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CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community.

Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.
EXECUTIVE SUMMARY

This paper analyses the implications of the United Kingdom’s decision to exit the European Union—“Brexit”—for the investment management industry. It serves as a guide for investment professionals.

The Brexit process began when the UK government exercised Article 50 of the Treaty on European Union on 29 March 2017. Under the provisions of Article 50, the exit process must be completed within two years. The outcome of these negotiations, and the future UK–EU trade relationship, will likely have significant implications for the shape of the investment management industry in Europe.

Brexit will alter the terms of trade between the UK and the rest of the EU, as it is expected to lead to the departure of the UK from the EU single market. Consequently, investment firms in the UK may have different or reduced access to the single market, which will impact their ability to establish branches and provide financial services freely throughout EU countries on the basis of a single regulatory authorisation in the firms’ home member states.

This “passporting” regime has played a significant role in the growth of London as a financial services hub for the EU. The UK runs a large trade surplus in financial services with the rest of Europe and hosts the largest investment management industry in Europe. UK investment management firms manage some £2.2 trillion of assets on behalf of overseas clients (close to 40% of total assets under management in the UK), of which £1.2 trillion is managed on behalf of clients in Europe (ex-UK). These figures illustrate both the global nature of the UK investment management industry and the importance of the European market among its client base.

The primary considerations of Brexit for investment management professionals and the clients they serve are a loss of passporting rights (primarily for UK firms but also for other EU firms passporting to the UK), possible restrictions on the management of assets from the UK for clients based in the EU, and possible restrictions on labour mobility impeding professional practice in the wake of Brexit. A loss of passporting rights for investment firms would impact several aspects of the investment management business. These include, for example, cross-border marketing and distribution of investment funds, as well as some ancillary services, such as custody and administration. The provision of investment services to retail clients may also be impacted, given the limitations of the “third-country” regimes under certain EU laws.

For investment professionals, any disruption in the ability to conduct portfolio management on behalf of overseas clients is a key concern. The ability of the investment management industry to source the talent it needs to serve clients may also be affected under Brexit. Restrictions on nationality or labour mobility, as well as potential differences in local licensing laws regarding professional practice, may adversely impact the talent pool available to firms (in both the UK and the EU).

Investment professionals are overwhelmingly negative about the impact of Brexit on the UK financial sector. In the most recent CFA Institute member survey on Brexit, conducted in February 2017, 70% of respondents in the UK believe that Brexit has caused the competitiveness of their market to deteriorate. Over half (57%) of CFA Institute member respondents expect firms with a strong UK presence to reduce their presence in the UK as a result of Brexit. Further, 70% of CFA Institute member respondents expect investment returns to be compromised by geopolitical uncertainties over the next three to five years. However, despite the risks identified by members, a large majority of portfolio managers surveyed (around two-thirds) said that they have not changed their strategy or investment horizon as a result of the Brexit vote.

The investment management profession plays an important role in facilitating capital formation, generating sustainable returns for end investors, and supporting economic growth. It is vital, therefore, that the legal and regulatory consequences of Brexit do not hurt the ability of firms to serve the best interests of clients. Irrespective of politics, and on whichever side of the debate one resides, upholding the interests of end investors needs to be a core objective for the negotiations surrounding financial services.

THE OUTCOME OF THESE NEGOTIATIONS, AND THE FUTURE UK–EU TRADE RELATIONSHIP, WILL LIKELY HAVE SIGNIFICANT IMPLICATIONS FOR THE SHAPE OF THE INVESTMENT MANAGEMENT INDUSTRY IN EUROPE
1. INTRODUCTION

On 23 June 2016, the United Kingdom held a referendum on its membership of the European Union (EU). The result was a decision to leave the EU, backed by 52% of voters.\(^1\) In the subsequent months, the UK government, under the leadership of prime minister Theresa May, announced its intentions to begin the formal process of exiting the EU—a process that began on 29 March 2017 and is expected to conclude within two years. This paper analyses the implications of the UK’s exit from the EU and serves as a guide to help investment professionals understand the relevant issues for the investment management industry.

The result of the referendum and the ensuing negotiations over the terms of the UK’s exit from the EU has ushered in a period of political and economic uncertainty in Europe. It comes at a time of rising geopolitical risks, both within Europe and elsewhere. Moreover, Brexit poses several uncertainties for financial services firms and investment management professionals. These include, for example, the location of operations in the UK and elsewhere (a function of EU market access post-Brexit), the future European financial regulatory landscape and supervisory architecture, and the role of London as a financial centre for the EU. These and other issues are considered in this paper.

The decision to put the UK’s membership of the EU\(^2\) to a referendum followed a period of negotiation between the UK and its European partners over the terms of the UK’s membership. At the heart of these negotiations was a desire on the part of the UK to strengthen its sovereignty, particularly regarding the jurisdiction of law and control over immigration. The failure to achieve an acceptable compromise—in the eyes of the British public—with the EU over these and other issues was manifested in the historic referendum outcome.

The backdrop of the referendum informs the negotiating position of the UK government and the possible shape of the future UK–EU relationship. In a white paper published in February 2017, following a speech by the prime minister in January, the UK government set out 12 principles to guide its negotiations. Among them, the government indicated its intention to be an independent nation with full control over its borders and full sovereignty over its laws, thereby repealing the jurisdiction of the European Court of Justice.

These aims are incompatible with full access to the EU single market, as acknowledged by the UK government, because they conflict with the “four freedoms” of the EU—namely, the free movement of people, goods, services, and capital. Full access to the single market is conditional upon these freedoms being respected.

Single market access confers the right to “passport” services (including certain financial services) freely throughout the European Economic Area (EEA)\(^3\) based on authorisation in a single member state. Given its stated aims, the UK has effectively ruled out membership of the EEA after exiting the EU, which may have important implications for investment firms providing cross-border services. Possible paths for the UK–EU relationship are explored in this paper.

The rest of this paper is organised as follows. Section 2 reviews the Brexit process and timeline. Section 3 examines the views and expectations of investment professionals on Brexit, drawing from CFA Institute member survey data. Section 4 analyses the relationship between the UK and the EU in financial services, focusing on the investment management industry. Section 5 considers the legal and regulatory implications of Brexit, and Section 6 concludes.

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\(^{1}\) Turnout for the referendum was high, with more than 33 million people casting votes, representing 72.2% of the electorate.

\(^{2}\) The members of the EU are Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

\(^{3}\) The membership of the EEA comprises the member states of the European Union plus Iceland, Liechtenstein, and Norway. Non-EU EEA countries are outside the EU but allow for the freedom of movement and make contributions to the EU budget.
The Brexit process formally commenced on 29 March 2017 when the UK government exercised Article 50 of the Treaty on European Union, the legal mechanism that provides for the exit of a member state from the EU. Under the terms of Article 50, the exit negotiations must be concluded within two years of the notification to leave the EU, setting a deadline of the end of March 2019.

The negotiations are multifaceted and are likely to involve significant concessions and tradeoffs if a comprehensive UK–EU trade deal is to be reached. Under the terms of the exit provisions, any deal must be agreed on by a qualified majority in the Council (representing EU member states) and must obtain the consent of the European Parliament and other national parliaments. The Article 50 provision gives the European Parliament a potentially pivotal role in the process, because it could block any deal otherwise agreed on by the respective member states. Further complicating matters, several EU member states will undergo national elections during this period (see the Appendix for a timeline), which could stall or destabilise the Brexit negotiations. Taken together, these considerations illustrate the inherent difficulty the UK faces in obtaining consent from all interested parties prior to the March 2019 deadline.

Absent a deal by March 2019, the UK would default to the rules of the World Trade Organization, implying the imposition of certain tariffs in its trade with the rest of the EU—sometimes referred to as a “hard” Brexit.

The political figures and chief negotiators in the Brexit process are illustrated in Figure 1. On behalf of the EU, the European Commission (EC) will lead the negotiations (under Michel Barnier, reporting to EC President Jean-Claude Juncker). The Council will focus on the overall political bargain; the Parliament has only an indirect role during the negotiations, yet it possesses a right of veto on the final deal.

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**FIGURE 1:**
**KEY POLITICAL FIGURES**

<table>
<thead>
<tr>
<th>UK Government</th>
<th>Theresa May</th>
<th>Prime Minister</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Government</td>
<td>David Davis</td>
<td>Secretary State for Exiting the EU</td>
</tr>
<tr>
<td>UK Government</td>
<td>Boris Johnson</td>
<td>Secretary of State for Foreign and Commonwealth Affairs</td>
</tr>
<tr>
<td>UK Government</td>
<td>Liam Fox</td>
<td>Secretary of State for International Trade</td>
</tr>
<tr>
<td>European Commission</td>
<td>Michel Barnier</td>
<td>Chief Brexit Negotiator</td>
</tr>
<tr>
<td>European Commission</td>
<td>Jean-Claude Juncker</td>
<td>EC President</td>
</tr>
<tr>
<td>Council of the European Union</td>
<td>Didier Seeuwa</td>
<td>Council Special Taskforce Chief Negotiator</td>
</tr>
<tr>
<td>Council of the European Union</td>
<td>Donald Tusk</td>
<td>Council President</td>
</tr>
<tr>
<td>European Parliament</td>
<td>Antonio Tajani</td>
<td>EP President</td>
</tr>
</tbody>
</table>

Note: Correct at time of Article 50 notification (29 March 2017).

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* Article 50 of Treaty on European Union states:
* 1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
* 2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
* 3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
* 4. For the purposes of paragraphs 2 and 3, the member of the European Council of or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.
* A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.
* 5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.
* 6. Under Article 238(3)(b) of the Treaty on the Functioning of the European Union, the qualified majority shall be defined as at least 72% of the members of the Council representing Member States comprising at least 65% of the population of these States.
In a global CFA Institute member survey conducted before the referendum, 71% of respondents predicted a negative impact on UK client portfolios over a one-year period in the event of Brexit, and 76% of respondents thought that the immediate impact on the pound sterling would be a depreciation of more than 5% against their domestic currency, a result borne out in financial markets following the vote. The pound’s weakness, however, has provided support to the UK equity market in the period since the June referendum and has coincided with a period of improving economic data and increases in asset prices more generally across developed markets.

The improving economic picture contrasts with the sentiment of investment professionals on the impact of Brexit. CFA Institute conducted a member survey on Brexit in July 2016 and again in February 2017. The results showed that although sentiment has somewhat improved since July 2016, investment professionals remain overwhelmingly negative about the impact of Brexit on the UK financial sector. This sentiment is reflected in Figure 2: 70% of respondents in the UK said Brexit has caused the competitiveness of their market to deteriorate, down slightly from 74% in July 2016.

Over half (57%) of CFA Institute member respondents expect firms with a strong UK presence to reduce their presence in the UK, while only a small proportion of respondents (8%) expect an increase in UK presence, as shown in Figure 3. In addition, 71% of respondents in the EU (ex-UK) expect firms to reduce their UK presence because of Brexit, and 52% of respondents from the rest of the world expect firms to reduce their UK presence.

### Figure 2: Impact of Brexit Vote on Market Competitiveness

<table>
<thead>
<tr>
<th>% of respondents indicating the Brexit vote has caused the competitiveness of their market to deteriorate</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
</tr>
<tr>
<td>EU (ex-UK)</td>
</tr>
<tr>
<td>ROW</td>
</tr>
<tr>
<td>July 2016</td>
</tr>
<tr>
<td>74%</td>
</tr>
<tr>
<td>5%</td>
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<tr>
<td>6%</td>
</tr>
<tr>
<td>Feb 2017</td>
</tr>
<tr>
<td>70%</td>
</tr>
<tr>
<td>2%</td>
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<tr>
<td>5%</td>
</tr>
</tbody>
</table>

Source: CFA Institute
Note: ROW stands for “rest of the world.”

### Figure 3: Expected Reaction of Firms with a Strong UK Presence

How do you expect firms in your local market with a strong UK presence to react to Brexit?

<table>
<thead>
<tr>
<th>How do you expect firms in your local market with a strong UK presence to react to Brexit?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce presence in the UK</td>
</tr>
<tr>
<td>Increase presence in the UK</td>
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<tr>
<td>July 2016 (N=2,037)</td>
</tr>
<tr>
<td>8%</td>
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<tr>
<td>36%</td>
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<tr>
<td>58%</td>
</tr>
</tbody>
</table>

Source: CFA Institute

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CFA Institute surveyed its membership between 6 and 13 February 2017—1,428 investment professionals completed the survey: 143 from the UK, 295 from other EU countries (excluding the UK), and 990 from the rest of the world. This survey follows the CFA Institute member survey of 2,043 investment professionals taken between 13 and 21 July 2016.
Assessing the relative attractiveness of international financial centres, respondents clearly identified London as the biggest Brexit “loser”. Frankfurt, Dublin, New York City, and Paris, meanwhile, are considered by respondents to be the biggest “winners”, as shown in Figure 4.

FIGURE 4: BREXIT WINNERS AND LOSERS: FINANCIAL CENTRES

<table>
<thead>
<tr>
<th>WINNERS FROM BREXIT</th>
<th>77%</th>
<th>63%</th>
<th>58%</th>
<th>58%</th>
<th>49%</th>
<th>45%</th>
<th>39%</th>
<th>32%</th>
<th>30%</th>
<th>20%</th>
<th>17%</th>
<th>16%</th>
<th>10%</th>
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</thead>
<tbody>
<tr>
<td>Frankfurt</td>
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<td>Dublin</td>
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<td>New York</td>
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<tr>
<td>Paris</td>
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<td>Luxembourg</td>
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<td>Zürich</td>
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<td>Amsterdam</td>
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<td>Singapore</td>
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<td>Hong Kong</td>
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<td>Shanghai</td>
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<td>Madrid</td>
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<td>Milan</td>
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<td>London</td>
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</tbody>
</table>

Source: CFA Institute

The effects of uncertainty caused by Brexit are expected to last longer in the UK markets than elsewhere: 50% of respondents in the UK believe uncertainty will remain longer than two years, whereas those in the EU and elsewhere expect the uncertainty to be more short-lived, as shown in Figure 5.

In further findings, a clear majority of respondents (70%) expect investment returns to be compromised by geopolitical uncertainties over the next three to five years, reflecting a widespread concern over geopolitical risk. However, despite the risks identified by members, a large majority of portfolio managers surveyed (around two-thirds) said that they have not changed their strategy or investment horizon as a result of the Brexit vote.

FIGURE 5: EXPECTED LENGTH OF MARKET UNCERTAINTY CAUSED BY BREXIT

For how many months do you expect Brexit uncertainty to remain in the markets?

- Less than 6 months
- 6–12 months
- 13–24 months
- More than 2 years

Source: CFA Institute
Europe is multifaceted: it consists of not only the EU, but also, within it, the euro area (or eurozone—i.e., countries that use the euro as their currency); and, outside it, other overlapping trade arrangements, as shown in Figure 6.
Until the withdrawal process is completed, the UK is a member of the EU and has access to the single market. Historically, this has meant that firms authorised in the UK can establish branches and provide financial services in other EU countries without the need for additional authorisation from the “host” country authority. The same applies for firms authorised in other EU member states seeking to access the UK market.

The ability to provide cross-border services in the EU, based on a single authorisation by the “home” member state regulatory authority, is referred to as the “single passport”. No additional regulatory requirements may be imposed by the host country authority on the cross-border provision of financial services or on the branches of EU financial firms (beyond notification and certain administrative arrangements between the respective authorities). The single passport thus operates on the principle of “mutual recognition” among the authorities and member states of the EU.

The single passport, however, does not apply uniformly to financial services. In practice, specific passports must be obtained under the specific legislation that applies to the activity in question. Therefore, financial firms may acquire several passports relating to different business activities.

The passporting regime has played a pivotal role in the growth of London as a financial centre. London’s time zone, common law framework and English language are other factors supporting its preeminence in financial services. Many international financial firms have based their operations in London, from where they can access the EU single market. According to TheCityUK (2016), half of all European headquarters of non-EU firms are based in the UK. Further, the EU is the biggest single market for UK exports of financial services, generating a trade surplus of £22.8 billion in 2015—41% of the UK’s total trade surplus in financial services.

This trade surplus is reflected in the balance between the number of “outbound” and “inbound” passports for financial services firms, as illustrated in Figure 7.

The UK accounts for a sizeable proportion of European financial services and markets activity, reflecting the dominance of London. For example, according to Sapir, Schoenmaker and Véron (2017), the UK accounts for 90% of European wholesale banking activity. It is by far the largest jurisdiction for foreign exchange trading, accounting for approximately 37% of global daily foreign exchange turnover and 78% of the foreign exchange turnover in the EU (Bank for International Settlements, 2016). The UK stock market is the largest in Europe; the market capitalisation of the London Stock Exchange (LSE) accounts for approximately 30% of total EU equity market capitalisation. Further, share turnover on the two largest exchanges in the UK (LSE and BATS Chi-X Europe) account for nearly 50% of total turnover on EU equity exchanges.

In investment management, the UK is a leading financial centre. In terms of assets under management, the UK has the largest investment management industry in Europe, which is second only to the United States in global terms (Financial Conduct Authority, 2016a).

### Figure 7: Number of Firms With Financial Services Passports To and From the UK

<table>
<thead>
<tr>
<th>Legislation</th>
<th>Passports Outbound</th>
<th>Passports Inbound</th>
</tr>
</thead>
<tbody>
<tr>
<td>MiFID</td>
<td>2,250</td>
<td>988</td>
</tr>
<tr>
<td>AIFMD</td>
<td>212</td>
<td>45</td>
</tr>
<tr>
<td>UCITS</td>
<td>32</td>
<td>94</td>
</tr>
</tbody>
</table>

Source: FCA (2016a)

Notes: Outbound passports are the number of firms authorised in the UK to do business in another EU/EEA member state, under each piece of legislation. Inbound passports are the number of firms authorised in an EU/EEA member state (other than the UK) to do business in the UK. The data show the number of firms with at least one passport; firms may hold several passports under each directive for different business activities. UCITS refers to the Undertakings for Collective Investment in Transferable Securities Directive, which is the European framework for mutual funds. AIFMD is the Alternative Investment Fund Managers Directive, which covers managers of all other authorised funds, including hedge funds and private equity funds. MiFID is the Markets in Financial Instruments Directive, which covers a range of investment services (e.g., portfolio management and investment advice) and financial instruments (trading in equity and non-equity securities and instruments).

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1 For more details, see, for example, Cherednychenko (2017).
2 According to Bortsoo (2017), under EU financial services law, “branches” are defined as a place of business—other than the head office—that are part of the financial firm and provide services for which the firm has been authorised. They differ from “subsidiaries”, which are separate legal entities that belong to a parent company and which require a separate licence from the host country regulatory authority to be able to operate. Subsidiaries are considered a “national” of the host country.
3 See TheCityUK (2016).
According to the Financial Conduct Authority and the Investment Association (2016), UK assets under management (AUM) amount to approximately £6.9 trillion, of which over £1 trillion is managed on behalf of UK retail investors and approximately £3 trillion is managed on behalf of institutional investors (mostly pension funds). The remainder is managed on behalf of overseas clients, reflecting the global nature of the UK investment management industry.

For Investment Association member firms (which manage 83% of total UK AUM, or £5.7 trillion), the overseas client market amounts to £2.2 trillion. Significantly, 55% of the overseas client market, or £1.2 trillion, is managed on behalf of clients in Europe (ex-UK), illustrating the importance of the European market to the UK investment management industry.

Figure 8 provides further statistics on the UK investment management industry.

Although the UK is dominant in asset management, it is not the primary domicile for investment funds. Luxembourg and Ireland are the top two domiciles for fund listings, as illustrated in Figure 9.

FIGURE 8: SELECTED UK INVESTMENT MANAGEMENT INDUSTRY STATISTICS

<table>
<thead>
<tr>
<th>UK Investment Management</th>
<th>% of total Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total AUM</td>
<td>36%</td>
</tr>
<tr>
<td>Hedge Fund AUM</td>
<td>85%</td>
</tr>
<tr>
<td>Private Equity Funds (by location of manager)</td>
<td>40%</td>
</tr>
<tr>
<td>Venture Capital Funds (by location of manager)</td>
<td>20%</td>
</tr>
</tbody>
</table>

Note: Figures presented are approximations, based on data presented in Financial Conduct Authority (2016a), TheCityUK (2016) and Lannoo (2017).

IN TERMS OF ASSETS UNDER MANAGEMENT, THE UK HAS THE LARGEST INVESTMENT MANAGEMENT INDUSTRY IN EUROPE

Taken together, the data shown above illustrate that the UK investment management industry is closely integrated with the European Union, with many functions, particularly portfolio management and other front-office functions, delegated to managers based in the UK on behalf of overseas clients and funds.

Brexit, therefore, could interfere with these arrangements. In this context, the primary considerations for investment management professionals, and the clients they serve, are a loss of passporting rights (primarily for UK firms but also for other EU firms passporting to the UK), possible restrictions on the management of assets from the UK for clients based in the EU and possible restrictions on labour mobility impeding professional practice in the wake of Brexit.

The legal and regulatory considerations associated with these considerations are explained in the next section.
5. LEGAL AND REGULATORY CONSIDERATIONS: IMPLICATIONS FOR INVESTMENT MANAGEMENT

A loss of passporting rights for investment firms or restrictions on outsourcing of asset management would impact several aspects of the investment management business. These include, for example, cross-border marketing and distribution of investment funds, as well as some ancillary services, such as custody and administration. The provision of investment services to retail clients may also be impacted, given the limitations of the “third country” regimes under certain EU laws (discussed further below).

For investment professionals, any disruption in the ability to conduct portfolio management on behalf of overseas clients is a key concern. The ability of the investment management industry to source the talent it needs to serve clients may also be affected under Brexit. Restrictions on nationality or labour mobility, as well as potential differences in local licensing laws regarding professional practice, may adversely impact the talent pool available to firms (in both the UK and the EU).

Assuming the UK leaves both the EU and the EEA (which is expected given its stated negotiating objectives), then by default, in the absence of any alternative arrangements, it will become a third country under EU law.

As a third-country, access to the EU single market would be conditional on the UK being able to demonstrate that it has an “equivalent” regulatory regime as the EU for the relevant legislation. Third-country regimes typically allow third country firms to access the single market via passporting or may provide for other forms of access based on mutual recognition. The laws of the third country need not be identical to EU laws, but its regulatory and supervisory framework should achieve similar outcomes and meet the same objectives as EU laws.11

The benefit of this arrangement is that, if deemed equivalent, the UK may enjoy a similar level of access to the single market as it does at present. However, there are three main caveats.

First, not all EU directives and regulations provide for a third-country regime, and those that do may provide more limited scope of market access. Figure 10 highlights the existence of third country provisions among the key EU laws for the investment management industry.

11 See Cherednychenko (2017) for further details on the regulatory equivalence framework.
### FIGURE 10: EXISTENCE OF THIRD-COUNTRY REGIMES UNDER SELECTED INVESTMENT MANAGEMENT LEGISLATION

<table>
<thead>
<tr>
<th>EU Legislation</th>
<th>EU Passport Right/Mutual Recognition</th>
<th>Corresponding Third-Country (Equivalence) Regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR)</td>
<td>Cross-border provision of investment services</td>
<td>Yes, for professional clients and eligible counterparties. No third-country regime for provision of investment services to retail clients.</td>
</tr>
<tr>
<td></td>
<td>Establishment of branches to provide investment services</td>
<td>Optional for member states</td>
</tr>
<tr>
<td>Undertakings for Collective Investment in Transferable Securities (UCITS) Directive</td>
<td>Marketing of UCITS funds across the EU</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>Cross-border management of UCITS funds; establishment of branches to manage UCITS funds</td>
<td>No</td>
</tr>
<tr>
<td>Alternative Investment Fund Managers Directive (AIFMD)</td>
<td>Marketing of EU AIFs to professional investors across EU</td>
<td>Yes, via single authorisation in EU member state</td>
</tr>
<tr>
<td></td>
<td>Marketing of non-EU AIFs to professional investors across EU</td>
<td>Yes, via single authorisation in EU member state</td>
</tr>
<tr>
<td></td>
<td>Cross-border management of EU AIFs; establishment of branches to manage EU AIFs</td>
<td>Yes, via single authorisation in EU member state</td>
</tr>
<tr>
<td>European Long-Term Investment Fund (ELTIF) Regulation</td>
<td>Marketing of ELTIFs across EU</td>
<td>No</td>
</tr>
<tr>
<td>Proposal for Money Market Fund (MMF) Regulation</td>
<td>Marketing of MMFs across EU</td>
<td>No</td>
</tr>
<tr>
<td>EU Venture Capital Fund (EuVECA) Regulation</td>
<td>Marketing of EuVECA funds across EU</td>
<td>No</td>
</tr>
<tr>
<td>EU Social Entrepreneurship Fund (EuSEF) Regulation</td>
<td>Marketing of EuSEF funds across EU</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: Adapted from Cherednychenko (2017)
Second, the decision to grant regulatory equivalence resides solely with the European Commission and can be revoked at any time. Therefore, relying on regulatory equivalence may be too fragile an arrangement to provide the basis for a long-term trading relationship between the UK and the rest of the EU. Indeed, as some EU policy officials and other stakeholders have noted, the equivalence regime was not designed or envisioned with the UK in mind.

Third, unlike other equivalence assessments, Brexit is not about a convergence of two separate jurisdictions, but a divergence of two interlinked economies. Political factors are therefore likely to play a significant part in the negotiations and may influence the outcome of any UK equivalence assessments. As Michel Barnier, the chief Brexit negotiator for the EU, has indicated, the final deal for the UK would have to be worse than EU membership. This sentiment reflects a desire by some within Brussels to deny the UK a favourable trade deal in order to deter other member states from pursuing a similar path. It also reflects the simple reality that being outside a free trading bloc cannot, by implication, confer the same benefits as being inside the bloc.

If neither membership of the EEA nor third country status are likely solutions for the UK, there are two other possibilities. One is a bilateral trade agreement between the UK and the EU that would provide a bespoke arrangement and (presumably) favourable access to each other’s markets. This option is likely the preferred outcome but may take several years to obtain. A bespoke deal is also likely to require some sort of transitional arrangement that would see the UK abiding by EU laws for some time beyond the initial two-year period for concluding Brexit negotiations.

The other option is for firms to establish subsidiaries inside the EU. Subsidiaries must be capitalised, authorised, and supervised. As such, they are relatively costly compared with passporting arrangements or the establishment of branches because subsidiaries are treated as “nationals” of the member state in which they are domiciled. Establishing subsidiaries is likely to be a bigger consideration for banks (which lend as principals) than for investment management firms (which are agents investing on behalf of clients), given the respective balance sheet considerations. Nonetheless, the need to establish a physical presence and staff implies a higher cost base than would otherwise be the case. However, the establishment of subsidiaries inside the EU would provide for maximum certainty regarding access to other EU markets.

Absent any formal arrangements of the type described herein, trading relations between the UK and the EU would default to the rules of the World Trade Organization, bringing about the imposition of tariffs and other provisions. This outcome has been referred to by many commentators as a “hard” Brexit, creating a cliff-edge effect and a substantial change in the UK’s access to EU markets.

Arguably, the improved economic environment in both the UK and the EU may increase the chances of a hard Brexit, as both sides feel emboldened by the apparent resilience of their economies, with less pressure to cede ground. Yet such an outcome would imply a worse outcome for both the UK and the EU and, therefore, would likely only arise as a result of political miscalculation.

In summary, the starting point for Brexit is very different than for other countries pursuing third-country equivalence arrangements, given the size and interconnectedness of the UK vis-à-vis the EU.

THE STARTING POINT FOR BREXIT IS VERY DIFFERENT THAN FOR OTHER COUNTRIES PURSUING THIRD-COUNTRY EQUIVALENCE ARRANGEMENTS, GIVEN THE SIZE AND INTERCONNECTEDNESS OF THE UK VIS-À-VIS THE EU
6. CONCLUSION

The decision by the UK to leave the EU is profound, impacting trade, capital flows, international relations and the institutions of the European Union. These impacts are not yet clear, though they will likely reverberate for years to come.

In the context of financial services, Brexit has important implications for the UK and European investment management industries and the clients they serve. The ability to conduct portfolio management and provide investment services from the UK for clients in the EU is a central issue for investment management firms and professionals, as are possible restrictions on the nationality of workers or on labour mobility post-Brexit.

The investment management profession plays an important role in facilitating capital formation, generating sustainable returns for end investors, and supporting economic growth. It is vital, therefore, that the legal and regulatory consequences of Brexit do not hurt the ability of investment management firms to serve the best interests of clients.

Whatever the outcome of Brexit, it is likely to alter the shape of the investment management industry in Europe. Irrespective of politics, and whichever side of the debate one resides, upholding the interests of end investors needs to be a core objective for the negotiations surrounding financial services.
REFERENCES


EU MACRO–POLITICAL TIMELINE

EU – 27 leaders summit (Valletta) (3 February 2017)
EU – 27 leaders meet in Rome for 60th anniversary of EU treaties (25 March 2017)

France (election 7 May 2017)
UK (election 8 June 2017)

Czech Republic (election October 2017)

Greek bailout package – informal deadline (April 2017)
Brexit Art. 50 Triggered (March 2017)

Germany (election 24 September 2017)

Russian sanctions renewal deadline (July 2017)

Russia (election 11 March 2018)

Sweden (election 9 September 2018)

European Parliament elections (May 2019)

SSM Chair Nouy & Vice-Chair Lautenschlager mandates end (January 2019)

Finland (election April 2019)

Denmark (election by June 2019)

New commission takes office (November 2019)

Greece (election by October 2019)

Poland (election by November 2019)

Draghi ECB mandate ends (1 November 2019)
Deadline for current EU budget (MFF) (2020)

Catalan referendum (by September 2017)

Source: FleishmanHillard Brussels
POSSIBLE BREXIT SCENARIOS

1: Art. 50 TALKS
2017–2019:
Exit negotiations take place
Money, people, transitionals, WTO schedule

2019: End of two-year deadline for agreement

UK Exits EU and customs union

EU-27 unanimity required to prolong exit talks beyond 2019
Consent of EP & Super "QMV" in Council needed for agreement

1a: Transition
2019–?: Post-Brexit transitional apply

1b: UK—third country relationships governed under "WTO" schedule of commitments

2: New UK/EU Relationships
2017–2019: New EU–UK agreement structure agreed in principle

By 2019: Agreement in principle on new EU-UK rel.

Where access to single market access, budget contributions, and freedom of movement are decided

UK exits the EU and customs union
UK operates under WTO schedule of commitments
UK negotiates new arrangements with EU-27