

AIFMD Passport: Europe Must Try Harder

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On July 30, 2015, the pan-EU securities regulator, European Securities and Markets Authority (ESMA), published two papers covering the application of the marketing “passport” under the Alternative Investment Fund Managers Directive (AIFMD).¹ The first paper contained ESMA’s advice to the European Parliament, Council and Commission (referred to collectively as the Trilogue) on the potential application of the AIFMD passport to non-EU Alternative Investment Fund Managers (AIFMs) and alternative investment funds (AIFs). The second paper contained ESMA’s opinion on the current functioning of the AIFMD passport (currently used by EU AIFMs marketing EU AIFs in the EU²) and National Private Placement Regimes (used for marketing by non-EU AIFMs and non-EU AIFs).

Both ESMA papers were eagerly anticipated by international alternative fund managers who hoped that the papers would contain clear recommendations to EU lawmakers to make it easier to market non-EU AIFs to EU professional investors than is currently the case under the AIFMD regime. Unfortunately, although there were some tentative positive signals in relation to a small number of non-EU jurisdictions, the ESMA papers gave little encouragement that AIFs located in major jurisdictions such as the U.S. and the Cayman Islands will be any easier to market to EU professional investors in the near future.

However, it seems likely that, for now, the status quo for non-EU AIFMs and AIFs will be maintained following the release of these papers. While this will be of comfort to some alternative fund managers who have adapted to the differing requirements stemming from EU National Private Placement Regimes (NPPRs), others hoping for an easier route to market non-EU AIFs to EU professional investors may be disappointed by the lack of apparent progress.

Summary

The conclusion of ESMA’s advice was that it is currently only able to recommend that EU lawmakers extend the passport to AIFMs and AIFs based in Jersey, Guernsey and, on the basis of soon to be enacted legislation, Switzerland. ESMA concluded that it could not recommend extending the passport to AIFMs and AIFs in the U.S., largely due to a lack of reciprocity that would be available to EU AIFMs wishing to market in the U.S. ESMA also analysed Singapore and Hong Kong but stated that it had insufficient information to complete its assessment at this time.

Significantly, ESMA advised the Trilogue to consider whether those extensions should be postponed until such time as it is able to advise the extension of the passport to a greater number of non-EU jurisdictions. If the Trilogue accepts ESMA’s recommendations and delays any extension of the passport, the status quo for non-EU AIFMs will be retained in Europe while ESMA continues to analyze the suitability of other non-EU jurisdictions for the passport.

Even if the Trilogue decides to extend the passport to Jersey, Guernsey and Switzerland, there is no indication of when this extension would take place. It is also unclear whether AIFMs and AIFs in these jurisdictions would cease to be able to utilize the NPPRs in order to avoid AIFMs in Jersey, Guernsey and Switzerland having an unfair advantage over their counterparts.

¹ Directive 2011/61/EU.

² The AIFMD applies to the full European Economic Area, being the 28 EU member states and Norway, Liechtenstein and Iceland. References to the EU in this note refer to all of these jurisdictions, and references to non-EU should be construed accordingly.

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ESMA's opinion stated that delays in AIFMD implementation by EU member states meant that it was not able to give a definitive assessment of the functioning of the EU AIFMD passport, or NPPRs. The opinion does, however, show that ESMA has acknowledged the most common industry complaints regarding the function of the passport. EU AIFMs will be hoping that the regulators in the relevant member states have regard to this opinion and seek to improve the operation of the passport.

Marketing Under the AIFMD

The AIFMD regulates AIFMs intending to manage or market their AIFs within the EU. Since AIFMD implementation, AIFMs based in Europe are required to become authorized by their local EU securities regulator. The AIFMD imposes a wide variety of obligations on EU AIFMs which cover conduct of business, organizational and prudential requirements and includes rules on executive remuneration and regulator and investor reporting. Authorized EU AIFMs benefit from the right to use the “passport,” which allows an EU AIFM to market an EU AIF across the EU without the need for approval or registration in the individual EU member states where such marketing occurs.

The AIFMD also provides for the extension of the passport to allow EU AIFMs and non-EU AIFMs to market non-EU AIFs to professional investors with the benefit of a passport. This extension of passport rights is subject to delayed implementation following completion of certain procedural steps, the first of which is the publication of ESMA advice recommending such an extension.

In the meantime, non-EU AIFMs have only been able to actively market their funds to investors in EU member states in accordance with the NPPR in place in the relevant EU member state where the investor is based. The AIFMD allows each EU member state to decide whether or not to allow non-EU AIFMs to market in its jurisdiction and to determine the rules that should apply provided that: (i) there is a cooperation agreement in place between the regulatory authorities in the member state and in the jurisdictions in which the non-EU AIFM and the AIF are established, (ii) neither of those jurisdictions is listed as a Non-Cooperative Country and Territory by the Financial Action Task Force, and (iii) the non-EU AIFM complies with the transparency and reporting requirements set out in the AIFMD.³ When implementing the AIFMD, most EU member states simply updated their existing marketing rules to incorporate these requirements. However, some member states took an opportunity to “gold plate” these rules by imposing additional requirements on those non-EU AIFMs wishing to market in their jurisdictions. The result is that EU marketing remains a nonhar-

monized “patchwork” of differing regimes that non-EU AIFMs must navigate should they wish to raise money from EU investors and are not able to rely upon a genuine reverse solicitation. Matters are not helped by the fact that major EU jurisdictions such as France, Italy and Spain are practically closed to NPPR, while some jurisdictions such as Germany are difficult to access through local NPPR.

ESMA Advice on Extension of the AIFMD Passport to Non-EU AIFMs and AIFs

Background

The AIFMD procedure for extending the passport to non-EU AIFMs and AIFs requires ESMA to issue its advice on the extension of the passport to the Trilogue. If ESMA considers that “there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk impeding ... the extension of the passport to non-EU AIFMs and AIFs based in a certain non-EU jurisdiction, ESMA shall issue positive advice in this regard.” The AIFMD also states that within three months of ESMA issuing positive advice and providing the opinion, the European Commission shall adopt legislation specifying the date on which the extension of the passport should come into force.⁴

ESMA Approach

In preparing the advice, ESMA decided to opt for a country-by-country assessment of the potential extension of the AIFMD passport. For each country, ESMA considered the following key elements in preparing its assessment:

- the operation of the existing memorandum of understanding covering cooperation between the relevant non-EU and EU regulatory authorities;
- the level of investor protection provided in the relevant non-EU jurisdiction;
- consideration of whether an extension of the passport to the relevant non-EU jurisdiction would cause EU market disruption;
- the identification of existing obstacles to competition for EU AIFMs wishing to market funds into the relevant non-EU jurisdictions; and
- whether the relevant non-EU jurisdiction adequately monitored systemic risk.

To address these elements, ESMA utilized feedback received from EU regulatory authorities as well as the responses to a call for evidence made in November 2014 ([Call for Evidence](#)).

³ See Article 42, Directive 2011/61/EU.

⁴ See Article 67, Directive 2011/61/EU.

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ESMA identified an initial list of 22 non-EU jurisdictions that it viewed as suitable for an assessment of a potential passport extension. However, ESMA stated that it currently only has sufficient information to assess six of those jurisdictions: Jersey, Guernsey, Hong Kong, Singapore, Switzerland and the U.S.

Positive Advice

ESMA has issued positive advice, recommending the extension of the passport to Jersey, Guernsey and, subject to the implementation of Swiss domestic legislation, Switzerland. Each of these jurisdictions has implemented its own “AIFMD-like” rules that clearly has made ESMA’s assessment simpler. Jersey and Guernsey recently have enacted legislation to introduce an AIFMD compliant regime that AIFMs and AIFs based in those jurisdictions may opt into. Switzerland enacted similar rules to those imposed by the AIFMD around the time of original AIFMD implementation, although legislation due to be implemented in December 2015 will further harmonize these rules with AIFMD requirements.

Negative Advice

ESMA is unable to give positive advice in relation to Hong Kong, Singapore and the U.S. at this stage. In relation to Hong Kong and Singapore, ESMA states that it does not have sufficient detailed information in order to complete its assessment and provide positive advice.

ESMA also advised that the Trilogue “may wish to consider whether to wait until ESMA has delivered positive advice on a sufficient number of non-EU countries before triggering the [extension of the passport]” in relation to Jersey, Guernsey and Switzerland.

Focus on the US

ESMA was able to conduct a more detailed assessment of the U.S. for the purposes of its advice, with the exception of the U.S.’ investor protection framework which ESMA stated it needed more time to assess.

ESMA’s main reason for not recommending the extension of the passport to U.S. AIFMs and AIFs was the difficulty of EU AIFMs marketing EU funds in the U.S. compared to the relative ease with which funds can be marketed in the EU with the passport. As a result, ESMA recommends that an extension of the passport to the U.S. be delayed “until such time as conditions which might lead to a distortion of competition are addressed.”

Conclusions

ESMA’s advice, and particularly its assessment of the U.S., will ring alarm bells for fund managers operating in sophisticated

financial markets outside the EU (such as the U.S., Hong Kong and Singapore) who wish to market to EU investors. When contrasted with the relatively simple task of comparing the regimes in Jersey, Guernsey and Switzerland (which, as noted above, have implemented AIFMD-style regimes), ESMA clearly had substantial difficulty in reconciling the regulatory framework in the U.S. against the expected requirements for extending the passport outside of the EU.

ESMA’s assessment of the U.S. places a substantial focus on the rules and protections in place for mutual funds and retail investors despite the AIFMD (as its name suggests) being focused on alternative funds which target professional investors. ESMA also highlights the risk of a lack of a level playing field between EU and U.S. AIFMs as regards market access, on the basis that very few non-U.S. fund managers register their funds under the U.S. Investment Company Act of 1940 to market their funds to the U.S. public. However, ESMA seems to disregard the fact that a vast number of U.S. and non-U.S. funds and fund managers use exemptions available under U.S. law to offer their funds privately to sophisticated and professional investors. Since the passport would only permit a fund manager to market to EU professional investors, the use of the exemptions in the U.S. would appear to be a more appropriate comparison.

To some, it may seem that ESMA is seeking to achieve a greater extraterritorial effect for the AIFMD by, effectively, only proposing to offer to extend the passport to jurisdictions which implement directly comparable regimes. Although ESMA’s advice states that it would not be appropriate to require a minimum degree of equivalence from a non-EU jurisdiction, it seems likely that the absence of equivalence will make it difficult for ESMA to give a positive determination. Jurisdictions such as the U.S. that have a substantial body of financial services law and regulation are unlikely to change their laws simply to make them more “AIFMD friendly.” Consequently, it may take some time and negotiation before the passport is extended to those jurisdictions.

There also may be some disappointment at the lack of progress made by ESMA in relation to other non-EU jurisdictions. The Cayman Islands, which is an important domicile for hedge, private equity and other alternative funds, is a notable absentee. The Cayman Islands has advertised its efforts to engage with ESMA and is in the process of enacting its own AIFMD-compliant regime. Some comfort may be found in ESMA’s acknowledgement that it has not been able to assess a sufficient number of non-EU jurisdictions and that the Trilogue should consider delaying implementing any legislation to extend the passport until a greater number of non-EU jurisdictions can be approved.

It is also unclear what will happen should the Trilogue disregard ESMA’s advice to delay and instead extend the passport to Jersey, Guernsey and Switzerland. The AIFMD simply obliges

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the European Commission to issue legislation specifying when the passport should be extended. The AIFMD did not envisage a country-by-country analysis of whether to extend the passport, nor does it specify the timeline within which any extension should be implemented.

There is also a question over whether, if the passport is extended to certain jurisdictions, AIFMs in those jurisdictions should cease to be able to utilize the NPPR. As noted above, one of ESMA's concerns when analyzing the U.S. was the lack of a level playing field between EU and U.S. AIFMs. However, if the passport were to be extended to Jersey, Guernsey and Switzerland, AIFMs would benefit from a choice between applying for a passport or utilizing the NPPRs when marketing in the EU. EU AIFMs, on the other hand, are not able to use the NPPRs to market EU AIFs. The AIFMD provides that if, three years after all EU member states have implemented legislation extending the passport to non-EU AIFMs and AIFs, ESMA is able to give positive advice about the functioning of the passport and termination of the NPPRs, the European Commission will enact legislation for the termination of the NPPRs. However, in light of the concerns above, it remains possible for ESMA or the Trilogue to seek to amend this position.

ESMA Opinion on the Functioning of the EU AIFMD Passport and NPPRs

Background and Approach

The AIFMD also requires ESMA to produce an opinion on the functioning of the passport for EU AIFMs and of the marketing of non-EU AIFs pursuant to the NPPRs. ESMA was obliged to deliver the opinion to the Trilogue at the same time as the advice.

In producing the opinion, ESMA has used the same data as it used for the advice — namely, the feedback received from EU regulatory authorities and responses gathered from the November 2014 Call for Evidence.

Implementation Delays

ESMA stated that AIFMD implementation delays in some EU member states made it difficult to perform a definitive assessment on the functioning of the passport or the NPPR. ESMA proposed the preparation of another opinion after a longer (undefined) period of implementation in all member states.

Operation of the Passport and NPPR

Notwithstanding the delays, ESMA has identified several issues in relation to the use of the EU passport, based largely on the feedback it received from the Call for Evidence, including:

- divergent approaches with respect to the marketing rules, including differing fee regimes and a differing definition of professional investor; and

- varying interpretations of what activities constitute “marketing” and “material changes” (requiring resubmission of the changed marketing documents) in different member states.

In relation to the NPPR, ESMA states that “there is insufficient evidence to indicate that the NPPRs have raised major issues in terms of the functioning and implementation of the AIFMD.”

Conclusions

It is not surprising that ESMA believes that it is too early to produce a definitive assessment of the functioning of either the passport or the NPPR. Notwithstanding the July 2013 deadline for implementing the AIFMD, many member states gave an additional grace period of up to 12 months for existing fund managers and non-EU fund managers to comply with the AIFMD.

ESMA has acknowledged the most common industry complaints regarding, in particular, the functioning of the passport. It is clear that some member states have “gold plated” the AIFMD requirements by charging additional fees or imposing additional requirements, such as the requirement to have a local agent or similar in the relevant member state. The interpretation of certain key concepts, such as the definition of “marketing,” also has caused significant difficulty. ESMA states that it sees merit in greater convergence in the definition of these terms.

AIFMs seeking to use the NPPRs have encountered similar obstacles; however, ESMA has little remit to impose harmonization in this area. The AIFMD is permissive in that it allows individual member states the discretion to determine whether to make a NPPR available and, accordingly, the obligations which may be associated with it. Notwithstanding this, any convergence of the definition of terms such as “marketing” and “material changes” would be welcome both to AIFMs using the passport and those seeking to rely on a NPPR.

It is unclear, however, what the next steps are for ESMA and the Trilogue in relation to the functioning of the passport and the NPPRs. The AIFMD does not specifically provide for the European Commission to implement additional legislation to harmonize the marketing regimes across the EU. However, given that one of the intended purposes of the AIFMD was to produce a single market for AIFs, it seems reasonable to expect either ESMA or the Trilogue to take additional steps in this regard.

Next Steps for Fund Managers

AIFMs (both inside and outside the EU) who are already using, or intending to use, the NPPRs should take some comfort that it seems highly unlikely that these regimes will be removed in the near future. It is clear that ESMA and the Trilogue will have a significant amount of work before they are able to extend the passport to a sufficient number of non-EU jurisdictions, such

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that the NPPRs could be terminated. However, AIFMs who have been unable to access markets due to there not being an NPPR in place (*e.g.*, Italy) or where in practice using the NPPR is difficult or prohibitively expensive (*e.g.*, Germany or France) will be disappointed to note the continued delay in being able to access those markets.

ESMA also seems to be giving appropriate credence to the issues raised by respondents in the Call for Evidence, and there should now be an expectation that either or both of ESMA and the European Commission will look to introduce measures to address some of the shortcomings.

In addition, EU AIFMs may see some benefit should the Trilogue choose to extend the passport⁵ to Jersey, Guernsey and Switzerland,

⁵ The AIFMD states that if ESMA gives positive advice, the European Commission should issue legislation within three months specifying the date from which the passport should be extended. There is no specification of when this date should be.

particularly with the additional choice of jurisdictions in which to establish AIFs that can use the passport.⁶

However, it is difficult to escape the sense that ESMA has focused its attention on protecting the competitive advantage that the AIFMD seems to provide to EU AIFMs, rather than the investor protection that the AIFMD was originally supposed to provide.

⁶ If the passport is extended to Jersey, Guernsey and Switzerland, non-EU AIFMs could seek to establish an AIFM in one of those jurisdictions to utilize the passport.