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The AIFMD Third Country Passport

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The Eurovision Song Contest notably allows countries from outside Europe an opportunity to participate. In a similar fashion, the Alternative Investment Fund Managers Directive (Directive 2011/61/EU or AIFMD), makes provision for “third countries” to access the EU's alternative investment fund market. Unlike the song contest however, the EU authorities are concerned to ensure that everyone who participates in the EU's alternative investment fund market is singing from the same hymn sheet.

Given that the most recent indications are that the United Kingdom (UK) will pursue a 'hard' Brexit, we take a look at the proposals to grant third country firms a passport under the AIFMD, and what this could mean for asset managers from the UK and non-EU countries (third countries) generally.

The AIFMD regulates the management and marketing of alternative investment funds (such as hedge funds, private equity and real estate funds) in the EU. It provides for a 'passport' which allows alternative investment funds managers (AIFMs) to manage and/or market alternative investment funds (AIFs) across the European Union (EU), on the basis of a single authorisation by their local regulator.

Currently, only EU authorised AIFMs managing and/or marketing EU registered funds can avail of the passport.

Non-EU AIFMs wishing to manage or market AIFs in the EU, and EU AIFMs marketing non-EU AIFs, do not have a passport, so any marketing of such AIFs may only be carried out in compliance with the private placement rules of each EU country into which the AIF is sold. The problem here is that private placement rules differ from one EU country to the next. Indeed, some EU countries are effectively closed to non-EU AIFs since they do not permit marketing to investors in their jurisdiction without the AIFMD passport. The disparity in treatment between EU and non-EU AIFMs has led to criticisms that the AIFMD has created a 'fortress Europe' in the AIF industry.

However, the AIFMD, which came into effect in 2013, envisages the extension of the passport to AIFMs and AIFs from third countries, and mandates the European Securities and Markets Authority (ESMA) to advise the European Parliament, Council and the European Commission in this regard.

ESMA has so far assessed twelve different non-EU countries to determine the suitability of granting AIFMD passporting rights to those countries' AIFMs and AIFs. ESMA assessed each country on the basis of a standard set of criteria, which includes a consideration of the effectiveness of the cooperation arrangements between the supervisory authorities in the EU and the relevant third country and whether there are any significant obstacles to extending the passport on the grounds of investor protection, market disruption, competition and the monitoring of systemic risk.

In July 2015, ESMA issued its initial advice on the extension of the AIFMD passport, followed by its second set of advice on 19 July 2016. Here is a summary of ESMA's findings:

- **Canada, Guernsey, Jersey, Japan and Switzerland**: ESMA issued a positive assessment to extending the passport to these countries.
- **Hong Kong, Singapore and Australia**: ESMA indicated there are no significant obstacles to

extending the passport to Hong Kong and Singapore when the assessment is based on those jurisdiction's AIFs alone. ESMA gave a largely positive assessment of Australia. However, for all three jurisdictions, ESMA qualified its endorsement by highlighting a lack of full reciprocal access for EU funds marketing in these third countries.

- **United States**: ESMA found no significant obstacles to extending the passport under the criteria of investor protection and monitoring of systemic risk. However, under the criteria of competition and market disruption, ESMA highlighted that extending the passport might result in an uneven playing field between AIFMs in the EU and the US. US funds accessing the EU through the passport would be faced with less onerous rules than would apply to those EU funds choosing to market in the US by way of public offer.
- **Bermuda and Cayman Islands**: ESMA stated that it is as yet unable to give definitive advice on the extension of the passport to these jurisdictions as each are in the process of implementing new regulatory regimes.
- **Isle of Man**: ESMA stated that in the absence of an AIFMD-like regime, it was difficult to carry out a full assessment.

The AIFMD's approach to third country entities can be contrasted with other EU Directives which grant access to the EU single market to firms from those third countries which are assessed as having a regulatory regime equivalent to that in the EU. The AIFMD is not concerned with equivalence per se, since non-EU AIFMs which are granted the AIFMD passport will in any event be required to sign up to substantially all of the AIFMD by obtaining authorisation in their 'Member State of reference', i.e. the Member State with which the non-EU AIFM is most closely connected based on certain criteria set out in the AIFMD.

The extension of the AIFMD passport is now dependent on the European Commission adopting rules extending the passport to those third countries which have received a positive assessment from ESMA, and such legislation not being objected to by the European Parliament and Council. However, ESMA suggests that the EU institutions might wish to wait until ESMA has advised on a sufficient number of non-EU countries before it legislates for the extension of the AIFMD passport, bearing in mind the market impact of extending the passport. In the meantime, ESMA will continue its assessment of other non-EU countries which have a presence in the EU funds sphere.

Implications for Brexit

ESMA's advice on the extension of the AIFMD passport will be of interest to UK asset managers. Currently, UK AIFMs can manage and market EU AIFs across the EU on the basis of authorisation by the Financial Conduct Authority. However, if the UK is outside the European Economic Area post Brexit, UK AIFMs will be considered as third country AIFMs and will lose their passport.

The position of UK UCITS funds is also relevant – they stand to lose their status as UCITS, and consequently their passport, post Brexit. Such funds will presumably then be categorised as AIFs. While UCITS are designed for sale to retail investors, many are sold exclusively to professional investors. The third country AIFMD passport would thus enable UK UCITS to be continued to be marketed to professional investors across the EU on a passported basis (with the UK UCITS perhaps re-branded but nonetheless adhering to UCITS-compliant investment strategies).

The granting of the AIFMD passport to the UK post-Brexit would, we expect, require ESMA to undertake a review of the UK regulatory regime. ESMA is unlikely to be in a position to advise on the extension of the AIFMD passport until the UK has put in place a replacement AIFMD regulatory regime post-Brexit (in much the same way as they were unable to adjudicate on Bermuda and the Cayman Islands in their most recent advice). While that regime may look largely the same as that in place at the moment it will not be identical and that may inevitably result in delay in ESMA's adjudications. Any delay could be very disruptive for the asset managers unless a transitional arrangement is in operation.

In this regard, the UK may have some concerns with the speed and transparency of the AIFMD passport extension process, i.e.:

- ESMA's assessment of a third country can take several months to complete and resource constraints on ESMA may hinder the chances of a speedier review. Furthermore, if ESMA delivers a qualified

approval of a third country, it may result in a further delay if the Commission has to consider different policy options regarding the conditions under which the passport is granted, e.g. in the case of its advice on extending the passport to the US, ESMA suggests three different ways in which the passport may be extended.

- There are no clear timelines; while the AIFMD envisages the Commission taking steps to extend the passport within three months of ESMA issuing positive advice on a third country, this timeline has not been complied with so far.
- Even where a third country receives a positive assessment from ESMA, it may have to wait until a sufficient number of third countries have been recommended for the passport before the Commission will act.
- The process is somewhat politicised, since the Commission has previously specified to ESMA which particular third countries should be assessed. The UK will hope that it is at the top of the queue for ESMA assessment if and when the time comes.

As the AIFMD approaches its fourth year in operation, a review of the Directive, involving a public consultation, is scheduled to begin by 22 July 2017. It will be interesting to hear the views of industry on the extension of the passport to third countries and to see how the review is impacted by Brexit considerations. We will continue to monitor this area and will issue updates on any developments.

If you would like to discuss any of the above issues, please contact a member of the Financial Services Group.

About the Author