Impact of the possible extension of the European passport regime on Canadian fund managers

May 25, 2016

Author

André Vautour

Partner, Lawyer

Martine Samuelian and **Virginia Barat**, **JEANTET**

Since July 22, 2013, investment fund managers ("**managers**") in Canada who wish to raise funds from investors located in member states of the European Union (the "**EU**") have had to consider **Directive 2011/61/EU**[1] (the "**Directive**"), dealing with managers of alternative investment funds ("AIFs").

This Directive was adopted following the G20 summits held in London in 2009 and Toronto in 2010, during which the G20 leaders agreed that hedge funds managers should be subject to oversight to ensure that they have properly implemented adequate risk management procedures. The primary aim of the Directive is to protect investors through the harmonization of the rules applicable to fund managers, thereby strengthening the appeal of the European financial centres.

To streamline the market, the Directive also provides for the implementation of a European passport regime which enables European managers to market AIFs throughout the EU, provided they obtain authorization from an EU member state and comply with certain requirements set out in the Directive.

Finally, the Directive also regulates the regime applicable to managers established in non-EU countries ("third countries") in order to "ensure a level playing field between EU and non-EU AIFMs".[2] Indeed, to date, non-EU managers have been hampered by the complexity of marketing without the benefit of a passport, under a regime which is left to the discretion of each EU member state in which they wish to market their AIFs. This situation is set to change in the near future by eventually enabling non-EU managers to benefit from a similar regime to that applying to EU managers who are able to use the European passport regime.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

1. Criteria for the qualification of AIFs

Firstly, it is appropriate to explain the concept of AIF in order to define the scope of the Directive. It seems that the majority of venture capital funds, private equity funds and hedge funds created in Canada should qualify as AIFs under the Directive.

Indeed, under article 4 of the Directive, an AIF[3] consists of any entity which meets all of the following characteristics:

> the entity raises capital from a number of investors with a view to investing it for the benefit of those investors in accordance with an investment policy which is defined by the AIF or its management company;
> the entity is not an undertaking for collective investment in transferable securities (UCITS), that is, neither an investment company with variable capital (*société d'investissement à capital variable (SICAV)*) (i.e. a *société anonyme* (limited liability company) or *société par actions simplifiée* (simplified joint-stock company)) whose sole purpose is to manage a portfolio of financial instruments and deposits) nor a mutual fund (co-ownership of financial instruments and deposits, with no legal personality).

In addition, an entity which has an investment policy governing the terms and conditions for managing pooled capital with a view to generating a collective return for the investors is equated with an AIF.

Thus, based on the foregoing, even traditional private equity funds, which do not normally qualify as investment funds under the Québec *Securities Act*, will be considered to be AIFs under the Directive.

The Directive provides for the eventual ability of any manager established in a third country, i.e. in a non-EU member state such as Canada, to market, in a country of the EU, units or shares of an AIF established in the EU or a third country, in accordance with two separate regimes:

> as of this date, managers from third countries cannot obtain authorization (registration) as an AIFM and cannot therefore invoke the application of the European passport regime. They are therefore subject to the terms of article 42 of the Directive which permits them to market the AIFs that they manage under the so-called "private placement" mechanisms applicable in each of the countries of the EU in which they wish to market their AIFs (we will review these mechanisms in greater detail in a subsequent newsletter);
> under article 67 of the Directive, the European Securities and Markets Authority (the "**ESMA**") was supposed to decide, by July 22, 2015 at the latest, on the possible extension of the European passport regime to managers established in certain third countries (including Canada), in accordance with the terms of articles 37 to 41 of the Directive. However, as regards Canada, this opinion was postponed until June 30, 2016.

This possible extension of the passport regime to managers established in non-EU countries will facilitate the marketing, within the EU, of the AIFs of both EU and third countries by managers from third countries.

Therefore, it is appropriate to outline the solutions that will be offered to Canadian managers on the assumption that the European passport regime provided for in the Directive will be extended to them.

2. The future Passport regime

2.1. Possible extension of the European Passport regime to Canadian managers

The European Passport regime (the "**Passport**") now enables investment fund managers authorized by the regulatory authority of an EU-member state (i.e., managers established in a country of the EU) to create, manage and market funds throughout the EU either through the principle of freedom to provide services (FPS) or freedom of establishment (FE).

Pursuant to articles 37 to 41 of the Directive, this regime ought potentially to have already been

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

extended to the managers in 16 non-EU countries, including Canada, following the receipt of positive opinions from ESMA on the guarantees provided by the legislation in each of these countries. These opinions were expected by July 22, 2015 at the latest,[4] but this deadline was extended by the European Commission to keep pace with the progress in ESMA's work.

Indeed, to date, ESMA has still not completed its analysis of the legislation of all these third countries. However, it already issued an opinion, on July 30, 2015, in favour of extending the Passport to managers located in the islands of Guernsey and Jersey. Switzerland has also received a favourable opinion, conditional upon the removal of certain obstacles. On the other hand, ESMA has reserved its opinion on managers located in the United States, Hong Kong and Singapore.

Regarding Canada, on July 30, 2015, ESMA considered that the current investment fund regulations in Canada were more favourable to the extension of the Passport to this country than those in the United States. In a letter dated December 17, 2015, the European Commission asked ESMA to submit its opinion on Canada by no later than **June 30, 2016**.

Other countries are also expecting to receive ESMA's position by June 30, 2016, namely, the United States, Hong Kong, Singapore, Japan, the Isle of Man, the Cayman Islands, Bermuda and Australia.

It should be noted that when ESMA renders a positive opinion, the European Commission is normally supposed to issue a delegated act within three months stipulating the date as of which the Passport regime will start applying to the managers in the relevant non-EU state. However, at this time, even with respect to countries that have already been the subject of a favourable opinion, the European Commission has not yet issued such a delegated act and has instead chosen to wait until a sufficient number of third countries have been evaluated.

Therefore, as of this date, Canadian managers are not able to market AIF units or shares in countries of the EU using the Passport. However, they may soon have this opportunity since an answer is expected by next June 30. It is therefore important to outline the obligations that would apply to them in the event of the extension of the Passport.

It should also be noted that, pending the issuance of the opinion by ESMA, and should it refuse to extend the Passport regime to Canadian managers, they still have the option of marketing their products either by creating a portfolio management company that is authorized in an EU-member state, or by resorting to the private placement regime (which will be dealt with in a subsequent issue of *Lavery Capital*).

2.2. Obligations applicable to Canadian managers in the event of the extension of the European Passport regime

On the assumption that the Passport regime is extended to Canadian managers, they will be required to comply with all of the requirements set out in the Directive, the main terms of which are outlined below.

a) Requirement to obtain authorization from the regulatory authority of a member state of reference:

To begin, Canadian managers must first apply for authorization (registration) to the competent authority of an EU-member state (the "**member state of reference**").[5]

Paragraph 4 of article 37 of the Directive sets out the criteria for determining this member state of reference (for example, the home member state of the AIF, or the member state in which marketing of the AIF is intended). This article also states that the manager must have a legal representative established in its member state of reference.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

The authorization process for non-EU managers is largely similar to that for EU managers. However, certain additional requirements have been introduced pertaining to the third country in which the manager and/or the AIF is established.

Thus, the manager's application for authorization must be submitted to the competent authority of the member state of reference, which verifies that the manager has properly complied with all the provisions of the Directive. The following are the main requirements for obtaining authorization: (i) comply with the minimum capital requirements, (ii) implement compensation policies and practices, (iii) adopt internal procedures for properly evaluating the assets held by the funds, (iv) appoint a depositary distinct from the manager whose role, among others, is to hold custody of the fund's assets, and (v) comply with the information disclosure obligations owed to the investors and regulatory authorities.

In addition, there must be appropriate cooperation arrangements between the competent authorities of the non-EU state where the manager is established, the competent authorities of the member state of reference, and those of the state where the AIF is domiciled (the AIF's state of domicile), if this is different from the former two. Also, the country where the manager or AIF is established should not be listed as a non-cooperative country or territory by the Financial Action Task Force on anti-money laundering and terrorist financing (FATF).

Furthermore, article 37 of the Directive states that the third country where the manager is established must have signed an agreement with the member state of reference which complies with article 26 of the OECD Model Tax Convention on Income and on Capital, and which ensures the effective exchange of information on tax matters.[6]

Once a Canadian manager obtains authorization, it will then be able to manage and market its European funds throughout the EU under the Passport regime after giving simple notice to each authority in each of the EU countries concerned.

b) Conditions applying to the marketing in the EU, with a Passport, of AIFs managed by non-EU managers

A distinction must be made between marketing to professional and nonprofessional clients.

i. Marketing to professional clients (articles 39 and 40 of the Directive)

In addition to complying with the requirements laid down by the Directive for managers established in EU member countries as outlined above, non-EU managers must also meet additional conditions, where the AIF is established in a third country,[7] similar to those required for the granting of authorization, namely:

> the existence of appropriate cooperation arrangements between the competent authorities of the member state of reference and those of the state in which the AIF has its domicile;
> the country in which the manager is established must not be listed as a non-cooperative country or territory by the FATF;
> the third country in which the AIF is established must have signed an agreement with the member state of reference which complies with article 26 of the OECD Model Tax Convention on Income and on Capital, and which ensures the effective exchange of information on tax matters.

These provisions were transposed to French law in article L. 214- 24-1 of the French *Code monétaire et financier* which requires that prior notice must be given to the Autorité des marchés financiers (France) (the "**AMF**"), and which refers to the provisions of the Règlement général (General Regulation) of the AMF (the "**AMFGR**") for the proper procedure.

No later than 20 business days after receipt of the complete notice, the AMF will inform the manager whether it can start marketing the AIF which was the subject of the notice in France.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

It should be noted that the AMF can only oppose the marketing of an AIF if the management of such AIF by the manager is not or would not be in compliance with the legislative and regulatory provisions applicable to French portfolio management companies.

In the event of a favourable decision, the manager can start marketing the AIF in France as soon as the AMF has given notice to this effect.

The AMF will also inform ESMA and the competent authorities of the country in which the AIF is established of the fact that the manager has been authorized to start marketing units or shares of the said AIF in France.

ii. Marketing to non-professional clients (article 43 of the Directive):

In addition to the obligations provided for in the Directive, non-EU managers benefiting from the Passport regime must also show they are in compliance with the specific conditions contained in article 421-13 of the AMFGR. Accordingly, they must comply with the same prior authorization procedure as required for marketing outside the Passport regime to non-professional clients (which will be dealt with in a subsequent *Lavery Capital* newsletter).

Finally, we note that it should be possible for Canadian managers to be exempted from compliance with certain provisions of the Directive relating to the Passport regime, if they are able to prove:

> firstly, that it is impossible for them to comply both with a provision of the Directive and a mandatory provision of the Canadian regulations;
> secondly, that the Canadian regulations that they are in compliance with contain an equivalent provision to the European regulations offering the same level of protection to the investors of the fund.

It should be mentioned that article 68 of the Directive provides for a transitional period of three years after the extension of the Passport regime to managers in third countries, during which the Passport regime and the national private placement regimes can coexist and be chosen freely and alternatively by managers from these third countries.

At the end of this transitional period and therefore, in principle, once three years have passed, at the latest, after the Passport regime has presumably been extended to Canadian managers, ESMA will have to make a decision on the possibility of allowing non-EU managers to continue opting for the private placements mechanism despite the extension of the Passport regime. In this regard, ESMA will be submitting a new recommendation to the European Commission for purposes of assessing the potential elimination of the national regimes.

Conclusion

Canadian managers registered with one or the other of the Canadian Securities Administrators (including the Autorité des marchés financiers (Québec)) can hope that the Passport regime will be extended to them in the near future so that they can benefit from the advantages offered by this regime.

In the meantime, because of the uncertainty in the timeframe in which a decision will be rendered by ESMA regarding Canada, Canadian managers wishing to market investment funds in EU-member countries have no other choice but to rely on the national private placement regimes of each of these countries, or opt for reverse solicitation where possible. Another Lavery Capital newsletter dealing with the option for Canadian managers of benefiting from these national private placement regimes or the rules of reverse solicitation will be published in the coming months.

---

1. Better known by the acronym “AIFM”, or “AIFMD”, meaning “*Alternative Investment Fund Managers Directive*”.
2. Whereas # 64 of the Directive.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.

3. These provisions were transposed to article L. 214-24 of the French *Code monétaire et financier*. In this regard, we note that there are different types of AIFs under French law meeting these distinct rules, namely:
   - AIFs open to professional investors,
   - AIFs open to non-professional investors,
   - employee savings funds,
   - securitization entities,
   - other AIFs (forestry groups, etc.).
4. See article 67 of the Directive.
5. Registration with a Canadian regulatory authority, such as the Autorité des marchés financiers (Quebec), is not sufficient.
6. Canada has concluded a tax treaty based on the OECD model convention (OECD) with each EU-member state.
7. Article 40, subparagraph 2 of the Directive.

Copyright (c) Lavery, de Billy, S.E.N.C.R.L. - L.L.P.