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AIFMD Transposition
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By E-Mail

Dear Sirs

Re: CLLS Regulatory Law Committee Response to HM Treasury's Informal Consultation: Policy options for implementing the Alternative Investment Fund Managers Directive ("AIFMD")

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 welcome and agree with the underlying principle stated in paragraph 1.5 that "*strong justification will be required for proposed additional measures which exceed the terms of EU legislation*". We consider that when implementing EU legislation in a field which has previously been extensively regulated at a domestic level it is important to review existing legislation critically to ensure that the "no gold plating" principle is applied appropriately. Otherwise the retention of existing domestic legislation may in itself involve gold-plating and, even when it does not, is liable to produce several layers of regulation with which firms are obliged to comply, an inherently burdensome result which needs a strong policy justification. It was disappointing that HM Treasury's (HMT) paper giving its initial thoughts on the "Policy

Options for implementing the Alternative Investment Fund Managers Directive" (the "**Paper**") did not address this policy question.

Key Transposition Issue - Section 236 Financial Services and Markets Act 2000

The Paper does not discuss whether, in view of the fact that the AIFMD is intended to regulate across the EU the management of all investment funds (collective investment undertakings) other than those which are already regulated under the UCITS Directive, it would be appropriate for the UK to have the same boundary of regulation and not to retain, in addition to the new definition of an "AIF" which is, in summary:

- a collective investment undertaking which "raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors";

- the existing definition of a collective investment scheme in s 235 FSMA which is, in summary:

  > "arrangements with respect to property of any description the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property" in circumstances where the participants do not have day to day control over the management of the property and, in addition, their contributions and the profits or income are pooled and/or the property is managed as a whole by or on behalf of the operator of the scheme.

Reading the two definitions side by side it is apparent that even though there are difficulties with the EU definition of an AIF, many of which HMT has raised in negotiations and been instrumental in improving as far as possible, that definition is clearer in both substantive and policy terms than the UK definition of a CIS.

The UK definition is only made workable at all by the existence of a number of specific exemptions including an exemption for closed ended bodies corporate (excluding, unfortunately, limited liability partnerships which are a standard form of corporate business structure which can suffer from the uncertainty of the definition), some very limited and specific types of joint venture, certain (but not all) individual investment management arrangements, franchise arrangements, insurance contracts, clearing services, pension schemes, bank and landlord deposits, debt issues, depositary receipts and timeshares. The fact that such a disparate range of exemptions are needed from the CIS definition in itself tends to indicate that the definition is inappropriately broad and unclear.

Members of this Committee have had extensive experience (in some cases stretching back before the Financial Services Act 1986 adopted the relevant definition from its predecessor

,the Prevention of Fraud (Investments) Act) of advising on the meaning of the definition of a CIS and the meaning of "operating" a CIS in a wide variety of commercial situations. Doing so remains very difficult and frequently reaches illogical results which do not appear to have any policy justification. A retail scheme of dubious merits may sometimes fall outside the CIS definition while, on the other hand, commercial negotiations between major industrial or real property businesses can be complicated by potentially falling within the CIS definition so that they require complex restructuring or the introduction of an FSA authorised "operator" which is not regarded by the firms concerned as adding any protection but, along with the expense of advice on the issue, does add to the ongoing costs of business.

The lack of clarity of the definition significantly adds to the risk of inadvertent breach of FSMA and, counter-intuitively, to the result that it is well advised substantial firms which suffer most from the current definition of a CIS, since it is only those who are well advised who realise that a normal commercial arrangement which, for instance, uses an LLP or partnership rather than a limited company for a joint venture which does not fall within the exact words of paragraph 9 of the FSMA (Collective Investment Schemes) Order 2001 may fall within the definition. We do not believe that it is to the credit of English law that such firms are obliged to spend significant sums first on analysis of the issue and then on rearranging their affairs. Rather than strengthening confidence in the regulatory system it tends to diminish it when that system applies to situations which do not, to either the lay or the professional mind, seem to require investor protection or to jeopardise market stability or integrity.

Layering a new definition of an AIF on top of the old definition of a CIS will mean that legal advice on such commercial arrangements would in future be even more complex since it would be necessary to analyse in turn two different very broad definitions, and their respective exemptions, both notionally covering investor protection in a similar area and resulting in similar regulatory and criminal consequences but potentially having different results when applied to a given set of facts. We believe that this type of duplication of regulation, with overlapping non-identical regimes tends to bring the law into disrepute and is exactly what the Government's commitment to "no gold plating" and avoiding unnecessary burdens on business should outlaw. At the very least there should be strong, clearly articulated, policy reasons for the two regimes. No such reasons are given in the Paper.

We are aware that HMT has in the past given some consideration to amending the definition of a CIS because of its inherent uncertainty (which was highlighted by the FMLC among others). We are also aware that the current definition of a CIS, although recognised to be unsatisfactory in nature, is viewed by the FSA as a useful weapon, particularly in the retail sector, against schemes which are essentially fraudulent or, at least, are used as a means of taking money from unsophisticated investors with little chance of their receiving the returns promised. Having reviewed relevant case law it is not, however, apparent to us that the courts would necessarily find it any more difficult to apply the AIFMD definition of an AIF to the types of scheme against which the CIS definition has been used. Indeed, a clearer definition might make it easier to enforce.

We respectfully suggest that HMT reconsiders the unstated assumption in the Paper that the current UK regime regulating those "establishing, operating or winding up" a "collective investment scheme" should be retained alongside the new regime regulating those "managing" an "alternative investment fund". It appears to us that retaining the existing regime in addition to the new one amounts to inappropriate "gold plating" in the context of the introduction of the AIFMD regime. The costs to business and consumers across all sectors (or at least to those sectors of business which take full legal advice) of doing so are not justified by any clear consumer protection benefits when compared with the likely effects of adoption of the AIF definition as the sole basis for regulation in this area. It is likely to reduce, rather than increase, confidence in the regulatory system to have two overlapping unclear definitions in the same area of activity and will make the UK less competitive than those jurisdictions which have a single definition of the relevant boundary of regulation.

Indeed it seems questionable to us whether, so far as the management of funds for professional investors are concerned, the UK will even be able to apply its definition of a CIS in addition to the EU definition of an AIF. It seems arguable that the AIFMD should be regarded as delimiting the activities which Member States can regulate in this field. Clearly full discretion is retained by Member States in relation to retail investors but it is not clear that the same is the case in relation to professional investors as defined under MiFID.

Even if, on further consideration, HMT considers that there are policy reasons justifying the retention of the CIS regime overlapping that of the AIFMD in relation to retail investors we therefore recommend that there should be a new exclusion from the FSMA definition of a CIS of any arrangement the only participants in which are professional investors.

If such an exemption were to be introduced it would be necessary to consider carefully the appropriate definition of professional investors. We do not believe the MiFID definition of a professional investor is well calibrated to AIFs – largely because the "opt up" provisions for elective professional clients do not reflect appropriately experience of relevant asset classes, nor the frequency of transactions in relation to different asset classes. On the other hand the MiFID definition is designed for application by an authorised firm which can be disciplined by its regulator for an inappropriate classification of a client whereas any definition used for an exemption would need to be robust enough for application by an unauthorised firm. It should be at least broad enough to allow individuals engaged in management of the assets to co-invest with the relevant professional investors.

Requirements for sub-threshold AIFMs

The Paper canvasses three options for implementing the AIFMD as it applies to those managers who have a level of funds under management falling below the Directive threshold which are:

a) to apply the Directive in full to all such firms; or

b) to apply a lighter regime on a selective basis to firms falling beneath the threshold; or

c) consistently with its "no gold plating" approach, not to apply the Directive requirements to firms falling below the threshold and instead to remove the current full scale FSA authorisation regime currently applicable to such firms and substitute the lighter registration regime envisaged by the Directive.

As a preliminary comment in this area we should note that paragraph 2.9 of the Paper, in our view, significantly understates the additional regulatory burden of the AIFMD would impose on small fund managers who are currently FSA authorised when it states that there would only be a limited number of additional obligations such as the depositary, use of leverage and private equity provisions. The Directive obligations in a whole range of other areas, particularly those relating to the capitalisation and internal organisation of the manager itself, will be very significantly more onerous and costly for the manager and particularly difficult for a small fund manager to apply.

The FSA rules for regulation of unregulated collective investment schemes have been developed over many years of regulating the sector extensively and are well adapted for the purpose. In most cases where the requirements of the AIFMD exceed those of the current FSA rules it is not apparent to us that they will bring investor protection or market stability benefits by comparison with those rules. It is, however, clear that they will bring significant additional costs to managers and investors and impose additional obligations on small managers which, in view of their limited human and other resources, could spread those resources too thin and divert their attention from more important aspects of taking care of their investors and the funds entrusted to them for management. Where a regulatory provision is of dubious benefit, as is regrettably the case for a significant number of the AIFMD requirements when compared with the equivalent current FSA requirements, its application should not, in our view, be extended more widely than is strictly required by the Directive.

While the FSA's indication that it would in practice seek to apply the Directive requirements in a proportionate way to smaller AIFM is welcome, we do not believe that HMT should regard that as a reason to apply the Directive requirements in full to below threshold managers. The FSA's ability to apply the Directive proportionately is limited by the terms of the Directive itself so unless it created a sub-category of below threshold firms within the FSA Rules a number of onerous provisions, and their related costs, would be loaded on smaller AIFM. In view of the fact that the Directive itself recognises that it is disproportionate to apply its requirements to smaller AIFM it is hard to see any justification for applying those requirements to them.

We note the concern expressed over the potential development of a two tier regulatory regime for AIFMs and a risk of investors making decisions to subscribe on the basis of false perceptions about the regulatory protections from which they might benefit. We agree that

professional investors should be able to check and understand the nature and extent of regulation applied so that this should not be a reason for the imposition of an inappropriate type of regulation.

Even in the retail sector arguably such a risk of false perceptions is greater in the context of regulated firms where the FSA applies the rules in a proportionate manner, or supervises on a more or less intrusive manner, depending on the level of regulatory risk it perceives, than in a situation where there is a clear distinction made between registered firms and authorised firms. Moreover the solution to any such false perceptions appears to us to be clear "branding" or communication of the differences. There are many situations where different types or levels of regulation apply and investors get different sorts of protections. For example an authorised unit trust (highly regulated product), investment trust (normal listed company), derivative (generally not available to the retail investor) and an insurance bond, in each case aiming to track the FTSE, are all treated differently. Many of these regulatory distinctions are not as easy for the average lay investor to understand as would be a distinction based on size or, as at present, on whether he is investing in an ordinary company or some other form of arrangement which is backed up by the use of authorisation on the one hand and registration on the other.

Accordingly we do not believe that full application of Directive requirements across all different types of AIFM above and below the threshold would have significant benefits in terms of investor understanding or enhance the reputation of the UK's financial services regulatory regime.

We cannot give precise costs but from our experience of advising authorised fund managers we believe that the impact would be very significant in terms of costs and the burden of regulatory compliance, which would be particularly significant for new fund management businesses and smaller existing businesses. It is common for such businesses to be established by a small number of dedicated fund managers who commit much of their personal wealth to the venture and to investing in the funds they manage. Imposing the full Directive requirements on all AIFM might prevent a number of such businesses being established and could have a disproportionate effect in the venture and growth capital sector where funds and managers tend to be smaller. The effect on those companies which are not currently subject to regulation at all but which would be classified as internally managed AIF would be even greater.

On the other hand we tend to agree with HMT's view that adopting Option 3 so that the burden of FSA authorisation and obligations under the current regulatory regime are removed from all AIFM which fall beneath the AIFMD threshold would be an inappropriate reduction in UK investor protection in relation to funds marketed to retail investors. Generally we believe there are strong policy reasons in favour of authorisation and appropriate regulation of all firms which manage third party monies, whether in the form of a fund or as individual mandates.

We do not believe there has been a market failure or failure of regulation justifying the imposition of significant regulation beyond the existing UK regulatory regime on AIFM, particularly those falling below the threshold. However, the AIFMD requires the introduction of a registration regime and such a regime will give regulators access to more information to assist them in predicting future threats to market stability.

For the reasons given above relating to the lack of clarity in the definition of a CIS we do not think it appropriate to define the boundaries of regulation beneath the AIFMD threshold by reference to that definition. We believe the definition should be abolished and only the AIF definition used in future. The divisions between types of sub-threshold AIFM and the level of regulation applicable to them should be clearer and have sensible policy justifications for the distinctions made. It may be appropriate to apply the FSMA (Collective Investment Schemes) Order exclusions, if there are not equivalent exclusions from the AIF definition, since each of those exclusions from the CIS definition had policy grounds and is drafted relatively clearly, at least by comparison with the main definition.

However, when implementing the AIFMD we do not think it will be sufficient to rely only on those exclusions. We would suggest that relevant distinctions could be one or more of the following:

a) Whether the AIF is internally managed or externally managed. As with any mutual, the whole costs of regulation of an internally managed AIF fall directly on the investors but may be borne by them unequally, depending on the time they invest. There is no external manager to discipline or from which to recover compensation.

b) Whether the AIF managed are available to anyone other than professional investors and those engaged in or closely connected with management or, at the other extreme, are authorised for sale to the retail public at large.

c) Whether the AIF managed are closed ended.

d) Whether the assets of the AIF are themselves regulated investments so that any external manager would require FSA authorisation to deal with the assets.

We suggest that rather than simply trying to produce a sub-threshold result which is as close as possible to the existing UK regime, although that is one possible approach, consideration could be given to adjusting that approach by applying a limited AIFMD registration only regime to below threshold AIFM of:

a) AIF which are not marketed to retail investors – either all such AIF or only those which principally invest in assets other than regulated investments; and

b) closed ended internally managed AIF.

Venture Capital Funds and European Social Entrepreneurship Funds

Until the substance of the relevant Regulations has been determined it is hard to comment on how far existing UK funds and managers may benefit from the Regulations. Our initial view is that there will be no significant benefit, and may be some detriment, for Venture Capital Trusts and closed ended investment companies in this area which can at present be marketed EEA wide under the Prospectus Directive. There may be some benefit for other types of fund but only if permitted investment policy is sufficiently flexible and the level and type of regulation is no more burdensome than that currently imposed in the UK.

Approved Persons regime

There are general issues surrounding the application of the approved person regime, its interaction with EEA passports and extension into parent entities which deserve more consideration in relation to "gold plating" and *vires*.

However, we do not see an obvious reason for treating the regulated AIF sector differently from other parts of the investment management world or, indeed, the rest of the regulated financial services industry in relation to the approved persons regime. The AIFMD envisages considerable vetting of the governing body/senior management which is an exercise the FSA currently does for other regulated entities through the approved person regime, whether or not those entities are listed.

Marketing to Retail investors

The United Kingdom currently imposes extensive restrictions on marketing collective investment schemes to individuals and other retail investors. We believe that it should continue to be possible to market to the retail public those AIF which are currently allowed to be so marketed. We do not have strong views on whether any other types of AIF should be marketed more freely. The very extensive regulation imposed by the AIFMD may lead to the conclusion in due course that wider marketing of some types of AIF should be permissible but we think this should be assessed very carefully. Generally we think the existing boundaries to marketing to the retail public are appropriate if properly policed.

Private Placement Regime

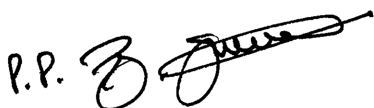
We strongly agree that the Government should not impose additional Directive requirements on third country managers of third country funds, nor indeed on the marketing of third country funds by UK managers. Professional investors in the UK need access to the widest range of funds worldwide as is possible and UK managers of such funds should not be made any more uncompetitive than is the unavoidable consequence of the Directive.

We also consider that the Government should not impose additional Directive requirements on third country managers of UK AIF but should continue the current regulatory approach

under which authorisation is only required when the relevant regulated activity is carried out in the United Kingdom. Imposing Directive requirements simply because the relevant company or other investment vehicle is formed in the UK, rather than because the manager manages it in the UK would deprive UK entities of the benefit of the expertise of third country managers and make it unlikely that the UK would be used as the place of formation.

If the Treasury 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,



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