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Third Country Rules for Alternative Investments: Passport flexibility comes at a price

ECMI Commentary No. 27/16 December 2010

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Introduction

On November 11th, the European Parliament approved the Alternative Investment Fund Managers (AIFM) Directive, which will enter into force next year.[1] Among the more controversial aspects of this piece of legislation are the rules applicable to third country managers and funds. Now more than 50 pages in length, the rules are well above the three pages the Commission initially drafted. And if length is any reference, one must ask whether EU institutions have agreed to an unworkable regime for the sake of compromise? This commentary has two purposes: 1) to present the third country rules in an accessible manner for non-specialists and 2) to critically discuss these rules. An Annex is provided to guide the reader through the numerous provisions and the different phases that will follow after the Directive enters into force.

The author argues that while the principles outlined initially by the Commission have prevailed, there are two issues that cause concern: On the one hand, there is no fixed date for the entry into force of the passport for non-EU managers, which sends the wrong signal to the industry, part of which still hopes to avoid compliance. On the other hand, the lack of trust among member states has brought unnecessarily complex provisions, which can act as a barrier to investments that would otherwise benefit the European economy. The author concludes that, while the rules have gained in flexibility, regulatory certainty and efficiency have suffered.

What the third country rules are all about

The EU, following an agreement at the G20, proceeded to propose regulation for alternative investments in April 2009. Currently, alternative investments are regulated at national level and managers are confronted with 27 different authorisation regimes if they want to market their funds in the European Union. The AIFM Directive will put an

[1] Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC, approved by the European Parliament during its plenary session of November 11th 2010. The approval by Parliament follows the so-called ‘EU trialogue’ – Council, Parliament and Commission – agreement of 26 October 2010. The numbering of the articles cited in this commentary follows the ‘trialogue’ agreement, pending proofreading and translation of the final text. The Directive is expected to be published by spring 2011, to be transposed into national legislation within two years (by spring 2013).

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end to this by setting up a single rule book and a single authorisation regime (called a 'passport'). However, when it came to granting this passport to non-EU managers, member states and Parliament have been quarrelling for more than a year.

The Commission initially envisaged four requirements: 1) equivalence of prudential regulation, 2) reciprocal market access, 3) exchange of tax information and 4) cooperation arrangements between supervisors. To allow for the negotiation of these arrangements with third countries, the passport would not have been applied for the first three years. In the meantime, according to well established principles of Community law, national laws would have continued to apply and member states would have been able to allow or continue to allow non-EU managers to operate in their jurisdictions.

Truth be told, the proposal of the Commission lacked flexibility in some respects – like passive marketing – and needed refinement but it was based on sound principles: regulatory oversight, level-playing field and tax cooperation. These principles still inform the Directive but they have been turned into an unnecessarily complex set of provisions, as discussed below.

The third country rules in the final draft

From the outset, regulators had to balance two conflicting objectives: 1) ensuring a level playing field so that there is fair competition among local and foreign managers and 2) avoiding any break-up of the international market. It was feared that non-EU managers would be unable to comply with the Directive and that this would act as a de facto barrier to trade. Given serious information asymmetries, policy-makers opted for a precautionary approach and relaxed the rules initially envisaged.

Figure 1. Entry into force of the EU passport for non-EU managers and funds

In the final draft, national regimes will remain in force for at least six years instead of three as initially anticipated. The passport for non-EU managers will not be available for the first three years, and ESMA[2] and the Commission will have a further three years to assess how the new system works before deciding whether or not to phase out the national rules. In the meantime, nationally authorised managers will have to comply with parts of the Directive,[3] which is hoped will encourage them to move to the passport. This adds a degree of flexibility to the Directive, which has been well received. However, there are two downsides to the final text: complexity and, more importantly, uncertainty.

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[2] The European Securities and Markets Authority (ESMA) will supersede the Committee of European Securities Regulators (CESR) from January 2011.

[3] Articles 22 (annual report), 23 (disclosure to investors), 24 (reporting to authorities), 26-30 (private equity rules). In addition, there will need to be cooperation arrangements between competent authorities and the country shall not be listed as a Non-Cooperative by the Financial Task Force on anti-money laundering and terrorist financing. See Article 40 of the Directive.

Firstly, a number of specific provisions relating to the passport remain unclear. In some parts of the text, there is a lack of precision as to whether it is purely management or also marketing that is being regulated.[4] There is a complex procedure to determine the member state of reference –i.e. the supervisory authority that will be responsible for a given manager − plus a period of two years during which a change in marketing strategy may alter the competence of the national authority. Further, ESMA mediation may be necessary at several stages throughout the authorisation procedure, if another member state disagrees with the application being made.

Much of this complexity could have been avoided if member states had granted ESMA powers to issue final decisions, as was first suggested for the new EU supervisory authorities. Unfortunately, the lack of trust and reluctance among some member states to 'transfer powers to Brussels', resulted in the formulation of this complex, and inherently dysfunctional set of rules. One might wonder what happened to the principles of better regulation. Given its fragile growth, Europe cannot afford to erect barriers to investment based on purely procedural reasons. When a non-EU manager will look at the 50+ pages of rules and the uncertainty that surrounds them, it is quite possible, s/he will walk away.

Secondly, the entry into force of the passport is also subject to a complex procedure, involving ESMA's advice and the Commission. This means it is not certain whether the passport for non-EU managers will come into force at all. As a matter of fact, part of the industry still expects this will not ever happen; it still expects to be exempt from the rules in the Directive if domiciled offshore. The lack of automatic entry into force of the passport is undoubtedly the biggest flaw in the Directive; it sends the wrong message to offshore managers and reduces their incentive to start preparing for compliance.

If the passport for non-EU managers is not implemented, national regimes will only allow managers to market their funds in their respective jurisdictions, and there will be no pan-European market for offshore funds. Yet, much of the industry seems to favour such an outcome, due to the strict requirements and potentially high compliance costs imposed by the Directive, for instance, for the rules on depositaries.

In practice, the final determinant of the success or failure of the new regime is a matter of investor preference. If investors will favour regulated rather than unregulated alternative investments, we will see more offshore fund managers applying for the passport. Investors will face an 'easy trade-off' between the security offered by regulated investments, and the lower returns that may come with increased compliance costs.

Nevertheless, the situation seems unlikely to shift in favour of the passport because of differences in taxation. The Directive does not require member states to sign OECD Model Tax Conventions with regard to national authorisation, but this is required in relation to EU authorisation of funds. In effect, this disparity in tax treatment will offset investors' preferences for regulated vehicles and render the success of the passport for non-EU managers increasingly unlikely. Besides, it is also indicative of the overall lack of consensus on how to deal with taxation in Europe, a crucial question at a time where markets demand single economic governance and the public is suffering heavy spending cuts.

[4] It is unclear what Article 37 actually authorises, whether it covers only management or also marketing. It is also unclear whether the exceptions in Article 37 also apply to the marketing in the EU of funds operated by the manager since Article 38 is silent in this respect while Article 39 does not allow for any exemptions.

A final concern is what will happen to offshore managers which fall below the *de minimis* thresholds of the Directive. EU managers whose assets under management do not exceed €100 million are exempt from authorisation,[5] but it is not clear whether the same applies to non-EU managers.[6] On the one hand, if these 'small' managers are exempt, there will be questions about regulatory oversight in the country of origin. On the other hand, if they are not exempt, a good explanation will need to be found to justify introducing this discrimination. The question is not trivial for Europe's economy since some small investors are thought to play an important role in the development of high-tech spin-offs. It is feared that subjecting them to heavy regulatory burdens could kill their initiatives. In this regard, a specific regime for foreign venture capital is worth a thought. In addition, better targeted – possibly less stringent – requirements for this purpose would be in line with the Europe 2020 strategy for smart, sustainable and inclusive growth.

Conclusion

Regulating alternative investments was about regulating the unknown, something that had gone largely unregulated before. Shortly after the financial turmoil, the Commission, which had been working on this area since 2006, rushed the proposal through the pipeline. It was not a propitious moment and the contents of the Directive became confused. An industry that was not used to dealing with regulation and did not feel guilty from the crisis reacted fiercely. So did jurisdictions like the US which feared a protectionist drift in Europe. On top of this, some politicians were carried away by their constituencies where there was outrage against the world of finance.

Debate was helpful in enhancing the flexibility of the Directive and ensuring a smooth transition to the regulated regime. This way, Europe has probably avoided foreclosing its market or denying its investors opportunities abroad. However, during this same debate, third country rules have reached an unnecessary level of complexity, contrary to good regulatory practice. The focus should have been on streamlining procedures, not on retaining powers at national level; ESMA should have been granted the authority to take final decisions and not mere 'mediation' capacities.

Most importantly, the entry into force of the passport for non-EU managers should have been kept non-discretionary. A fixed date would have sent the right message to offshore managers who would have started to prepare for compliance. Instead, the lack of regulatory certainty, together with burdensome and lengthy procedures, is likely to deter the development of a pan-European fund industry. It will be difficult to make these third country rules work efficiently. Yet, clever implementation and cooperation among member states can still make a difference.[7]

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[5] EU managers which assets under management do not exceed €500m are also exempt from authorisation if they are not leveraged and require 5 year lock-in to investors.

[6] A strict interpretation of the Directive will rule out the application of the *de minimis* rules to non-EU managers.

[7] Overall, there are more than 100 implementing measures in the Directive. Around half of those consist of binding technical standards developed by ESMA. The Commission will carry out the implementation in parallel with transposition so that implementation is finalised by the end of the transposition period.

ANNEX I. AIFMD third country rules: Navigating the many provisions

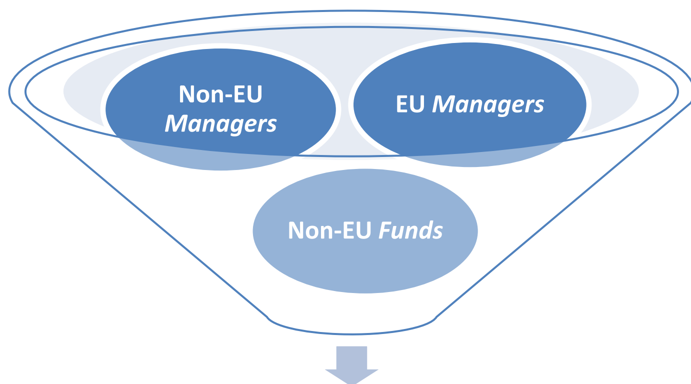
Timeline	Article	Addresses	Purpose	Exemptions (articles)	Additional requirements	Procedure	Duration
From year 1	34	- EU manager (authorised) - Non-EU fund - Marketing only outside the EU	Management	21 (depositary rules) 22 (annual report)	- Cooperation arrangement between competent authorities (home MS / third country)	None	-
Years 1 to 5 (Article 63ter)	36	- EU manager (authorised) - Non-EU fund - Marketing inside the EU	Marketing without passport	21 (depositary rules)	- Duties in paragraps 6, 7 and 8 of article 21 cannot be performed by the manager. - Cooperation arrangements between competent authorities (home MS / third country) - Not listed as Non-Cooperative Country	Authorisation (National Law)	-
	40	- Non-EU manager - Both EU and non-EU funds - Marketing inside the EU		*Full exemption apart from:* 22 (annual report) 23 (disclosure to investors) 24 (reporting to authorities) 26-30 (private equity rules)	- Cooperation arrangements between competent authorities (MS / third country) - Not listed as Non-Cooperative Country	Authorisation (National Law)	-
From year 3 (Article 63bis)	35	- EU manager (authorised) - Non-EU fund - Marketing inside the EU	Marketing with passport	22 (annual report) 23 (disclosure to investors) 24 (reporting to authorities)	- Cooperation arrangements between competent authorities (home MS / third country) - Not listed as Non-Cooperative Country - OECD Model Tax Conventions (each MS where AIFM intends to be marketed / third country)	Notification (EU Law)	20 working days
	37	- Non-EU manager - Mangement of EU funds - Marketing of funds managed in the EU	Management of EU funds / Marketing of funds managed in the EU	Incompatible provisions*	- Legal reprentative established in MSR - Cooperation arrangements between competent authorities (MSR / third country) - Not listed as Non-Cooperative Country - OECD Model Tax Convention (MSR / third country) - Effective supervision is not impeded	Authorisation (EU Law)	At least 3 months (Article 8)
	39bis	- Non-EU manager (authorised) - EU fund (established in other member state than the MSR)	Management	No reference is made	- Communicate programme of operations - Communicate further details if establishing a branch	Notification (EU Law)	One month
	38	- Non-EU manager (authorised) - EU fund - Marketing inside the EU	Marketing with passport	No reference is made	- No additional requirements	Notifcation (EU Law)	20 working days
	39	- Non-EU manager (authorised) - Non-EU fund - Marketing inside the EU		No exemptions	- Cooperation arrangements between competent authorities (home MS / third country) - Not listed as Non-Cooperative Country - OECD Model Tax Conventions (each MS where AIFM intends to be marketed / third country)	Notification (EU Law)	20 working days

* Manager has to show: incompatibility of the AIFMD provision with a mandatory provision from its jurisdiction + existence of equivalent rule in that jurisdiction + compliance with the rule.
Abbreviations: MS refers to Member State and MSR refers to Member State of Reference.
Note: The numbering of the articles cited in this commentary follows the trialogue agreement of 26 October 2010, pending proofreading and translation of the final text.

ANNEX 2. Understanding the third country rules in the AIFMD

The Alternative Investment Fund Managers Directive (AIFMD) aims to provide a European internal market for AIF managers, and a harmonised and stringent regulatory and supervisory framework for the activities of all AIF managers, EU or non-EU, within the European Union.

Figure A2.1 Scope of regulated universe



Single authorisation and rule book for the whole EU

Regulated universe

The AIFM Directive regulates managers and not funds. However, there are special provisions for non-EU AIF managers and for non-EU funds.

Managers rather than funds are regulated since the Directive wants to cover all investment strategies outside the scope of UCITS.

The structure of the regulated universe is in reality quite complex since the Directive applies to:

1) EU AIFMs managing EU AIFs or non-EU AIFs (whether they are marketed in the EU or not) and
2) Non-EU AIFMs managing EU AIFs (whether they are marketed in the EU or not); or marketing EU AIFs or non-EU AIFs within the European Union.

Figure A2.2 Structure of regulated universe

EU Fund

	Marketed in the EU	Marketed outside EU
EU manager	Covered	
Non-EU manager		

Non-EU Fund

	Marketed in the EU	Marketed outside EU
EU manager	Covered	Covered
Non-EU manager		Exempt

As a result, only non-EU managers of non-EU funds that are only marketed outside the European Union are completely exempt from the Directive. It is unclear how the general thresholds of the Directive will work for non-EU managers.

Non-EU managers are only regulated by the Directive with regard to the management of EU funds and the units or shares of non-EU funds that are marketed in the EU.

The final text of the Directive

The Directive was proposed by the Commission in April 2009. Negotiations between the European Parliament and the European Council have been going for several months. On 19 October 2010, the member states agreed on a Council Position with a view to concluding negotiations with the Parliament. When compared with previous compromise proposal, the current position brings changes in two areas: 1) third country rules and 2) private equity rules. On 26 October 2010, the Parliament, the Council and the Commission agreed what will become the final text, subject to formal approval by the first two institutions.

Passport mechanics

The Directive enables a single EU passport for the management and marketing of alternative investments. Managers will need to apply for authorisation and comply with the Directive to gain access to this passport.

Authorised managers will be able to manage EU funds and market them to professional investors. Marketing to retail investors remains a national matter.

- Authorisation is the first step: It allows managers to manage EU funds established in the same member state.
- To manage EU funds established in another member state, the manager needs to follow a notification procedure.
- To be able to market funds to professional investors in the EU, the manager also needs to notify the authorities.
- However, to be able to market funds to retail investors, the manager will need to demand authorisation in each of the member states that allows this; the EU passport does not cover marketing to non-professional investors.

Introduction to the third country rules

Third country rules refer to the provisions in the AIFMD that apply to non-EU managers and funds in two circumstances:

1) For non-EU AIF managers, when they perform management and/or marketing activities within the European Union and
2) For EU AIF managers, where they manage non-EU AIFs.

Third country rules foresee the availability of the EU passport for non-EU managers and funds, meaning they will be able to access the European market via a single authorisation and subject to a single rule book, as opposed to the current situation where 27 different national regimes apply.

During the first two years after the entry into force of the Directive, non-EU managers and funds will not have access to the EU passport available to their EU counterparts. This passport will become only available two years after the entry into force of the Directive. In addition, a transition period of three years is foreseen during which national regimes will co)exist with the EU passport, subject to certain conditions. After this transition period, national regimes will disappear and every manager operating in the EU will need to be authorised under the AIFMD.

During the transition period, member states will continue to be able to authorise non-EU managers to market funds on their territory only. They may also authorise non-EU managers to

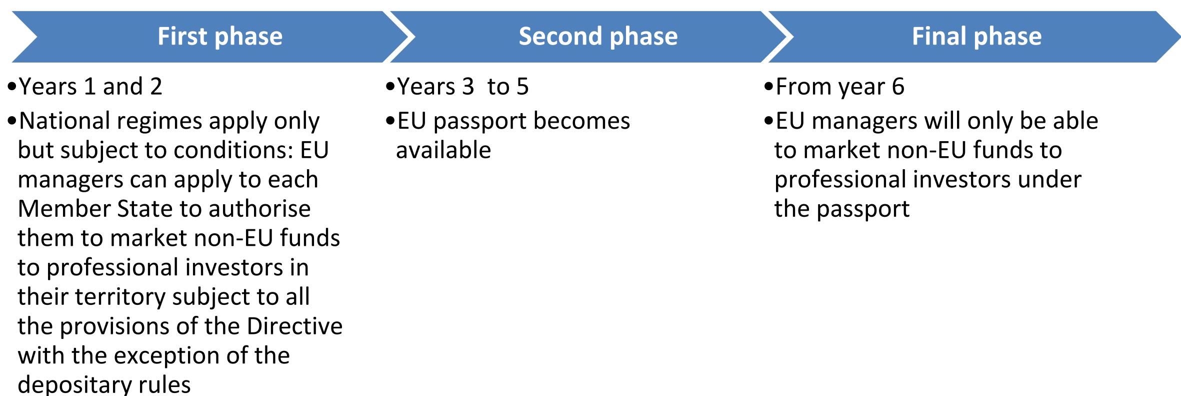
manage EU funds on their territory only. After the transition period, both activities will require a single authorisation for the whole European market under the AIFM Directive.

The entry into force of the passport for non-EU managers and the phasing out of the national regimes are both subject to separate decisions from the Commission after receiving advice from ESMA.

Details of the third country rules

1) *For EU managers managing non-EU funds*
   - ✓ EU managers will need to be authorised under the AIFMD to manage both EU and non EU funds.
   - ✓ They may market non-EU funds outside the EU freely. In addition, they will not be subject to the depositary requirements of the Directive, nor to the requirements relating the annual report.
   - ✓ The Directive will not impede EU professional investors from requesting EU managers to invest in non-EU funds managed by them.
   - ✓ If they wish to market non-EU funds inside the EU, the general transition periods for third country rules apply.

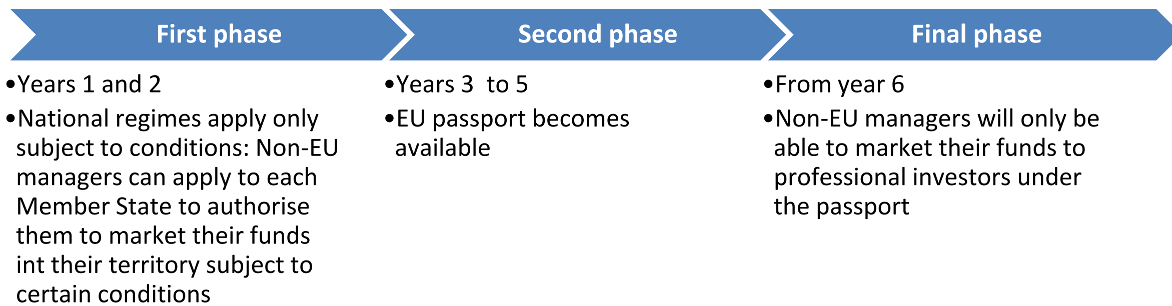
Figure A2.3 Entry into force of EU passport for non-EU funds



In addition, national authorisations may not be granted unless there are cooperation arrangements between the home member state of the manager and the third country or if the third country is listed as Non-Cooperative by the Financial Action Task Force.

2) *For non-EU managers*
   - ✓ The basic principle that informs the Directive is that of ‘level-playing-field’ between EU and non-EU managers. Non-EU managers will be granted the benefits of the Directive (will have access to the passport) but will also have to comply with all its provisions.
   - ✓ The Directive will not impede EU professional investors from requesting non-EU managers to invest in their funds.
   - ✓ The general transition periods for third country rules apply.

Figure A2.4 Entry into force of EU passport for non-EU managers



Authorisation by individual member states will only be issued subject to several conditions:

1) Managers will be subject to similar rules as those contained in the AIFMD with regard to the disclosure to investors.
2) Managers will have to comply with the transparency requirements in the AIFMD, as well as with Section 2 of Chapter V (Obligations for AIFM managing AIF which acquire control of non-listed companies and issuers).
3) There need to be cooperation arrangements between the member state where the AIF is marketed and the third country.
4) The third country may not be listed as Non-Cooperative by the Financial Action Task Force.

The EU passport will only be granted via a specific authorisation procedure before the member state of reference and subject to the existence of cooperation arrangements. The non-EU manager will have to comply with the entire Directive except if it can demonstrate that it is subject to an equivalent rule in its country of origin, it complies with that rule, and it is not possible to combine compliance. In addition to the requirements listed above for national authorisations, there needs to be an OECD Model Tax Convention for every member state where the fund will be marketed.

Passport authorisation for non-EU managers

The Directive foresees a special authorisation procedure for non-EU managers, which consists of several stages.

Step 1 *Determination of the member state of reference (MSR)*

Authorisation and supervision of non-EU managers depend on the member state of reference (MSR). The designation of the MSR depends on the number, origin and destination of the funds. In some instances, several MSRs are possible. In such cases, managers will have to submit a request to the competent authorities of all the possible MSRs, which will have one month to agree among each other and notify the manager. If only one member state has been requested, it will need to consult ESMA, which may take up to one month to issue the advice. The member state may act as MSR contrary to advice of ESMA but if another member state disagrees, it may refer the matter back to ESMA for mediation. In order to follow this procedure, the manager will have to appoint a representative in one of the possible MSR.

Step 2 *Request for authorisation*

Once the MSR has been determined, the manager will have to appoint a representative established in that member state. The manager will need to request the MSR for authorisation. If the manager considers it cannot comply with certain provisions of the Directive, he needs to submit written evidence supported by the opinion of a legal expert. In such case, the MSR will need to ask ESMA for its advice on the matter, which may take up to one month. If at any stage, another member state disagrees with the assessment of the MSR, it may refer the matter to ESMA for mediation.

Step 3 *Change of the member state of reference*

Two years after the initial authorisation, the determination of the member state of reference will be reviewed. If the marketing strategy submitted by the manager at the time of authorisation was untrue or has changed, the MSR will request the manager to indicate the correct MSR based on the actual marketing strategy. Upon reception of the manager's response, ESMA will need to be consulted, which may take up to one month. If another MS disagrees with the assessment of the MSR, it may refer the matter to ESMA for mediation. If a new MSR arises out of this procedure, the manager will have to appoint a representative in the new MSR and follow the authorisation procedure again.

Estimated duration of the procedure

The duration of the procedure of authorisation for non-EU managers will depend on whether there is a single possible MSR or multiple ones. It will also depend on the level of consensus among member states with regard to the application of the Directive, since any member state which disagrees can refer the matter to ESMA for mediation at different stages of the procedure. The procedure will last for at least 3 months, as for EU managers.

Sample case

If a non-EU manager intends to manage several EU funds established in different member states and market them in more than one member state, the member state of reference will be the one where it intends to develop effective marketing for most of those funds. The manager needs to be domiciled in a country that fulfils all the condition required in the Directive in terms of supervisory and tax cooperation.

On top of the general conditions for the granting of authorisation, it will have to appoint a representative in the member state of reference and disclose its marketing strategy to justify its choice of member state. The member state has up to six months to accept or reject the application from the manager.

During the first two years after the granting of authorisation, if the manager changes its marketing strategy it needs to pay attention to whether such changes would modify its member state of reference. After that period, further business development of the manager in Europe shall not affect the member state of reference.

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