

ESMA Publishes Further Advice on the Application of the AIFMD Passport for Non-EU Jurisdictions

A Legal Update from Dechert's Financial Services Practice

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The European Securities and Markets Authority (“**ESMA**”) published further advice to the European Parliament, Council and Commission on the extension of the AIFMD passport for non-EU jurisdictions on 18 July 2016.

Key points

- ▶ No significant obstacles impede the application of the passport to Canada, Guernsey, Hong Kong, Japan, Jersey, Singapore or Switzerland;
- ▶ Market disruption and competition are seen to be obstacles to extending the AIFMD passport to the United States, though ESMA has suggested three options that could modify the application of the AIFMD passport to certain types of funds to overcome these;
- ▶ Investor protection is seen to be an obstacle for both Bermuda and the Cayman Islands, although this is mainly due to the legislative changes that will create an AIFMD compatible regime in these countries not yet being in force.

The decision on whether to extend the passport rests with the European Commission, subject to the right of the European Parliament and European Council to raise objections. The AIFMD envisages a three month period after the date of ESMA’s advice for the European Commission to consider that advice and adopt any delegated act extending the passport, and this delegated act will set the effective date for the extension. The European Parliament and Council then have up to six months to object. It is therefore currently unclear whether the AIFMD passport will be extended for any of the jurisdictions considered by ESMA, and if so, when the extension would be effective.

If the AIFMD passport were implemented in line with ESMA’s advice, it could pave the way for the passport to be extended to the UK after it leaves the EU.

Current situation

Following the implementation of the Alternative Investment Fund Managers Directive in 2013¹ (“**AIFMD**”), access to investors in the European Economic Area (“**EEA**”) (which comprises the European Union plus Iceland, Liechtenstein and Norway) has been restricted for alternative investment fund managers (“**AIFMs**”) which are based outside the EEA as has their ability to act as AIFM of an EEA alternative investment fund (“**AIF**”). Access to EEA investors has also been restricted for EEA AIFMs who manage non-EEA AIFs.

The AIFMD EEA marketing and management passports are currently only available to EEA AIFMs which manage EEA AIFs. An AIFM may submit a notification to its “home” state regulator to passport the EEA AIFs that it manages across the EEA and market those AIFs to professional investors (or such other investors permitted under local laws) in those “host” state jurisdictions. Once the passport has been notified to the home state regulator and the home state regulator has notified the relevant host state regulator(s) of the passport, that AIFM may market the AIF in the host state(s).

EEA AIFMs which manage non-EEA AIFs, and non-EEA AIFMs, must rely on those EEA jurisdictions which operate national private placements regimes (“**NPPR**”) in order to market the AIFs they manage, under articles

¹ Directive 2011/61/EU

36 and 42 of the AIFMD, respectively. In such cases, the AIFM must deal directly with the regulator in each member state in which it wishes to market the AIF. Moreover, each EEA member state is free to add any more onerous requirements it wishes to the minimum NPPR requirements under AIFMD, including to prohibit such private placements altogether. In addition, there may be difficulties in relation to a non-EEA AIFM acting as the AIFM to an EEA AIF.

What does extending the AIFMD passport mean?

The extension of the AIFMD passport applies to both: (i) the marketing of non-EEA AIFs by EEA AIFMs; and (ii) to the management of EEA AIFs and/or marketing of any AIFs in the EEA by non-EEA AIFMs. This would allow both EEA and non-EEA AIFMs to market both EEA and non-EEA AIFs across the EEA by way of a single marketing passport, removing the need for registration on a state by state basis and providing wider access to EEA investors than is currently available through NPPR.

Significantly however, the extension of the AIFMD passport would trigger a three-year transitional period under the AIFMD, during which the AIFMD passport and the NPPRs could both be available, but after which the European Commission could issue a further delegated act turning off the NPPR provisions of AIFMD. If NPPR rights were terminated in this way, the AIFMD passport, which as noted below requires the manager to become fully authorised under AIFMD, would be the only way for non-EEA AIFMs to actively market their funds in the EEA.

ESMA's most recent advice covers twelve non-EEA jurisdictions (Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Jersey, Isle of Man, Japan, Singapore, Switzerland and the United States).

In assessing each country, ESMA has taken into consideration investor protection, market disruption, competition and the monitoring of systemic risk.

Following its review, ESMA has indicated that there are no significant obstacles impeding the application of the passport to Canada, Guernsey, Hong Kong, Japan, Jersey, Singapore or Switzerland.

For the United States (“**US**”), ESMA has indicated that no significant obstacles exist regarding investor protection and monitoring systemic risk, however, ESMA is of the view that market disruption and competition are obstacles that impede the application of the AIFMD passport.

ESMA acknowledged that should the AIFMD passport be extended to the US, market access conditions for both EEA and US managers marketing certain types of funds (which do not involve a public offering) to professional investors in the EEA and US would be broadly comparable. However, due to the registration requirements in the US to publicly market a fund, ESMA was of the view that the market access conditions applied to EEA funds in the US would be different to those that would apply to US funds that are marketed in the EEA.

Instead of excluding the US entirely from the possibility of obtaining the AIFMD passport, ESMA has suggested that restricted options may be possible, such that access be granted to: (i) US funds dedicated to professional investors and not involving any public offering; (ii) US funds which are not open-end investment companies (under the Investment Company Act of 1940); and (iii) US funds which restrict investment to professional investors.

Unlike the US, the Cayman Islands are seen to have no significant obstacles in relation to market disruption and competition, however, definitive advice cannot yet be given by ESMA in the areas of investor protection, monitoring of systemic risk and the effectiveness of enforcement as the legislation creating an AIFMD compatible regime has not yet been implemented.

Similar to the Cayman Islands, Bermuda is in the process of implementing its AIFMD compatible regime and ESMA again decided that it could not yet provide definitive advice in the area of investor protection.

In relation to Hong Kong and Singapore, ESMA has noted that, in relation to reciprocal arrangements, market access restrictions do apply to managers from certain EEA jurisdictions with regards to marketing retail funds (e.g. UCITS) to retail investors. This however does not appear to affect ESMA's positive assessment of the extension of the AIFMD passport to these countries, as no obstacles are seen to apply in relation to marketing funds to professional investors.

Timing and implementation

The decision to extend the AIFMD passport rests with the European Commission, and is subject to rights of the European Parliament and the European Council to raise an objection. It is therefore currently unclear whether the AIFMD passport will be extended for any of the jurisdictions considered by ESMA, and if so, when any extension would be effective.

ESMA will continue to assess further non-EEA jurisdictions and deliver further advice to the European Parliament, Council and Commission (together, the "EPCC"). ESMA has also suggested that the EPCC may wish to consider waiting until positive advice on a sufficient number of non-EEA jurisdictions has been received before taking legislative steps to extend the AIFMD passport. This reflects the position taken by the European Commission in its December 2015 letter to ESMA, but may also reflect ESMA's own "move slowly" approach to the passporting question which appears to have been adopted to date.

Should the European Commission decide to extend the AIFMD passport, a non-EEA AIFM would, in order to access that passport, need to apply for authorisation with and become fully regulated by the regulatory authorities of its "member state of reference", which is determined by a number of factors including where any EEA AIFs that are managed by it are established or where AIFs are to be marketed. The full regulatory burdens of the AIFMD would thus apply to that non-EEA AIFM and to the AIFs that it manages under that authorisation.

Is there an appetite among non-EEA AIFMs to access the AIFMD passport?

Whether there is an appetite to access the AIFMD passport will depend on the target market for that manager and whether it wishes to comply with the full burden that would be imposed on it under AIFMD (which is a condition to obtaining a passport), including the appointment of a depositary and remuneration provisions. If the EEA forms a small percentage of the target investor market, the costs of complying with AIFMD may be too great to warrant accessing the AIFMD passport.

Also, if the target markets operate NPPR and are easily accessible through that process, then until NPPR is switched off (which, at the earliest, may occur three years from the entry into force of the passporting provisions), the lighter burden imposed on non-EEA AIFMs to comply with NPPR may be preferable.

How about EEA AIFMs with non-EEA AIFs?

A number of EEA AIFMs operate non-EEA AIFs established in offshore jurisdictions such as Bermuda and the Cayman Islands. Unlike non-EEA AIFMs, such EEA AIFMs already have to comply with the majority of requirements (and costs) of complying with AIFMD, albeit that lighter depositary arrangements apply. There might therefore be more of an appetite by those AIFMs to have the AIFMD passport extended to their non-EEA AIFs, but if the NPPRs are turned off this would also require EEA AIFMs that can currently apply "depo lite" to subject their non-EEA AIFs to the full AIFMD depositary requirements.

What does ESMA's decision mean to the UK?

ESMA's advice may be encouraging to the UK in terms of its options once it has exited the EU. In a post Brexit world, provided that changes to existing legislation are not made, the UK should be seen by ESMA to operate an equivalent regime to the AIFMD and indeed could be seen to operate a "super-equivalent regime".

Consequently, it is hard to see on what legal grounds ESMA would conclude that the UK regime is not equivalent to the EU regime and that the passport should not be extended to the UK. Absent a change in EU law, the issue of 'free movement of people', which currently divides EU and UK thought, should not prevent the AIFMD third country passport being extended to the UK following its departure from the EU.

The UK could also consider opting to implement a "twin pillar" approach for UK managers through (i) operating an AIFMD compliant regime for those managers who wish to market in the EEA and make use of the AIFMD passport, while (ii) offering an opt out from the requirements for those managers who wish to market only to the rest of the world. This approach is used in some of the other countries that ESMA has considered.

As it is not yet known when the European Commission will extend the AIFMD passport (if at all), the question still remains as to whether a UK AIFM may be able to continue to manage an EEA AIF, once the UK leaves the EU. ESMA's advice notes that under Article 42 of AIFMD, a non-EU AIFM may be permitted to manage EU AIFs where permitted by the relevant member state, however, it remains to be seen whether UK managers could take advantage of this provision in relation to their existing EEA AIFs. There would clearly be a first mover advantage to jurisdictions with a large number of UK AIFM managed funds if they chose to make the position clear in this respect. In any event, UK managers would also need to rely on third country passporting under the Markets in Financial Instruments Directive II (MiFID II) if they wish to provide portfolio management or other MiFID services to professional clients.

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