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By e-mail

Dear Sirs

Re: CLLS Regulatory Law Committee Preliminary Responses to Certain of the Questions in the FSA's Discussion Paper No. 12/1 on the Implementation of the Alternative Investment Fund Managers Directive

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.

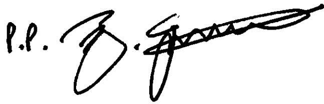
This paper has been prepared by The City of London Law Society Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets and in particular advise a wide range of investment managers, custodians, private equity and other specialist fund managers.

We have already supplied preliminary comments on the FSA's Discussion Paper 12/1 (the "**AIFMD DP**") relating to the implementation of the Alternative Investment Fund Managers Directive. This paper contains our full response and replaces our earlier comments.

Accordingly, we set out our comments by reference to the relevant question in the Schedule below.

If the FSA 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.

Yours faithfully,



Margaret Chamberlain
Chair, Regulatory Law Committee
CLLS

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THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

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Schedule

CLLS Regulatory Law Committee

Preliminary Responses to Certain of the Questions in the FSA's Discussion Paper No. 12/1 on the Implementation of the Alternative Investment Fund Managers Directive

Q1. What other criteria could be used to distinguish a JV from an AIF and, in particular, a JV where not all participants are involved in its day-to-day management?
A. We consider, in relation to question 1, 2 and 3, that a critical distinguishing element is that both joint ventures and family investment vehicles do not involve the raising of capital from "investors". The joint venture or family investment vehicle is typically created to provide a legally convenient means by which the joint venture parties or family members may combine their resources either to carry out a specific commercial or other business activity or to achieve an economy of scale or for an administrative convenience. Each should be regarded as an example of an arrangement which falls outside the Directive because it is a matter of investing private wealth without raising external capital rather than being a specific exemption requiring precise definition. We are concerned that any attempt at a precise definition of a joint venture (or indeed a family investment vehicle) may bring with it a presumption that anything falling outside that definition must be an AIF, a conclusion which we believe would both be wrong on the terms of the Directive and also likely to damage a wide range of normal commercial and non-commercial activities. We agree that arrangements in which all of the participants are involved in management can be distinguished from AIFs, and we would suggest that is because the participants in such circumstances should not be regarded as "investors" (but rather as joint venturers). We also support the view, however, that it is not necessary for all participants to be involved in day-to-day management for an arrangement to be in the nature of a joint venture (and thus exempt) rather than an AIF. For example, a joint venture between three parties which continued when one party retired but remained a party should not be transformed into being an investment fund, merely by one party's retirement. Moreover we not think it helpful to import into the AIFMD the complexities which have been generated by the FSMA attempt to distinguish between "day to day" and other types of management nor, indeed, the FSMA exclusion of powers of consultation and direction from management. Powers of consultation and direction would be common in joint ventures which might, for example, have particular reserved items where the joint venturers had some consultation, consent or veto rights. We agree that a further convenient means of distinguishing a joint venture from an AIF would be that a joint venture does not raise capital from the public and believe this is generally the more important factor. This might also suggest that 'friends and family' investment arrangements, which typically do not involve a public solicitation of capital, could also be exempt regardless of the purpose of the arrangements (which might, without prejudice to any other parallel objectives, involve the pursuit of a defined

investment policy) and the relative involvement of its participants in day-to-day management.

We suggest that, in addition to describing arrangements which are definitively exempt joint ventures (a "safe harbour"), it could also be helpful to provide a series of 'have regard' factors which, albeit non-exhaustively, indicate circumstances in which an arrangement is likely to be an exempt JV. For example:

- the absence of a defined investment policy governing the arrangements, as opposed to a policy focussed on the achievement of the parties' commercial goals;
- the nature of the parties' (including the parent or controllers of any SPV participant) existing business activities and the relationship of those business activities to the objectives of the JV; and
- the structure of the profit allocation/remuneration retained for the JV vehicle itself and/or its management (for example, if the management services provided by the vehicle are remunerated on essentially a cost or cost-plus basis, without the performance-related element characteristic of the external AIFM-AIF relationship).

We do not consider the fact that a JV is to be managed or controlled wholly or predominantly by one or more (but not all) of the participants, as opposed to an executive management appointed by the parties, should be a relevant distinguishing factor.

It should be noted that in the UK the current definition of a joint venture is extremely narrow and unsatisfactory. The only reason that it has not caused a significant practical problem is that the classic joint venture vehicle, a closed ended corporate, is excluded from the definition of a collective investment scheme. This will not be the case under the AIFMD.

Q2. How should we look to characterise the 'family relationship' between investors?

A. This question presupposes that "family investment vehicle" is a term which requires specific definition. In our view it does not since it is only an example of a situation in which private wealth is invested without raising external capital.

If any definition is given if should be clearly stated to be on a "safe harbour" basis, rather than as giving rise to a presumption that other situations which do not involve raising external capital would constitute AIF.

It is clear that there must be a degree of 'relationship' between the investors. It is not clear why money or assets (presumably only those which are contributed to the vehicle) should need to pre-date the relationship between the family members and the AIF or

AIFM: that could potentially suggest, for example, that exempt family investment vehicles would cease to be regarded as such if money or assets acquired after initial formation of the vehicle were contributed by a family member or if a child was born or partner added to the family.

Family investment vehicles can be used by large extended families spanning a number of generations. We have concerns about a definition because any definition which seeks to capture the constituency of a family relationship needs to be sufficiently broad and flexible to ensure that, at the least, step, adopted, civil partnership and cohabitation relationships as well as blood and other immediate family relationships may be included, and that other persons or vehicles representing or participating for the benefit of otherwise 'eligible' family members (such as the trustees of a family trust holding money or assets beneficially for a family member or charitable purposes) may also be included in that constituency. The connected persons definition in section 993 of the Income Tax Act 2007 may assist (into which at least adopted children and co-habitees would need to be added) as may the approach of the Dodd Frank Act which would involve a definition on the lines of:

> *"any body of persons corporate or unincorporated (including its directors, partners, members, mangers, trustees and employees acting within the scope of their position or employment) that:*
>
> *(a) has no clients other than family clients;*
> *(b) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities;*
> *(c) does not hold itself out to the public as an investment adviser.*
>
> *Family client means:*
>
> *(i) family member;*
> *(ii) former family member;*
> *(iii) any estate of a family member or former family member;*
> *(iv) any trust established anywhere in the world of which one or more other family clients are beneficiaries;*
> *(v) any trust funded by one or more other family client;*
> *(vi) any company wholly owned (directly or indirectly) exclusively by and operated for the sole benefit of one or more family clients;*
>
> *Family entity means any estate, trust or company falling within (iii), (iv), (v), or (vi) above.*
>
> *Family members means all lineal descendants (including by adoption, stepchildren, foster children, children treated as children of the family) of a common ancestor (living or deceased) and such lineal descendents' spouses*

or spousal equivalents."

But even this would need further amendment as it does not address the reality of many family office arrangements which may:

- involve more than one family, without any external fund raising;
- involve legal structures in many jurisdictions which do not necessarily fall into the categories of trust or company;
- make it difficult or impossible to establish what the relationships of all possible beneficiaries are;
- very commonly incorporate not only some charitable purposes supported by one or more family members but also broader philanthropic goals; and
- be relationships that are not recognised by national law in the same manner as the way in which a particular family sees itself or joins together for the purposes of investment.

Q3. Are there other features of a family investment vehicle that might distinguish it from an AIF?
A. As noted above the principal feature appears to us to be that external capital is not raised. Putting it another way: a) either there is no raising of capital at all in the sense of there being no: • commercial request by way of business • for the contribution of money or other assets • to be invested in accordance with a defined investment policy • in order to make profits for those investing the capital; or b) if there is a capital raising of the kind described, it is carried out only within a related group so that it should not be regarded as "external" capital.

Q4 (a) which aspects of the Directive should we consider applying to small UK AIFMs (b) in particular, which aspects of the Directive should we consider applying given that a distinction may be drawn between types of AIF or AIFM
Generally we consider that the FSA should be wary of imposing extensive new levels of regulation or "gold-plating' the Directive. We note that even applying existing levels of FSA regulation to small AIFM could be regarded as "gold plating" since it is more than the Directive would require. We acknowledge that a distinction between levels of regulation applicable runs the risk of consumer misunderstanding but think this best addressed by clear communication than by imposing identical levels and types of regulation. In this context a distinction between authorised AIFM and small AIFM which are only registered may in fact be easier to communicate and clearer to investors than a requirement for authorisation across the board which is then adapted for proportionate application to small AIFM.

Where the provisions of the Directive are more extensive than current FSA regulation (e.g. depositary, segregation of risk management and valuation, capital, delegation, detailed reporting) it is not clear to us that the additional provisions will provide any significant additional protection to investors (even retail investors) by comparison with the rules currently applicable to FSA authorised operators of unregulated collective investment scheme.

If an extension is to be made to the current scope of the FSA rules as they apply to small AIFM we suggest that it should be confined to applying certain of the current FSA rules in relation to operators of unregulated collective investment schemes to small AIFM who are required to be registered/authorised for the first time. However the principal group of such AIFM will be closed ended corporate AIF. Any fine or other disciplinary action taken, or compensation ordered, against any such body will, as is the case with any mutual, principally damage the investors in the AIF, who are the very people intended to be protected. The necessarily small size of the relevant AIF will increase the costs burden on investors of both any new regulatory obligations imposed and any disciplinary action subsequently undertaken.

Accordingly a very careful cost benefit analysis should be conducted before imposing any aspects of the Directive on small AIFM, and before imposing aspects of existing FSA rules on small AIFM which have not previously been required to be authorised. Where additional regulation is to be imposed on small AIFM we recommend that it is confined to AIF offered to retail investors.

Q7. What organisational arrangements might raise particular issues for UK AIFMs? Do these requirements pose particular difficulties for private equity firms in the light of their distinct business model?

Many of the organisational requirements will raise issues for all AIFMs, not just those in the UK, and whether or not they are private equity firms, though some may be particularly acute for private equity firms.

These include:

a) Segregation of risk management and portfolio management and, indeed, segregation of functions generally in firms which are often small in size;
b) Overly prescriptive due diligence requirements of the kind proposed by ESMA. The level and manner of due diligence will vary with the asset, the price, the circumstances (e.g. if buying from a liquidator) and may also be affected by the investment policy and capital raising circumstances (professional investors may specify or approve the approach proposed to be taken to diligence);
c) Delegation restrictions where the management of many potentially relevant asset

classes is not normally subject to authorisation requirements; and

d) MiFID style provisions relating to inducements of the kind proposed by ESMA. (Taking private equity as an example it is common for limited partnership agreements to specify in some detail which types of transaction and monitoring fees (from investee companies and other third parties) can and cannot be taken by the management group and how far any such fees received must be set off against management fees or profit share. That is an arms length negotiation quite different to a retail investor situation or, indeed, to the range of MiFID services and related benefits which are rarely addressed in such a clear manner. However, it will commonly not be possible to specify in advance exactly how such third party payments or benefits will be calculated and the concept of " designed to enhance the quality of the relevant service" is simply not apposite to some of the fee arrangements-the key point is that these are professional investor approved arrangements.

Q8. What are the major challenges in the development of remuneration guidelines appropriate to the structure of AIFMs?

Introduction

The remuneration provisions in the AIFMD present many challenges for AIFM structures including:

- the treatment of LLP and partnership profit shares;
- what counts as remuneration and what is treated as fixed or variable;
- how and when value is calculated and attributed;
- how percentage calculations and deferrals will interact with carried interest structures; and
- how much flexibility will be available by way of the "proportionate" application of the remuneration provisions by reference to the size and internal organisation of the relevant AIFM and nature, scope and complexity of its activities.

Most of these issues also arose in relation to CRD3 remuneration provisions but in practice did not need to be addressed in detail because of the proportionality provisions in CRD3 which were recognised in both the CEBS guidelines and the FSA proportionality provisions which meant that asset management firms subject to the CRD3 provisions are correctly categorised as Tier 4 firms and not subject to a number of the more difficult provisions which are clearly designed for institutions taking significant balance sheet risk. The fact that the timing of finalisation of the AIFMD meant that some of these provisions were incorporated into it shortly before they were effectively disapplied to similar firms subject to CRD3 presents a major problem in achieving fair and appropriate alignment of regulation. The AIFMD makes it necessary to address each of these issues and find a workable solution.

As a general principle we recommend that the presumption should be that a

proportionate application of the AIFMD remuneration provisions, bearing in mind the nature, scope and complexity of the activities of most AIFM, should be to align them as closely to the CRD3 Tier 4 firm provisions as possible. Some of the difficulties in applying the remuneration provisions of the AIFMD to owner-managed type structures could be addressed by introducing a flexible approach to the definition of remuneration and/or proportionality dis-applications.

Staff subject to the Remuneration Provisions

The AIFMD's provisions on remuneration policy cover a very broad range of payment arrangements and includes any type paid by the AIFM but also any amount paid directly by the AIF itself, including carried interest (a term which for the purposes of the Directive does not have its normal meaning but is defined to mean shares in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF), and to transfers of interests in the AIF for the benefit of staff (which may possibly include carried interest as the term is normally used).

We assume that the term staff will cover those who fall within the FSA definition of "employees" and include partners and LLP members. This has a number of unfortunate implications, which are discussed further below. Given the difficulty in applying the concept of remuneration to certain individuals, particularly in the context of executives who are also owners (including partners or LLP member) considerable care needs to be taken in the identification of which members of staff are to be subject to these provisions (referred to for convenience in this submission as "**AIFMD Code Staff**"). For example, LLP Members should not automatically be considered AIFMD Code Staff for the purposes of the AIFMD as firms which are LLPs or partnerships register all members or partners as CF4 even though governance of the firm is entrusted to one or more committees which act in a manner similar to the board of directors of a company. Other LLP members do not have the same level of impact on the firm's risk profile or senior management powers, even though they are registered as CF4.

AIFM are commonly independent firms with a relatively small number of staff and AIFMD Code Staff should be strictly limited to those who those who fall into the "risk taker" and "control" functions and in fact have a material impact on the AIFMs or AIFs risk profile. In most, if not all, AIFMs this group will be limited to those making up the governing body and chief investment officer or investment committee responsible for setting the parameters of investment strategies, together with (if not already on one of those bodies) the head of compliance and (if any) the head of risk and/or internal audit.

Fixed and Variable Remuneration Ratios

As is known in respect of LLPs or other tax transparent partnership structures, members receive their returns as a profit share which does not normally distinguish between the

element that they receive as an investor and returns they receive for their work as manager of the fund. Moreover some of the profit shares are commonly a return on investments in respect of ownership, not in any normal sense remuneration for work done. For example, if the business is sold they may receive capital profits from payments buying out their interests as members or the LLP may sell the business so that its profits on sale are allocated to members. However more complex transactions are often done under which the purchaser is admitted as a member, makes contributions to the LLP which are reallocated between members and agreements are reached for on-going profit sharing which would also reflect the purchase of the business (so that executive members took part of the disposal proceeds on an on-going basis by reference to the continued success of the business, and in some cases their agreement to remain involved in it). Therefore, applying remuneration structures which require a calculation of percentages of fixed and/or variable remuneration, or even an assessment of what element is remuneration across the board, does not make a lot of sense in the context of owner-managed type structures.

Further, the whole amount received by members or partners will vary by reference to the profits ultimately achieved in the relevant tax year. Even if some regular drawings are made throughout the year these will only be an advance on future profits (and will generally be set at a low rate), not fixed in the same way as a salary is. In the normal course therefore a partner or LLP member's entire "remuneration" will be variable. More generally in owner managed businesses, whether or not LLPs, the focus on the long term health of the business and desire to avoid burdening it with high fixed costs tends to mean that the owner-managers are willing to allocate themselves low salaries by comparison with the profits they hope to share. The same can apply to other employees in the case of start-ups and other ventures where success is uncertain but they have high hopes for the future of the business. Arguably the requirements for particular ratios between fixed and variable remuneration could be disproportionate in all these cases. Alternatively it could be said that in such circumstances there is an appropriate balance between fixed and variable remuneration because even with no element, strictly speaking, being "fixed" it still allows the operation of a fully flexible policy including the possibility of paying no variable remuneration component, That is the nature of partnership, including LLPs, and of most other owner managed businesses.

Non-Cash Interests

The AIFMD states that 50% of variable remuneration should be paid in interests in the fund rather than in cash. Whether any part of variable remuneration can be paid in interests in the fund rather than in cash will, as is recognised in the Directive depend on the structure and constitution of the AIF, and the willingness of investors to agree to such provisions. Frequently, as in the case of carried interest, investors positively expect a particular structure and involvement of individuals in the rewards generated by the fund but it does not follow that it will be easy to apply the Directive provisions to such interests.

It raises numerous issues around how and when remuneration is actually valued and has specific implications for carried interest vehicles. Where a fund is not open ended, or where the interests in a fund which are allocated to investors have limited rights which are subordinated to those of investors (e.g. normal carried interest before the hurdle for participation in profits is met) valuation for the purposes of calculating a percentage is difficult or impossible. It is not a matter, as in the case of an open-ended fund or a listed and traded fund, of holding shares whose value will move by reference to performance of the fund and can reasonably readily be realised.

For example, for tax purposes carried interest is generally regarded as having little or no value when awarded, which makes it more difficult to apply the 50% non-cash remuneration to carried interest and thus it might mean that this may require firms to apply this rule to any other form of bonus, which is normally relatively unimportant by comparison with the importance attached to carried interest.

We suggest that it is disproportionate to apply the provisions requiring a calculation of 50% of variable remuneration to be paid in interests in the fund to situations where the relevant fund is not either open ended or traded on a liquid market. The provisions in Annex II of the Directive requiring the imposition of retention policies presuppose that the interests concerned would normally be marketable.

If fund interests are granted which do not have such an immediately marketable value for calculation purposes we suggest that either (i) paragraph (m) should be completely disapplied as disproportionate/inapplicable in view of the legal structure of the AIF and its constitution; or (ii) the interests concerned should be given a notional value, for the purposes of this calculation only, equal to the value which they would have if the fund met its performance targets. Imposing on the AIFM or the AIF the costs of a separate valuation exercise simply in order to address the requirements of paragraph (m) in a situation for which it does not seem to have been designed would be disproportionate.

Deferral Issues

If a particular remuneration component is subject to the deferral requirements then we suggest it should be made clear that the deferral can be made net of any distributions required to meet taxation. Any other result would be unnecessarily penal and could cause real difficulties.

The AIFMD requires at least 40% of variable remuneration to be deferred and 60% in the case of particularly high amounts. In some types of AIF it is common to grant executives rights in the fund which are effectively deferred to the realisation of returns by investors. Carried interest (as normally understood) is a classic example of this since the carry holders are not entitled to share in any performance of the AIF until the external investors have received the return of sums invested together with a hurdle rate of return in addition. Structures of this kind appear to us to meet all the policy goals of the AIFMD, in line with

the life cycle of the particular fund. They normally do have vesting provisions over several years but, as noted above, valuation of the carried interest on grant is difficult or impossible and it is also a major exercise if valuation is required at any other time.

The valuation issues referred to above could present real difficulties in calculating not only the percentages but also the deferral periods because real value crystallises much later than grant of the interest and in some cases only attaches at the time that the carry starts to be payable. It seems to us that recognition should be given to the deferral inherent in the structure of the instrument and no further deferral should be superimposed after the value of the carry crystallises. Crystallisation only takes place because investors have actually received a full return on their investments (on a realised basis) which is an appropriate and fully risk adjusted timing. Such an interpretation would, however, required guidance on its application.

Investment and Co-Investment

We assume that the FSA will make it clear in its guidelines that investment in an AIF and co-investment rights do not form part of an executive's remuneration.

Remuneration Committee

Most AIFM in the UK are relatively small in size and will not have any, or at least any significant number of non-executives, even when they have substantial assets under management. This is appropriate for the relatively simple nature of their activities and organisations. Accordingly we think that it will rarely be the case that an AIFM, even one with very large AIFs under management, will be in a position to establish a remuneration committee which is made up of members of the management body who do not perform any executive functions in the AIFM concerned. The restriction on the permitted activities of an AIFM, and the identification of risk management as a separate executive function is likely to make it more, rather than less, likely that there will be no (or no more than one) non-executive members of the governing body.

Q18. Do you have any comments on our analysis as to how we expect the capital and PII requirements to apply to the different types of firm acting as managers of AIFs?

A. We note that there is some duplication in that the concept of AIFM investment firm appears twice, we assume that one of them should refer to an external AIFM which also provides the non-core services in Article 6 (4) (b)?

It is not clear to us as to why this is a necessary separate category since such firms would also be authorised for discretionary management. The AIFMD is not entirely clear as to whether it is the case that a firm which provides discretionary management services as well as collective investment will be subject to CAD as well as the capital requirements

of the AIFMD. Article 6(6) seems only to require the imposition of only the initial capital requirements of CAD by referring only to Article 12 of MiFID but Article 11(d) suggests that full compliance with CAD, without that limitation, may be required. The DP analysis presumes that the latter is the case. There will be significant problems in seeking to apply both sets of rules to the same firm, not least in relation to the form in which capital is to be held, the extent of PII cover and consolidation and remuneration policies.

Q.19 Do you agree that it would be appropriate to set out the requirements for UCITS firms and UCITS AIFM firms in IPRU (INV)?

A. It would be appropriate to set out the requirements in the same place. If IPRU (INV) is used then we think it would be useful to relocate the rules in IPRU (INV) 5 (without changing them except for incorporation of the UCITS and AIFM provisions) so that all capital rules are easily located and are treated in the same way as the main rule book, rather than as a PDF link.

Q24. Do you have views on the intended meaning of CAD-defined terms and our approach to incorporating them in the rules for AIFMs?

A. We also take this opportunity to note a very important point. The Directive restricts the activities of an AIFM. Member States may also permit an external AIFM to provide discretionary portfolio management, and if authorised to do so it may also provide certain "non-core services". We note that:

- it is essential that there is clarification of what is meant by "non-core", do these words add some limitation on the nature or volume of the activity, or is it simply that they are "non-core" because they are not the activity of "management" (whether as AIFM or discretionary manager). We believe it is the latter.
- Whilst an entity may be permitted to carry on these additional activities, on the CAD interpretation proposed by the FSA, the entity will be subject to the full CAD regime as if it were a MiFID firm without 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 both have passports for the full range of their permitted activities. We believe this to be an oversight in the Directive, as there can be no policy reason to subject a firm to the burden of a European capital regime and then 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. The UK has already formalised a process by which this can be done generally in the financial services filed, so part IV of FSMA could be used as a precedent.

Q37. Reporting by third country AIFMs marketing AIFs in the UK will need to be captured. There is no current process for this. What do you believe would be a practical solution for this?

A. We do not think that the FSA should expect third country AIFM to report via a specified data system such as GABRIEL. The FSA will need to develop a means of capturing this information which is user friendly and it may have to prescribe more than one acceptable reporting method. For example, where a third country AIFM has an affiliate who is authorised in the UK, it may be possible to use that affiliate as a reporting agent, but an authorised firm should not be a necessary conduit, just a possible one.

We also note the comment in paragraph 8.20 that the FSA will need to consider how non-EU AIFM prove they are complying with the Directive's minimum requirements. We question why there is a need to consider this, the FSA/ESMA will have a memorandum of understanding with the domestic regulator, and we would have thought this is the vehicle through which such matters should be dealt with. In addition, if too high a burden is placed on a MiFID investment firm then this will discourage those firms from becoming involved in offering or placing the units, which could reduce rather than enhance the possibilities for investor protection.

Q38. While a depositary is a feature of FSMA-authorised funds (including NURS), the requirement to ensure the appointment of a depositary for unregulated CIS represents a change for UK AIFMs. What additional costs and benefits might this change give rise to?

A. There is no obvious benefit, though clearly there will be significant costs.

Q39. Should the capital requirements for depositaries within the third bullet of paragraph 7.3 of this DP be increased and, if so, what approach should be taken? What role could insurance have in supplementing this requirement? Where the depositary is within a group, to what extent would a parent stand behind its subsidiary in the case of a default and/or loss of assets?

A. It needs to be borne in mind that capital requirements are not a panacea for depositary liability. Capital requirements would never be sufficient to cover the loss of a large number of assets, segregation is the key to investor protection here. We see no particular reason to increase the capital requirements for depositaries within the third bullet of paragraph 7.3, and we doubt that insurance is available or suitable. Parent/subsidiary relationships are infinitely variable and there can be no generally correct answer to the question raised.

Q40. Are there any bodies (e.g. lawyers, accountants or fund administrators) that intend to offer depositary services to the type of AIF in paragraph 7.7 of this DP? What would be an appropriate prudential regime for these types of depositary and what level of financial

or professional guarantees should be given? Should we apply any other FSA requirements to these depositaries?
A. We expect that at least some fund administrators will offer these services. This regime was developed to recognise the inherently different and reduced risk profile of the assets that fall within its scope, so as to enable cost effective and proportionate depositary arrangements to be possible. It would be counterproductive to impose excessive requirements that would discourage such firms from offering these services.

Q41. Do you agree with our view that a depositary, in having to meet its existing FSA requirements, may already be carrying on most or all of the Directive requirements in relation to monitoring cash flow? If you disagree, what costs and benefits do you consider the Directive requirements will impose?
A. Where there is a depository in relation to a current fund (i.e. under COLL) then yes we would agree with the FSA view that that depository may already be carrying on most or all of the directive requirements in relation to monitoring cash flow. However the position is fundamentally different in relation to unregulated funds where there will often be no separate depository today and, if there is an FSA authorised entity with custody of assets/cash, this will not be carrying out the same function as a depository under COLL.

Q45. Do you consider that those entities performing the primary depositary functions should be acting independently of the AIFM and not be part of the same group as the AIFM? What are the implications of such an interpretation?
A. We think it is entirely possible for a depositary and an AIFM to be in the same group and to act independently. It is a question of fact as to whether they do and this will largely be determined by the group organisational arrangements.

Q47. In which jurisdictions does national law not recognise the segregation of assets during insolvency proceedings? What actions are currently undertaken in such circumstances to mitigate this risk?
A. The global custodians are probably best placed to answer the question on a per jurisdiction basis (although we believe that Saudi Arabia does not recognise segregation) but there are a number of issues we think need to be taken into account when considering the 'segregation' question. These are: - segregation is usually a helpful factor (though not always an essential one) in protecting client assets in an insolvency. However, as has recently been demonstrated in the U.K., the complex interplay of insolvency and other laws can produce surprising results even in jurisdictions with well developed insolvency and

property laws. Whilst the recent House of Lords case involved client money, it still demonstrates that segregation is not always a sufficient protection. We therefore caution against regarding segregation as such.

- not all the suggestions in the ESMA explanatory advice are practicable. For example, the concept of buffers is of no real use, the value of assets in custody simply cannot be covered by buffers/ capital. The fact is that there are risks with holding assets indirectly, these risks are generally higher in less developed jurisdictions, and the risks arise not generally because of custody decisions made by custodians, but flow from the investment decisions made by investors. Therefore the first ESMA suggestion (disclosure) is the most appropriate additional measure that could be taken.

Q50. It is possible that the Commission with national regulators may consider the definition of 'marketing' in AIFMD transposition workshops during 2012. With this in mind, which marketing practices do you consider may be within the definition of 'marketing' in article 4(1)(x) of the Directive? Which practices should not be considered as 'marketing'?

A. We think it is best to address this question by considering first which practices should not be considered as marketing. In our view there is a difference between 'active solicitation' which should constitute marketing for the purposes of the AIFMD and (i) investor relations activity, (ii) initial conversations and discussions the purpose of which is to discover whether there is investor appetite for a particular kind of fund, and if so, on what terms. It is common practice in the unregulated sphere, for some potential investors are approached for general discussions as to whether they may be interested, and if so, in what type of investment. At that stage there is nothing to offer (and indeed there may never be anything to offer). In a practical sense therefore, there is nothing to which the provisions of the Directive could attach, and this seems to us to be the logical result, because this is a preliminary rather than an active marketing activity. We believe there has to be something specific, a real prospect that something is being offered which can be accepted for there to be "marketing" within the meaning of the Directive.

In view of the context it also seems likely that "marketing" should not include "passive" solicitation such as:

(i) supplying information or subscription in response to an unsolicited approach by a prospective professional investor; or

(ii) having information on a website, provided that the website makes it clear that the funds on it have not been approved for marketing the EU.

(We also note paragraph 26 in the ESMA DP on types of AIFM which acknowledges that communications between an entity seeking capital and prospective investors "*may or may not*" constitute marketing within the AIFMD).

Q51. Which material factors should also be considered when determining whether the activity of offering or placement of units or shares in an AIF falls within the Directive 'marketing' definition?

A. The definition in the Directive sets out the key factors, being that there must be:

- A direct or indirect offering or placement
- At the initiative of the AIFM or on behalf of the AIFM
- Of units or shares of an AIF it manages.

In addition the provisions of Article 32 and Annex IV need to be considered.

For some types of AIF (though not necessarily all), as noted above, there is a period of discussion with potential investors, at which time there is no AIF and indeed no firm proposal on many of the matters covered by Annex IV (and Article 23 in particular). There is therefore nothing that can be notified in accordance with the Directive at this preliminary stage. The Directive clearly envisages a settled proposal which provides investors with sufficient information on which to make an investment decision. Since (i) the Directive passport procedure has to be followed in order for an offer to be made and (ii) this only concerns professional investors, we cannot see any reason why a wider view has to be taken on "marketing" than is suggested by a natural reading of the words of the Directive. In our view "marketing" of an AIF is not equivalent to the UK financial promotion regime, it is a subset of it.

Q52. What else should we consider concerning the 'on behalf of the AIFM' element of the 'marketing' definition?

A. Where an AIFM has appointed a placement agent, then we consider that a placement agent acts on behalf of the AIFM. We would distinguish this from the situation where an AIFM pays a commission to, say, an independent financial adviser, private bank or wealth manager who is the agent of the prospective investor. In such a case there is an independent relationship and the IFA is not acting on behalf of the AIFM (and is subject to other regulatory requirements in relation to the payment of any commission, etc). That is, the mere fact that another entity is involved in the distribution of an AIF, does not of itself mean that that entity is acting on behalf of the AIFM. Not all distributors are acting on behalf for the AIFM , they may have an arms length commercial relationship with the AIFM, but they are not acting on his behalf, rather they are advising and arranging transactions for their investor clients.

In addition, we do not think that an entity should be regarded as acting 'on behalf of the AIFM' in this context unless it is acting on behalf of the AIFM in relation to the issue of new units or shares. Thus, for example, a company broker is not acting on behalf of the AIFM simply by being the company broker. Nor would the provider of an investment trust savings scheme usually be acting on behalf of the AIFM.

Q.53 Should we create a distinct register or list for those non-EU AIFMs from whom we have received a notification of intention to market an AIF in the UK through national private placement?
A. We consider that this would be appropriate.

Q54. Do you agree that those listed AIFs marketed by virtue of a public offer are undertaking the activity of 'marketing' as defined in the Directive and are therefore subject to the relevant requirements?
A. When a public offer is in course then clearly the 'marketing' activity is being undertaken. However once the public offer is closed, then we would not expect the listed AIF to be regarded as 'marketing' merely by reason of its public status. As the company's shares will be traded the corporate brokers will need to publish information from time to time to meet their obligations, we do not consider that this is marketing, nor in any event should it be seen as acting on behalf of the AIFM. Similarly the creation and making available of information as part of the listing obligations, e.g. publication by the AIF of its annual report, is not marketing.

Q55. Do you agree there are potential conflicts of interest between the role of the board in the context of the UK corporate model and the role of the AIFM? If so, which conflicts do you foresee?
A. We do not consider any potential conflicts of interest in these circumstances are different in kind from those which potentially exist between any AIFM and the AIF/its investors or, indeed, between the board of an AIF and the investors in the AIF. The duties of the AIFM and of the board of the AIF are to act in the interests of the AIF. The AIFMD adds significant detail to the way in which the AIFM should carry out its obligations just as UK corporate law adds detail to the way in which the board should carry out its duties. Those duties do not appear to us to be in conflict with one another and, moreover, the AIFMD specifically addresses the situation where the powers reserved to a board in a particular case are such that an appointed AIFM is not able to ensure compliance with the Directive.

Q56. Do you agree we should develop proposals to ensure that a premium listed fund must itself hold the AIFM permission envisaged under the Directive?
A. 1.1 In Section 9 of DP 12/1, the FSA explains that the board of a premium-listed investment trust qualifying as an alternative investment fund ("**AIF**") under the AIFMD would risk becoming unable to fulfil its governance obligations under the Listing Rules where it appoints an external entity as its alternative investment fund manager ("**AIFM**"), given in particular the requirement under the Listing Rules for the board of a premium-listed investment trust to be independent of any external portfolio manager and the requirement under the AIFMD for an

AIFM to exercise certain senior management responsibilities.

1.2 Accordingly, the FSA suggests that the Listing Rules be amended to ensure that an investment company can only obtain or maintain a premium listing if it is able to exercise "ultimate and unfettered oversight" over certain matters, such as the supervision of portfolio management by an external manager and the implementation of the general investment policy of the investment company. The consequence of this change to the Listing Rules would be that, following implementation of the AIFMD, an investment company would be obliged to act as its own AIFM (and would be precluded from appointing an external AIFM) in order to obtain or maintain a premium listing.

2. Commentary

2.1 Generally speaking, we welcome the FSA's constructive consideration of these issues. More particularly, however, we consider that the proposed change to the Listing Rules does not reflect the regulatory aims of the AIFMD, and that it is not required for the purposes of ensuring sound governance within premium-listed investment companies. In our opinion:

2.1.1 **The FSA's proposal goes beyond what is required for the purposes of implementing the AIFMD in the UK.** While the AIFMD does require an AIFM to perform certain minimum responsibilities, there is no suggestion in the AIFMD Level 1 framework directive or in the advice delivered to the European Commission by the European Securities and Markets Authority on AIFMD Level 2 implementing measures that an AIF (such as an investment company) which does not itself perform the responsibilities of an AIFM should be precluded from obtaining or retaining a listing.

2.1.2 **No changes to the Listing Rules are required in connection with UK implementation of the AIFMD**. The appointment of an external AIFM by a premium-listed investment trust would not be inconsistent with the requirement under the Listing Rules for the investment trust's board to be independent of an externally appointed manager. In practice, it would be consistent both with the AIFMD and the Listing Rules in their current form for the board to exercise non-executive oversight over an external AIFM and to consult with the AIFM on investment management matters, notwithstanding that the board does not exercise "ultimate and unfettered" oversight over the functions carried out by the AIFM.

2.1.3 **No changes to the Listing Rules are required to prevent conflicts between the AIFMD and UK company law.** The fact that the board of a premium-listed investment company does not exercise the responsibilities of an AIFM under the AIFMD will not restrict or fetter the directors' ability to comply with their company-law duties (for example, their duty to promote the success of the investment company). As the directors remain capable of terminating any management agreement with an externally appointed AIFM and appointing a new external AIFM, the appointment of an external manager does not pose the risk of the board losing oversight over that manager or of the board fettering itself in respect of the functions carried out by the manager.

2.1.4 **Regulatory authorisation as an AIFM would be disproportionately burdensome for most premium-listed investment companies with appointed external managers.** In order to operate, investment trusts and other listed investment companies do not currently require FSA authorisation in their own right. The costs which investment companies would incur in establishing a regulatory compliance infrastructure and obtaining individual regulatory approval for their directors and other relevant staff would reduce shareholder returns and could have the effect of restricting investor choice and competition in the market. Furthermore, most investment companies with external managers do not have the resources to carry out the executive management functions of an AIFM.

2.2 In our view therefore, the Listing Rules in their current form will not conflict with the requirements of the AIFMD, and it would not be necessary or appropriate to introduce a requirement for boards of premium-listed investment companies to exercise ultimate and unfettered oversight over the functions carried out by an externally appointed manager. We do, however, consider that certain other changes to the Listing Rules may be appropriate to take account of the external appointment of AIFMs by premium-listed investment companies – for example, so that the board of the investment trust periodically reviews the appointment of the external AIFM, consults with the AIFM on investment-strategic matters, or exchanges information with the AIFM for the purposes of complying with its obligations under the Listing Rules, the Disclosure and Transparency Rules, and the Prospectus Rules.

2.3 At paragraph 3.22 of the DP, we note the comment that the Treasury is considering what, if any, stricter requirements it will apply to AIFMs below the article 3 thresholds and how such AIFMs will be regulated. We would welcome confirmation that small listed investment funds, whose assets under management fall below the Article 3 *de minimis* threshold, will be subject to member state regulation (i.e. under the Financial Services and Markets Act 2000 (as amended)).

Q57. Should the listing regime, as far as possible, treat off-shore and other non-EU AIFs the same as EU AIFs?
A. As noted above we do not consider it appropriate for the listing regime to prohibit listed AIFs from appointing an external AIFM. If any such obligation was imposed it is not clear to us that it would be either possible or appropriate to apply it to AIF from other EU countries, which should be governed by those countries' implementation of the AIFMD. In any event we do not think that third country AIF should be treated in the same way as EU AIF, particularly where they have third country AIFM so that the AIFMD applies completely differently to them.

Q61. What should we consider in permitting EU AIFs to be marketed to UK retail investors?
A. We think that the current regime for the marketing of unregulated schemes is a good starting point. It provides a clear means for distinguishing between the mass retail public

and those who are in a position to invest in unregulated schemes.

Q63. Which types of UK AIF are most likely to deem themselves as internally managed?
A. Those closed ended bodies corporate which do not currently have an external investment manager.

Q64. Which aspects of the current UK regulatory framework might present particular challenges for internally managed AIFs? (See also Q23)
A. The "client" concept in the current UK regulatory framework will need consideration, as with an internally managed AIF there is no "third party" client, the AIF is the client. The investors are not clients of the AIFM, in the sense used in FSA rules. Chapter 18 of the FSA Handbook may need some further thought in this context.

Q65. What changes, if any, are necessary to the process or requirements for FSA authorisation for AIFMs in cases where the AIF under management takes the form of a partnership?
A. This will depend on whether the analysis in any particular case is that the AIF is internally or externally managed. We consider that, for example, a limited partnership could be either internally or externally managed depending on how the partnership and related documents are drafted. Even so generally we doubt that any particular change is required, although it may be worth considering whether, in the case of an internally managed partnership, the limited partners should be approved persons, we suggest not and that it is sufficient for this to be the general partner(s).

Q68. Which types of investment fund currently excluded from the UK definition of a collective investment scheme are likely to come within the definition of an AIF?
A. Closed –ended bodies corporate.

Q69. What other changes should we consider making to rules on the marketing and distribution of unregulated AIFs to retail investors?
A. We consider that the existing law is clear and balanced, it just needs to be enforced. Whilst the FSA is aware of cases where it has not been complied with, we are aware of many cases where it is complied with and is successfully used to the benefit of both firms and investors.