The AIFMD – Third Country Update: October 2012

The first draft of the Alternative Investment Fund Managers Directive (the "**AIFMD**") was published in April 2009 and came into force in each European Union ("**EU**") member state in July 2011. It aims to establish a common authorisation and supervisory regime for managers ("**Managers**") of all investment funds ("**Funds**"), other than UCITS, that are managed or marketed to professional investors in the EU and is due to be transposed into national law for all EU member states by 22 July 2013 (the "**Transposition Date**").

Despite the impending Transposition Date, the investment funds industry is still waiting for the publication of the Level 2 technical implementing measures ("**Level 2**") by the European Commission, which were due in September 2012. Level 2 will put much needed flesh on to the bones of the AIFMD and allow the financial services industry to anticipate more clearly the practical effects of the AIFMD on managers and the funds that they manage. As a result, uncertainty around the implementation of the AIFMD and its impact on the investment funds industry persists.

One of the key areas of debate surrounding the AIFMD is in respect of the status of so-called third countries, being those countries situated outside of the EU, which include the key fund jurisdictions of the Cayman Islands, Bermuda and the British Virgin Islands ("**Third Countries**"). In respect of Third Countries, there are a number of important issues to consider. The first and most obvious question is: **When does the AIFMD affect Third Country Managers and/or Third Country Funds?** In short, the AIFMD only affects Third Country Managers and/or Third Country Funds after the Transposition Date where:

(i) an EU Manager manages a Third Country Fund (where the Fund is not marketed in the EU); or
(ii) an EU Manager manages a Third Country Fund (where the Fund is marketed in the EU); or
(iii) a Third Country Manager manages an EU Fund or a Third Country Fund, which is marketed in the EU.

Therefore, if a Manager is based outside of the EU, does not manage a Fund in the EU and does not market within the EU, then the AIFMD does not apply. For example, a US Manager of a Cayman Islands Fund can offer interests in that Fund to investors in Asia, North and South America, Africa, Australasia and the fifteen odd European jurisdictions outside of the EU bloc without reference to the AIFMD. In addition to this, reverse solicitation and passive marketing in respect of a Fund continue to be permitted under the AIFMD. For example, if an EU investor approaches a Manager about investing in a Fund that they manage without prior solicitation, then neither the Fund nor its Manager will be subject to the burden of the AIFMD by virtue of this indirect approach.

The status and requirements of Third Countries will be subject to the implementation timetable of the AIFMD. For example, the passporting regime, which after the Transposition Date will allow EU Managers to market their Funds across the EU, will not be available to Third Country Managers until 2015. Until 2015, therefore, Third Country Managers wishing to market their Funds in the EU will need to do so in accordance with the private placement regimes ("**PPRs**") of the EU member states into which they are marketing, in much the same way as they have done previously. However, compliance with certain aspects of the AIFMD will still be necessary, as set out below. Post 2015, passports will, if introduced, be made available to Third Country Managers and Third Country Funds of EU Managers. A dual system of PPRs and passports will then exist until at least 2018 when the European Securities and Markets Authority will review the passport regime and consider whether to recommend that national PPRs be brought to an end. To be clear, if the passport is not switched on, PPRs would not be switched off. Should PPRs be switched off sometime during 2018, a passport to market in the EU will be required in respect of all Funds managed by a Third Country Manager and all Third Country Funds managed by an EU Manager. Given the relatively longer term for the introduction of the passporting regime in respect of Third Countries, it does not form part of this paper.

What will be required of Third Country Managers and Third Country Funds caught by the AIFMD and what will be required of Third Countries themselves?

(i) For an EU Manager managing a Third Country Fund (where the Fund is not marketed in the EU):

- full compliance with the AIFMD for the EU manager will be required, except in respect of depositary and annual reporting requirements.

In respect of the Third Country:

- cooperation arrangements must be in place between the competent authorities of the country of domicile of the EU Manager (for example the FSA in respect of a UK domiciled manager) and the supervisory authorities of the Third Country Fund (for example the Cayman Islands Monetary Authority in respect of a Cayman Islands domiciled fund) .

(ii) For an EU Manager managing a Third Country Fund (where the Fund is marketed in the EU):

- full compliance with the AIFMD for the EU Manager will be required, except in respect of depositary requirements.

In respect of the Third Country:

- cooperation arrangements must be in place between the competent authorities of the country of domicile of the EU Manager and the supervisory authorities of the Third Country Fund; and
- the Third Country Fund must not be domiciled in a Non-Cooperative Country and Territory ("NCCT") as determined by the Financial Action Task Force.

(iii) For a Third Country Manager managing an EU Fund or a Third Country Fund, which is marketed in the EU:

- an annual report must be produced for each Fund it markets in the EU and be made available for all investors in the Fund and the relevant regulators; and
- disclosure to investors in respect of the Fund must be made, to include in respect of its investment strategy and

objectives, risk factors, details of service providers and fees and expenses borne by investors; and

- regular reporting must be made to the relevant regulators in respect of the principal markets and instruments on which the Manager trades; and
- where a Fund acquires control of a non-listed company (an "**Acquired Company**"), then in respect of the Acquired Company the Third Country Manager will be subject to additional notification and reporting provisions to the shareholders of the Acquired Company, the Acquired Company itself and the relevant regulators as well as be subject to the asset stripping provisions of the AIFMD[1].

In respect of the Third Country:

- cooperation arrangements must be in place between (a) the competent authorities in each EU member state where the Third Country Fund is to be marketed; (b) the supervisory authority of the country of domicile of the Third Country Fund; and (c) the supervisory authority of the country where the Third Country Manager is established; and
- neither the Third Country Fund or the Third Country Manager should be domiciled in a NCCT.

It should be noted that EU member states have discretion under the AIFMD to impose stricter conditions on Third Country Managers and, as a result, the conditions referred to above may not be exhaustive.

What next?

At the time of writing, Level 2 still remains unpublished, so it is not possible to be precise on how the EU investment management landscape will form in the future; however, all Managers of Funds should be considering whether they will be subject in any way to the burden of the AIFMD. Many of the additional requirements of the AIFMD, such as reporting and disclosure, are already undertaken as part of the regulatory regime of Third Countries or considered as industry best practice and Third Country Governments are taking steps to

[1] Article 30 of the AIFMD imposes certain restrictions and obligations on a Fund where it, individually or jointly, acquires control of a non-listed company for a period of 24 months following such acquisition, for example, in respect of distributions to shareholders.

ensure that appropriate frameworks for cooperation and exchange of information will be in place in advance of the Transposition Date.

With considerable regulatory infrastructure already in place, it is hoped that, where the AIFMD is relevant, the transition for Third Country Funds and Managers to AIFMD compliance will be smooth without the burdensome excesses of full compliance with the AIFMD. This will not just be to the benefit of Third Countries and the investment funds industry in general, but more importantly for the EU professional investors the AIFMD is designed to protect and Third Countries, such as the Cayman Islands, Bermuda and the British Virgin Islands will continue to provide the kite mark of solid, reputable, regulatory environments in which Managers and their Funds can operate whether those Funds have a focus on the EU or beyond.

Martin Lane
Director

+44 (0)20 7562 0341
martin.lane@conyersdill.com

Kieran Loughran
Director

+44 (0)20 7562 0343
kieran.loughran@conyersdill.com

About Conyers Dill & Pearman

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For more information please contact:
Camon Sit
+1 (416) 682-6071
news@conyersdill.com
conyersdill.com