

September 1, 2016

## The AIFMD Third Country Passport – An Update

The European Securities and Markets Authority (“ESMA”) published on 19 July 2016 its final advice to the European Commission (the “Commission”) on the extension of the marketing passport under the Alternative Investment Fund Managers Directive (“AIFMD”)<sup>1</sup> to 12 non-EEA<sup>2</sup> countries, including the United States. This note is intended to highlight ESMA’s advice to the Commission and set out the steps firms would need to consider when applying for a third country passport.

The AIFMD envisages the granting of a marketing passport to third country alternative investment fund managers, which are managers established outside the EEA. Any manager that meets the conditions to obtain the passport - broadly, compliance with the whole of the AIFMD on the same basis as an EEA manager - will be able to market funds established in jurisdictions that benefit from the passport to professional investors in the EEA on the basis of a single authorisation from an EEA state regulator. We note that to rely on the passport, managers must ensure that the passport is granted to the jurisdiction of both the manager and the fund. The passport also grants the same access to EEA managers of non-EEA funds (established in jurisdictions that benefit from the passport), such as hedge funds established in the Cayman Islands.

Non-EEA managers (and EEA managers of non-EEA funds) must currently market their funds on a private placement basis based on each Member State’s national private placement rules (NPPRs), requiring contact with and on-going supervision by the competent authority in each jurisdiction. This is an efficient process in some jurisdictions, but can be an expensive and time consuming process in others. Some jurisdictions – such as Italy - do not

allow private placement marketing at all, requiring managers to rely on approaches at an investor’s own initiative.

In its final advice, ESMA:

- has recommended the grant of the passport to managers and funds established in Canada, Guernsey, Japan, Jersey and Switzerland.
- has given positive advice to the grant of the passport to managers and funds established in the U.S. Although we note that ESMA has added that European Union (“EU”) legislators may wish to consider some additional points, such as whether the passport may be qualified to restrict U.S. mutual funds being offered widely in the EEA.
- has limited the grant of the passport only to funds established in Hong Kong and Singapore (for instance, a UK manager of a fund in Hong Kong). Managers in these jurisdictions will not, for the time being, be able to obtain the passport, regardless of where their fund is established.
- is minded to grant the passport to managers and funds established in Australia, pending changes to the Australian regulatory framework.
- is not minded to grant the passport to Bermuda or the Cayman Islands for the time being, pending adoption of new rules in those jurisdictions. A U.S. or EU manager with a fund established in these jurisdictions may be able to market these funds under the passport at some point in the future, when ESMA carries out further assessment work.

## Status of Advice and Legislative Process

It is up to the Commission to adopt ESMA's advice and introduce legislation (a "delegated act") that will specify the date on which the passport is granted. The date on which the Commission will adopt the delegated act has not yet been specified. The Commission or the European Parliament may consider other factors in giving their approval, such as (as flagged in ESMA's advice) the latest intelligence on the Anti-Money Laundering and Counter-Terrorism Financing regime in the non-EEA country. ESMA has suggested that the Commission waits until ESMA has delivered positive advice on further non-EEA countries before starting the legislative procedure. If the Commission does start the legislative procedure in the short term, it is unlikely that the relevant legislation will be in place until (at the earliest) the first half of 2017.

## ESMA's Criteria

For the passport to be granted to non-EEA managers, ESMA must be satisfied that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk.<sup>4</sup> These conditions must be satisfied on an ongoing basis. In its advice, ESMA primarily considered the following:

- The robustness of the third country's regulator, its treatment of investor complaints and its responsiveness to EEA regulators under the regulator-to-regulator cooperation arrangements that are now in place.

- The comparability of the third country's rules on manager supervision and investor protection to the rules in the AIFMD. ESMA does not require "equivalence" of rules, but has looked at the rules in the third country governing matters such as investor disclosure and protection of assets. ESMA also points out that, if there are major gaps between the third country's rules and the AIFMD, the third country manager's "host" EEA regulator will play a much more active role in supervising the third country manager and will rely heavily in practice on the regulator-to-regulator cooperation arrangements.
- Whether there is a level playing field between EEA and non-EEA managers as regards market access, in particular whether the third country regime allows marketing by EEA managers of their funds on reasonable terms. This is a particularly important issue in the case of the U.S., because granting the passport would allow U.S. managers to market their mutual funds (which are, in AIFMD terms, alternative funds) more widely in the EU.

Please see overleaf for a summary of ESMA's country-by-country assessment in its final advice.

## Country-by-Country Assessment

### Will the passport likely be granted to managers and/or funds established in this jurisdiction?

COUNTRIES		SUMMARY of ESMA's advice
 <b>AUSTRALIA</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport established in Australia (on the condition that the Australian regulator extends its “class order relief” (which currently allows UK and German fund managers to market funds in Australia) to other EEA states).
 <b>BERMUDA</b>	No current indication	ESMA advised that it cannot provide definitive advice in relation to the “investor protection” condition until Bermuda has finalized legislation applying an equivalent regime to the AIFMD for managers in Bermuda to opt into.
 <b>CANADA</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in Canada.
 <b>CAYMAN ISLANDS</b>	No current indication	ESMA advised that it cannot provide definitive advice in relation to the “investor protection” condition until the Cayman Islands has finalized legislation applying an equivalent regime to the AIFMD for managers in the Cayman Islands to opt into (as for Bermuda), and cannot provide definitive advice in relation to the “effectiveness of enforcement” condition until the Cayman Islands has finalized various changes to its legislation.
 <b>GUERNSEY</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in Guernsey.
 <b>HONG KONG</b>	Funds only	ESMA advised that there are no significant obstacles to the grant of the passport only to funds (not managers) established in Hong Kong (noting that Hong Kong only allows marketing of EU UCITS funds from five EU states).
 <b>ISLE OF MAN</b>	No current indication	ESMA advises that the passport not be granted to the Isle of Man for the time being, mainly in view of the absence of an AIFMD equivalent regime.
 <b>JAPAN</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in Japan.
 <b>JERSEY</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in Jersey.
 <b>SINGAPORE</b>	Funds only	As for Hong Kong, ESMA advised that there are no significant obstacles to the grant of the passport for funds (but not managers) established in Singapore (noting that Singapore does not allow marketing of EU UCITS funds from all EU states).
 <b>SWITZERLAND</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in Switzerland.
 <b>UNITED STATES</b>	Managers and funds	ESMA advised that there are no significant obstacles to the grant of the passport to managers and funds established in the United States. ESMA qualified its advice by stating that, if a U.S. fund is “publicly offered” in the EEA under the AIFMD passport, there would be – in ESMA’s opinion - an unlevel playing field in terms of competition, as EEA funds cannot (in practical terms) be publicly offered in the U.S. In particular, ESMA is thinking of the ability of U.S. managers to “publicly” offer U.S. mutual funds in the EEA under the AIFMD passport (albeit that AIFMD restricts marketing to professional investors only). ESMA suggested that, when the passport is granted to U.S. managers and U.S. funds, possible options include that there is no “public offering” in the EEA (although this is not a term used in the AIFMD) or only to grant the passport to U.S. funds that are not mutual funds. It is likely that there will be no general passport for U.S. mutual funds.

## How Can a Firm Obtain the Third Country Passport?

If a non-EEA manager wishes to obtain the third country passport, it must comply with the same conduct and prudential rules in the AIFMD as an EEA manager, and obtain authorisation from and be subject to ongoing supervision by an EEA regulator. This raises numerous questions. How, in practice, will a non-EEA manager ensure compliance with the AIFMD at the same time as compliance with its local regulatory regime? What resources will it need to ensure compliance with AIFMD, and complete the filings and reports required by the EEA “host” regulator? How will the host regulator practically supervise a manager outside its jurisdiction? Will the manager need to ensure compliance with AIFMD in respect of all its funds, or only those funds marketed under the passport? Will compliance with the AIFMD also require compliance with other EEA legislation that applies to authorised EEA managers (“AIFMs”), such as the European rules on trading in OTC derivatives?<sup>5</sup> Equally, will compliance with AIFMD grant the same benefits that are available to EEA AIFMs, such as a “management passport”, allowing the manager to manage funds in other EEA states, or the “European Long-Term Investment Fund”, allowing the manager to promote a fund under this “brand” in the EEA? We address some of these questions.

## Non-EEA Managers of EEA Funds

The main focus has been the opportunity for non-EEA managers to market their funds in the EEA under the passport regime currently available to EEA managers. Non-EEA managers can currently manage funds established in the EEA without requiring authorisation as EEA AIFMs, but can only market such funds under any available national private placement regimes. Granting the passport switches on a separate requirement for non-EEA AIFMs that currently manage EEA funds to be authorised under AIFMD.<sup>6</sup> Underlying this requirement is that, if non-EEA managers are established in a third country that is granted the passport, there will be a facility to authorise those managers under AIFMD and thereby ensure a level playing field between EEA managers of EEA funds and non-EEA

managers of EEA funds—ensuring that any investor in an EEA fund receives equivalent protection. It may be that there will be a transitional period for a non-EEA manager of an EEA fund to obtain authorisation, although there does not appear to be a basis for this in the AIFMD. In addition, individual member state requirements should be checked.

## EEA Managers of Non-EEA Funds

The grant of the passport will allow EEA managers of non-EEA funds established in jurisdictions that benefit from the passport to market with the passport.<sup>7</sup> Any such EEA manager will need to switch from a “depository-lite” arrangement (under an exemption currently granted to EEA managers of non-EEA funds) to a full depository arrangement.

## Conditions to Obtain the Passport

### Selecting a Member State of Reference

The first step for a non-EEA manager to obtain the third country passport is to choose a “member state of reference” in the EEA. The manager will be authorised and supervised by the competent authority in its member state of reference. Managers cannot choose a member state of reference at will. The member state of reference is determined by reference to any EEA state in which the manager intends to market its fund and any EEA state in which the manager intends to manage an EEA fund.<sup>8</sup> In many cases, more than one member state of reference is possible (in particular, where the manager intends to market a single non-EEA fund in more than one member state). In this case, it must communicate with each competent authority in those states, which will jointly determine the relevant member state of reference.<sup>9</sup> The manager must disclose a written marketing strategy in this process.

### Authorisation as an AIFM

The non-EEA manager must obtain authorization from the competent authority of its member state of reference in accordance with the authorization process that currently applies to EEA managers. Whilst AIFMD sets out the broad process, the documents to be submitted and the processing of the application

depends on the member state. It is unknown whether the member state will receive applications other than in its local language. An application will need to cover in detail matters such as the compliance monitoring plan, staff and other resources, and financial projections. The local competent authority may have additional requirements that reflect local rules and its implementation of the AIFMD, such as (in the UK) the requirement for certain individuals to be approved by the FCA as “approved persons”.

#### **Compliance with the AIFMD**

Authorisation from the member state of reference will require full compliance with the AIFMD, subject to the proviso that if compliance with any provision of AIFMD is incompatible with compliance with local law, the manager need not comply, if it can demonstrate that, firstly, it is impossible to combine compliance with AIFMD with compliance with local law, and, secondly, local law provides for an equivalent rule with the same regulatory purpose and same level of investor protection.<sup>10</sup>

Both Jersey and Guernsey have introduced AIFMD “opt-in” regimes. These regimes allow a manager established in Jersey or Guernsey to obtain local authorization under a regime that is equivalent to AIFMD. This will not avoid the requirement to obtain further authorization from the competent authority of the member state of reference, but should avoid any need to comply with two potentially incompatible regulatory regimes.

#### **Supervision by an EEA Regulator**

The manner in which the host regulator will supervise the third-country manager in practice is unknown, and will likely differ throughout the EEA. If the host regulator is satisfied that the third country manager is subject to similar local rules, it may adopt a light touch. It is planned that the host regulator uses the regulator-to-regulator cooperation arrangements for investigation and enforcement matters.

#### **Appointment of a Legal Representative**

A further requirement is for the manager to appoint a “legal representative” in its member state of reference.<sup>11</sup> The legal representative will be the manager’s point of contact for any correspondence

with its host regulator, and a point of contact for EEA investors. The AIFMD also requires that the legal representative performs the compliance function relating to the manager’s management and marketing activities “together with the manager”. The scale of the activities to be performed by the legal representative, and the types of entities that will perform this service, are unclear.

#### **Marketing under the Passport**

Having obtained authorisation as an AIFM, the manager can obtain the marketing passport by notifying the competent authority of its member state of reference that it intends to market in one or more EEA states. Once it has made this notification, there are no further conditions to the manager marketing on a passport basis throughout the EEA.<sup>12</sup> Note that marketing on the basis of the passport is limited to professional investors only—it may be possible to “opt-up” any retail investors (in particular, individuals) to professional investor status on a case-by-case basis.

Existing restrictions on “pre-marketing” (i.e., making initial contacts with prospective investors with presentations and draft documentation) that apply to managers marketing on a private placement basis are likely to apply to an authorized third-country manager. In particular, it is likely that member states that do not currently allow private placement (such as Italy) will limit the ability of a manager to approach prospects in these jurisdictions for “pre-marketing” prior to obtaining the marketing passport.

#### **Structuring Considerations**

In AIFMD terms, the AIFM is the entity primarily responsible for management of the fund – this does not preclude delegation of portfolio management to another entity, but any such delegation is subject to the strict conditions (including the “anti-letter box” provisions) in AIFMD. It may be possible to restructure existing management arrangements so that the funds are managed by an AIFM in a jurisdiction where the passport has been granted (such as Guernsey or Jersey), with possible delegation arrangements to a separate portfolio manager. Other issues, such as tax, will need to be considered.

Further structuring possibilities are either to establish a new parallel fund or feeder fund (EEA or non-EEA), in each case managed by a non-EEA AIFM in a jurisdiction that qualifies for the passport.<sup>13</sup>

### Use of the AIFMD Management Passport

A manager that obtains authorisation under AIFMD may wish to use a management passport to allow that entity to open branches in the EEA or perform services on a cross-border basis (such as management of a fund established elsewhere in the EEA). It appears that a third-country AIFM that is authorized under AIFMD can exercise a passport right to manage a fund in another EEA state or establish a branch to manage a fund in another EEA state. It is presently unclear whether a third-country AIFM can exercise passport rights under the Markets in Financial Instruments Directive (“MiFID”) to perform services regulated by MiFID, such as segregated account management or acting as a delegate (i.e. sub-advisor) to another fund manager – it may be that the AIFM would need to rely on the new regime in MiFID for third-country firms to provide these services. This is an important point that will need to be clarified at the EU level.

### Transitional Arrangements

In its advice, ESMA confirmed that, once the third-country passport is granted, non-EEA AIFMs may be allowed to continue to market on a private placement basis, regardless of the fact that they could be authorized to market on a passport basis. It will be up to individual member states to follow this position in their AIFMD implementing law – there is a risk that some states will not allow private placement for managers in any countries where the passport has been granted.

### Further Countries

ESMA has drawn up a list of other non-EU countries that might be included in a future assessment, comprising Bahamas, Brazil, British Virgin Islands, Curacao, Mexico, Mauritius, South Africa, South Korea, Thailand and the US Virgin Islands.

<sup>1</sup> Directive 2011/61/EU.

<sup>2</sup> The European Economic Area (EEA) comprises the 28 member states of the European Union plus Iceland, Liechtenstein and Norway.

<sup>3</sup> In AIFMD terms, an alternative investment fund (“AIF”) is broadly any fund that is not an EU UCITS fund (subject to limited exceptions, such as “funds of one”). U.S. mutual funds are therefore AIFs.

<sup>4</sup> Article 67(4) of AIFMD.

<sup>5</sup> The Regulation on OTC derivative transactions, central counterparties (CCPs) and trade repositories (Regulation 648/2012) (known as “EMIR”).

<sup>6</sup> Article 37(1) of AIFMD.

<sup>7</sup> Article 35 of AIFMD.

<sup>8</sup> Article 37(4) of AIFMD.

<sup>9</sup> Where the non-EEA manager intends to market several non-EEA AIFs (as opposed to a single non-EEA AIF) in the EEA, the member state of reference is the member state which it intends to develop effective marketing for most of those funds, and no joint determination by regulators is required (Article 37(4)(h)).

<sup>10</sup> Article 37(2) of AIFMD.

<sup>11</sup> Article 37(3) of AIFMD.

<sup>12</sup> Note that some EU competent authorities currently charge registration and/or annual fees as a condition to granting the passport.

<sup>13</sup> Under AIFMD, an EU feeder of a non-EU master fund cannot obtain the passport. An EU feeder of a non-EU master fund that satisfied the conditions once the third country passport has been granted (for an EU AIFM) can be marketed under the passport. It is unclear whether a feeder fund will obtain the passport, where the underlying master fund of the feeder fund is a non-EU fund that is managed by a non-EU AIFM in a jurisdiction that qualifies for the passport.

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

**FINANCIAL REGULATION/INVESTMENT MANAGEMENT**



**Monica Gogna**  
*Partner*  
 +44 20 3201 1630



**Michelle Moran**  
*Partner*  
 +44 20 3201 1638

**PRIVATE INVESTMENT FUNDS**



**Anand Damodaran**  
*Partner*  
 +44 20 3201 1627



**Matthew Judd**  
*Partner*  
 +44 20 3201 1633

**ASSET MANAGEMENT**



**John Young**  
*PSL Counsel*  
 +44 20 3201 1630