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The impact of Brexit on the Luxembourg funds industry

Existing ties between the UK and Luxembourg could form the foundation of new opportunities for co-operation post-Brexit, based on London's pre-eminence in Europe as an investment management centre and Luxembourg's dominance as a fund domicile and servicing and distribution hub. However, the Grand Duchy could also face potential disadvantages as a result of the Brexit process.

Britain's vote in June to leave the European Union represents a huge leap into the unknown for the United Kingdom, but also for the EU partners with which it currently shares close trading relationships as well as common political and economic interests. How these relationships are reconfigured represents a major challenge for EU leaders over the next two-and-a-half years, and possibly longer, and perhaps even more for companies whose business encompasses both the UK and other European countries. These issues are particularly important for the financial sector, given the way it has been shaped by the single market in goods and services and the developing concept of cross-border "passporting", especially over the nearly 25 years since the signing of the Maastricht Treaty. Today the industry is subject to a complex, interwoven web of directives, delegated regulations and regulatory guidance, even more so since the 2007-8 financial crisis revealed gaps in the EU's ability to monitor and ward off existential threats to the financial system.

Now, at least for the UK, some of that web of rules is likely to be unwound, but when and how is shrouded in uncertainty. The British government has indicated that it may decide to "repatriate" directly applicable EU legislation by enacting it into domestic law, giving it the option subsequently to repeal or amend measures with which it disagrees, and the freedom to keep in place those it remains comfortable with.

How the political and legal complexities of withdrawal are resolved will have a major impact on the financial industry within the UK and outside. Institutions that conduct significant business in Europe from a London base, especially those originating from North America, Asia and other parts of the world, are already on record exploring their options for the future. These options include setting up EU subsidiaries that can keep access to passporting rights, to shifting parts of their business to new locations that will remain part of the single market.

Luxembourg is a keenly interested observer of this process. Although the government has made clear it has no desire to 'raid' the City of London for businesses looking to keep an EU foothold, existing ties – especially in the investment fund industry – could form the foundation of new opportunities for co-operation. This is based on London's pre-eminence in Europe as an investment management centre and Luxembourg's dominance as a fund domicile and servicing and distribution hub. However, it should be noted that the Grand Duchy could also face potential disadvantages as a result of the Brexit process.

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A new trading relationship

The British government has indicated that it intends to trigger the withdrawal process by serving notice under Article 50 of the Lisbon Treaty at the latest by the end of March 2017. This would start the clock on a two-year period by which time arrangements for withdrawal would have to be completed, unless all parties to the negotiations agree to extend the deadline.

However, the negotiations launched by Article 50 will deal only with matters such as budget issues and the position of existing British employees in EU institutions, not with future trading arrangements. Talks on the latter issues could potentially last much longer before reaching a conclusion, which is in any case not guaranteed.

Before the vote, the Leave camp did not specify what kind of trade agreement it would seek with the EU once outside, and the government's negotiating stance remains under wraps. However, there are indications that the UK may not be prepared to make concessions, notably on freedom of movement for EU citizens, that may be required by EU partners in return for meaningful access to the single market.

After the referendum was called, the UK government and other commentators put forward various models for the country's future relationship with the EU, such as the Norwegian, Turkish and Swiss models. However, none are without difficult trade-offs for the UK (see our note on "What might Brexit look like"). The fall-back position of the standard World Trade Organisation tariffs and rules (which are complex and prone to disputes that can take years to resolve) would hurt businesses on both sides of the English Channel.

British ministers have expressed hope that they will be able to negotiate a customised arrangement, presumably striking a balance between single market access and freedom of movement, but this might take significantly longer than the deadline for leaving the EU. Financial industry leaders in London believe some of the potential obstacles can be avoided in certain cases if UK regulation is treated as equivalent to that in the EU.

New hurdles for the fund industry

The desire of the Luxembourg authorities to smooth as far as possible the transition for UK financial institutions and the counterparties in the Grand Duchy with which they do business cannot avoid the reality that, whatever the ultimate form of the post-Brexit trading arrangements, life will become more complicated for Luxembourg as a financial centre.

One of the most basic areas is the single market for UCITS retail funds, arguably one of the brightest successes of the EU passporting system. For example, Brexit would probably make it more difficult for Luxembourg UCITS to be distributed in the UK, one of the main markets for the Grand Duchy's fund industry, even if regulation in Britain remains broadly welcoming to EU-domiciled funds.

By contrast, UK-domiciled funds previously qualifying as UCITS will technically become AIFs for the purposes of EU legislation and could potentially be distributed to professional investors through the proposed future AIFMD third-country passport.

Many Luxembourg Management Companies ("ManCos") have branches in other EU countries, notably in the UK, for the distribution of both UCITS and AIFMD funds ranges. If there are no longer passporting arrangements with the UK, ManCos would have to be licensed under whatever rules applied in Britain; these might, at least initially, be the same as those applicable within the EU, but there is no guarantee of this; and interpretation and application of those rules would be completely in the hands of the UK regulator.

Luxembourg alternative investment funds are already authorised to use a third-country AIFM, and UK management companies could continue to exercise this role, although if outside the single market they would no longer enjoy a distribution passport. Whether or not Luxembourg ManCos could continue to manage UK investment funds, to the extent that they do, would depend on the British rules. UK ManCos could still manage Luxembourg UCITS and AIFs through the widely used existing delegation model. Distribution through branches of Luxembourg ManCos in the UK may remain possible, but is likely to become more costly.

Business barriers outside the single market

UK banks could no longer offer depository services for UCITS or AIFs through their Luxembourg branches, obliging them to create a standalone Luxembourg institution in order to keep business in the Grand Duchy. Cross-border mergers involving a UK fund would become impossible under current UCITS rules; other methods would be much more costly and complicated.

Luxembourg funds of funds could continue invest in UK-domiciled former UCITS funds, but would be restricted by the 30% ceiling on holdings of non-UCITS funds in their portfolios. An early consequence of the UK's departure from the single market would be to require asset managers, depositaries and administrators to have to review fund portfolios for compliance with the ceiling. The same applies to master-feeder structures; a Luxembourg UCITS could no longer feed into a UK ex-UCITS master fund.

To access institutional investors, such as for insurance policy wrappers, a non-UCITS fund from the UK would need to meet Luxembourg's five tests[1] to demonstrate its equivalence to domestic rules. Pension funds, insurance companies and other institutional investors might have to divest from UK funds when they cease to become UCITS. Grandfathering of fund distribution rights may be possible through negotiation – or indeed provided by the UK on a unilateral basis. However, for now this is pure speculation.

Other financial services fields in which Luxembourg could win business through the UK's exit from the single market include the listing of bonds and other financial instruments by the Luxembourg Stock Exchange, under provisions that enable a prospectus approved by the regulator in one EU member state to be used for marketing throughout the union. It may also benefit from the requirement that market infrastructure providers offering central clearing of certain derivatives should be EU institutions.

Goodbye to regulatory convergence, hello to a new relationship?

Once the UK leaves the EU, it is highly possible that its regulatory framework will begin to diverge from the European single market rulebook. This could result in both British and Luxembourg institutions having to deal with increasingly different regulatory and legal regimes rather the common framework they have enjoyed up to now.

The prospect that the UK may no longer accept freedom of movement for EU nationals could affect Britons living and working in the Grand Duchy. Meanwhile EU citizens settled in the UK might consider leaving either because of employment restrictions or a less favourable job market – which might increase the talent pool available to Luxembourg.

Nevertheless, given the longstanding financial and business ties between the two countries, the complementary nature of their financial industries, and the extensive consensus between their respective authorities on the philosophy and application of financial regulation, there is no reason why Luxembourg cannot become a bridge to facilitate a harmonious future relationship between the UK and the rest of the EU.

In the asset management sector, this will require a demonstration of substance within British-owned, EU-based management companies, including people on the ground and genuine decision-making functions, to enable them to benefit from passporting rules. The benefits of bringing together portfolio management expertise from the UK with administrative and operational capabilities from Luxembourg will remain as relevant in a post-Brexit future as it does within the single market today.

Rapid and efficient communications could enable UK-based investment managers to conduct meaningful operations in Luxembourg, perhaps under contracts dividing their duties between the two jurisdictions. This would be reinforce long-established ties of professionalism and friendship – not to mention history – binding together the two countries, their economies and people, a development that would give the UK a lifeline to the European market and fit fully with Luxembourg's tradition of openness and co-operation with business partners throughout the world.

[1] Law of 17 December 2010 on UCITS

This article was written by Hermann Beythan, partner in our Investment Management group in Luxembourg. Our Luxembourg Investment Management group is a pioneer and leader in asset management with the breadth and depth to deal with a wide range of fund structures investing in all types of asset classes. Please get in touch with any of the team if you would like to discuss any of the issues raised in this article, or other issues relating to investment management.

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