



**INVESTMENT PRODUCTS UPDATE**

## **AIFM Directive – Analysis of ESMA Consultation Paper on Third Country Issues**

### **Introduction**

On 23 August 2011, the European Securities and Markets Authority (“**ESMA**”) published its consultation paper in relation to the “third country” aspects of the Directive on Alternative Investment Fund Managers (the “**Directive**”) (the “**Consultation Paper**”).<sup>1</sup> This follows the publication on 13 July 2011 of ESMA’s earlier consultation paper on all other aspects of the Level 2 implementing measures relating to the Directive.<sup>2</sup> The deadline for responses to the Consultation Paper is 23 September 2011.

Please refer to our previous Update of 12 November 2010<sup>3</sup> for a detailed analysis of the provisions of the Directive and our Update of 6 July 2011<sup>4</sup> regarding the final implementation timetable.

### **Issues discussed**

The Consultation Paper covers the following issues:

- cooperation arrangements for third country alternative investment funds (“**AIFs**”) and alternative investment fund managers (“**AIFMs**”);
- delegation of portfolio/risk management functions to third country undertakings;
- assessment of third country depositaries; and
- identifying the “Member State of reference”.

### **Cooperation arrangements for third country AIFs and AIFMs**

The Directive requires that, both for the purposes of marketing third country AIFs under the national private placement regime, as well as the passport regime, cooperation arrangements should be entered into between the relevant third country regulator(s) and the relevant EU Member State regulator(s).

ESMA proposes that the relevant cooperation agreements allow for the exchange of information for supervisory and enforcement purposes. The agreement should ensure cooperation by the third country regulator in assisting the relevant EU Member State regulator in enforcing EU or national legislation.

<sup>1</sup> <http://www.esma.europa.eu/popup2.php?id=7702>

<sup>2</sup> [http://www.esma.europa.eu/data/document/2011\\_209.pdf](http://www.esma.europa.eu/data/document/2011_209.pdf)

<sup>3</sup> <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4609>

<sup>4</sup> <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4877>

ESMA has recommended basing these cooperation agreements on similar documents prepared by IOSCO.<sup>5</sup> ESMA has suggested that it could negotiate and establish a template cooperation agreement for the purpose of satisfying the cooperation arrangement requirements. This would have the benefit of consistency, with third countries not having to negotiate cooperation agreements with each EEA Member State on a bilateral basis. However, it raises the question as to whether ESMA will, in preparing the template, consult with interested third countries such as the United States, the Cayman Islands, Hong Kong, *etc.*

As a separate matter, although the Directive requires ESMA to publish guidelines on the conditions for application of the measures adopted by the European Commission regarding the cooperation arrangements,<sup>6</sup> the Consultation Paper merely says: “ESMA will commit to adopt such guidelines by the time the Commission will complete the process for the issuance of Level 2 measures.” It is hoped that ESMA will carry out a public consultation on the guidelines before they are finalised.

Finally, ESMA has proposed that the provisions related to the third country passport should be finalised at a later stage since such provisions do not become relevant until late 2015 when the passport becomes available. This means that ESMA will not be providing guidance as yet on the conditions for the supervision of non-EU AIFMs and non-EU AIFs under the passport,<sup>7</sup> on how certain notifications are to be given, or how the “legal representative” concept will operate in practice.

### **Delegation of portfolio/risk management functions to third country undertakings**

Article 20(1)(c) of the Directive provides that, where an AIFM (authorised under the Directive) delegates portfolio management or risk management activities to third parties, the delegation may only be to “undertakings which are authorised or registered for the purpose of asset management and subject to supervision”. ESMA proposes that a third country undertaking should be deemed to satisfy the requirement under Article 20(1)(c) “when it is authorised or registered for the purpose of asset management based on local criteria which are equivalent to those established under EU legislation...”

This proposal appears to suggest that AIFMs should consider whether the relevant third country’s regulatory regimes for asset management are “equivalent to those established under EU legislation”, in order to be satisfied that the requirement in Article 20(1)(c) of the Directive is met. That may be a difficult determination for an AIFM to make, unless the Commission determines that particular third countries are deemed to be equivalent.

Separately, the Directive requires cooperation arrangements to be in place between the AIFM’s home Member State regulator and the regulator of the delegate. The cooperation arrangements proposed by ESMA in this regard are similar to those discussed under the section entitled “Cooperation arrangements for third country AIFs and AIFMs” above. One question that is raised by the requirement for such cooperation arrangements is what happens where the delegate is not required under the laws of its home jurisdiction to be supervised by any regulator.<sup>8</sup>

### **Assessment of third country depositaries**

Under the Directive, a non-EU AIF’s depositary can be located either in the non-EU AIF’s (*i.e.* third country) jurisdiction, in the home Member State of the AIFM (in the case of an EU AIFM) or in the EU “Member State of reference” of the AIFM (in the case of a non-EU AIFM). In order for a depositary to be located in a third country, that third country depositary must be “subject to effective prudential regulation, including minimum capital requirements, and supervision which have the same effect” as EU law and are effectively enforced.

ESMA has set out its proposals for the criteria to be taken into account when determining whether a third country depositary is subject to such equivalent standards. ESMA notes that the European Commission may issue decisions

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<sup>5</sup> *E.g.* the IOSCO Multilateral Memorandum of Understanding of May 2002 (with respect to cooperation for enforcement purposes) and the IOSCO Technical Committee Principles for Supervisory Cooperation (with respect to cooperation for supervisory purposes)

<sup>6</sup> Although not entirely clear, it is possible such guidelines might include how the cooperation agreements will actually be negotiated, entered into or enforced.

<sup>7</sup> Under the passport regime, a non-EU AIFM would have to be authorised under, and comply with all provisions of, the Directive.

<sup>8</sup> For example, prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act, many hedge fund managers were not registered with the Securities and Exchange Commission. Absent an applicable exemption, such managers would be required to register as a result of that Act.

declaring a given third country as equivalent if it determines that the criteria have been fulfilled. To the extent third country AIF jurisdictions wish to take advantage of the possibility that AIF depositaries may be located in those jurisdictions, those third countries will need to consider whether the equivalence requirement can be met.

## Identifying the “Member State of reference”

The Directive provides that, where a non-EU AIFM intends to market several AIFs in the EU, that non-EU AIFM’s “Member State of reference” is “the Member State in which [that AIFM] intends to develop effective marketing for most of those AIFs...”. ESMA proposes that that phrase be interpreted to mean the Member State where the non-EU AIFM intends to target investors by promoting and offering most of the AIFs.

To the extent this means the Member State where the non-EU AIFM has the most investors by number or value, this approach could be problematic. This is because a non-EU AIFM’s target investor base in the EU can change over time, resulting in theory in a change of that non-EU AIFM’s Member State of reference. A Member State of reference is, for a non-EU AIFM, its “home” Member State for purposes of the Directive. Thus, its authorisation is granted by the regulator in that Member State; the depositary for its AIFs must also be in that Member State (or in the home jurisdiction of the non-EU AIF). If a non-EU AIFM’s Member State of reference can change easily depending on where most of that non-EU AIFM’s investor contacts are at any point in time, that would mean that authorisation may have to be sought with new Member State regulators from time to time, and a new depositary for the AIFs would have to be appointed in the relevant new Member State each time.

## Conclusion

As noted above, responses to the Consultation Paper must be submitted by 23 September 2011. ESMA is then supposed to provide its final advice to the European Commission by 16 November 2011.

It is important for the alternative investment management industry to remain engaged with ESMA and the Commission throughout the Level 2 process, to ensure that the implications of the proposed Level 2 measures are properly understood.

If you have any questions regarding this Update, please contact the author of this Update or the regular Sidley lawyer with whom you work.

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