The Alternative Investment Fund Managers Directive – "Third Country Provisions"

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Contents

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THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE – "THIRD COUNTRY PROVISIONS"

Introduction

After 18 months of political wrangling, the text of the new EU Directive on Alternative Investment Fund Managers (the "**Directive**") was agreed in a trialogue meeting of October 26, 2010 between co-legislators, the European Council's Economic and Financial Affairs Council ('ECOFIN') and the European Parliament's Committee on Economic and Monetary Affairs ("ECON"), was agreed by the Committee of Permanent Representatives (COREPER) on November 3, 2010 and was the subject of a successful plenary vote in the European Parliament on November 11, 2010.

The Directive seeks to establish a harmonised EU wide framework to address the potential prudential risks which might arise from the activities of "alternative investment fund managers" or "**AIFMs**" and to create a single market for the marketing of non-UCITS collective investment schemes or "**AIFs**" to EU professional investors.

The Directive is now expected to be published shortly in the Official Journal of the European Union and come into force in January 2011. EU Member States will have two years to transpose the Directive into national legislation.

The Directive runs to over 200 pages and is divided into ten chapters covering:

Chapter 1:	The scope of the Directive and exemptions
Chapter 2:	Rules governing the authorisation of AIFM
Chapter 3:	Operating conditions for AIFM (including principles of governance, risk management, liquidity management, valuation and custody)
Chapter 4:	Transparency requirements
Chapter 5:	Rules for AIFM managing specific types of AIF (leveraged AIF and private equity type AIF)
Chapter 6:	The rights of EU AIFM managing and marketing EU AIF
Chapter 7:	Third Country Rules
Chapter 8:	Marketing to retail investors
Chapter 9:	Designation of competent regulatory authorities; and
Chapter 10:	Transitional and final provisions.

This briefing paper focuses primarily on the Directive's **Third Country Rules** (Chapter 7) which deal with the rights of EU AIFM to manage non-EU AIF and to market non-EU AIF in the EU and of non-EU AIFM to manage EU AIF and to market EU or non-EU AIF in the EU.

Who does the Directive apply to?

Scope

Unless a partial or complete exemption is available or the activities in question fall outside the scope of the Directive, the Directive applies to;

(i) any legal person (an "alternative investment fund manager" or "**AIFM**") established in an EU Member State whose regular business is managing one or more "alternative investment funds" or "**AIFs**" meaning any collective investment undertaking, including investment compartments thereof, established within or outside the EU:

(a) which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(b) which does not require authorisation pursuant to Article 5 of Directive 2009/65/EC (the UCITS Directive (re-cast));

(ii) any non-EU AIFM managing AIF established in the EU, irrespective of whether they are marketed in the EU or not; and

(iii) any non-EU AIFM marketing within the EU any AIF (wherever domiciled) that it manages.

The definition of AIF would appear to exclude single mandate managed accounts and any investment structure which has just a single investor. Please also see "**Exemptions from the Directive**" below.

Authorisation Required?

Once the Directive is transposed, an AIFM must be authorised in the Member State in which it has its registered office and it will be responsible for ensuring compliance with the requirements of the Directive. The AIFM can either be the AIF itself where its legal form permits it or a separate legal person.

Note, however, that it is not just EU AIFMs which will require authorisation.

A non-EU AIFM managing an EU AIF or seeking to use a passport to market an AIF into an EU Member State will in the future (from no earlier than 2015) require prior authorisation from the regulator of the EU "Member State of reference" (i.e. either the Member State in which the AIF is established or the Member State in which the AIF is principally marketed).

Where a non-EU AIFM seeks to market a non-EU AIF into an EU Member State on a private placement basis, it will have to comply with various parts of the Directive.

Managing AIFs?

The activity of "managing" AIFs is defined in the Directive as providing at least investment management services referred to in Annex I of the Directive to one or more AIF.

Those Annex I services are:

- portfolio management; and
- risk management.

The Directive makes it clear that a single AIFM can never be authorised to provide only portfolio management or only risk management services. It must provide both.

Other Services

In the course of the collective management of an AIF an authorised AIFM may also provide other services, including the administration and marketing of collective investment undertakings.

The Directive also provides that AIFM should not be prevented from:

- acting as UCITS management companies, or
- managing pension schemes, or
- providing the non-core services of investment advice; or
- safe-keeping and administration in relation to units of collective investment undertakings.

However, each regulated activity extraneous to managing AIF pursuant to the Directive may require a separate authorisation and may subject the AIFM to a separate (i.e. additional) regulatory regime.

Exemptions from the Directive

The Directive provides certain full and partial exemptions from its scope depending on the nature of the entity or the relationship between the entity and the investors. It also provides for a more limited type of authorisation where an "opt-in" is not taken.

Full Exemptions

The Directive provides a full exemption for the following entities:

- holding companies;
- institutions which are covered by Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP), including, where applicable, the authorised entities responsible for managing IORP and acting on their behalf referred to in Article 2(1) of that Directive or the appointed investment managers pursuant to Article 19(1) of the same Directive, insofar as they do not manage AIF;
- supranational institutions such as the World Bank, the IMF, the ECB, the EIB, the European development finance institutions (DFIs) and bilateral development banks, the EIF, other supranational institutions and similar international organisations, in case such institutions or organisations manage one or several AIF in so far as those AIF act in the public interest;
- national central banks;
- national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems;
- employee participation schemes or employee saving schemes; and
- securitisation special purpose entities.

Partial Exemptions

The partial exemption provision is that the Directive will not apply to AIFM insofar as they manage one or more AIF whose only investors are:

- the AIFM; or
- the parent undertakings or the subsidiaries of the AIFM; or

- other subsidiaries of those parent undertakings

provided that none of those investors itself is an AIF.

Limited Authorisation

The following AIFM will be subject to registration in their home Member State and will be subject to certain disclosure requirements relating to the monitoring of systemic risk but will not benefit from the rights available to other AIFM under the Directive unless they choose to "opt in":

- AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million; or

- AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, in total do not exceed a threshold of EUR 500 million when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.

“Marketing” under the Directive

The activity of “Marketing” is defined under the Directive as any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the EU.

Significantly, the definition of marketing does not explicitly include reverse solicitation, which was included in earlier drafts of the Directive.

The Passport: EU AIFMs managing EU AIFs

Once the Directive is transposed into national law in the Member States concerned (i.e. at the latest January, 2013), an EU authorised AIFM will have a "**passport**" to freely market its EU-domiciled AIF to “**professional investors**” in its own Member State and other EU Member States, subject to a straightforward notification process.

A “professional investor” is any investor which is considered to be a professional client or may be treated as a professional client on request within the meaning of Annex II of Directive 2004/39/EC. Such investors comprise:

(a) Credit institutions

(b) Investment firms

(c) Other authorised or regulated financial institutions

(d) Insurance companies

(e) Collective investment schemes and management companies of such schemes

(f) Pension funds and management companies of such funds

(g) Commodity and commodity derivatives dealers

(h) Locals

(i) Other institutional investors

(j) Large undertakings meeting two of the following size requirements on a company basis:

- balance sheet total: EUR 20,000,000
- net turnover: EUR 40,000,000
- own funds: EUR 2,000,000.

(k) National and regional governments, public bodies that manage public debt, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.

(l) Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

(m) Clients other than those mentioned in sections (a) to (l) above, including public sector bodies and private individual investors, who, as a minimum, meet two of the following criteria:

- the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters,
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,
- the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

Marketing to Retail Investors

Individual Member States may also allow marketing of AIFs to retail investors within their own territories and in this regard may impose stricter requirements on the AIF or AIFM than required by the Directive.

What about Non-EU AIFMs and Non-EU AIFs?

One of the main areas of contention in the negotiations leading to agreement on the text of the Directive involved the treatment of non-EU AIFMs and AIFs.

There was a difficult balance to be struck in the Directive between allowing EU investors access to AIF managed by non-EU managers and addressing potential risks which might arise from the activities of non-EU entities within the EU as well as providing some sort of level playing field between EU and non-EU managers in relation to access to EU investor markets.

The practical issues of seeking in some way to regulate non-EU AIFM which manage or market AIF within the EU but which have no place of business in the EU have been recognised in the Directive and are addressed in the following sections.

EU authorised AIFM managing or marketing EU AIF in the EU

The rights of an EU AIFM to manage or market EU AIF in the EU are dealt with in Chapter 6 of the Directive.

An AIFM which is established in a Member State of the EU and has been authorised by the competent regulatory authority in that Member State will have the right under the Directive to:

(a) market shares of any EU AIF that it manages to professional investors in the AIFM's home Member State subject to providing a prescribed notification file to its home Member State regulator:

(b) market shares of an EU AIF that it manages to professional investors in another Member State subject to providing a prescribed notification file to its home Member State regulator;

(c) manage EU AIF where the AIF is established in the AIFM's home Member State; and

(d) manage EU AIF where the AIF is established in another EU Member State subject to providing a prescribed notification file to its home Member State.

The home Member State regulator may only prevent marketing of shares in EU AIFs where the information provided in the notification demonstrates that the AIF concerned will not be managed in accordance with the Directive.

In the case of (a) and (b) above where the EU AIF is a feeder AIF (i.e. one which invests not less than 85% of its assets in shares of another AIF or invests at least 85% of its assets in more than one master AIF where those master AIFs have identical investment strategies or has otherwise an exposure of at least 85% of its assets to one or more such master AIF), then the right to market referred to above is subject to the condition that the master AIF is also an EU AIF and is managed by an authorised AIFM.

EU authorised AIFM managing a non-EU AIF which is not marketed in the EU

The Directive allows an authorised EU AIFM to manage non-EU AIF which are not marketed in the EU provided that:

(a) the AIFM complies with all the requires of the Directive (except for Article 21 and Article 22) in respect of those AIF; and

(b) Appropriate cooperation arrangements are in place between the regulator of the AIFM's home Member State and the supervisory authority of the third country where the AIF is established in order to ensure an efficient exchange of information to allow the AIFM's home Member State regulator to carry out its duties.

Article 21 and 22 form part of Chapter 3 of the Directive and deal, respectively, with the requirement for an AIF to have a single depository and for each AIF to produce an annual audited set of financial statements to investors and the home Member State regulator of the AIFM.

A common framework to facilitate the establishment of "cooperation arrangements" will be legislated for by the European Commission.

EU authorised AIFM marketing its non-EU AIF in the EU under each Member State's individual private placement rules (up to at least 2018)

The Directive provides that each Member State may allow an authorised EU AIFM to market a non-EU AIF to professional investors in that Member State under the Member State's own national private placement rules, **without a passport**, provided that:

(a) the AIFM complies with all of the requirements of the Directive with the exception of Article 21 provided that one or more entities are appointed to carry out the basic custody requirements set out in Article 21 (including safe-keeping of assets and supervision of specific administrative type management functions);

(b) there is a cooperation arrangement for the purpose of systemic risk oversight between the regulator of the home Member State of the AIFM and the supervisory authority of the third country where the AIF is established; and

(c) the third country where the AIF is established is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

The Directive envisages that in 2015 the European Securities and Markets Authority ("ESMA") will issue an opinion on the functioning of the European passport then in force and on the functioning of national private placement regimes and an advice on the extension of the European passport to EU AIFM marketing non-EU AIF in the European Union and to non-EU AIFM managing and/or marketing AIF in the European Union.

If the ESMA considers that there are no significant obstacles regarding matters such as investor protection, market disruption and distortion in competition impeding the application of the European passport to the marketing of non-EU AIF by EU AIFM or the management and/or marketing of AIF by non-EU AIFM in the Member States, then it will issue a positive advice.

Based on this advice, the Commission will adopt rules within three months specifying the date when the European passport shall be available to EU AIFM in respect of their non-EU AIF and to non-EU AIFM in respect of their management and/or marketing of AIF in the EU.

It is therefore envisaged by the Directive that, subject to a favourable opinion by the ESMA, authorized EU AIFMs shall, no earlier than 2015, be entitled to market non-EU AIF managed by them to EU professional investors using an EU marketing passport.

The Directive envisages that three years after the European passport becomes available to EU AIFM marketing non-EU AIF in the European Union and to non-EU AIFM managing and/or marketing AIF in the European Union (i.e. 2018 assuming the European passport becomes available to such AIFM in 2015), the ESMA will issue an opinion on the functioning of the European passport for such AIFM and on the continuing functioning of the national private placement regimes and an advice on the termination of such national regimes.

If the ESMA considers that there are no significant obstacles regarding matters such as investor protection, market disruption, monitoring of systemic risk and distortion in competition impeding the termination of the national private placement regimes and to maintain the availability of the European passport for the marketing of non-EU AIF by EU AIFM or the management and/or marketing of AIF by non-EU AIFM in the Member States, then it will issue a positive advice.

Based on this advice, the Commission will adopt rules within three months specifying the date when the national regimes will terminate and the European passport will become the sole and mandatory regime applicable in all Member States.

EU authorised AIFM marketing its non-EU AIF in the EU under the European passport (available no sooner than 2015 and only if ESMA agrees)

Subject to the ESMA having issued the favourable advice referred to in the previous section, and the European Commission having adopted the appropriate rules, the Directive provides that an EU authorised AIFM may market its non-EU AIF in the EU **under the European passport** provided that;

(a) the AIFM complies with all of the requirements of the Directive with the exception of Chapter 6 (which applies to EU AIFM managing and marketing EU AIF);

(b) the jurisdiction where the non-EU AIF is established has appropriate cooperation arrangements in place with the AIFM's home Member State regulator;

(c) the jurisdiction where the non-EU AIF is established is not be listed as a non-cooperative country and territory by the Financial Action Task Force; and

(d) the jurisdiction where the non-EU AIF is established has a tax agreement in place with the home Member State of the AIFM which complies with the OECD Model Tax Convention.

There is a facility under the Directive for another Member State to disagree with the assessment made under (i) and (ii) above by the AIFM's EU home Member State regulator in which case the matter may be referred to the European Securities and Markets Authority.

The national private placement regimes, as mentioned above, will continue to be in place until at least 2018.

Non-EU AIFM managing only non-EU AIF which are not marketed in the EU

The Directive does not apply to such AIFM.

Non-EU AIFM managing EU AIF none of which are marketed in the EU

It would appear that, by virtue of Article 63(1), such AIFM are not subject to the Directive until Article 37 of the Directive comes into force, which is not until a positive opinion is issued by the ESMA on the extension of the European passport to EU AIFM marketing non-EU AIF in the European Union and to non-EU AIFM managing and/or marketing AIF in the European Union.

Whereas Article 37 provides that non-EU AIFM which seek to manage EU AIF (whether or not such AIF are marketed in the EU) must obtain the prior authorisation of the regulator of the EU "Member State of reference" (i.e. either the Member State in which the AIF is established or the Member State in which the AIF is principally marketed), Article 63(1) provides that this Article (among other "third country" provisions) will only apply, subject to a favourable opinion by the ESMA, from 2015.

Non-EU AIFM marketing non-EU AIF into an EU Member State under the Member State's individual private placement rules (up to at least 2018)

The Directive provides that each Member State may allow non-EU AIFM to market a non-EU AIF to professional investors in that Member State under the Member State's own national private placement rules (i.e. without a passport) provided that:

(a) the AIFM complies with Articles 22, 23 and 24 in respect of each AIF marketed by the AIFM in this way and with Section 2 of Chapter V of the Directive where an AIF marketed in this way falls under the description of Article 26, paragraph 1;

(b) there is a cooperation arrangement for the purpose of systemic risk oversight between the regulator of the home Member State of the AIFM and the supervisory authority of the third country where the AIF is established; and

(c) the third country where the AIF is established is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

Article 22 deals with the requirement of AIFM to produce an annual audited set of financial statements for AIF which it manages and to deliver it to the investors and the home Member State regulator of the AIFM.

Article 23 deals with disclosure to investors of certain information prior to investment in the AIF as well as any material changes to that information, including a description of the investment strategy and objectives of the AIF, a description of all fees, charges and expenses directly or indirectly borne by investors, etc.

Article 24 provides for detailed reporting obligations to the home Member State, including the risk profile of the AIF, its risk management tools, the main categories of assets in which the AIF is invested and the overall level of leverage employed by the AIF.

Non-EU AIFM marketing AIF into an EU Member State under the European passport (available no sooner than 2015 and only if ESMA agrees)

Subject to the ESMA having issued the favourable advice referred to in the previous sections, and the European Commission having adopted the appropriate rules, the Directive provides that a non-EU authorised AIFM may market its AIF in the EU **under the European passport** provided that:

(a) the AIFM acquires a prior authorisation from the regulator of the "Member State of reference" and complies with all of the requirements of the Directive with the exception of Chapter VI (which applies to EU AIFM managing and marketing EU AIF);

(b) the non-EU AIFM must have a legal representative in its Member State of reference which shall be the contact point of the AIFM in the European Union and shall perform the compliance function relating to the management and marketing activities performed by the AIFM under the Directive, in conjunction with the AIFM;

(c) the jurisdiction where the non-EU AIFM is established has appropriate cooperation arrangements in place with the AIFM's Member State of reference regulator;

(d) the jurisdiction where the non-EU AIFM is established is not be listed as a non-cooperative country and territory by the Financial Action Task Force;

(e) the jurisdiction where the non-EU AIFM is established has a tax agreement in place with the non-EU AIFM's home Member State of reference which complies with the OECD Model Tax Convention;

(f) the effective exercise by the European authorities of their supervisory functions under the Directive is not prevented by the laws or regulations or supervisory or investigative powers of the third country governing the AIFM.

In the case of a non-EU AIF, the following additional conditions apply:

(g) the jurisdiction where the non-EU AIF is established has appropriate cooperation arrangements in place with the AIFM's Member State of reference regulator;

(h) the jurisdiction where the non-EU AIF is established is not be listed as a non-cooperative country and territory by the Financial Action Task Force; and

(i) the jurisdiction where the non-EU AIF is established has a tax agreement in place with the Member State reference of the AIFM which complies with the OECD Model Tax Convention.

As part of its application for authorisation, the non-EU AIFM suggests the Member State of reference which it believes to be relevant. The “Member State of reference” will be responsible for compliance with its management and marketing related obligations under the Directive.

The choice of the Member State of reference depends on the Member State in which the AIF are established and the Member State in which the AIF is principally marketed. ESMA is required to advise on the appropriateness of the choice of Member State of reference.

As part of its application for authorisation, the non-EU AIFM must supply a list of the provisions of the Directive for which compliance is impossible together with evidence that the relevant third country law provides equivalent rules with the same regulatory purpose and level of investor protection.

If compliance by the non-EU AIFM with a particular provision of the Directive would be incompatible with the law to which the non-EU AIFM is subject, the AIFM will be exempted from compliance with the provision of the Directive if it can show that it is impossible to comply with the Directive’s provision and a mandatory provision of the law to which the non-EU AIFM is subject and the latter provision is equivalent to the Directive’s provision having regard to its regulatory purpose and the level of investor protection to investors of the AIF which it provides. Again, ESMA is required to give advice on the appropriateness of exemption in case of incompatibility with an equivalent rule.

EU authorised AIFM delegating portfolio management to a non-EU manager

The Directive allows an AIFM to delegate functions concerning portfolio management or risk management provided that:

(a) the delegation is only to entities which are authorised or registered for the purpose of asset management and subject to supervision or otherwise subject to the prior approval by the AIFM's home Member State regulator;

(b) in the case of a non-EU entity, in addition to the requirement at (a) above, there must be a co-operation arrangement between the AIFM's home Member State regulator and the supervisory authority of the non-EU entity;

(c) the AIFM must be able to justify the delegation (and its entire delegation structure) with objective reasons;

(d) the delegate has to have sufficient resources and the persons who effectively conduct the business must be of sufficiently good repute and sufficiently experienced;

(e) the AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the function in question, was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors;

(f) the delegation must not prevent the effective supervision of the AIFM or the AIF from being managed in the best interests of investors.

The Directive requires that the liability of the AIFM towards the AIF should not be affected by the delegation and that the AIFM may not delegate to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity.

Grandfathering Provisions

AIFM established in the EU before the transposition deadline must fully comply with the Directive within a year of the transposition deadline unless either of the following principal grandfathering provisions apply:

(a) AIFM that manage closed-ended AIF that make no additional investments and are not marketed after the Directive's transposition deadline are not required to apply for authorisation; or

(b) AIFM that continue to make investments but whose subscription period ended prior to the entry into force of the Directive and have a fixed term life which expires at the latest three years from the Directive's transposition deadline may continue without authorisation, but these AIFMs must comply with the disclosure requirements of the Directive (Article 22 and where relevant Article 26 to 30).

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