The Debrief

Scaling Brexit's Walls: Key Issues for Non-EU Private Equity Sponsors

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Brexit's Reordered Regulatory Landscape Raises a Host of Questions for Private Equity Sponsors and Fund Managers Outside of the EU, who Market to EU Investors.

To help clarify some of these issues, we convened a group of senior private equity leaders for a discussion led by the Debevoise Private Equity Practice, including Rebecca Silberstein, Simon Witney, Patricia Volhard, Cécile Beurrier and Delphine Jaugey. Here are some of the highlights:

While the general direction of Brexit is clear, the details affecting managers and funds are murky. The current expectation is that a transition period running through the end of 2020 will be followed by a free trade agreement between the UK and the EU. But nothing is certain. The transition period needs to be ratified by each of the EU member states, and any free trade agreement that might be reached may or may not include financial services. Sponsors and fund managers thus need to be prepared for any contingency.

Any transition period will still be full of bumps and surprises. During the transition period as currently envisioned, the UK will still have the obligations and benefits of EU membership. But even so, the fact that the UK is legally no longer part of the EU will create ripple effects throughout management agreements, depositary agreements and investment policies that specify EU membership as a contractual or regulatory requirement.

In the worst-case scenario, UK managers and funds will face significant barriers reaching EU investors. Once the transition period ends, UK managers and funds are likely to lose the "passporting" that allows free access to other EU markets. Marketing a fund could then mean applying through each country's National Private Placement Regime—each with different requirements and levels of market access and functionality. Sponsors and fund managers need to examine the full range of their activities and determine a strategy for complying with regulatory obligations. In doing so, it's important to remember the regulatory and tax considerations of investors, who may be prohibited or disincentivized from investing in non-EU funds.

Many sponsors from the UK—and countries that relied on the UK for EU access—are considering establishing parallel structures in an EU country. Setting up a fund manager, however, is no small task. To prevent "letter-box" operations, EU regulations require the EU manager to have substantial operations, know-how and decision-making capabilities—not to mention regulatory approval, which typically take at least six months or more. Keep in mind that logistical, regulatory and tax considerations may point to having the manager in one country and the fund in another, which is perfectly allowable. (Luxembourg is emerging as a popular choice, while Ireland may be used as a base for fund managers but not always for funds, given it does not yet have unregulated partnership structures that can be used.)

To accelerate the process, many fund managers are turning to "hosted" fund managers. These are service providers who will act as on-the-ground operations in the EU, delegating portfolio management authority back to the non-EU manager. But that relationship needs to be handled with care so as to not warrant concern from regulators guarding against letter-box operations. It is common practice to work with the European Securities and Markets Authority in the establishment of structures to ensure approval. If authority is delegated back to the non-EU manager, that manager must be prepared to agree contractually to comply with a number of AIFMD regulations, such as being subject to EU-type remuneration rules that prevent conflicts of interest. Non-EU managers unwilling to take on those obligations may consider establishing an advisory relationship instead—but remembering that this brings a corresponding reduction in influence over the EU manager. The litmus test: In an advisory relationship, the EU manager conducts its own qualified analysis before a transaction.

"Substantiality" requirements can exist on both sides of the relationship, so satisfying the full range of tax and regulatory considerations calls for a careful allocation of tasks.

Working with a hosted manager can also be a good option for non-EU sponsors and managers who intend to establish their own EU-based parallel structure, but who first want to see how the many Brexit variables play out.

Sponsors with operations or investments in the UK, or setting up in the EU will need to review their structure and investments from a tax perspective. In particular, sponsors should consider whether existing structures rely on the availability of tax treaties or EU tax directives that may not apply following Brexit. Some of the tax considerations that are relevant in the UK in setting up a fund, such as VAT, may also be different when setting up a Fund in another EU jurisdiction.

The recently proposed "omnibus" directive would severely limit the ability to pre-market funds. Currently, there is a wide range of country-level interpretations of where to draw the line between regulated "marketing" and unregulated "premarketing." The new directive proposed by the European Commission seeks to harmonize those rules—but does so by greatly expanding what falls under the marketing umbrella. No specific fund can be mentioned; sharing early drafts of documents would trigger marketing approval requirements. Even general conversations with investors may be affected. The proposal also makes it more difficult for investors to join the fund under reverse solicitation.

Rebecca F. Silberstein
Partner, New York
+1 212 909 6438
rfsilberstein@debevoise.com

Patricia Volhard
Partner, London
+44 20 7786 5505
pvolhard@debevoise.com

Simon Witney
Special Counsel, London
+44 20 7786 5511
switney@debevoise.com

Cécile Beurrier
International Counsel, London
+44 20 7786 9146
cbeurrier@debevoise.com

Delphine Jaugey
Associate, London
+44 20 7786 5428
djaugey@debevoise.com