

A nighttime photograph of a cityscape, likely Sydney, Australia. The Sydney Opera House is the central focus, illuminated and reflected in the water. The city lights are visible in the background under a dark, cloudy sky.

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Brexit and its Impact on Cross-Border Activity in Europe

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On June 23rd last year, British voters decided that the United Kingdom (UK) ought to leave the European Union (EU) – the successor of a group of European nations it had formally joined back in 1973¹.

Several months down the line a lot of uncertainty remains, and the ways in which the separation is to be achieved are still broadly unknown.

Over the past four decades or so, policy made at an EU level has permeated many areas of legislation in each of the national jurisdictions, in an effort to harmonize the “playing field” within a zone of complete free trade, in which regulatory arbitrage was not to be permitted. From Agriculture to Manufacturing, through to Intellectual Property, the EU’s array of topics in which the legislator has been active is extremely wide.

Financial services, of course, have been impacted by those “EU laws”, with the regulators of each EU country having

to implement those – mutually- (and multilaterally-) agreed – “laws” within their own jurisdictions. As a result of the UK breaking away from the EU, it is, at this stage, still unclear what will happen to all those financial regulations which the UK has adopted over the past many years – including those which, in some cases, were designed for the purpose of allowing financial services to operate across borders within the EU.

How will cross border financial services work in the EU post-Brexit?

The following is attempt to answer this question, from a theoretical perspective at this stage insofar as all the decisions have yet to be made, in the context of a political climate that has been difficult in Europe overall.

Many pieces of EU legislation in the field of financial services currently include the option of operating – including, in many cases marketing – across border or via the opening of a branch in a “host state” within the EU.

A “host state” is an EU country other than the one where a financial services company was initially authorized; the country of authorization is called the “home state”. Choosing to operate in that way has been called “passporting” financial services within the EU; that is one of the mechanisms of free trade on which Brexit could have an impact.

Hedge funds will be looked at more specifically, because they are the target of a recent piece of EU legislation called the Alternative Investment Managers Directive (AIFMD), which was published in 2011 but has been implemented in stages since. The AIFMD also includes various passporting options, which could be impacted as a result of Brexit.

1. More, or less, free trade?

Before looking at the specific case of hedge funds, or of financial services even, there is one point one has to bear in mind: among other objectives, the EU regulatory framework aims at “leveling the playing field” in order to enhance competition within the EU. However, it has been acknowledged that many of those in favor of Brexit articulated their own reasons for being dissatisfied with EU policies in either one of the following – somewhat contradictory – two ways:

- Some of those who voted for Brexit were, in fact, in favor of more free market policies and practices, which they felt the EU framework was stifling; they perceived the weight of EU regulations as heavy, anti-business, and preventing rather than enhancing competition. Besides, competition and free-trade in relation to zones outside of the EU (e.g. the United States) also suffered from what has been perceived as an increasingly high regulatory burden, and the creation of a market which has been caricatured by some as “fortress Europe”².
- Others, who also voted for Brexit, allegedly did so for completely opposite reasons: to them, free trade represents a danger to the interest of the UK; they rejected the EU for the very reason that they think the UK ought to be protected as a market. Beyond the economic rationale, this group often seeks to protect a culture and an identity; they also object to the free movement of the labor force which the EU allows, as they feel this has a detrimental impact on employment.

There are many examples of aspects of EU legislation that currently either enhance or, on the contrary, restrict the functioning of a free market, including the following:

- Free movement of labor within the EU applies to all sectors of economic activity. As far as financial services are concerned, the City of London – the financial center within Europe – does attract young and highly qualified individuals from all over the continent (and beyond). Those who voted for Brexit may have had in mind sectors other than financial services when they felt non-UK workers ought no longer to be naturally allowed to come and work in the UK; it is nevertheless the case that the “foreign” workforce has been part of the growth of the City, and that the decision to breakaway from the EU will have an impact on that aspect of financial services.

- European hedge funds had, until recently, been kept relatively outside of the scope of financial regulations – coming from national and EU regulators alike. To put this situation into perspective, the rest of the financial services industry has, on the contrary, had to apply rules that had originated in Brussels – the center of the EU institutions – for a long time, from the Markets in Financial Instruments Directive (MiFID³, applicable to most investment firms) to rules on solvency ratios (for insurance companies). To some, those regulations, including the more recent ones on hedge funds, constitute a barrier to entry into an industry which, as a result, can be seen as less competitive.

2. The passporting of financial services within the EU

In 2005, the Financial Services Authority (FSA, UK financial regulator at the time) issued a Discussion Paper aiming to gather thoughts and data about hedge funds from the industry, starting with the definition of what might constitute a hedge fund. This was an initial step towards the possibility of regulating a sector which was relatively unknown at the time, including by the regulator itself. The financial crisis that was about to start three years later somewhat precipitated the decision of imposing further regulation on hedge funds, which regulators decided partly to blame for the crisis, as far as the systemic risk they presented potentially was concerned. The AIFMD was born as a result; it contains several passporting options.

Other European Directives such as the one on Undertaking for Collective Investments in Transferable Securities (UCITS⁴) and MiFID also contain passporting provisions:

- European “UCITS” are types of investment funds that meet certain criteria (as defined by the various UCITS Directives, the first of which was published in 1985) and can be marketed to retail investors. Unlike hedge funds, UCITS funds have to be incorporated onshore – i.e. in Continental Europe. UCITS funds must follow certain rules (for instance on asset diversification); as a trade off, they may benefit from a “European passport”. While that passport did not function well for a while, practitioners have noticed some clear improvement over time: it is now easier than before to sell a UCITS fund incorporated in one EU country to retail investors in another EU country without the need to seek formal approval from the host state(s). It is absolutely unclear at this stage what will happen to that possibility of passporting UCITS funds once the UK leave the EU, especially in the context of many UCITS funds being incorporated in Ireland or Luxembourg, where the tax treatment is deemed to be more favorable, and being sold everywhere across Europe, including in the UK. A non-negligible proportion of UCITS funds are incorporated in, or managed from, the UK; those situations are also likely to require some adjustments in the post-Brexit Europe.
- MiFID Directives are revamped versions of the Investment Services Directive⁵, initially published in 1993. While deemed constraining by many, these

Directives include passporting provisions, which increased the amount of cross border business in financial services over time within the EU. For instance, within the EU investment banks (to name but one firm type) can operate via the incorporation of one single legal entity, which they are then able to branch out throughout the EU. This possibility, and the ease with which the whole of the European market becomes accessible as a result, could disappear as a result consequence of Brexit; that is one of the reasons why large US banks have said they would relocate their European headquarters away from the UK, and into jurisdictions from where it may still be possible to use the EU passport, post-Brexit.

It is, of course, not easy to envisage what – if anything – might replace the “EU passport” going forward as far as the UK is concerned. If the latter were to disappear completely, and if the UK were to be treated like a country completely outside of the geographical zone altogether, that would equate to barriers being erected around the UK as far as financial services are concerned. The objective of leaving the EU for the purpose of enhancing free market would, in that case, be defeated absolutely.

More likely outcomes could be as follows:

- Switzerland never joined the EU, and yet has a strong culture of financial services, supported by its relationship with the EU. From a regulatory perspective, this relationship works as follows:
 1. Switzerland has published its own rules which are different from EU rules but in-keeping with them. Among other things, the intention of the legislator has been to “keep its market clean” and avoid attracting companies would have come to Switzerland as a result of refusing to abide by the relatively higher standards of the EU. Doing so was a stated intention in the case of the AIFMD a few years ago, with Switzerland feeling a pressure somewhat to have “its own AIFMD” – its own piece of legislation regulating hedge funds but with a “Swiss finish”.
 2. As far as UCITS are concerned, Switzerland also replicated the EU rules; in addition, they provided for an easier way of approving UCITS funds recognized by one of the EU jurisdiction: while this is not quite “passporting”, the procedure is more flexible and faster than it would normally be (e.g. for a non-EU / non-UCITS fund).
- Many are currently talking about the UK becoming a lot closer to the US once it becomes unconstrained by the EU legislation. In the minds of many commentators, such an outcome could result in the UK being to keep its pre-eminence in financial services, as a result of the reopening of a channel which, in some cases, had been somewhat restricted by the proliferation of regulations on both sides of the Atlantic in the aftermath of the financial crisis. The new regimes in both countries could influence that outcome.

3. A few words on the AIFMD, the EU hedge fund regulatory framework still in its infancy

As mentioned, it took a while for hedge funds to be regulated in Europe. In the absence of any other reference, the model that was adopted by regulators for the making of the AIFMD was the UCITS Directive. The latter regulates retail funds though, and hence fund managers have argued that its provisions are far too restrictive to be transferable to the management of funds that are designed to appeal to more sophisticated investors. Running a hedge fund in Europe has, over the past few years, become a lot more expensive than it used to be as a result of the AIFMD, and this has created barriers to entry. That aspect could be looked at in parallel with the fact the number of candidates to become hedge fund managers in Europe has risen during that time, a second-order consequence of the financial crisis and its impact on investment banking, including the fact the latter also became more regulated.

The AIFMD contains some passporting options, however these are complex, and they are being implemented in stages, depending on where funds, and their managers, are located. The fact that Brexit came in precisely at a time when the functioning of those passporting rules has not yet been established is adding a further layer of uncertainty since we are working with two moving targets here, the interaction of which might give way to more possibilities than is the case as far as the becoming of the other Directives is concerned.

Given the hostility against the AIFMD in the Anglo-Saxon world – from the point of view of both the cost of running a hedge fund business and the ability to market a product for the purpose of generating revenues – it is likely that Brexit will give way to a relative deregulation of hedge funds. Scaling down the EU regulatory framework currently applicable to hedge funds may not necessarily equate to throwing out the baby with the bathwater:

- As is the case in Switzerland – to a lesser extent perhaps given the timeframe and the prevailing opinions within the countries in question – the UK could keep some form of regulatory framework applicable to hedge funds, in-keeping with the necessity to provide market surveillance and ensure the latter stays “clean”.
- Passporting provisions currently soften the fact that having simple conversations – with investors who are sophisticated enough to know what they are doing – has become harder and harder as a result of the new regulation (AIFMD). If those restrictions no longer were in the first place – or, at the very least, if they were fine-tuned – the relative advantage of having passporting provisions may be lessened. Lowering international barriers as far as the marketing of hedge fund products is concerned is not, however, something that can happen unilaterally: the possibility of achieving that outcome would depend, also, on the willingness of other countries, outside of the EU, to offer reciprocity in terms of market access. A lot of work between the UK and the US remains to be done in that context.

References

1. At the time, the “group of European nations” was called the European Economic Community.
2. The phrase was used during the negotiation phase that led up to the making of the AIFMD, from 2009 to 2011. In its initial form at least, the Directive would have been very restrictive as far as the marketing of non-EU hedge funds to EU investors was concerned.
3. https://ec.europa.eu/info/law/markets-financial-instruments-mifid-directive-2004-39-ec_en
4. https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en
5. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52002PC0625>

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Marianne Scordel is the Founder of Bougeville Consulting, a consulting firm that assists hedge fund managers in doing business in Europe. She has managed set up and business migration projects since 2012 and her business has received numerous awards since that time, including three from UK national publication Financial News. She has worked in investment banking and was previously a co-chair of the Legal Issue Special Interest Group at CFA UK. She is French, an Alumna of the University of Oxford, and recently relocated to the United States.