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## Potential implications on the use of passporting for asset management firms in a post-Brexit world

Following the “Leave” result of the United Kingdom’s Referendum on whether to Remain or Leave the European Union, one of the most talked-about issues is whether the UK will continue to have access to the EU’s financial services single market and—crucially—whether UK financial services entities will maintain their ability to use the passporting regimes provided for under a variety of EU Financial Services legislation. Whilst we acknowledge the high degree of uncertainty as to what the final form of any new relationship between the UK and the EU will look like, in this note we set out to highlight and consider some of the key questions surrounding the implications of the EU passporting regime as we currently understand them and what potential passporting options may look like going forward for UK financial services entities in the asset management sector.

### What is passporting? – A quick reminder

Passporting is a concept that allows a firm to establish in one jurisdiction and obtain a “passport” to provide services in another jurisdiction, either on a cross-border basis or through establishing a branch. For the financial services sector, the ability to passport has created harmonised access to the single market for financial services in the European Union (“EU”) and European Economic Area (“EEA”). In the past, the availability of a passport to perform financial services was restricted to firms that have been established in one EU/EEA member state having the ability to utilise a passport and perform financial services in another EU/EEA member state (the “EU/EEA Passport”). However, in recent years, the concept of passporting has been extended to allow firms who are not members of the EU or EEA to obtain a passport to provide certain services in an EU/EEA member state (the “3<sup>rd</sup> Country Passport”). The availability of each type of passport differs according to different EU financial services legislation. This note focuses on the passporting regimes available under three key Directives that are relevant for asset management firms, the Markets in Financial Instruments Directive (“MiFID”), the Alternative Investment Fund Managers Directive (“AIFMD”) and the Undertakings in Collective Investments in Transferable Securities Directive (“UCITS”).

### Passporting Options

#### *The EU/EEA Passport*

Subject to its fulfillment of conditions under the relevant EU Directive, a firm authorised in an EU/EEA member state is entitled to carry on regulated financial services activities in any other EU/EEA member state by either exercising the right of establishment (of a branch and/or agents) or providing cross-border services through the use of an EU/EEA Passport. For EEA states, this relationship is governed by the EEA Agreement, which allows 3 Non-EU states (Iceland, Liechtenstein and Norway) (“EEA member states”) access to the EU’s financial services single market. However, we note that, at present, there is an outstanding issue in relation to the incorporation of the EU Regulations establishing the European Supervisory Authorities (ESAs) into the EEA Agreement. This means that, currently, EEA member states are not members of the EU financial supervisory systems and the ESAs, with the consequent effect that



some EU member states do not accept EEA AIFMs to passport into their jurisdictions. An agreement has been reached to find a solution to this issue between the EEA member states and the EU Ministers of Finance and Economy, however, this solution has not yet been fully implemented into current EU legislation. Therefore, currently, there is an impasse on the availability of the EEA Passport under certain EU Directives. However, we understand that the implementation of this solution is being worked upon by the relevant authorities and legislative bodies and should be resolved in the coming months. The application of the EU/EEA Passport and the regulated financial services activities that are “passportable” vary depending on the rules set out in each EU financial services Directive. EU/EEA Passports are available to firms under each of the following EU Directives:

- The Markets in Financial Instruments Directive (“MiFID”), in respect of brokers, dealers, portfolio managers and distributors;
- The Undertakings in Collective Investments in Transferable Securities Directive (“UCITS”), for UCITS fund managers;
- The Alternative Investment Fund Managers Directive (“AIFMD”), for alternative fund managers;
- The Capital Requirements Directive IV (“CRD IV”) and Capital Requirements Regulation (“CRR”), for credit institutions;
- The Solvency Directives (as amended), in respect of insurers.

Activities that are not covered by these Directives and are not “passportable” require the firms wishing to carry on regulated financial services activities to contact the national competent authority (i.e., the local national regulator) in relevant EU jurisdictions to determine whether direct authorisation is needed to conduct such services. In practice, marketing and conducting regulated financial services in an EU jurisdiction is difficult without a passport.

The EU/EEA Passport is only available for EU/EEA member states, and therefore any state that is not within the EU or EEA, including the Channel Islands (Jersey, Guernsey) or the Isle of Man, does not have access to apply for the EU/EEA Passport.

### ***The 3rd Country Passport***

In addition to the EU/EEA Passport, certain EU Directives also provide for access to conduct cross-border services to countries outside the EU/EEA – so called “3rd Countries”. For asset management firms, the most relevant Directives that provide access to 3<sup>rd</sup> Country firms are MiFID (once the MiFID II amendments are implemented) and the AIFMD. Both Directives grant 3rd Country firms (i.e., firms established outside the EU/EEA) rights to conduct business in the EU/EEA by exercising 3rd Country Passport rights as stated under each Directive, subject to certain provisos as detailed below.

#### ***MiFID II***

With effect from the 3 January 2018, the MiFID II Directive and Markets in Financial Instruments Regulation (MiFIR) (often jointly referred to as MiFID II) will repeal and recast MiFID.

MiFID II provides access to 3rd Country firms to conduct investment services in the EU by obtaining a 3rd Country Passport. However, the approach for allowing 3rd Country access via a passport is not harmonized, and the manner in which a 3rd Country Passport may be obtained by a 3rd Country firm will be dependent



on an individual EU member state's implementation of MiFID II and will vary from member state to member state.

However, bearing the above in mind, and in summary, MiFID II will allow for two types of 3rd Country Passport to be available as follows: the first will allow for the provision of cross-border investment services by a 3rd Country firm to per se professional clients and eligible counterparties; and/or the second option will allow for the provision of investment services by a 3rd Country firm by that firm establishing a branch in an EU jurisdiction when providing services to elected professional clients and retail clients.

Under Article 47 of MiFIR, in addition to obtaining co-operation agreements between regulators, in order for a third country to be able to obtain access to the 3rd Country passporting regime, the European Commission is required to examine a third country's legal and supervisory arrangements to ensure that firms authorised in that third country comply with legally binding prudential and business conduct requirements which have the "equivalent" effect to the requirements set out under MiFID II. This decision is also permitted to be reviewed by the European Commission on an ongoing basis and as such the European Commission maintains a right to withdraw its equivalence decision for a 3<sup>rd</sup> Country if it believes that the 3<sup>rd</sup> Country firm no longer meets certain requirements (the procedures is as set out in MiFIR).

Consequently, whilst the possibility of a 3rd Country Passport is clearly one that may prove to be beneficial in circumstances where the UK leaves the EU nor is deemed an EEA state and therefore UK firms no longer have access to the EU single market using an EU/EEA Passport, firms will need to keep a close eye on Brexit-related developments and discussions as they occur, and particularly in relation to the application of an "equivalence" decision by the European Commission.

In our view, given that (as set out by the UK Financial Conduct Authority on 24th June 2016) the implementation efforts for MiFID II in the UK continue without change, and, consequently, the text adopted by the UK is highly likely to be the same as that adopted by EU member states (even if legislative changes may be required to remove any reference to the EU once the UK is no longer subject to EU regulation or law), the UK should have a good case for proving equivalence under the MiFID II provisions. Having said that, firms should be mindful that such decisions are not usually merely based on whether the language is the same under legislation but more often takes into account wider policy implications of the relationship between the EU and a third country, which may include consideration of the effects on competition or investor protection or even apply a principle of proportionality to an equivalence decision (as recently seen with discussions on Solvency II). Consequently, at present, it is hard to see how the effects of politics will not have any effect on any discussion on "equivalence" in relation to providing access to the UK. This is clearly something that is difficult to predict and therefore re-emphasises the need for the industry to maintain a watchful eye on developments.

### *AIFMD*

Currently under the AIFMD, Non-EU Alternative Investment Managers (Non-EU AIFMs) and Non-EU Alternative Investment Funds (Non-EU AIFs) may only have access to the EU/EEA under the national private placement regime (NPPR) of each EU Member State. However, the AIFMD provides that the European Securities and Markets Authority (ESMA) will issue an opinion to the European Parliament, Council and Commission in relation to the continuing operation of the NPPRs and the possibility of applying a 3rd Country Passport to Non-EU AIFMs and Non-EU AIFs.

This process has already begun with ESMA issuing its advice to the European Parliament, Council and Commission on this issue in July 2015, where ESMA assessed six jurisdictions: Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the United States. ESMA concluded that it sees no obstacles to extending this passport to Guernsey, Jersey and Switzerland (subject to the latter amending certain provisions in its legislation). However, ESMA did not reach a definitive view on the remaining three jurisdictions in this



advice and the European Commission responded to ESMA's advice in January 2016 requesting ESMA to provide further assessment on the remaining three jurisdictions (Hong Kong, Singapore and the United States), plus six additional jurisdictions (Australia, Bermuda, Canada, Cayman Islands, Isle of Man and Japan). This advice was due at the end of June 2016. The European Commission also agreed with ESMA's suggestion that ESMA produces another opinion on the functioning of the EU/EEA Passport and the NPRRs once the AIFMD has been fully transposed in all EU member states and there is more experience on the functioning of the framework.

In addition to the obtaining of appropriate cooperation arrangements and compliance with relevant FATF and OECD tax rules, Article 67(4) of the AIFMD sets out additional elements that ESMA would need to consider to ensure that there is no further impediment to obtain a Third-Country passport; this includes an assessment on investor protection, market disruption, competition and the monitoring of systemic risk.

As with MiFID II, we are of the view that the UK should have a good case to meet the criteria set out both in the AIFMD and in the recent guidance provided by ESMA's advice on the application of a Third-Country passport. However, the assessment made by ESMA will take the form of advice to the European Parliament, Council and Commission, and therefore there may be additional elements (not least political) that are taken into consideration prior to an approval for the UK to be able to utilise the Third-Country passport route under the AIFMD. Consequently, as with many items under consideration for Brexit, firms will need to continue to monitor how any potential discussions progress.

#### *UCITS Directive*

There is currently no 3rd Country Passport available under the UCITS Directive.

#### **What does this mean in practice?**

A lot will depend on the final form of any future relationship that the UK has with the EU and EEA. For instance, if the UK was to exit the EU but become a member of the EEA (such as Norway), UK firms would still have the EU/EEA Passport available to them in much the same way as they do now, (provided that, as aforementioned, the application of the EU financial supervisory systems and the ESAs is resolved under the EEA Agreement). However, the distinction between being a member state of the EU and being a member state of the EEA is that EEA member states are not represented (nor have a vote) in the European Parliament, European Council or European Commission, but are still bound to implement directives that have EEA effect, and are also required to make significant contributions to the EEA budget. Consequently, this may have certain undesirable results for the UK as they would, in effect, lose their "voice" within the EU institutional structure, which may mean, from a political standpoint, the UK government may not wish to enter into such a relationship. Therefore, it will also be necessary to look at alternative "Brexit" options, which may include entering into bilateral arrangements following either existing precedent relationships such as that between the EU and Switzerland or something that is completely unique to the UK and the EU. We also note that, whilst in the short term, it may be the case that, upon a Brexit, the UK adopts legislation "as is" currently drafted and/or already in place under EU legislation, in the longer term it may also very well be the case that as the UK seeks to shape out a new pathway for itself outside of the EU, certain EU financial services provisions may be amended or indeed removed. In such instances, the discussion and analysis around the use of 3<sup>rd</sup> Country Passports, the timing of the UK receiving access to such passports and the ability to review "equivalency" on an ongoing basis by the European institutions will become more relevant and certainly "one to watch" as the impact of Brexit progresses.

If you have any questions on this Alert or Brexit-related queries, then please contact your usual Ropes & Gray contact or reach out to our UK Asset Management team.

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