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***Re: CLLS Regulatory Law Committee Response to ESMA Discussion Paper (ESMA/2012/117) on Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM***

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The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

This response to ESMA's Discussion Paper (ESMA/2012/117) on Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM has been prepared by The City of London Law Society Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets. European clients include banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

The CLLS is registered on the European Commission's Transparency Register, and its registration number is **24418535037-82**.

We set out our comments by reference to the relevant questions in the Schedule below.

If ESMA would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

**Margaret Chamberlain**
Chair, Regulatory Law Committee
CLLS

**SCHEDULE**

**ESMA Discussion Paper – Key Concepts of the Alternative Investment Fund Managers Directive and types of AIFM**

We found the ESMA paper a helpful and constructive approach to a number of difficult issues which need to be resolved in order for both regulators and the fund management community to have certainty as they make their preparation for AIFMD implementation. We have the following particular comments:

***Q1. Do you see merit in clarifying further the notion of family office vehicles? If yes, please clarify what you believe the notion of "investing the private wealth of investors without raising external capital" should cover.***

We doubt that it is possible to clarify this further. We believe that although there will necessarily be some relationship between the investors, this would be difficult properly to define since family investment vehicles are frequently used by large extended families spanning a number of generations, include bodies corporate, trusts and other undertakings and vehicles established by or for the benefit of family members and are also often coupled with philanthropic and charitable activities. Sometimes more than one family may be involved. We believe it is clear enough that the entire concept of the family office vehicle is that it does not look to third parties (i.e. “external capital” beyond the "family") for capital contributions.

It appears to us that there are a number of other situations in addition to family office vehicles where the private wealth of investors is invested without raising external capital. Family office vehicles should be seen as an example of situations which do not amount to AIF because they do not involve raising external capital rather than as a specific type of structure to be narrowly defined. Other examples of such situations which would not amount to AIF might include joint ventures (see below), situations where entrepreneurs who have previously been in partnership or otherwise worked together decide to invest some of the proceeds of a sale of business together, friendly investment clubs which do not involve professional management, or, indeed, a “friends and family” start up venture. Endeavouring to be precise about the exact prior relationship or relationships required will not, we believe, help to clarify the concept.

***Q2. Do you see merit in clarifying the terms "insurance contracts" and "joint ventures"? If yes, please provide suggestions.***

We think it would be extremely dangerous and impossible to clarify the term "insurance contract", since this is a matter of law and, as there are very important Directives in the insurance sphere, it would seem inappropriate to define the content of those Directives in a

Directive on alternative investment fund management.

As far as joint ventures are concerned, we think that care would have to be taken in any "clarification" as we doubt that it is possible to create an exhaustive definition of a joint venture and it is very important that any attempted clarification should not prevent normal commercial activity. At best ESMA could list a number of factors that might be relevant in determining the existence of a joint venture. For example a joint venture vehicle is typically created to provide a legally convenient means by which the joint venture parties combine resources to carry out a specific commercial or investment activity, it does not "raise capital" as such, the joint venture vehicle is the natural result of a business proposition, rather than a business proposition in itself.

***Q3. Do you see merit in elaborating further on the characteristics of holding companies, based on the definition provided by Article 4(1)(o) of the AIFMD?***

We do not see any particular merit in elaborating further on the characteristics of holding companies. The Directive creates, as ESMA acknowledges, a clear exemption for certain types of entity. This does not (to state the obvious) mean that any other holding company is automatically an AIF; it is always a question of fact looking at the definitions in the Directive. The exemption for the holding company is precise and contains a number of conditions (one of which is an anti-avoidance condition). We do not agree therefore that it provides a means of circumventing the provisions of the Directive.

***Q4. Do you see merit in clarifying further the notion of any of the other exclusions and exemptions mentioned above in this section?***

In our view, we think it is unnecessary to clarify these exemptions further, in most cases they are already fairly specifically defined. The only more general exclusion relates to employee participation and saving schemes. Given that the nature and structure of these will vary across Member States, we would not have thought it particularly useful or practicable to clarify the concept further. Such schemes are by definition confined to a narrow class.

In addition on this section, we have the following comments:

*Paragraph 10*: We strongly disagree with ESMA's statement in paragraph 10 that *"where an AIFM chooses not to perform itself the additional functions set out in Annex I of the AIFMD, in such a case these functions should be considered as having been delegated by the AIFM to a third party".*

There is nothing in the Directive which supports such an interpretation. In

the case of many types of fund these are not activities that would be carried out by the entity that in future will be regarded as the AIFM, indeed the AIFM may, depending on the structure of a fund, have nothing to do with their appointment. For example, in the case of an AIF that is a listed company, the maintenance of shareholder registers, tax returns, distribution of income may well form part of the responsibilities of the board, company secretary, registrar or some other entity appointed directly by the board to deal with shareholders.

The AIFMD, unlike UCITS, is concerned with a wide range of different types and structures of fund designed for professional investors. It was not intended to regulate the structure of AIFs and should not do so.

As ESMA itself recognises in paragraph 4, the activity of managing an AIF is defined in the Directive as performing at least the portfolio management and risk management functions (which includes performing them through delegation, subject to the letterbox issue). The other Annex 1 activities are clearly not within the scheme of the Directive as mandatory AIFM responsibilities. Section 2(a)(b) and (c) are clearly stated in Annex 1 to be functions which the AIFM "may" perform, not functions which it "shall" perform. This permission is necessary because of the restrictions placed on AIFM activities by Article 6. Performance through delegates is a choice of the AIFM for those functions which the AIFM is entrusted with in relation to the particular fund (including at the least investment management). If the structure of the fund is such that the AIFM is not responsible for the functions in Section 2 of Annex 1 then it should not be regarded as either performing them or as delegating them.

This is particularly important given the range of asset classes and the breadth of the activities which might be covered by paragraph 2(c) of Annex 1 - Activities related to the assets of AIFs. Although in view of the wide scope of the Directive and range of types of fund covered it would not have been appropriate to ban an AIFM from carrying on a very wide range of such activities it would be even more inappropriate to impose an obligation on the AIFM to perform (or be treated as delegating the performance of) all such activities in all circumstances

***Q5. Do you agree with the orientations set out above on the content of the criteria extracted from the definition of AIF?***

We agree with the ESMA statements in paragraphs 25 and 26 concerning capital raising, however we disagree with paragraph 27. The definition of an AIF in the Directive expressly includes, as a core condition, that it is an undertaking which raises capital from a number of investors. However we think there is another reason why the example given by ESMA need not cause a policy concern. In the example we assume ESMA intends to refer to a position where the investors in the original entity become investors in the new entity, as unless this occurred there would be no policy or other concern. In such a case we would expect the successor entity to be an AIF, it is clearly "stepping into the shoes" of the first vehicle.

We also do not agree with paragraph 29 in two separate respects.

1. The mere fact that an AIF's rules do not restrict the sale of units to a single investor does not make it automatically an AIF. It is not the rules alone which matter, the question is whether in fact there is a capital raising from a number of investors.

2. A nominee arrangement is not of itself an AIF, many firms which are managing individual investment portfolios register their clients' investments in a single nominee name, but the nominee has not raised capital and the investors' interests are separate. We would agree that in some cases an AIF or AIFM use a nominee structure to raise capital for an AIF (in which case there would have been capital raising).

***Q6. Do you have any alternative/additional suggestions on the content of these criteria?***

***Q7. Do you agree with the details provided above on the notion of raising capital? If not, please provide explanations and an alternative solution.***

See the answer given to Q 5. We also suggest that a key factor is that capital is raised from external, or unconnected sources, for investment in accordance with a defined investment policy.

***Q8. Do you consider that any co-investment of the manager should be taken into account when determining whether or not an entity raises capital from a number of investors?***

We do not. Such co-investment would not be "external" capital and should not be regarded as "raising" capital. The same applies to capital contributed by executives and other connected parties of the manager.

***Q9. Do you agree with the analysis on the ownership of the underlying assets in an AIF? Do other ownership structures exist in your jurisdiction?***

We agree that investors in AIFs are generally not the registered holders of the underlying assets, but we think the rest of paragraph 33 is over simplified. When an investor holds shares in a company, it is the company, not the investor which owns the assets. Whether an investor has any beneficial or legal ownership rights depends on the legal nature of the AIF and the applicable law (e.g. a shareholder's rights will be different in nature to the rights of a trust beneficiary).

It is also important to distinguish between situations where assets are held collectively. In some cases, where assets are raised for collective investment in accordance with a defined investment policy then there may be an AIF. If the assets are collectively owned and registered in a nominee name the investors will be beneficial owners (in English law they will not have rights to any particular assets, they are 'tenants in common' in respect of the pool of assets). In other cases there may be joint registration in a nominee (see above) but no common investment policy or pooled ownership and no AIF.

***Q10. Do you agree with the analysis on the absence of any investor discretion or control of the underlying assets in an AIF? If not, please explain why.***

We think that the core issue is that the AIFM has responsibility for management in accordance with the defined investment policy. We do not see the need for superimposing the concept that an investor has "day to day no discretion or control.

***Q11. Do you agree with the proposed definition of open-ended funds in paragraph 41? In particular, do you agree that funds offering the ability to repurchase or redeem their units at less than an annual frequency should be considered closed-ended?***

We agree it is desirable to give harmonised guidance on this question and think the proposal is sensible.

## V. Appointment of AIFM

***Q13. Do you agree with the above analysis? If not, please provide explanations.***

We agree that the AIF is free to appoint any duly authorised manager as the AIFM and that it is for the agreement entered into by the AIF to be clear as to the relationship and responsibilities (paragraphs 45 and 47).

## VI. Treatment of MiFID Firms and Credit Institutions

***Q14. Do you agree with the above analysis? If not, please provide explanations.***

The analysis as to the position for MiFID firms and credit institutions reveals two serious issues.

The first is that many firms which currently both manage some investment funds and advise on, receive and transmit and execute orders for other investment funds or clients will not be able to continue both activities in one entity and will have to divide up their activities if Art 6 means they cannot be authorised under both MiFID and the AIFMD.

The second is that it appears, according to the UK FSA, that an entity which is permitted to carry on certain limited MiFID activities (discretionary management and limited advice and reception and transmission of orders) in addition to being an AIFM, will be subject to the full CAD regime as if it were a MiFID firm. However it also appears that it will not have the related benefits that a MiFID firm has, namely a passport for these extra activities. This puts the AIFM on an unlevel playing field compared with MiFID and UCITS firms, who are subject to CAD but who are both entitled to passports for the full range of their permitted activities. We believe this to be an oversight in the AIFMD, as there can be no policy reason to subject a firm to the burden of a European capital regime and MiFID conduct of business rules, and not provide it with the benefit of a passport. It is an issue however which ESMA can resolve, preferably by agreeing a basis between Member State regulators under which an AIFM authorised in one Member State can use its Treaty rights to provide any additional services permitted under AIFMD for which it is authorised, rather than individual firms exercising their Treaty rights outside an organised process. The UK has already formalised a process by which this can be done generally in the financial services field, so Schedule IV of the UK Financial Services & Markets Act 2000 could be used as a precedent.

**THE CITY OF LONDON LAW SOCIETY**
**REGULATORY LAW COMMITTEE**

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