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Client Memorandum

Much Ado About Nothing (Significant)
ESMA and the Cayman Islands AIFMD Passport

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Recent commentaries by various offshore law firms on the delay by ESMA in extending the pan European passport for marketing the securities of Cayman Islands domiciled funds throughout the EU under the Alternative Investment Fund Managers' Directive ("the Directive") may have over emphasised the importance of the ESMA approval.

Firstly, the relevant statistics. Based on the most recently available figures from the IMF Coordinated Portfolio Investment Survey, EU investors have not historically been and continue not to be significant in terms of investment in Cayman Islands funds and notwithstanding efficacy of the private placement regimes. Most recently available figures from the Cayman Islands Monetary Authority ("CIMA") put Cayman Islands fund AUM at US$2.4 trillion, whilst the IMF figures put portfolio investment in the Cayman Islands at US$1.9 trillion. But even adopting the lower IMF figure, the EU element is only around US$158 billion (post-Brexit) or 8.3% of the aggregate Cayman fund AUM. Luxembourg investors lead at US$58 billion with Ireland at US$34 billion (of the non-EU jurisdictions, Switzerland leads at US$45 billion followed by (post Brexit) the UK at US$22 billion). Thus, investment by EU-based investors in Cayman Islands funds is dwarfed by those jurisdictions where the writ of the EU does not run, the US at US$908 billion, Japan at US$423 billion and Hong Kong at US$331 billion.

If we analyse the figures by jurisdiction of investment, we see that the EU is a net beneficiary of Cayman hedge fund investment as US$365 billion is invested by Cayman funds in the EU through EU situs managers. Interestingly, that figure has dropped by nearly 40% since the introduction of the Directive. This statistic not incidentally makes a mockery of the OECD assertion fundamental to its "Harmful Tax Competition" thesis that offshore financial centres drain capital from high tax jurisdictions.

Secondly, there seems to be confusion in the commentary to date about what it is that ESMA is approving. Whilst CIMA is indeed consulting with the private sector to introduce an alternative regime for Cayman Islands situs fund managers that meets the test laid out in the Directive for investor protection, market disruption, competition and the monitoring of systemic risk, this regime is not likely to be relevant even if introduced in the Cayman Islands and approved by ESMA (it is fair to say that on an objective analysis and absent overarching political influence it should be since it will be based on the recently approved Guernsey alternative regime). It is not likely to be relevant because there are very few fund managers as defined by the Directive based in the Cayman Islands undertaking portfolio investments that are EU-facing.

Indeed, in relation to the 7,600 Cayman regulated funds, there are only 170 Cayman managers based in the EU, the great majority of which are based in London and FCA regulated and would therefore necessarily be duly qualified under the Directive.

This is the point that appears to have been missed in most of the commentary. It is the manager which is regulated under the Directive not the fund, thus Recital (14) of the Directive states in the following terms:

> "*This Directive lays down requirements regarding the manner in which AIFMs should manage AIFs under their responsibility.*"

So too Recital (10) of the Directive explains why it does not seek to regulate funds:

> "*AIFs should therefore be able to continue to be regulated and supervised at national level. It would be disproportionate to regulate the structure or composition of the portfolios of AIFs managed by AIFMs at [European] Union level and it would be difficult to provide for such extensive harmonization due to the very diverse types of AIFs managed by AIFMs.*"

The foregoing analysis might therefore have led to the conclusion that the extension by ESMA of approval to an FCA regulated London based fund manager of a Cayman fund was unnecessary as nothing more needed to be done. But for a quite distinct and partly procedural reason that is not the case. The distinct reason is that Article 67(4) of the Directive requires ESMA first to advise the EU Commission (the "Commission") that, notwithstanding that the focus of its approval with respect to investor protection, marketing disruption, competition and the monitoring of systemic risk (more particularly described in Article 67(2)) is intended by the Directive to be based on a review of the fund manager, nevertheless, Article 67 appears to include the jurisdiction of the fund domicile in the analysis of the application of those matters.

Therefore, until such time as ESMA advises that none of these factors are obstacles in a Cayman Islands fund structure, albeit one managed by a London based fund manager, the Commission will not act to approve the application of Article 35 to the Cayman Islands. And it is in fact, Article 35 which will enable the FCA (being the materially relevant home country regulator for the purposes of the overwhelming majority of EU based managers of Cayman funds) to arrive at the necessary determination that the three factors specified by Article 35(2) are in place, namely (a) appropriate cooperation arrangements, (b) the fund domicile is not FATF blacklisted and (c) appropriate tax information exchange arrangements. It is apparently of no import that in fact all three of these requirements are clearly met and have been regarded as such for the purposes of the private placement regime arrangements (which continue in effect). Nevertheless, the FCA is not yet enabled by Article 35 to arrive at this self-evident determination simply because Article 35 has not yet been triggered by the Commission pursuant to Article 67(6). So much for the single market.

Thirdly, in any event, the ESMA approval is not a pre-condition to managing a Cayman fund out of the UK. With specific structuring, it is possible for a London based fund manager to manage a Cayman Islands fund under the MiFID II regime and avoid the application of the onerous AIFMD restrictions as to leverage, concentration and remuneration, and the involvement of the distributor otherwise required by the Directive (provided the fund is content to rely on marketing by way of reverse solicitation).

Fourthly, the foregoing analysis may well prove to be relevant only for the two year period following the United Kingdom government triggering Article 50 under the Lisbon Treaty after which the UK would be well advised to implement a regime for institutional investment into hedge funds free of the restrictions as to leverage, concentration, risk and remuneration imposed by the Directive.

Lastly, there is a more commercial point. Investors tend to follow yield and, given that Cayman Islands funds are almost exclusively marketed to institutional investors, it is unlikely that an institution seeking investment in a Cayman Islands hedge fund demonstrating superior performance would not have an affiliate in the United States or Asia that could do so in any event and free from the marketing and other restrictions that might otherwise be of application to a Cayman Islands fund managed in the EU pursuant to the Directive.

Accordingly in our view the ESMA passport approval is unlikely to be of much significance to the issue of investment in Cayman Islands funds and much less so than the issue of investment performance of the fund in question. That said, it is difficult to see good reason why ESMA has failed to provide its positive advice to the Commission to trigger Article 35(2).

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Thorp Alberga at any time if you have any specific questions or would like more detail on any of the points made in this Memorandum.