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To consider the EU regulatory principles of passporting and equivalence as applied to financial services firms operating from the Crown Dependencies in relation to the Alternative Investment Fund Manager's Directive and MiFID II and to consider the implications for systemic risk management and macro-prudential supervision

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1. Abstract

This paper will discuss the rise of equivalence as an assessed precondition for third countries to access the European Union financial markets. Following the financial crisis there has been a raft of EU financial regulation, often with extraterritorial reach. The Alternative Investment Fund Manager's Directive and the Markets in Financial Instruments Directive and Regulation will be considered in detail, after which consideration of the evidence provided by ESMA in relation to the functioning of the AIFMD passport within the EU and the extension of the AIFMD passport outside the EU will be outlined. Despite the lack of evidence to suggest that the parallel banking system either caused or exacerbated the financial crisis, regulation of hedge and private equity funds and over the counter derivatives intensified following 2009 and access to the European markets could be severely curtailed by the extraterritorial imposition of EU regulations. Ostensibly the new regulations have been designed to prevent systemic risk spreading to the system from poorly regulated third countries, and to mark a departure from home state control. However, having examined the Jersey and Guernsey assessments, it will be argued that the prevention of systemic risk is no longer the main concern when assessing equivalent regimes, where market access and reciprocity are key. ESMA will also be shown to have considerable power in determining whether equivalence is determined against rules or principles.

2. Alternative Investment Fund Managers Directive

2.1 Rationale and History

The Alternative Investment Funds Managers Directive ("AIFMD") forms part of the European Union's regulatory response to the financial crisis of 2007/8, and "aims at establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the union".[1] The legislation was born of the de Larosiere report[2] which recommended that the parallel banking system be considered as a possible source of systemic impact[3], despite acknowledging that in their view the hedge fund industry did not "play a major role in the emergence of the crisis."[4] Prior to the financial crisis and the recommendations of de Larosiere the parallel banking system was not deregulated, and was subject to the first Markets in Financial Instruments Directive and the market abuse regime. Moloney notes that in 2010 80% of hedge funds and 60% of private equity funds were regulated by the UK's Financial Services Authority[5]. However, despite this, de Larosiere was concerned about leverage, a lack of transparency and banks with retail customers engaging in proprietary trading without capital requirements being enforced. These opinions form the basis of Recommendation 7 of the report. Prior attempts to regulate the

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[1] Council and Parliament Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L174/1 Recital (2)

[2] Jacques de Larosiere et al, '*The High Level Group on Financial Supervision in the EU*', (Brussels, 25 February 2009)

[3] Ibid. Para 86

[4] Ibid.

[5] Niamh Moloney, *EU Securities and Financial Markets Regulation,* (OUP, 3rd Edition, 2014), p. 275

industry had been made by France and Germany prior to the crisis, with France's Sarkozy seeking to tax hedge funds in 2006 and Germany calling for codes on conduct and transparency requirements at the May 2007 G8 meeting, where he met with transatlantic opposition[6]. It is unsurprising, therefore, that once a recommendation had been made for EU wide regulation, Germany and France were eager to ensure that it came to fruition in the form of a Directive. It is worth noting de Larosiere's stipulation though, that the US should adopt a similar set of measures[7] and any regulation should be both 'appropriate' and 'proportionate'[8].

The AIFMD was entered into the Official Journal on the 8th June 2011, with a view to being fully transposed into Member States law by July 2013, with a transitional period until July 2014. However, in reality the Directive did not become transposed into all Member States until the end of July 2014 so has currently been in effect for 2 years.

Alternative Investment Funds (AIFs) are classified as all Collective Investment Schemes not covered by UCITS (Recital 3), which includes hedge funds and private equity funds but also covers real estate funds and venture capital. AIFs are by their nature not available to the retail market. The AIFMD is a wide ranging piece of legislation which regulates all AIFMs based in the EU, whether the funds they manage are marketed in the EU or not, and any AIFMs who seek to market Non-EU AIFs in the EU to European investors. However, the rules are complicated and essentially provide for 4 situations: EU AIFMs managing an EU AIF; an EU AIFM managing a Non EU AIF; a Non EU AIFM managing an EU AIF; and finally a Non EU AIFM managing a Non EU AIF (together, the "Fund Classes").

2.2 Marketing of EU AIFS in other EU countries

Since July 2014 the regime has been effective across Member States for EU based managers managing and marketing EU funds, and since that date an EU AIFM requires authorisation from its National Competent Authority in order to manage and market an EU or Non EU AIF within its home country. Once authorised, EU AIFs can theoretically be marketed across the EU subject to a simple notification process.

At present the EU-wide passport is only open to authorised EU AIFMs marketing EU AIFs.[9] The remaining three Fund Classes currently have three options if they wish to market an AIF within the Union. The AIFM can either establish a subsidiary fund based in the EU, in which case the passport would become available; use the national private placement regime (NPPR), or they can circumvent the legislation via reverse solicitation. At the time of transposal it was anticipated that the passport would be extended to the remaining three Fund Classes after July 2015, two years after the passport became available to those EU AIFs managed by EU AIFMS. ESMA was tasked with producing an Opinion on the functioning of the passport and the NPPRs and Advice on the extension of the passport

[6] Ibid, page 275, n. 505.
[7] Note 2, para. 87
[8] Note 2, Recommendation 7
[9] Note 1, Articles 31,32

to third countries by this date[10]. Were ESMA to conclude "that there [are] no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk, impeding the application of the passport to the marketing of non EU AIFs by EU AIFMS in the Member States and the management and/or marketing of AIFs by Non EU AIFMs"[11] then it would be required to issue positive advice to the Commission. On receipt of said positive advice, the Commission is required to adopt the rules relating to the extension of the passport to third countries[12] within three months.

Accordingly, the earliest that the third country passport was envisaged to be available was October 2015. The AIFMD anticipates that the NPPRs will run concurrently with the AIFMD for three years after the extension of the passport, therefore allowing a dual regime to run until 2018, at which point all Fund Classes would be eligible for the passport and the varying NPPR rules would become defunct.[13]

In July 2015 ESMA issued its Advice[14] and its Opinion[15]. Most notable is the decision of ESMA to only consider the extension of the passport to 6 jurisdictions; the United States, Jersey, Guernsey, Switzerland, Hong Kong and Singapore. Therefore, the extension of the passport to third countries has become a de facto assessment of equivalence, which was not envisaged in the Directive. The Commission does have statutory authority to extend the deadline for the Advice and Opinion, however, as noted by Modrall et al[16], the Advice as published creates "significant legal uncertainty". Through taking a decision to assess the extension of the passport on a country by country basis, ESMA is effectively determining whether a third country's regime can be classed as equivalent. This being the case, extension of the passport may be recommended to third countries in a piecemeal fashion; this is not how the legislation was drafted. There is no legal provision for the passport to be extended in tranches, and if positive advice is received, there is no legal provision for the extension of the passport to be delayed. The Chairman of ESMA claims that the timetable for transposition of the AIFMD was delayed, stating that "for a number of reasons the Level 2 measures were in fact not published in the Official Journal until March 2013, only four months before the transposition deadline"[17].

2.3 ESMA's Opinion on the functioning of the passport – a harmonised approach?

The Opinion focuses on the functioning of the passport for EU AIFs managed by EU AIFMs and the effectiveness of the NPPR regime for the other three Fund Classes. The former have to abide by the Directive in its entirety and have no other option to market. All four Fund Classes, whether passported

[10] Note 1, Article 67
[11] Note 1, Article 67(4)
[12] Note 1, As detailed in Articles 35 and 37-41
[13] Note 1, Recital 4
[14] ESMA, 'Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to Non-EU AIFMs and AIFs', 30 July 2015, ESMA/2015/1236
[15] ESMA, 'Opinion to the European Parliament, Council, Commission and responses to the call for evidence on the functioning of the AIFMD EU Passport and of the National Private Placement Regimes' 30 July 2015 2015/ESMA/1235
[16] Modrall, Garner and Punia '10 things to know about the AIFMD Third Country Passport ' <www.nortonrosefulbright.com/knowledge/publications/131254/10-things-to-know-about-the-aifmd-third-country-passport> accessed August 2015
[17] Steven Maijoor, Speech to the Economic and Public Affairs Committee, 13 October 2015 ESMA/2015/1535

or relying on the NPPR are required to produce an annual report, report to the National Competent Authority, manage their leverage limits and abide by the regulations governing asset stripping, aimed at private equity funds. Those additional areas which are regulated as requirements for the AIFMD passport include capital adequacy requirements, operating conditions, remuneration, conflicts of interest, risk management, liquidity management, rules governing securitisation positions, organisational requirements, valuation, delegation and the appointment of a depositary. Furthermore, Member States are able to stipulate further requirements for private placement in addition to the minimal regime outlined in the AIFMD.

With regards to the functioning of the passport, ESMA "is of the view that there is insufficient evidence to indicate that the AIFMD EU passport has raised major issues in terms of the functioning and implementation of the AIFMD framework"[18], however, a review of the call for evidence would suggest otherwise. Many respondents reported that, despite the notification procedure detailed in the Directive, many Member States had "introduced additional requirements"[19], establishing de facto authorisation regimes. The aim of the AIFMD was "establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach" however, the gold-plating of the AIFMD notification process has failed to achieve this. The fees charged across the Union vary significantly, and how they are devised and paid is also a matter of confusion. According to one respondent Austria charge 1000 EUR per AIF for processing, plus 220 EUR per sub fund and an additional 600 EUR per annum thereafter. France charge 2000 EUR per processing the passport notification and 216 EUR per amendment, Spain initially did not charge fees, but notified in July 2015 that it intended to apply them in future[20]. Notwithstanding, the time taken before marketing can commence differs between Member States, the passport notification documents which are listed in Annex IV to the Directive are not uniformly applied, and not all states have devised and issued notification templates. Where notification templates have been issued, respondents have reported that they differ widely, therefore making the provision of one set of information a fallacy.[21] One respondent noted that "the UK, the Netherlands and Ireland…honour passport notifications from other Member States without imposing additional requirements or fees or requiring additional time"[22], yet it would appear these countries are in the minority. France has chosen to insist that the AIF appoint a correspondent bank for each AIF to be marketed, and whilst the Directive allows for the imposition of additional rules for EU AIFMs marketing EU AIFs to retail clients, such additional requirements are not acceptable when marketing to professional investors[23].

A lack of definitions within either the Level 1 or Level 2 measures has also been identified. The meaning of 'marketing' has been interpreted differently across Member States, resulting in a situation whereby AIFMs are unsure whether or when they are required to notify the host state; for example, one state

[18] Note 15, Opinion, 1.1, (8)
[19] Note 15, Opinion, Annex 1, 53
[20] Note 15, Opinion, 56 i, ii, v
[21] Note 15, Opinion, 53
[22] Note 15, Opinion, 59
[23] Note 15, Opinion, 93

considered marketing to be defined as any contact with a potential investor, whilst another considered presentation of the subscription document to the investor as the first element of marketing, at which point contact may have been continuing for some time[24]. This is of particular importance with regard to closed end funds, where documentation is often not produced until likely interest has been evaluated. Therefore, in some countries this would be interpreted as marketing and notification to the state would have to have been approved (Germany), whereas in the UK this behaviour is considered pre-marketing, and is allowed to take place prior to authorisation and notification, as the AIF may not yet be in existence. Other definitions lacking in the Level 2 rules are 'material change', which also has to be notified to the host state, and what constitutes a professional investor: in France a professional investor is an investor of over 100,000 EUR, whereas in Germany any investor of under 200,000 EUR is a semi-professional investor. Accordingly, as part of the supposed notification regime, BaFin has requested that the rules of the French fund be altered to fit German legal definitions[25]. Shockingly, one respondent confirms that BaFin charge different amounts depending on the jurisdiction in which the AIF is based[26]. These anomalies, in conjunction with the requests for further information and the imposition of additional requirements by host state regulators, do not suggest that the AIFMD passport is working effectively for EU AIFMs marketing EU AIFs across the Union. In addition to the administrative and notification fees charged across the EU, and the considerable costs of appointing a centralised paying agent, such legal and regulatory uncertainty requires the appointment of external counsel to establish the rules in each jurisdiction, which appears to fundamentally contradict the purpose of the primary legislation.

Indeed, one response to the call for evidence recognised that administrative fees were to be expected, but only if they were "reasonable, proportionate and justified": it seems that AIFMs recognise that the passport regime has become "unnecessarily politicised, and many Member States appear to be attempting to restrict the free flow of capital with the imposition of 'border controls'"[27].

2.4 ESMA's Opinion on the functioning of the NPPRs

Given that the Directive does not allow for the gold-plating of the passport standard, ignored by many Member States, it is unsurprising that the NPPRs also differ greatly, as Member States are free to impose any rules they wish in addition to those stipulated in the Directive with which all third country AIFs and AIFMS must comply.

Whilst certain countries have refrained from any additional requirements to those stipulated in the AIFMD, namely the UK, the Netherlands, Ireland, Belgium and Luxembourg, other countries have exercised the freedom to impose more stringent requirements for national private placement. In some cases these are excessive, and can be seen as a barrier to trade. Denmark is prohibitively expensive, with application fees and annual supervision fees of 5000 EUR apiece, and additional depositary and

[24] Note 15, Opinion, 101
[25] Note 15, Opinion, 152
[26] Note 15, Opinion, 77
[27] Note 15, Opinion, 113

publication requirements[28]. Authorisation in Germany may take up to 5 months, requires the appointment of a local legal advisor, additional evidence regarding how retail clients will be circumnavigated, the appointment of a local tax agent and application and supervision fees of 6,852 EUR each. One respondent estimated the total costs of registering in Germany to be in the region of 60,000 EUR[29]. France has introduced an NPPR regime which requires that the Non EU AIFM comply with the same rules as the AIFMD, effectively absenting itself from the NPPR process; in this situation, surely a fund manager would seek to establish a subsidiary in France, or perhaps elsewhere within the Union, in order to have access to the passport. Italy also has failed to implement an NPPR regime, and Spain requires such further information on equivalence of the home state as to be prohibitive.

The requirements differ vastly across the states, from the imposition of fees to equivalence and appointment of various local agents, and establishing the precise rules when looking at a new market is also prohibitive. Annex IV to the AIFMD details the filing requirements, but as there are no standardised templates, and Member States differ over the application of the requirements, in effect Annex IV is defunct and the individual Member States have individual requirements. There have been no templates issued by ESMA and some states have produced no guidance at all in relation to their addition requirements or their Annex IV reporting. In direct contravention of Article 22, one respondent reported the host state demanded equivalent auditing standards[30]. Perhaps more astounding, is the additional requirement that the third country "grants reciprocal marketing access to funds from that Member State"[31], which would suggest that investor protection and systemic risk were not the main concerns of the host member state in this instance.

In addition, a complete lack of understanding regarding the application of reverse solicitation, as can be found with the functioning of the passport, also haunts the NPPR system.

Given this smorgasbord of unidentifiable additional requirements, it is important to consider how this assortment of schemes affects both the market and the investor. Respondents to ESMA's call for evidence report that the current "patchwork of rules"[32] have resulted in the largest funds targeting the least onerous environments, which has resulted in the investors in the UK, Netherlands et al having access to a wider range of fund and investment choices than those based under the more stringent regimes. Furthermore, this has led to increased concentration risk for those funds which have an unusually high level of exposure to those markets, and vice versa. Not only have residents of Spain, France, Germany and Italy effectively been denied access to any third country alternative investments, smaller investment funds who are unable to navigate the confusion are denied access to European investors due to either an inability or unwillingness to pay for external legal counsel. By allowing Member States to gold-plate the NPPR regime, access to alternative investment funds across the

[28] M Flint, M Cornish 'The Alternative Investment Fund Managers Directive' MJH Hedge Insight <http://mjhudson.com/emailers/hedge-insight-aifmd.htm> accessed 12 July 2016

[29] Note 15, Opinion, 193
[30] Note 15, Opinion, 219
[31] Note 15, Opinion, 219
[32] Note 15, Opinion, 211

European Union is anything but uniform, and may even result in lower returns for public investment funds, insurers and pension funds in those more onerous countries, increasing the cost to the citizens purse.[33]

From an international perspective, it has been argued that the NPPR process hinders cross-border investment and is in contravention of Principle 6.2 of the G20 High-Level Principles of Long Term Investment Financing[34], which seek to avoid unnecessary barriers to international investment. Moreover, one respondent argued that some NPPRs were also in violation of Article 63 of the Treaty on the Functioning of the European Union, which establishes that "all restrictions on the movement of capital between the Member States and third countries shall be prohibited".[35] This is hard to deny. Surveys carried out by the industry would appear to establish that this is indeed the case, with a 2014 Prequin Report[36] finding that 71% of US fund managers believe that the regulations will negatively affect the industry, with 40% stating that they would not seek to market in the EU. Of the 12% stating that they were planning to use the private placement regimes, only 9% sought to establish a presence in 5 or more Member States, and 37% stated that they would seek to market in the UK alone. This is concerning, as the greater the choice of funds, the lower the level of concentration and systemic risk, so it appears that the AIFMD is inherently forcing the situation it was supposedly aiming to avoid. Another apposite point relates to the incomparability of Annex IV reporting, which, until standardised, is inoperable as a means of evaluating systemic risk across the EU.

Despite these criticisms of the NPPRs, in the majority of cases they are still less onerous than the AIFMD as applied to EU AIFMs. For this reason, many third country fund managers who have identified their investor base in one or two Member States are eager to utilise the regimes. Although it was envisaged that access to the NPPRs would be cancelled in 2018 after a three year dual regime, the delay and confusion relating to the extension of the passport has resulted in calls for the NPPR process to remain open for those countries to whom the passport is not extended, and also, to be retained concurrently ad infinitum even for those countries granted admission to the passport to ensure market access for those smaller funds which only seek to market in one or two Member States. The decision to assess de facto equivalence and extend the passport to a country or countries on a 'tranche-basis' has resulted in an NPPR regime which may be relied upon for longer than anticipated, and also, one that may be becoming more attractive as the issues and gold plating regarding the AIFMD proper become clear. ESMA have issued no information relating to access to the NPPRs after 2018 should the third country not receive a passport by this time. Furthermore, sub-threshold EUAIFs, which have chosen not to opt in to the full AIFMD regime and have exercised the exemption detailed in Article 3(2)

[33] Note 15, Opinion, 277

[34]G20 High Level Principles for Long Term Investment, <http://www.oecd.org/finance/private-pensions/G20-OECD-Principles-LTI-Financing.pdf>, accessed 9 August 2016

[35] Consolidated Version of the Treaty on the Functioning of the European Union, [2007] OJC326/47

[36] Prequin, 'Global Hedge Fund Managers Respond to AIFMD' July 2014, <https://www.preqin.com/docs/reports/Preqin-Special-Report-Hedge-Fund-Managers-Respond-to-AIFMD-July-14.pdf> accessed 4 August 2016

of the Directive, are also unable to access the passport, and can only utilise the NPPRs when seeking to market within the Union. Given the above, it is unsurprising that upon issuing this Opinion and Advice, ESMA requested more time.

2.5 ESMA's Initial Advice

On the basis of the call for evidence upon which the above Opinion was based, ESMA issued its Advice on the extension of the passport to six third countries (Jersey, Guernsey, the U.S., Hong Kong, Switzerland and Singapore) concurrently in July of 2015. It had been anticipated that this Advice would recommend that the passport be extended to those states deemed to have regimes which were in accordance with Article 67(4), specifically "Where ESMA considers that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk". In the Advice ESMA establishes a selection of criteria for each of these four areas against which the jurisdiction will be measured, these will be discussed in more detail where appropriate in the following section.

In addition to the above criteria, the passport could not be extended to a jurisdiction unless it also complied with the requirements of Articles 35 (EUAIFM/Non EUAIF) and 37 (Non EUAIFM/Non EUAIF). These refer to i) the existence of a co-operation agreement between the third country and the home Member State or Member State of Reference, ii) whether the third country is listed as a non-co-operative country by the Financial Action Task Force and iii) whether a tax agreement has been signed by both the third country, home Member State or Member State of Reference and any countries within which the AIF is to be marketed. Each of these Article 35 and Article 37 stipulations have been met by both Jersey and Guernsey.

2.6 Jersey

The Jersey Financial Services Commission (JFSC) established the Alternative Investment Finds (Jersey) Regulations 2012 and these were issued and came into force in July 2013. The Regulations seek to provide an opt-in regime for Jersey based AIFMs/AIFs so that they could devise funds which were already compliant with the AIFMD with a view to the passport being extended to Jersey and those funds so authorised in July 2015. It is interesting to note that the JFSC managed to devise and issue their regulations within the deadline set for the initial transposition of the AIFMD, a feat not achieved by several Member States. The Jersey regulations essentially mirror the European Directive, although they do differ in relation to the custody and remuneration disclosure requirements. ESMA established that the relevant memoranda of understanding had been signed and deemed to be working effectively. With regard to the depositary requirement, Jersey noted that for an extension of the passport, Jersey based funds and managers would need to abide by the depositary rules in addition to the Jersey Regulations, and with regard to remuneration, the JFSC had agreed to reconsider the reporting requirements in the light of the European Directive. The depositary requirements in the AIFMD form a central tenet of the investor protection mechanisms, and accordingly are important when assessing third countries against the Article 67(4) criteria. With regard to market disruption, ESMA asks whether "the granting of the passport to the non-EU AIFMs and AIFs unduly undermine the activity of the existing EU AIFMs due to differences in the regulatory environment in the non-EU country and allow them to change their operating arrangements so as to circumnavigate the AIFMD?".[37]This is an interesting question – essentially ESMA is trying to establish whether, if Jersey were to be granted the passport, EU AIFs and AIFMs would move operations to Jersey because the regime was less onerous and therefore funds and fund managers who *should* be applying the full AIFMD would be able to lever a market advantage by relocating their business in Jersey. Jersey has applied a mirror regime, and has agreed that where the Jersey Regulations deviate from the AIFMD, the Directive's rules on remuneration and depositaries shall apply. This makes the question a moot point, and indeed, ESMA do not even publish a response to it, merely noting that an extension of the passport to Jersey would likely result in a wider range of funds being available to EU investors.

However, in the preamble to the advice, ESMA repeatedly state that a positive recommendation should not be taken as an assessment of equivalence: in relation to investor protection, ESMA is quick to point out that it is the role of the Member State of Reference to establish whether the AIFMD rules are obeyed or not[38], which makes one wonder why they are assessing the third country provisions at all. Furthermore, ESMA notes that "while it would not be appropriate to require … that there be a minimum degree of equivalence between the regulatory framework of the third country and the AIFMD, it is nevertheless relevant and necessary to investigate the extent to which the regulatory framework of the non-EU third country differs from the AIFMD"[39]. This seems to be a circuitous argument, as on those occasions where the Jersey Regulations are not equivalent, ESMA has extracted a reassurance that the AIFMD rules will therefore apply, both with regard to depositaries and, if the Jersey Regulations are not changed, then with regard to remuneration disclosure also.

With regard to obstacles to competition, Jersey extends the same access to market to third countries as it does to national AIF/Ms and therefore no reason to deny the passport can be found here. The final Article 67(4) matter for consideration is systemic risk which is to be assessed against whether there is "tangible evidence of adequate surveillance of market developments with a view to tracking systemic risk" and an assessment of how the regulatory regime complies with IOSCO Principle 6[40]. Given the importance of managing systemic risk to the origination of the AIFMD one could be forgiven for expecting a considerable discussion on the mechanisms and manners in which the third country acquired systemic risk indicators, standardised macro-prudential data and evidenced application of IOSCO principle 6. It is therefore surprising that the assessment of systemic risk management in Jersey is succinct "ESMA is of the view that Jersey has frameworks in place for addressing systemic risks. Reporting obligations in Jersey are similar to AIFMD reporting obligations."[41] This is an interesting assessment. Principle 6 of the June 2010 'Objectives and Principles of Securities Regulation'[42] states

[37] Note 14, Advice, 95(a) (Jersey)
[38] Note 14, Advice 17(1)
[39] Note 14, Advice 20
[40] Note 14, Advice 95 (a) (b)
[41] Note 14, Advice 98
[42] International Organisation of Securities Commissions, '*Objectives and Principles of Securities Regulation*', June 2010

that "The regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate." Jersey was most recently the subject of a Financial System Stability Assessment in September 2009[43]. The Main Recommendations list as a High Priority that Jersey should "seek to develop mechanisms to receive early information on financial strains" and to "develop capacity to assess overall financial system soundness, including through stress testing."[44]The report notes that the number of collective investment schemes and the assets under management have been increasing, with the sector aimed at alternative investments for institutional and high net worth individuals, yet the total assets under management of these are not stipulated[45]. The report continues to recommend that Jersey "develop its capacity to assess overall financial sector stability"[46] and notes that "there is no authority with an explicit mandate to maintain overall financial stability"[47]. Additionally, the report notes that funds regulation had been reformed to make the business more attractive, and that as at 2009, funds designed to attract institutional and larger private investors were considered by authorities "to be outside the scope of IOSCO principles relating to CISs."[48] Most interestingly, the Table detailing implementation of the IOSCO principles[49] is based on the implementation of the 2003 IOSCO principles. The 2003 IOSCO principles[50] do not include Principle 6 relating to the management of systemic risk, this Principle was a 2010 edition addition, and therefore not a marker against which Jersey has been measured.

2.7 Guernsey

The Guernsey Financial Services Commission have likewise introduced an opt-in regime for Guernsey AIFMs. The AIFMD Rules 2013 and AIFMD (Marketing) Rules 2013 are mirror legislation and came into force in early 2013. As in Jersey, the rules are slightly different in relation to the depositary; with regard to remuneration Guernsey has transposed Article 13 directly from the AIFMD and recognises that the depositary rules from the EU AIFMD would apply should a passport be granted. The 2015 ESMA Advice considers the application of the IOSCO Principles 10 -11 in relation to Investor Protection and states that Guernsey received "positive outcomes at that time." (IMF – not published the Appendix) Again, ESMA found no threats to market disruption, nor obstacles to competition given that the regulations are a mirror regime and EU AIF/Ms are welcome to market under the same rules as Guernsey nationals. With regard to the assessment of systemic risk provision, the ESMA Advice states "ESMA is of the view that Guernsey has frameworks in place for addressing systemic risks. Reporting obligations in Jersey (sic) are similar to AIFMD reporting obligations". Perhaps this typographical mistake is demonstrative of the care taken by ESMA in assessing systemic risk management in

[43] International Monetary Fund, '*Jersey: Financial Sector Assessment Program Update – Financial System Stability Assessment'* September 2009, IMF Country Report No. 09/282
[44] Ibid. p8
[45] Note 43, Jersey FSAP Table 1
[46] Note 43, p18
[47] Ibid.
[48] Note 43, para. 23
[49] Note 43, Table 20
[50] Note 42, IOSCO 2003

Guernsey. The 2011 Guernsey Financial System Stability Assessment Update[51]recommends that Guernsey "establish a forum devoted to monitoring financial stability and coordinating policy responses"[52] as a high priority, and later states that "there is scope for the GFSC to further develop its work on financial stability analysis"[53]. The 2011 Guernsey FSAP confirms that the 2003 IOSCO principles have been 'substantially implemented', however, as with Jersey, Principle 6, as relating to systemic risk monitoring, was not a given principle at this time.

In July 2015, ESMA's advice in relation to Jersey and Guernsey was that there were "no significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risk impeding the application of the AIFMD passport"[54]. However, this did not translate into a recommendation that the passport be extended to these jurisdictions. ESMA suggested to the Commission that they wait until a "sufficient number" of non EU jurisdictions had received positive advice before the legislative procedures to extend the passport detailed in Articles 67(5) and (6) be triggered[55]. The Commission agreed that a country by country approach was preferable, and agreed to decide when a sufficient number of countries had been positively assessed[56]. The Commission requested that a second set of Advice be produced by 30 June 2016, focussing on the countries already assessed and a further 6 countries not yet considered.

2.8 ESMA – July 2016 Advice

ESMA's subsequent Advice[57] was published in July 2016, and the explanation of the assessment criteria includes several interesting caveats. With regard to the IOSCO principles 10-12, which relate to Investor Protection, ESMA determined that only FSAP reports dated later than 2013 were relevant to these criteria. Should the latest FSAP have taken place prior to 2013, as is the case for both Guernsey and Jersey, then follow up questions should be sent and effectively these criteria would be self-assessed. ESMA continues to explain the limitations of such self-assessment, confirming that these are effectively sub-standard to an FSAP review as they "could not include extensive research, on-site interviews and/or visits to cross check information"[58]. In accordance with the above, both Jersey and Guernsey received the follow-up questionnaire in relation to the application of IOSCO Principles 10-12, which relate to regulatory powers of securities regulators. Both the JFSC and GFSC completed the self-assessment and answered all questions positively, however, ESMA do reiterate that this assessment of investor protection is subject to desk-based limitations. Despite the fact that FSAPs that have taken place in 2009 rely on the 2003 IOSCO principle, thereby not assessing provision for managing systemic risk (Principle 6), there is no mention of this in the 2016 ESMA Advice under the

[51] International Monetary Fund, '*Guernsey: Financial System Stability Assessment – Update*' January 2011, IMF Country Report 11/1
[52] Ibid. Table 1
[53] Ibid. para 37
[54] Note 14, ESMA Advice, pages 30 and 35
[55] Note 14, ESMA Advice, para 12
[56] Letter from the European Commission to ESMA (7 December 2015)
[57] ESMA, 'Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to Non-EU AIFMs and AIFs', 18 July 2016, ESMA/2016/1140
[58] Ibid. para 23

'Monitoring of Systemic Risk' criteria, and once again, the Advice in relation to the extension of the passport to both Guernsey and Jersey is unchanged, however, whilst there are still no significant obstacles, there is still no clear suggestion as to when the passport may be extended.

2.9 Isle of Man

The Isle of Man was assessed for the first time in the 2016 Advice and, unlike the other crown dependencies, has not taken the opportunity to adopt opt-in mirror AIFMD legislation. Whilst the necessary memoranda of understanding have been established, the other requirements are distinctly lacking. Depositary requirements only exist in the Isle of Man for funds available to retail investors and remuneration requirements are principle rather than risk based. In addition, the Isle of Man has not been subject to an FSAP IMF report, even prior to 2013, and accordingly only self-assessment against IOSCO principles 10-12 has been performed, again with the paragraph 23 caveat from ESMA that this information has not been validated. There is little concern with regard to market disruption, but with regard to competition, any retail fund wishing to market within the Isle of Man must obtain recognition from the Isle of Man Financial Services Authority ("IOMFSA"). At present, those funds from 'designated territories' are able to achieve recognition; however, the IOMFSA has indicated that it would be happy to extend designated territory status to the EEA area[59]. Although the Isle of Man has a small economically active population, only 44,609 in 2011[60], it is becoming clear in the assessment criteria of the 2016 Advice that the Obstacles to Competition criteria are increasingly being interpreted as a means of ensuring reciprocal market access before extension of the passport.

3. MiFID II

3.1 MiFID I

The first Markets in Financial Instruments Directive was introduced in 2004 (MiFID I) and came into force in 2007. MiFID I was based on the 1993 Investment Services Directive and sought to ease the cross border provision of investment services and investment firm regulation. Accordingly, the Directive was applicable to "investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms many futures and options firms and some commodities firms."[61] The directive was recast following the financial crisis and replaced with both a Directive[62] (MiFID) and a Regulation[63] (MiFiR) (together, "MiFID II") in 2014 following a lengthy consultation process which began in 2010. Given the complexity of the legislation it is now due to come into force in 2018. Under MiFID I, access to European markets by third country investment firms was managed by the Member States, and whilst the aim of

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59 Note 57, para 313

60 The Isle of Man in Numbers, 2016, Cabinet Office, <https://www.gov.im/media/1350838/2016-02-19-isle-of-man-in-numbers-2016-report-final.pdf> accessed 11 August 2016

61 Guernsey Financial Services Commission, <www.gfsc.gg/Investment/Guernsey%20and%20the%20EU%E2%80%99s%20MIFID%20II/Pages/Overview.aspx> accessed 14 July 2016.

62 Council and Parliament Directive 2014/65/EU of 15 May 2014 on Markets in Financial Instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) [2014] OJ L173/349

63 Council and Parliament Regulation 600/2014 of 15 May 2014 on Markets in Financial Instruments and amending Regulation (EU) No 648/2012 OJ L173/84

MiFID I was to ease the provision of cross border services within the EU, the extension of a harmonisation regime to third country providers was not included. Each EU Member State decides its own rules on access to the market for third countries and, providing that preferential treatment is not given to a third country over an EU firm, the Member State was free to make its own rules. In the UK, access for third country firms is currently available via the Overseas Persons Exemption detailed in Article 72 of the Financial Services and Markets Act (Regulated Activities) Order 2001, which excludes a third country firm from requiring authorisation under the s19 of the FSMA.

3.2 Third Country Firms and Passporting under MiFID II

MiFiD II has changed the access requirements for third country firms, however, the final rules have been the subject of considerable debate and consternation. As with MiFID I, access to clients in the EU is based upon classification of investor. Under MiFID II there are four classifications of investor; retail, elective professional, per se professional and eligible counterparty. Access to per se professional clients and eligible counterparties will be available on a passported basis across the EU to third country firms, via one of two regimes. Access to retail and elective professional clients is not possible on a cross-border EU passport basis.

The first means of passporting to eligible counterparties and per se professional clients is detailed in Article 46 of MiFIR[64]. This route requires the third country firm to register with ESMA, that the third country jurisdiction has been assessed as ‘equivalent’, that the firm is authorised in its home member state to provide those services and that co-operation agreements are in place between ESMA and the third country. Access to retail clients is governed by Article 39 of MiFIR. Third countries are given the option to establish a branch regime, or not. Should a Member State choose not to opt in to the branch regime, then Member State rules will apply; however, should the Member State choose to introduce the branch regime, then the rules as detailed in the Regulation will apply. The UK has already established that it does not wish to implement the branch regime, which will enable third country firms to access retail clients in the UK without having been assessed for equivalence and without establishing a branch. However, if a third country firm has already established a branch in accordance with Article 39, then this branch can be used to passport services to professional clients and eligible counterparties across the Union, if the third country has been assessed as equivalent.

3.3 Article 47 and the assessment of equivalence

Equivalence will be assessed in accordance with Article 47 of MiFIR. A decision of equivalence will be determined by whether “the legal and supervisory arrangements in the third country ensure that firms authorised in that country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements of [MiFID II].” [65] The prudential and business conduct framework will be assessed against ongoing supervision requirements, own capital requirements, “appropriate requirements applicable to shareholders and their management body”[66], internal controls,

[64] Regulation (EU) 600/2014
[65] MiFIR Article 47, 1
[66] Ibid. 47, 1 (b)

conduct of business and the prevention of insider dealing. Most interesting is the requirement that the third country framework must provide for an equivalent regime for recognising EU investment firms, a de facto reciprocity agreement. It is also interesting to note that there is no mention of systemic risk in the equivalence decision as detailed in Article 47, however, in Recital 44 of the Regulation it states that the equivalence decision will be based on the G20 principles, and the management and mitigation of systemic risk is stipulated.

3.4 MiFID II – Jersey Consultation

The JFSC issued a consultation paper in April 2016[67] relating to whether or not Jersey should attempt to gain a positive decision of MiFID II equivalence. Whilst the AIFMD enabled the crown dependencies to choose whether to introduce an opt-in regime which could run concurrently with their existing fund regulation structure, the level of regulation imposed by MiFID II would result in considerable changes to the Jersey Codes of Practice. Such is the level of complexity that the Jersey regulator had already determined that either a comprehensive reorganisation of the regulatory space was required or alternatively equivalence not be sought: "The consultation paper proposes that a Jersey MiFID II equivalent regime would apply to all clients, irrespective of EU residency. The rationale behind this is reduced complexity for both the industry and the Commission from operating one regulatory regime, equal treatment of clients, and because, based on feedback received to date, it appears to be industry's favoured option. In addition, *the Commission understands that the European Commission may demand it as a condition of equivalence*."[68] This is an interesting aside which will be considered in due course.

The JFSC note that there are three main unknowns relating to the MiFID II third country regimen. With regard to the MiFID harmonised branch, it is still unclear which Member States are likely to insist on the establishment of a branch to access retail clients and professional clients. It is probable that the more closed economies of the EU, those which had extremely onerous NPPR regimes under AIFMD, are also likely to require third country firms to establish a branch under the Article 39 rules; the more open economies, such as Luxembourg and Belgium, who did not gold plate the NPPR rules are also less likely to invoke the Article 39 branch regime. Secondly, the importance of being deemed equivalent, and an understanding of how that is likely to work in practice, and finally the transitional provision which enables a country to use national regimes for three years after an equivalence decision has been given.

In order to be deemed equivalent, Jersey would need to extend its list of regulated activities, and update its corporate governance requirements. MiFID II incorporates the corporate governance requirement in the Capital Requirements Directive, and determines that individuals can be personally liable for fines and limits the number of directorships that individuals can hold, with a split between the Chairman and CEO. Many investment businesses in the Channel Islands are managed by a very small board, with the majority of administrative and portfolio management functions being delegated to professional services providers. Limiting the number of Directorships and requiring the inclusion of various

[67] JFSC Consultation Paper No. 3 2016, MiFID II Consultation on whether to introduce an EU Equivalent Regime in Jersey.
[68] Ibid, 1.3.2

governance committees at the Board level would mark a dramatic shift for the investment management business on the island, with Directors actually resident often necessary for tax purposes. Those that are actually categorised as Jersey resident are in short supply and high demand and therefore, the imposition of these corporate governance requirements could result in a shortage of skills at the requisite level. The inclusion of the capital adequacy requirements from CRD IV extends the need for an 'own funds' capital requirement to third country investment firms. At present, the JFSC appear to have little understanding of the implications on this for home state firms in relation to their existing ANLA ratio, which is currently used to measure both capital adequacy and liquidity in Jersey. It is unlikely that this will prove satisfactory as a calculation, however, as the consultation paper states, there is a chance that the capital adequacy requirements will be simplified at the behest of the European Banking Authority for non-systemically important institutions.[69] Investor protection forms a central tenet of MiFID II, and the JFSC note in the consultation paper that at present there is no active Investor Compensation Scheme in Jersey, and that the introduction of one would result in a levy being placed on the industry of between 0.2 and 0.4%, furthermore, the Commission identifies a considerable number of conduct requirements and internal controls which would further place a financial burden on the investment business. In addition, the costs to the JFSC are not small, given the redrafting of regulation, increased monitoring of firms and products and the increased regulatory scope.

3.5 Guernsey

Unlike Jersey, the GFSC has not consulted with the industry in relation to whether MiFID II equivalence should be sought. Similarly to Jersey, one can assume that the adoption of a MiFID II regime would result in comprehensive changes to the current regime, given the resources that would be required to manage two regulatory regimes concurrently. As at August 2014 the GFSC appeared to assume that MiFID II equivalence was an extension of assessment under the AIFMD and sought to "educate those [ESMA] officials in respect of the regulated financial services sectors in the Bailiwick"[70]; however, it is probable that they have underestimated the extent to which seeking MiFID II equivalence would result in fundamental changes to the regulatory regime in Guernsey.

3.6 Criticisms of the MiFID II Third Country Regime

MiFID II initially required all Member States to require that a branch be established by any third country firm wishing to access the retail markets. This was the subject of much debate, and contested by the House of Lords, who considered the third country requirements, both the establishment of a branch and the assessment of equivalence and reciprocity as "deeply flawed"[71]. Whilst concerns regarding access to retail clients were eventually reflected in the final Directive, with the branch opt-in clause, the Committee was also deeply concerned about the assessment of equivalence and reciprocity, noting that "it was unlikely that many third country jurisdictions" would meet the tests. It was apparent to the

[69] Ibid, 4.5.4
[70] Note 53,
[71] European Union Committee, *MiFID II: Getting it Right for the City and EU Financial Services Industry* (HL 2012-13, 28 I)

Committee that the third country rules would result in an effective barrier being placed around both European markets and investors, which would be incredibly damaging to the City of London and likewise, not in the best interests of European investors. As one adviser to the Committee stated "Effectively, we would be saying to the rest of the world, 'Don't call us, we'll call you.'"[72]Professor Avgouleas agreed, noting that the equivalence and reciprocity requirements effectively created a 'Fortress Europe' situation, and conceding that whilst protection for retail investors was a worthy aim, it was a "different thing from shutting down the borders of European Markets to third country providers."[73] In the same report, it was noted that the likelihood of assessing 100 jurisdictions against the considerable requirements of Article 47 and Recital 44, including systemic risk and the G20 principles, within a four year timeframe was "unrealistic"[74].

The assessment of equivalence and reciprocity will be carried out by ESMA, and given the amount of time that it has taken to assess six countries for de facto equivalence with the AIFMD regime, which is a simpler piece of legislation, unrealistic could be considered an understatement. Effectively, the Commission needs to decide whether equivalence will be judged against regulatory outcomes, i.e. a principles based regime, or whether complete adherence with MiFID II is sought. This argument touches on the extent to which large trading blocks, such as the US or the EU, can expect to apply their legislation extraterritorially, and what happens when these continental powers have differing or even opposite regulatory approaches? The US essentially addressed the G20 principles with the Dodd-Frank Act, and if abidance with Dodd-Frank were to equate with MiFID II, and the US were to allow access to their market to MiFID II compliant firms, then perhaps the statement from Steven Maijoor "that the easiest and most efficient option is relying on mutual recognition"[75]could be relied upon and interpreted as a move from ESMA toward an assessment based upon regulatory objectives rather than a rules based approach. Swinburne confirms that "strict equivalence and reciprocity would effectively close down the EU financial markets"[76] and it cannot be denied that "we will never be effective if a single regulator seeks to regulate the entire global financial markets from one single location"[77].

It is important to note that at present, and until the Directive has been transposed into statute across the Union, the desire by third countries to be deemed equivalent is an unknown quantity. If a considerable number of large countries choose not to impose the Article 37 branch regime, then both professional and retail investors will be available to third country firms without either establishing a branch or the third country being deemed as equivalent. However, as is likely, the adoption of the branch regime by some of the largest economies in the Union may drive a desire to achieve equivalence thus accessing a cross border passport for professional investors and access to retail clients.

[72] Ibid. para 54
[73] Ibid. para 57
[74] Ibid, para 55
[75] Steven Maijoor, 'Keynote Speech' (EVCA Investors Forum, Geneva, 15 March 2012) <https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-195.pdf> accessed 18 August 2016
[76] Note 60, HoL, para 56
[77] Note 71, (Maijoor)

4 The Rise of Equivalence – The European Regulatory Environment post the 2007 Financial Crisis.

4.1 Alternative Investment Funds and Systemic Risk

The AIFMD and MiFID II were introduced following the crisis, ostensibly in response to the crisis, however, the extent to which alternative investment funds caused or even exacerbated the crisis is a matter for debate. This section will consider the nature of both private equity funds and hedge funds and how they contribute to systemic risk.

Private equity funds are typically arranged as limited partnerships, with each investor being a limited partner and the fund manager acting as general partner. Private equity funds are closed end funds, meaning that the equity is invested for a set time period with no redemptions until that time, up to ten years, and once the fund has closed additional investors/limited partners cannot partake. The fund then invests in private companies and seeks to increase the value of those companies over time. Private equity funds do utilise leverage, but this is typically done at investee company level. Due to the length of time over which a private equity fund seeks to make a return, and the means of so doing, private equity funds are typically illiquid. Returns are generally created by selling or floating investee companies after a three to five year time frame. The capital structure of a private equity fund prior to the financial crisis was typically 30% equity (provided by investors), 10% loan notes (quasi-equity) and 30% debt, which may be arranged over a number of levels[78]. This debt was typically provided by banks. Private equity funds aim to make a return through managing the company in such a way as to service the debt and increase the value of the company and provide a return to investors.

Hedge funds are structured similarly, as a limited partnership with the fund manager acting as general partner. However, hedge funds are not limited to the investment mandate that private equity funds are, and may use a variety of means to secure the highest returns possible. For this reason, hedge fund managers usually have a broad investment mandate that does not stipulate available asset classes, or investment limits within certain geographic areas or instruments. For the most part, hedge fund managers are free to utilise the fund in any way they see fit to create higher than average returns. As hedge fund managers are paid a set fee, plus a proportion of the increase in the value of the fund, this can encourage risk taking. Whilst private equity funds are typically illiquid, hedge funds are highly liquid, and trading by hedge funds contributes considerably to daily trade volumes. McDonald reports that whilst hedge funds comprise an estimated 5% of assets under management, they also contribute an estimated 40-50% of daily trading volumes[79]. Hedge funds utilise investment strategies such as short selling and trading in derivatives. Whilst private equity funds create leverage in the market at investee company level, hedge funds use leverage at the fund level as a matter of course, indeed, "the relationship between hedge funds and systemic risk is bound up in hedge funds defining characteristic: to pursue aggressive investment strategies to make immediate returns whilst maintaining significant

[78] Jennifer Payne, 'Private Equity and its Regulation in Europe' [2011] 12 EBOLR 559
[79] Michael McDonald, 'Containing Systemic Risk' [2011-2012] 34 Loy. LA Int'l & Comp. L. Review. 237 p247

levels of leverage vis-a-vis other market participants.[80]" Hedge funds create systemic risk via one of two ways, market risk and credit risk. Credit risk supposes that the highly leveraged fund may not be able to repay its counterparty when its debts fall due; this may be created through a liquidity and maturity mismatch, whereby sufficient liquid funds are not available at the time of either a redemption request or the need to secure further debt at maturity of a loan. When that counterparty is a large investment bank, which may also have a retail division, and the collateral posted is not sufficient to cover the debt, it is possible that systemic risk could spread into the retail banking sector. Secondly, market risk supposes that should credit become harder to secure, one or more hedge funds may seek to dispose of their assets, which may be the same asset or same asset class, at the same time, thus flooding the market and driving down prices. This in turn can cause a downwards trend in the market due to the vast volumes of assets that hedge funds can trade. As McDonald[81] points out, in a highly leveraged environment where credit is cheap, the collateral placed against debt may not be worth an equivalent amount and accordingly, whilst a high leverage ratio will amplify gains, it will also amplify losses.

As private equity funds take on leverage at the investee company, the fund itself does not contribute to systemic risk in this fashion. As Payne points out, highly leveraged portfolio companies could indeed fail, and in so doing create counterparty risk, however, this should not have a knock on effect to other portfolio companies as they are not cross-collateralised[82]. Furthermore, should an external event encourage the swift sale of private equity assets on the markets, this is unlikely to create an equivalent effect due to the closed ended, long term, highly illiquid nature of private equity investments. In short, there is little to suggest that private equity funds contributed to the financial crisis of 2007/8, and the European Central Bank agreed, stating "the likelihood of LBO [leveraged buyout] activity posing systemic risks for the banking sector appears remote at the EU level.[83]"

Prior to the financial crisis, the risks to the market posed by hedge funds were largely assumed to be contained through market discipline. McDonald explains this clearly. Should the level of collateral provided fall against the level of credit extended, the extent to which this causes liquidity and credit risk is determined by the risk management policies of the counterparties themselves. McDonald points out that in order to mitigate these risks, the counterparties need to have sturdy internal control procedures, but they also need to have access to information regarding the fund's risk profile. Accordingly, when a hedge fund is financed via a large number of counterparties, there is a risk that they each rely on the due diligence of others "which may render resultant collective discipline inadequate"[84]. Despite this, there is a general consensus that the recent financial crisis was not caused by the private equity and hedge fund industries. De Larosiere states that "they did not play a major part in the emergence of the crisis"[85] however, he went on to confirm "there is a need for greater transparency since banks, the main lenders to hedge funds, and their supervisors have not been able to obtain a global view of the risks

[80] Anita Anand, 'Is Systemic Risk relevant to Securities Regulation' [2010] 60 no. 4 UTLJ 941
[81] Note 79, McDonald
[82] Note 74
[83] ECB, *Large Banks and Private Equity Sponsored Leveraged Buyouts in the EU* (April 2007) p 5
[84] Note 79, p246, note 63
[85] Note 2, para 86)

they were engaging in."[86] De Larosiere's report marks a sea change in the approach to EU regulation of the parallel banking system, which Quaglia[87] argues is political in its foundations.

4.2 The politics of post-crisis Financial Services Regulation in the EU

Quaglia frames the European Union's regulatory stance as a tale of two coalitions, one being the Anglo-American coalition, and the second being the Franco-Germanic coalition. Because of the unique nature of the European Union, EU legislation is by its nature a result of the competing wishes of the Member States. Quaglia terms the Anglo-American coalition as 'market-making' and the Franco-Germanic coalition as 'market-shaping'. Market-making is defined as a regulatory outlook which favours the market, and emphasises the objectives of competition and market efficiency, whereas market–shaping is defined as a regulatory outlook with a focus on financial stability and consumer protection. A market-making regulatory environment would demonstrate a minimum of regulation, and a belief and reliance on market discipline, "light touch, principles based regulation and private sector governance[88]". Conversely, "the market-shaping approach favoured prescriptive, rule-based regulation, with a strong steering action by public authorities."[89] Quaglia argues that the single market is by its very nature a product of a market-making regulatory approach, which favours equal access for market players to a large number of consumers, and this was intensified by the introduction of a single currency. For these reasons, it is argued that the market-making paradigm was the dominant force behind EU financial regulation in the years following the creation of the single market up to the financial crisis of 2007/8. Whilst this argument is an interesting construct through which to consider post crisis EU regulation, it should be noted that all hedge funds were required to be registered with the FSA prior to 2007.

The failure of the financial system in 2007 was seen as a failure of the market-making regulatory approach, and accordingly, the regulatory response can be viewed as a move towards a regulatory model dominated by the market–shaping paradigm. Ferran[90] argues that alternative investments funds were not unregulated in the EU, just not regulated at the EU level, and were subject to a variety of Member States' rules. Despite an awareness of the growth of the industry, Ferran argues that Commissioner McCreevy was an advocate of the market-making paradigm, and accordingly, although regulation of the sector was considered, it was with a view to promoting, rather than curtailing the industry. However, support for the regulation of hedge funds at a Union level was growing, with the strongest advocates being both the European Parliament, and, at a Member State level, France and Germany, with France calling for a tax on speculative capital movements in 2007 whilst Germany's call for codes of conduct and transparency standards at the 2007 G8 failed following opposition from the US and the UK[91]. However, as the crisis deepened, a sea change in political will was apparent, and at

[86] Ibid, para 88)
[87] Lucia Quaglia, 'The "Old" and "New" Politics of Financial Services Regulation in the EU' Observatoire Social Europeen April 2010 No.2
[88] Ibid, p7
[89] Ibid.
[90] Eilis Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU', [2011] 12 EBOLR 379
[91] Note 5

the 2009 G20 a commitment was given "to ensure that all financial markets, products and participants were subject to appropriate regulation…including hedge funds, that may present a systemic risk."[92]

The AIFMD marks a triumph for the market-shaping coalition, and a move towards dominance in the EU of the Franco-Germanic coalition, ostensibly under the guise of breaking down the opacity of the parallel banking system and enabling regulators to confidently assess the levels of systemic risk in the system, including that created by excessive use of leverage in the private equity and hedge fund markets. However, commentators have argued that post crisis EU financial policy has political aims that are more complicated than the management of systemic risk. By its nature, systemic risk cannot be contained by borders, and this is the rationale for the application of 'equivalence' to third countries seeking to do business in the European Union. However, several commentators and industry professionals see 'equivalence' not just as a means of containing and measuring systemic risk, but rather an opportunity for the EU to exert control over both access to its markets, access to other markets and global financial policy.

4.3 The Rise of Equivalence

Pagliari[93] agrees with Quaglia's market-making v market-shaping power shift in the EU after 2007. Pagliari argues that prior to 2007 equivalence was not a feature of European Union financial regulation, partially due to the willingness of the EU to recognise US regulation. This was not a willingness that was reciprocated, and the US "continued to require European firms seeking to access the US markets to comply with US regulations"[94]. However, following the perceived failure of the system, ostensibly based on the market-making paradigm, the EU was no longer so favourable towards allowing home state regulation over activities within its borders. Pagliari argues that the financial collapse did not originate in the EU, and the failure of US institutions to effectively supervise their European activities increased the desire within the new political power structures in the EU to restrict market access to third country players, on the basis of the fact that they were likely to import systemic risk. Accordingly, the situation arose whereby in the post crisis era, the EU had not only increased its regulatory capacity by moving away internally from the Anglo-American coalition, but in so doing the drivers of regulation were more interested in promoting financial stability rather than a competitive market environment. Pagliari argues this explains the equivalence requirements in post crisis EU financial regulation, and demonstrates a distinct move away from the authority sharing arrangements of the pre-crisis, market-driven, period. Unsurprisingly, both third country regulators and EU market players are disappointed by what is interpreted as an increasingly protectionist regime. One hedge fund manager describes the AIFMD as "a politically driven effort to place obstacles in the way of an industry that is almost exclusively based in the US and UK[95]", and Pagliari quotes US Senator Schumer, who refers to the insistence that

[92] Lucia Quaglia, 'The "Old" and "New" Political Economy of Hedge Fund Regulation in the EU', Western European Politics [2011] 34:4 665 p 671
[93] Stefano Pagliari, 'A Wall Around Europe? The European Regulatory Response to the Global Financial Crisis and the Turn in Transatlantic Relations', [2013] JOEI 35 4 391
[94] Ibid. p 394
[95] Note 90, p398

European trades in over the counter derivatives be cleared in the EU as a “protectionist policy” and a “power grab”[96].

Quaglia[97] argues that ‘equivalence’ has become a “cornerstone” of post 2009 EU regulation, noting that up until this point, the EU held a multilateralist, rather than unilateralist stance (citing Posner and Veron). However, the origination of the financial crisis in the US due to the lackadaisical regulation of the sub-prime mortgage market marked a move away from reliance on third party regulators and a move towards closer regulation of all market actors, whether they originated in the EU or not. Quaglia posits three possible reasons for the rise of equivalence post 2009. Primarily, equivalence could simply be a means of preventing the importing of financial risk from less well-regulated jurisdictions, the argument given by the European Commission. Secondly, Quaglia follows Pagliari’s argument and suggests that the imposition of equivalence clauses is an attempt to flex regulatory muscle extraterritorially. Finally Quaglia suggests that equivalence is driven by protectionism, with European market-shapers utilising their newly discovered regulatory clout to limit access to European markets. Quaglia argues that in fact, equivalence and the terms it has been couched within, has been carefully designed to “appease both the market-makers and the market-shapers”[98], whilst maintaining an objective of both stability and competitiveness.

Quaglia argues that for the market-makers, equivalence is an enabler, a means of maintaining international competitiveness, whereas for market-shapers, it is a provider of stability by ensuring that EU standards are maintained by third party providers. What remains to be seen is how the meaning of equivalence is applied. Equivalence and identikit are two different words with very different meanings. Equivalence has largely been passed to ESMA to assess, and whether equivalence will be interpreted as ‘equal in value to’, or whether equivalence will be assessed as ‘identical’ will have far reaching implications. If the true meaning of equivalence is applied, then those countries that are well regulated, but that have different rules may well find they have access to the European markets. However, should the converse be true, and equivalence is interpreted to mean ‘having the same rules’, then access to the European markets may well be restricted and equivalence could be interpreted as a policy of protectionism. Is equivalence a matter to be judged on a principles-based approach, typically the regulatory space preferred by the Anglo-American coalition, or is equivalence to be assessed from a rules-based approach, typically the regulatory space adopted by the Franco-German coalition?

The next section will return to the July 2016 Advice issued by ESMA in relation to the extension of the third country passport, and discuss on the basis of this Advice whether the assessment of equivalence appears to be principle or rule-based.

4.4 Equivalence – Rules-Based or Principles-Based?

[96] Note 93, p399
[97] Lucia Quaglia, ‘The Politics of Third Country Equivalence in Post-Crisis Financial Services Regulation in the European Union’, (2015) 38:1 West European Politics 167
[98] Ibid. p169

In July 2015, the U.S. was one of the first countries to be assessed by ESMA, who reached the conclusion that at present, they did not have enough information about the American system to assess whether the passport should be extended. The 2016 Advice is more comprehensive. When being assessed against the criteria of investor protection, market disruption, obstacles to competition and systemic risk, it becomes apparent that for certain of these criteria, a rules-based approach is being applied, and for other criteria, a principles-based approach is being applied. With regard to investor protection, the US does not have rules which are equivalent to the EU regarding either depositaries or remuneration. However, as has been noted above, in paragraph 19 of the Advice, ESMA state that the third country, should a passport be extended, will still be required to comply with both the depositary and remuneration requirements as established in the AIFMD, so with regard to investor protection, the rules of the AIFMD will extend extraterritorially. With regard to systemic risk, ESMA note that "reporting obligations for US managers are extensive, but differ[s] from the requirements in the AIFMD to some extent."[99] Regardless, the Advice still states that "ESMA is of the view that there are no significant obstacles regarding the monitoring of systemic risk impeding the application of the AIFMD passport to the US"[100]. Accordingly, one can assume that this is demonstrative of a principle-based approach to the assessment of equivalence in relation to systemic risk. Interestingly, the section relating to 'obstacles to competition' is by far the most detailed. ESMA note that in order for a foreign fund to market in the US it can either establish a subsidiary which is subject to US regulation, or it has to be judged as "practically feasible" to enforce the 1940 Act, thereby ensuring that US based investors have the same level of protection as when investing in a US fund. In practice, this is rarely the path chosen to access the market as it results in a foreign fund having to abide with two sets of regulation, and accordingly usually a sub fund is established, or a reverse solicitation process is utilised. ESMA concluded that, should a third country passport be extended to the US, a level playing field between the two jurisdictions would not exist; access to EU markets for US funds would be extended without the same access being permitted in the other direction, however, this only relates to funds which were likely to be offered publically, ESMA admits that access to private markets would remain comparable. In its final Advice on the matter, ESMA therefore recommends that the passport only be extended to US based funds with one of three caveats; that either the passport is only extended to professional investors that will be privately placed, or a strict restriction to professional investors only. Effectively, ESMA is recommending an extension of a 'private equity only' passport in direct response to the market access granted to EU funds in the US.

When looking to the assessment of Australia in the same document, the investor protection elements of the AIFMD (depositaries and remuneration requirements) are also to be interpreted as rules-based equivalence to be regulated by the Member State of Reference, and effectively need not form part of the assessment. However, once again, the 'obstacles to competition' section is extensive, and notes a 'class order relief' which is currently only available to German and UK funds. The Australian Securities and Investments Commission has "indicated that they are willing to discuss extending this to EU

[99] Note 57, para 65
[100] Ibid.

AIFMs…on a more reciprocal basis”[101] and accordingly, on the basis of this, ESMA is once again of the view that there are “no significant obstacles” to the extension of the passport to Australia.

With regard to the Advice in relation to Hong Kong, it is interesting to note that the Hong Kong Securities and Futures Commission has its own equivalence regime, whereby jurisdictions can be classified as ‘acceptable inspection regimes’ (“AIR”) and furthermore, does not restrict access to AIFs who only market to professional investors. The AIR regime only applies to retail investors, and as such would be outside the remit of AIF equivalence, but would only apply to UCITS regimes. At present, five EU Member States are deemed as AIR, which means that access to the Hong Kong retail market is not currently on a par across all Member States. ESMA has no concerns about extension of the passport, “if ESMA considers the above assessment only in relation to AIFs”[102], however, ESMA does take into consideration the AIR regime in its concluding Advice, and notes that the rules applying to UCITS funds based in different EU states are not the same. It is an interesting development that the extension of the AIFMD passport should take into consideration access to the retail markets, and is perhaps demonstrative of the manner in which the third country passport may be utilised by the market shaping coalition.

To reconsider the assessment of Jersey and Guernsey discussed earlier, it is to be remembered that both the crown dependencies were swiftly issued with positive advice relating to the extension of the passport, despite less than convincing assessment of the control measures in relation to the management and measurement of systemic risk. Both jurisdictions also allow unbridled access to their markets for EU players.

4.5 Analysis of July 2016 Equivalence Assessment

Having reconsidered the application of the equivalence criteria in the light of Quaglia and Pagliari’s research it is possible to draw several conclusions. Primarily, equivalence is evidently assessed against both principle and rule-based criteria. With regard to investor protection, the Directive insists that the depositary and remuneration rules will apply to all funds equally, and equivalence can be seen as an extension of EU legislation extraterritorially. With regard to systemic risk, it appears that a principle based approach has been determined, with a positive response to the US regime despite its differences. Jersey and Guernsey were demonstrably lacking in the area of systemic risk management and macro-prudential supervision, yet the extension of the passport to the Channel Islands was recommended. What becomes apparent is that market access and reciprocity is a major consideration when determining equivalence. Quaglia posited three possible reasons for the inclusion of equivalence provisions in the post crisis era, the prevention of imported financial instability, the exertion of extraterritorial power and creation of a protected EU market. Based on the analysis of the 2016 Advice, the least important of these criteria to ESMA is the prevention of imported financial instability, the exertion of extraterritorial power certainly forms a part of the equivalence criteria, as can be seen with

[101] Ibid, para 208
[102] Ibid, para 128

regard to elements relating to investor protection. The additional NPPR requirements in place in some states are indeed evidence of a protectionist regulatory stance, with a preference for EU based managers and funds over those that originate from third countries. Moreover, there is little evidence that equivalence assessment directly links to protectionist policy, and one can conclude that protectionism is more applicable as a concern at Member State rather than Union level. More evidence is available to suggest that reciprocal market access is a greater concern to the Union, and that the changing political environment after the breakdown of the Anglo-American market making paradigm has been utilised by European policy makers to ensure that the hegemony of US regulation as a global standard is now being brought into question.

5. Conclusion

To conclude, following the financial crisis of 2007/2008 there was a global move to introduce greater regulation of the parallel banking system, having been agreed at the G20 that the opacity and size of both the private equity and hedge funds industries, in conjunction with over the counter trading of derivatives, had resulted in an inability to accurately assess global systemic risk. At the EU level, this resulted in the introduction of the Alternative Investment Fund Managers Directive and the Markets in Financial Instruments Directive and Regulation, which extend the remit of EU financial regulation to third countries. Whilst the AIFMD allows for temporary access to the EU markets via Member State's NPPRs, it was envisaged that a third country passport would be made available to third country firms from July 2015. ESMA published an Opinion on the functioning of the passport for EU Member States and the NPPRs at this time and determined that there were considerable differences between the application of the Directive across Member States, with variations in pricing, barriers to access, and NPPR regimes which mirrored the AIF regime in its entirety. Having considered the functioning of the existing regime, ESMA considered the extension of the third country passport to third countries on a case by case basis, effectively creating a de facto assessment of equivalence. In July 2015 ESMA issued Advice which, whilst positive in regard to the extension of the passport to Jersey and Guernsey, did not recommend that the third country passport mechanism be activated by the Commission at this time. When considering the extension of the passport to third countries, ESMA took into consideration the standards of investor protection, market disruption, competition and the monitoring of systemic risk. As has been demonstrated, equivalence has been assessed against both rules and principles. With regard to investor protection, the AIFMD regulations on depositaries and remuneration policies are to be abided by in full to achieve a positive recommendation of equivalence, whereas assessment of systemic risk is more likely to be assessed in principle. As has been shown, systemic risk provision in Jersey and Guernsey has been deemed satisfactory by ESMA despite shortcomings in their process which cannot be overlooked.

Prior to the crisis, EU financial regulation relating to third country access was established at Member State level, and the EU approach to regulation was typically dominated by the Anglo-American coalition, which favoured market-discipline as opposed to rule-based regulation. Following the crisis, the perceived failure of the Anglo-American model resulted in a global sea change in relation to regulation of financial services. The failure of the UK-centric model predicated the resultant rise of the Franco-

Germanic coalition in the EU, whilst additionally the EU's regulatory capacity increased following the failure of the US-centric model and the increasing size of the EU as a trading block. Quaglia argues that this marks a move from market-making regulatory dominance to market-shaping regulatory dominance. Quaglia argues that the rise of equivalence is a means of balancing the needs of the market–shapers and the market-makers within the Union, with the UK based coalition preferring a loose, principles based assessment of third country regimes, and with the Franco-German alliance seeking a more prescriptive rules based assessment.

Pagliari argues that prior to the crisis, transatlantic financial regulation was typified by a slanted playing field, with US players having access to EU markets with home supervision, whilst EU players wishing to access US markets had to abide by US regulations. Following the move towards a more stringent regulatory environment, the EU has capitalised on its revived regulatory capacity and Quaglia gives three possible reasons for the increase in equivalence provisions; to prevent imported financial stability, to exert extraterritorial regulatory power, or protectionist intent. Having considered the evidence, it is apparent that reciprocal market access has become an additional, if not dominant, driver behind ESMA's assessments in relation to the AIFMD third country passport, and that the prevention of systemic risk is not a major concern.

ESMA has likewise been tasked with the assessment of equivalence of third countries in relation to MiFID II. As yet there is no evidence available in order to assess whether this will take a rules-based or principles-based approach, however, it is probable that reciprocity and equal access to markets will be required before any passport is extended. The third country passport can be considered a tool which the newly invigorated market-shaping ruling EU coalition can, and will, wield to ensure that EU market participants are not disadvantaged on the world stage.

The question of regulating global markets by regional governments is fraught with difficulties. It is likely that, despite the post-crisis fragmentation of transatlantic regulation, a more permanent solution will be sought. Ng[103] discusses "equivalent reciprocal recognition" and suggests "it is time for the EU to engage with important third countries seriously in order to develop a mutual recognition framework"[104]. In 2007 this matter was discussed at the EU summit, and has been shown to be the path of choice for Maijoor. Ng suggests as a minimum some form of 'omnibus legislation' so that the third country access issue is no longer dealt with in a piecemeal, directive by directive, fashion. Others are more ambitious. Merkel and Sarkozy clearly stated their ultimate goal in a letter to the Commission President in 2009: "The first priority is to build a new global financial architecture. The European Union must assert a common position and take the lead on this."[105] To some, it seems inevitable that global securities regulation will finally be assumed by a supra-national body, equivalent to the Basel Committee on Banking Supervision, and should that be the case, the current positioning of the EU could be interpreted as a

[103] Leonard Ng, '"Third Country" Issues in Current EU Financial Services Regulation', (2012) 5 JIBFL 287
[104] Ibid. 291
[105] Note 90, p671

means of ensuring that global governance standards are based on the European rather than the American model.

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