New City Initiative

A New Regime for Asset Management

Why the UK should adopt a Dual Funds Regime

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

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Charles Gubert is a consultant to the NCI. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

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Foreword

The New City Initiative (NCI) was formed to provide a collective voice for smaller boutique managers which were being overlooked by policymakers, regulators and to a lesser extent customers, who did not always appreciate the strong alignment of interests and risk management culture that differentiates boutiques from larger firms.

Recent years have seen waves of regulation and boutiques have shown the flexibility required to deal with this despite their smaller size. Post-Brexit, we operate in a world of "VUCA" – Volatility, Uncertainty, Complexity and Ambiguity. This presents challenges for all firms, but therein lies the opportunity.

The exact regulatory and competitive landscape is still to be finalised. It is therefore vital that the industry puts forward ideas and potential solutions for debate and that those responsible for shaping the agenda, negotiating terms and planning for the future, open a dialogue with all participants. In this paper, the NCI outlines how an agile and thoughtfully considered dual funds regime in the UK could help firms retain EU access, but also expand and grow beyond the EU.

This regime – as the paper points out - would allow for further innovation by UK managers in a global marketplace. Fund management is one of the UK's most successful exports, and we feel a dual regime respecting both UK and EU interests, can bring about new opportunities and be practical, proportionate and fully protective of consumer interests.

The key for all businesses, not just within financial services, is clarity and certainty, and this must be provided by the government. The financial infrastructure and regulation of the UK is so intertwined with Europe that Brexit will require time and patience to implement effectively. This paper provides one solution which could be implemented with relative ease.

Jamie Carter
Deputy Chairman, New City Initiative
Chief Executive, Oldfield Partners

Executive Summary

Brexit is the biggest challenge facing UK asset managers since the financial crisis – potentially even for a generation. The UK government has confirmed that the country will leave the Single Market, a process that will cement drastic change at financial institutions including fund managers in both the UK and EU-27.

The NCI recognises that financial institutions including fund managers will face disruption over the coming years, including uncertainty over where euro denominated swaps will be cleared, or concern that inflexible UK immigration quotas could deprive organisations of EU talent leading to severe skills shortages. This paper does not seek to remedy those problems, but proposes a positive solution to some specific challenges that asset managers may encounter over the next two to five years.

Pulling out of the Single Market means UCITS and AIFMs located in the UK will lose their EU regulatory designation, and passporting rights. UK managers will fall back on national private placement regime (NPPR) rules if they choose to raise assets in the EU post-Brexit. If NPPR is taken away simultaneously to Brexit, UK asset managers will lose any access to the EU unless they have a structure in an EU country.

Industry participants have warned of other challenges. A loss of single market access could require UK managers to rewrite and even renegotiate terms and conditions for existing investors. This could risk withdrawals, especially if EU investors have a portfolio selection mandate that prescribes them to onshore products only. Service provider relationships – certainly with depositaries – would also need to be reconsidered.

Any regulatory arbitrage would be unwanted, and it is a concern among NCI members. The NCI polled its members in the months after Brexit to gauge their opinions on the current market predicament. Respondents comprised a diverse range of asset managers with a global investor base. Regulatory arbitrage between the UK and EU was cited by 54.5% of NCI members as their biggest worry; 27% identified market volatility as a paramount concern, while 18% acknowledged investor outflows/fundraising challenges was likely to be a challenge.

The NCI believes that if the UK government set up a dual funds regime, it would help asset managers deal with many of these worst case scenarios. A dual funds regime would allow UK managers with EU interests to continue to comply with EU laws and directives and retain favourable access to their EU investors, while simultaneously letting others market to the rest of the world ex EU, and avoid the worst excesses of EU regulation. Such a regime may also enable fund managers to avoid re-structuring their businesses to onshore EU locations such as Ireland and Luxembourg providing equivalence for the UK is granted.

However, a dual funds regime is not something that can be established with ease, and we recognise huge challenges lie ahead. That being said, it is an approach which could help improve competitiveness in the UK funds' market, and ensure both the UK and EU gets a good deal out of Brexit negotiations.

Impact of Brexit on Financial Services

The implications of Brexit cannot be ignored. An October 2016 Treasury Report indicated that a hard Brexit may cost the UK around £66 billion while GDP would be 9.5% lower in 15 years than what it would have been had the UK remained a member of the EU.

Table 1 - Outcomes for UK Financial Services[1]

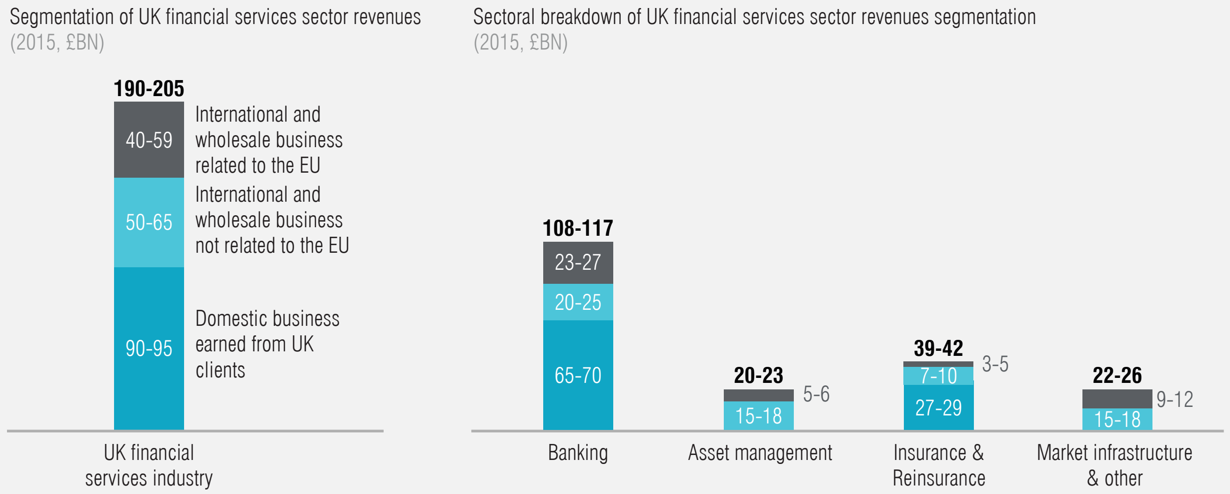
Brexit Scenario	Outcome for UK financial services
The UK moves to a third country arrangement with the EU with no regulatory equivalence and its relationship with the EU is defined by terms set out under the World Trade Organisation (WTO).	A loss of 50% of EU-related activity (£20 billion in revenue); 35,000 jobs at risk; a fall in tax revenues of £5 billion per year.

In the near-term, the focus for the UK should be to ensure market uncertainty is minimised during its negotiations with the EU. The inherent complexity and interconnectedness between the UK and EU means that negotiations on exit and subsequent trade deals could take years to finalise. Greenland, a country of around 50,000 people and miniscule GDP took three years to formalise its exit from the EU. Brexit will be a far greater challenge.

It is critical the UK government consults regularly with a wide representation of industry participants to ensure diverse interests across the spectrum are recognised and on-boarded. A number of industry associations and consortia are proliferating in order to push their constituents' interests forward during negotiations. This is understandable and inevitable, but it is imperative that the government listens to all segments of the industry, and not just the largest and most powerful voices.

Preserving the international status of the UK fund management industry is imperative. For the UK to thrive, it needs to retain strong European and international links. UK domiciled fund managers have global businesses. Many have investors and interests in the EU, US, Asia-Pacific (APAC), Middle East and Africa (MEA). Ensuring managers remain competitive globally is paramount to any negotiations.

Figure 1 - Segmentation of the UK financial services industry[2]



1 The City UK 'The Impact of the UKs Exit from the EU on the UK-based financial services sector' https://www.thecityuk.com/assets/2016/Reports-PDF/The-impact-of-the-UKs-exit-from-the-EU-on-the-UK-based-financial-services-sector.pdf

2 Ibid.

Dual Funds Regime

The creation of a dual funds regime would permit UK managers with EU interests to continue to comply with EU laws and directives and retain favourable access to their EU investors, while simultaneously letting others market to the rest of the world ex EU, and avoid the worst excesses of EU regulation. A significant majority of NCI members (73%) said it was in the UK's interests to develop a dual regulatory funds regime. No single member disagreed about establishing a dual funds regime, although 27% said they were unsure.

Such a regime may also enable fund managers to avoid re-structuring their businesses to onshore EU locations such as Ireland and Luxembourg providing equivalence for the UK is granted. Avoiding a restructuring would be beneficial to firms in terms of costs.

That being said, no single respondent to the NCI study said they were actively re-locating or re-structuring their business operations into an onshore EU location at present. However, 25% said they were unsure about whether this would remain the case going forward, while 75% acknowledged they were not looking to re-locate following the vote.

Some believe in the near term that a mutual recognition scheme should be agreed between the UK and EU as soon as possible. "Such a scenario would be win win for the UK and EU, and it would be a good outcome for Brexit. UCITS in the UK export to the EU, and vice versa. The UK should negotiate a mutual recognition scheme primarily with the EU. This should help UK funds access the EU, and EU funds access the UK. I think an agreement on a mutually recognised funds regime is more achievable than banking as there is less economic incentive in changing the status quo for funds," said Sean Tuffy, senior vice president, investor services, at Brown Brothers Harriman (BBH) in Dublin.

Planning or consulting on the creation of a dual funds regime quickly might help stem the outflows from European investors and discourage hesitation among prospective investors about putting money into UK funds. Some EU investors are restricted to investments in onshore (i.e. EU) funds only, and once the UK becomes a third country, those investors may have to unwind their stakes or allocations in UK funds. Having a dual funds regime providing managers with an onshore fund structuring option would give the UK a major boost in retaining European investors. One mechanism to avert excessive market dislocation would be to grandfather existing rules on a temporary basis once negotiations have concluded.

How would a dual funds regime work practically?

Any eventual dual structure should also allow the UK to create its own funds regime borrowing from the best of breed regulations globally. The importance of the UK as a European fund centre should not be underestimated.

So what should a dual funds regime look like? UCITS and AIFMD, for example, ought to be used as a template for any post-Brexit UK fund regime. UCITS is an industry- leader and has widespread investor popularity across APAC and Latin American jurisdictions. Efforts to create pan-Asian fund passporting schemes through the ASEAN Collective Investment Scheme (CIS) and Asia Region Funds Passport (ARFP) have both looked to UCITS as a role model. The UK should certainly follow suit and look to leverage UCITS' foundational principles if and when it develops its own funds structure separate to that of the EU.

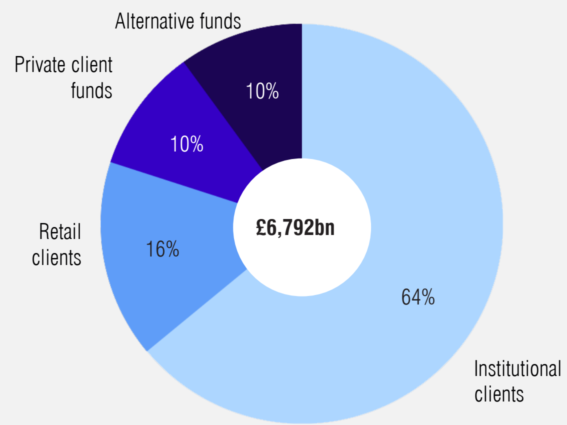
Asset eligibility criteria for AIFMs and UCITS should be retained in any bespoke UK fund structure so as to enable institutional and retail managers to invest sensibly according to the underlying risk profile of their clients. Safeguards such as the appointment of an independent valuer, and depositary should also be retained. Investor protection mechanisms through depositaries are often under-appreciated. The fact that a UCITS or AIFM investor is only exposed to market risk and negligible operational risk due to the presence of a depositary safeguarding assets and being subject to strict liability for any losses at the custodian/sub-custodian is a major selling point to numerous risk-averse institutions beyond Europe.

Some go further and believe the UK fund structure could scale down AIFMD and UCITS for funds that are not marketed into the EU. "For the UK parallel regime, I see no reason why we could not borrow from EU rules and create a "UCITS-lite" regime and an "AIFMD-lite" regime. Post-Brexit, the UK needs to show the rest of the world that it is open for business. With this philosophy, it could be argued that provisions under UCITS and AIFMD, such as the appointment of a depositary and remuneration restrictions could be considerably relaxed. This would simplify the regulatory process for asset managers looking to market into the UK, or UK managers managing or marketing non-EU funds in the UK," said Neil Robson, partner at Katten Muchin Rosenman. Adopting a lighter regime would also make it easier for UK regulated firms to transition into an EU regulated structure should they choose to.

An alternative regime could also enable – in theory – for a disapplication of future EU rules for managers without EU interests. However, these managers would still be subject to prudential oversight by the UK regulatory authorities. Nonetheless, this is an approach that can only be taken once the terms of the UK exit are firmed up. The UK – is after all – a full member of the EU and will be so until exit is finalised. "The FCA cannot begin changing the rule book until Brexit is finalised, and this could delay any dual funds regime," commented Tuffy. It is also imperative that the UK does not end up becoming viewed as too 'light touch' a regulatory regime as this could make selling into some countries challenging.

Figure 2 - Segmentation of the UK financial services industry[3]

Funds under management in the UK
% share of UK funds, end-2014



£bn	2013	2014	% Change
Managed by IA member firms	4,957	5,404	9.0
Institutional clients	3,958	4,341	9.7
- insurance companies	1,029	1,008	-2.0
- corporate pension funds	1,832	2,091	14.1
- other (local gov, charities, etc.)	1,098	1,243	13.2
Retail clients	999	1,063	6.4
Other funds	598	683	14.2
- hedge funds	252	277	9.9
- Property funds	217	264	21.7
- Private equity funds	129	142	10.1
Private Client funds	638	705	10.5
Total funds under management in UK	**6,192**	**6,792**	**9.7**

3 The City UK (https://www.thecityuk.com/assets/2015/Reports-PDF/UK-Fund-Management-An-attractive-proposition-for-international-funds.pdf)

How taxation rules may help the UK

Perhaps the biggest incentive the UK could use is a generous taxation regime for managers electing to domicile their funds in the UK. Ireland has thrived as an asset servicing centre for hedge funds in part due to its generous tax set-up. A similar taxation scheme to Ireland (12.5% tax for managers and 0% tax for funds) should be implemented in the UK to win domiciliation share. Such a policy could be hugely advantageous in light of the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) initiative.

BEPS is a 15-point action plan and will be applicable to financial institutions globally. Action six of the 15-point plan is directed at treaty abuse and seeks to restrict treaty shopping. In other words, this could make it harder for hedge or private equity funds established in offshore or non-UK tax efficient jurisdictions such as the Cayman Islands or British Virgin Islands (BVI) to incur tax benefits through the use of treaty entitled subsidiary companies as there is likely to be an increased need to demonstrate substance/business rationale in countries where treaty benefits are claimed. Funds in tax haven territories are not themselves able to benefit from treaties and may struggle to justify why intermediate companies in treaty jurisdictions have been established. Furthermore , it is not always easy (and it is usually costly) to build substance outside the UK if an entity is a UK based investment manager.

As such, BEPS provides the UK with an excellent opportunity to grow its stature not only as a home for investment managers but also as a jurisdiction for fund domiciliation as the funds themselves can benefit from the UK's double tax treaty network. The UK is also home to numerous institutional investors and fund managers, so demonstrating substance under BEPS would not be an issue. Creating a lower tax and less complex tax regime for UK funds would encourage more firms to consider the UK as a fund location as they seek to demonstrate adherence to the OECD's BEPS programme. This should be leveraged by the UK as and when BEPS' clampdown on aggressive tax planning comes into fruition, enabling the UK to win business from offshore centres, many of whom require managers to undertake back office and administration in those locations as well.

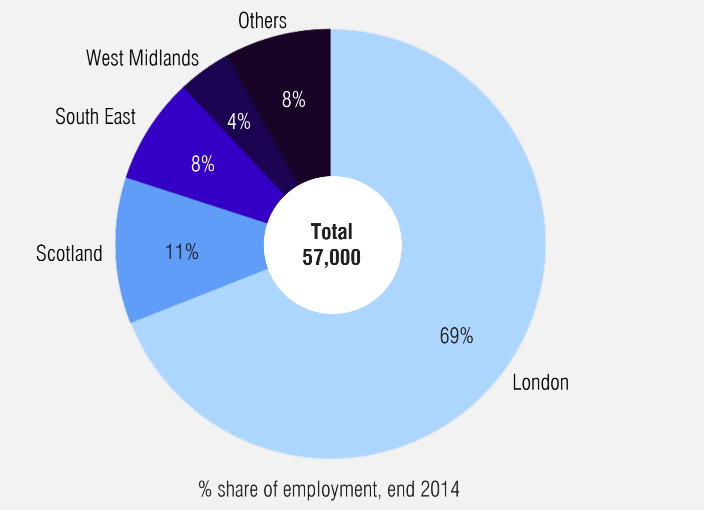
"It is still early days but the UK does have a better chance in maintaining treaty access post BEPS than other jurisdictions which rely on downstream structures established in a different jurisdiction to the fund. Many offshore funds establish Irish or Luxembourg structures so as to obtain treaty benefits and while this is often just to achieve overall tax neutrality there is a great deal of concern that this sort of structuring is going to be under threat from BEPs, particularly if they lack meaningful substance in those countries," said Mark Stapleton, partner at Dechert.

However, there are impediments to this. The UK tax regime for funds is notoriously complicated and this could dis-incentivise some firms from domiciling funds in the UK. In addition, investment managers may need to charge VAT on their management fee for their unregulated funds, although Stapleton said that once out of the EU, organisations could lobby the UK government to change the VAT rules.

New Opportunities and Stimulating UK Growth

A dual funds regime would also allow service providers such as administrators, law firms, auditors, and depositaries to thrive within the UK thereby retaining and potentially boosting employment in financial services. The UK has a sizeable workforce working in the funds' industry, but this could grow with the creation of a dual funds regime.

Figure 3 - Breakdown of fund management jobs by region[4]



A number of service providers are located in EU onshore locations such as Luxembourg and Ireland, or offshore centres including the Cayman Islands, Bermuda or BVI. Attracting more service providers such as fund administrators and lawyers would reap a number of benefits for the UK fund management industry. The financial sector in Luxembourg, which includes private banking and funds, contributes to roughly one third of the country's GDP. Having more individuals employed in financial services would mean more taxes for the UK government as well.

Equally, back office and administration are roles that can be undertaken anywhere, and a number of service providers do have offices in places such as Belfast, Glasgow, Liverpool, Birmingham and Bournemouth. As such, administration and audit could stimulate regional economies and potentially mitigate some of the financial consequences of Brexit. The Financial Times reported that an Ernst & Young analysis had concluded 83,000 jobs could go if the UK lost its right to clear euro denominated swaps. The London Stock Exchange (LSE) put job losses higher at 232,000 were euro denominated swaps to leave the UK. "If the UK became a fund centre, the creation of UK-onshore administrative jobs might be such as to offset some losses from jobs in financial services moving into the EU post-Brexit," commented Robson.

Creating a dual funds regime that borrowed from best practices of the onshore and offshore world would put the UK asset management industry in a strong position. It would enable it to maximise its European and ROW coverage in this new geopolitical, economic and regulatory framework. It would simplify operational processes for managers as well if all of their service providers were UK-based. There is also a far larger skilled workforce in the UK than in many offshore centres, and again this would be a huge benefit.

4 The City UK (https://www.thecityuk.com/assets/2015/Reports-PDF/UK-Fund-Management-An-attractive-proposition-for-international-funds.pdf)

Potential Barriers

However, there are some significant challenges. The concept of a dual funds regime is sensible, but there are major political issues that must be resolved. “A dual funds regime would probably allow funds marketing from the UK to the rest of the world to operate in a regulatory framework that is lighter touch than the existing EU regime. The question is how will the EU-27, particularly Ireland, Luxembourg or Malta view that. The EU may say to the UK that it will only give equivalence if the entire UK dual funds regime meets EU regulatory standards given the interconnectedness the UK has with the EU. I cannot imagine Brussels will let the UK pick the best of both worlds. In addition, Guernsey and Jersey operate a dual funds regime and they have not been given EU approval for equivalence yet despite receiving a positive opinion from ESMA,” said one partner at a major law firm.

Perhaps the biggest stumbling block is that the dual funds regime is untested. To make matters more complex, the AIFMD authorisation process for third countries has not progressed over six months as EU regulators seek greater reciprocity for passporting. This will cause major delays and is in part a result of Brexit. Nonetheless, this does not look promising for the concept of a dual funds regime for the UK. In such a scenario, the UK could simply set up its own funds regime unilaterally and extend equivalence to third countries such as the US, Hong Kong, Singapore and Australia in a more-timely fashion than that of the EU.

With yet another regulatory regime comes another set of regulatory reporting. Reporting obligations must remain straightforward, and adopting a dual structure inevitably raises the issue of requiring firms to adhere to dual reporting regimes in the UK and EU, a point made by Tuffy. “Does the UK Financial Conduct Authority (FCA) really want to manage a two stream regulatory regime? It raises obvious practical implications,” said Tuffy. The UK interestingly has taken a robust approach towards implementing EU rules of late so a new regime could end up being quite onerous. The UK’s FCA, for example, has adopted a tough line on Annex IV reporting, requiring information by the master fund of a UK AIFM be supplied even if it is not marketing into the EEA. As such, it is crucial that any additional regulatory reporting be kept to the minimum so as to make the funds regime as attractive as possible. The NCI would urge that any future regulatory reporting for managers be straightforward to reduce costs and allow firms to run their businesses without excess impediment.

The other major challenge is that a dual funds regime cannot be viewed in a silo. Other industries are likely to press for similar treatment, namely banking, insurance, car manufacturers and pharmaceuticals. The list goes on. This will create an enormous amount of work for the UK government, already grappling with a huge negotiating task.

Conclusion

UK and EU interests are interlinked, and a strong UK means a strong EU and vice versa. Negotiations should be framed so that both the UK and EU attain the best deal, and one that allows equivalence or fund passporting rights across both jurisdictions to ensure customers can benefit from competition, innovation and access to the right products.

Should passporting be unattainable, some sort of equivalence regime or bespoke deal must be agreed upon. A failure to achieve this could lead to a resurgence in regulatory fragmentation and protectionism, which will bring harm to the asset management industry and financial services sector globally.

However, the complexity of the task should not be underestimated. “Brexit is going to be a significant administrative barrier. We don’t know yet what the UK relationship with the EU will be. Only once this barrier has been overcome can meaningful progress be made in areas such as the creation of a dual fund regime. I am hopeful that the UK government will create a more flexible and nimble fund regime, as this could enable the UK to compete with Luxembourg and Ireland, as well as offshore centres such as the Cayman Islands,” said Robson.

A dual funds regime – should it be successful – would bring revenues to the UK, and create new opportunities across financial services. However, the outcome of negotiations will not be known for some time, but the government should be considering how it could leverage the UK’s deep expertise in fund management to create a truly bespoke funds regime, which would allow managers to market into both the EU and rest of the world. While the UK government is not legally permitted to create a dual fund structure until Brexit is finalised, it can certainly – at least- start thinking about how to achieve this objective by:

- Speaking with industry participants including fund managers, lawyers, banks, financial technology providers and consultants about how a dual fund regime could operate.
- Setting in motion a detailed plan outlining the regulatory and tax requirements of this new dual regime, at least for the parallel UK structure.
- If Brexit results in equivalence being denied, the UK should have a contingency plan in the form of setting up its own UK funds regime, but not a parallel EU regime.

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