilitate trade and to avoid UK companies with significant EU exports from the costs of having to comply with two different regimes. Significant divergence in interpretation of EU derived law could also endanger the availability of positive equivalence assessments in financial services law on an ongoing basis. Perhaps the most likely outcome is that where the relevant UK rule or law is derived from EU law, the UK courts will view CJEU judgments post-Brexit as being highly persuasive but not binding.

Conclusion

These are only some of the legal and regulatory issues that will need to be addressed during the legislative passage of the Bill. Shying away from these questions could threaten the rule of law (in the sense of ensuring a law that is clear, foreseeable and coherent) and the resulting uncertainty would harm vital sectors of the UK economy. The continuing lack of certainty on the future relationship between the UK and the EU could make the drafting and legislative passage of the Bill a complex undertaking, even where the the government reserves substantial flexibility for itself in being able to amend newly incorporated legislation post-Brexit.

AIFMD and Brexit

What is AIFMD?

In the wake of the financial crisis, the EU enacted a programme of regulatory reform targeting the hedge fund and private equity industry. The direct result of this focus was AIFMD.

AIFMD regulates the authorization, operations and transparency of managers of alternative investment funds ("**AIFMs**") who manage or market funds in the EU. The scope of AIFMD is wide and regulates the provision of risk management and portfolio management services in relation to an alternative investment fund ("**AIF**"). The definition of an AIF in AIFMD is very broad and includes a wide range of structures and fund types. Both open-ended and closed-ended vehicles and listed and un-listed vehicles can be AIFs, as can investment structures not typically thought of as being "funds".

Current treatment of EU and third country fund managers

AIFMD distinguishes between EU and third country fund managers. In general, fund managers in the EU are subject to more extensive regulatory restrictions and must comply with more onerous reporting requirements under AIFMD than third country fund managers. In addition, an EU fund manager must obtain authorization from the relevant regulator of an EU member state (e.g., the Financial Conduct Authority in the UK) before providing risk management or portfolio management services in the EU.

AIFMD provides for a passport that permits an EU fund manager to manage and market AIFs in other EU member states without further authorization in those other member states. As the UK is a member of the EU, EU fund managers are permitted to passport in and out of the UK, thereby facilitating the management and marketing of alternative investment funds across the EU with relative ease.

For context, as of July 27, 2016, 212 firms passport from the UK to other EU member states and 45 firms passport into the UK under the provisions of AIFMD. This constitutes a relatively small percentage of firms that provide fund management services in the UK, as many firms simply provide the service of delegated portfolio management on the basis of a Markets in Financial Instruments Directive ("**MiFID**") permission and a cross-border services passport, rather than using the AIFMD passport (please see the **first issue of Lex et Brexit** for more detail on the implications of Brexit for passporting under MiFID). That said, for some UK firms, the availability of the passport under AIFMD is critical for their business model.

Third country fund managers that either: (i) manage or market AIFs established in the EU to investors in the EU or (ii) market AIFs established outside the EU to EU investors are not subject to the full spectrum of requirements under AIFMD.

However, such third country fund managers must comply with the individual national private placement regimes ("**NPPRs**") of the EU member states in which they intend to market an AIF. In practice, the private placement regimes vary significantly across the EU, although all require a base level of compliance with the investor disclosure and regulatory reporting aspects of AIFMD. As such, the cost and method of compliance with NPPRs can vary drastically depending on the particular EU member state in which registration is sought.

Third country passport

The ability for member states to provide for NPPRs was designed in AIFMD to be a temporary measure. By early 2019, AIFMD envisages that the European Commission will adopt secondary legislation providing for the termination of NPPRs, meaning that the "third country passport" described below will become the only mechanism for third country fund managers to market to members in the EU.

AIFMD provides that the third country passport will only be extended to regimes which have been assessed as "equivalent" for the purposes of AIFMD. A determination of equivalence broadly provides for an assessment as to whether or not the third country's regime exhibits sufficient similarities with that of the EU, implements international standards and allows EU fund managers access to the respective third country market on a similar basis.

Under the AIFMD third country passport, the third country AIFM from an equivalent jurisdiction would be required to become authorized by the regulator of the AIFM's "member state of reference" – this will be an EU member state determined by the third country AIFM based on a complex procedure set out in detailed EU secondary legislation. A third country AIFM wishing to apply for such authorization must also establish a legal representative in the member state of reference to act as a contact with the relevant national regulator and will be required to comply with the full panoply of AIFMD's requirements. An AIFM using the third country passport will therefore be subject to a dual regime in that it would have to be authorized in the relevant third country jurisdiction and in the EU in the member state of reference.

It was originally envisaged that the third country passport would be available in late 2015 and would run alongside the NPPRs for a period of time. In July 2015, however, the European Securities and Markets Authority ("**ESMA**") suggested that the implementation of the third country passport would be substantially delayed. In the interim, ESMA undertook a review of certain non-European jurisdictions to determine if there were significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risk which would impede the application of the third country passport.

On July 18, 2016, ESMA advised the European Commission of the following:

- Canada, Guernsey, Japan, Jersey and Switzerland have no significant obstacles;
- subject to minor conditions, Hong Kong, Singapore and Australia have no significant obstacles;
- the extension of the marketing passport to the US risks creating an un-level playing field between EU and third country AIFMs; and
- given the infancy of the regimes in Bermuda, the Cayman Islands and the Isle of Man, ESMA cannot adequately assess and advise on these jurisdictions.

The European Commission is now considering the advice set out above and will set a date in the near future for the "switching on" of the third country passport in the countries it ultimately deems equivalent.

Implications for the UK post-Brexit

If the UK exits the EU but remains a member of the European Economic Area ("**EEA**"), then AIFMD should continue to apply and the passport will therefore remain available to UK AIFMs.

If the UK is neither a member of the EU nor the EEA, then it is possible, albeit unlikely, that Parliament could repeal the UK legislation implementing AIFMD and enact a new regime to regulate the asset management industry. However, it is more likely that the UK will retain the existing legislation and seek equivalence in order to obtain the third country passport. If the latter option is pursued, the UK should, initially at least, be able to meet the criteria for equivalence for the purpose of the third country passport with relative ease (subject, of course, to the law remaining materially the same as is currently implemented in the UK).

However, a number of factors may complicate an equivalency decision in respect of the UK. First, the delays in the provision of ESMA's equivalency advice in relation to other jurisdictions suggest that any equivalency assessment in respect of the UK could progress slowly, especially if the UK is forced to join the back of the queue for such assessment after Brexit. It would also be surprising if the European Commission is amenable to issuing (or even contemplating) a final AIFMD equivalency decision before the UK has actually left the EU, potentially leaving a substantial gap in the ability of UK firms to passport to the EU after Brexit. In addition, the reluctance of ESMA to extend the passport to the US may indicate that political considerations ultimately influence the timing and willingness of the EU authorities to formally extend the third country passport to the UK.

Alternatively, if the UK is not granted equivalency, UK fund managers will be able to market in the EU through the NPPRs, as discussed above, for as long as those regimes remain available. As mentioned above, AIFMD itself requires the NPPRs to be terminated, meaning that the third country passport will eventually be the only means by which a third country fund manager can market in the EU. At that time, if the UK has not been granted equivalency by the European Commission, then a UK AIFM will not be able to market AIFs to investors based in the EU.

Even if the UK is granted access to the third country passport on an expedited basis, or following a transitional period (where passporting for UK financial services firms is retained past the date of Brexit), some UK AIFMs may still consider moving their operations to the EU to avoid the application of a dual regime as described above (i.e., being subject to regulation and authorization in the UK and the EU member state of reference). When combined with the uncertainty over the availability of the passport for the provision of MiFID services such as portfolio management after Brexit, some UK fund managers may well decide it is prudent to consider establishing a licensed entity in the EU to ensure sustained access to the whole of the EU market.

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