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By email: cp13_09@fsa.gov.uk

10 May 2013

Dear Sirs

Re: FSA CP 13/9 – 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.

This paper has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets, including alternative investment fund managers specialising in numerous strategies and asset classes such as hedge, private equity, real estate, listed equities and fixed income, as well as service providers such as depositaries/custodians, prime brokers and fund administrators.

The Committee has the following comments on the consultation:

1. Chapter 2, paragraphs 2.20 to 2.28

We agree with the FCA's Statement of Intent that its assessment of delegation arrangements will be more qualitative than quantitative. Indeed we think this is a necessary approach, for example if a firm were to delegate portfolio management, but retain all risk management, then the application of a percentage threshold would be impracticable. We note that the FCA does not propose to issue guidance in this area but think it would be helpful, even if more detailed general guidance is not issued, if some or all of the comments in this statement of intent were to appear in PERG.

2. Chapter 3

The application of SYSC to any business which manages both funds and segregated mandates seems unnecessarily complex. In practice these businesses, at an operational level, are unlikely to be discrete and firms carrying on both types of business will be subject to some AIFMD and also MiFID rules. It is extremely difficult to follow the intended application of SYSC and we hope that this will be an early candidate for streamlining and improvement in its clarity.

We also suggest that it is unhelpful for full scope AIFM to layer a relatively small number of COBS provisions on top of FUND by an adaptation of the Chapter 18 specialist funds regime. It would be preferable to place all the relevant rules in FUND. Moreover some of the provisions it is proposed to apply should be amended in order to comply with the AIFMD. For instance, in relation to best execution obligations the AIFMD Regulation makes it clear that these obligations do not apply where there is no choice of execution venue but the provisions adopted in COBS18.5.4A do not include that clarification.

3. Chapter 4

We note that the definition of funds under management now appears to apply the AIFMD method of calculation not only to AIF AUM but also to all other CIS managed by the relevant manager, whether or not the other CIS are in fact AIF or UCITS. It is not clear to us that this is appropriate since it appears, potentially, to increase the required capital levels in that (a) as far as UCITS managers are concerned it is not clear to us that the same calculation method (absolute value including assets acquired through leverage) applied previously rather than a more normal net asset calculation and (b) as far as AIFM are concerned we do not believe the calculation should extend to other CIS which are not also AIF.

As a separate point we note that AUM of "grandfathered AIF" under the transitional provisions are excluded from the calculation of funds under management for the purposes of the threshold and we consider they should also be excluded from the definition of funds under management. We note in this context that there is clearly no general policy requirement for managers to hold capital relating to the level of their AUM since no such requirement is imposed in relation to segregated portfolios the firm manages. Restriction of funds under management to those of AIF and UCITS managed would avoid gold plating

We think it is unfortunate that the opportunity is not being taken to move all the prudential requirements into the Prudential Standards Handbook; the retention of IPRU(INV) is an anomaly and we think that the FCA should commit to incorporating all the prudential rules into the same part of the Handbook. At the very least the rules in IPRU(INV) should become part of the normal Handbook in electronic form, rather than only as a linked PDF.

4. Chapter 5

Paragraph 5.22 indicates that the FCA is proceeding on the basis that there will be a passport for "MiFID type" additional activities carried on under Article 6(4) of the Directive but that the availability of this passport is still under discussion at an EU level so that the final rules might need to be changed. This is clearly an issue with much broader importance than in relation to the FSCS and FOS. We note that the EU Commission has since produced Q&A which include answers to the effect that an AIFM cannot have a passport under the AIFMD for Article 6(4) nor can it have a limited authorisation under MiFID in order to passport its services under the Directive.

We consider this approach by the Commission to be unnecessarily and inappropriately restrictive. We can see that the contrast between the wording of the AIFMD and of the UCITS Directive on passporting tends to support the Commission's view that there is no passport under the AIFMD itself for the additional activities. However, we agree with the FCA that it does not follow that the firm cannot have a simultaneous, though appropriately limited, MiFID authorisation and passport (with appropriate restrictions). The Commission indicates that its concern is that because the power to carry on additional activities is a derogation it should be read narrowly. We do not believe that if follows that the derogation under the AIFMD need be read so narrowly as to exclude European rights under MiFID and to imply that the two Directives are mutually exclusive. It is perfectly possible to restrict the exercise of those rights in a manner which ensures there is no breach of the AIFMD.

MiFID excludes managers of collective investment undertakings but that has not previously prevented MiFID firms also being authorised to carry on collective portfolio management (e.g. operate CIS as non-MiFID business while managing individual portfolios as MiFID business). Article 6(8) AIFMD states that MiFID investment firms are not required to obtain AIFMD authorisation to provide individual portfolio management services to AIF. It does not imply that that they would not need to obtain such authorisation in order to provide collective portfolio management services, still less that they are prohibited from doing so. Article 6(4) of the AIFMD allows Member States to authorise the additional activities, and no further activities, It does not state the manner in which Member States can exercise that power of authorisation or prevent it being exercised by way of a limited MiFID authorisation.

Even on a narrow reading of the derogation, we can therefore see no reason why it should not be possible for an AIFM in a member state which permits it to carry on limited additional activities to choose between:

a) domestic authorisation only to carry on those activities under the AIFMD, subject to the limited MiFID provisions applied under the AIFMD; and

b) a broader MiFID authorisation to carry on those activities, subject to the heavier burden of full MiFID compliance. and subject to requirements limiting the activities to those permitted under the AIFMD.

There would then be no risk of passporting without full EU authorisation, supervision and control for the relevant activity but firms would not have to multiply entities and complicate their groups just in order to comply with this restriction.

On a related point we are concerned more generally about the restriction on AIFM activities. We believe that guidance will be necessary in order to make the restriction copied out in FUND 1.4.3 workable. For example, clearly in order to run its business an AIFM will in fact need to carry out many other activities besides those listed. For instance it will need to purchase or lease premises, employ staff, invest its capital (in liquid securities to the extent the capital is required for regulatory capital), arrange insurance etc.

The derogations/exclusions from the restrictions on activities are all phrased by reference to EU regulated financial sector activities and we believe this is probably the best way of approaching the restrictions, i.e. to interpret them as a statement of restrictions on the permitted EU regulated financial sector activities. But in any event, since the UK has retained its own very broad definition of a CIS which is not identical to the definition of an AIF and made operating CIS a regulated activity (which is not the case in other Member States), this could mean that an AIFM was not able to run CIS which were not AIF, which would be an absurd conclusion and would lead to unexpected (and costly) implications.

5. PERG 8.37 – AIFMD marketing

We note that this guidance is based on the current approach in the Treasury Regulations, which is to extend the definition of marketing contained in the AIFMD so that it includes offerings which are not made on behalf of the AIFM. We assume that there will be further changes to the guidance to reflect any revisions to the HMT Regulations. We do not therefore comment on specific issues where we have already noted disagreement with the stance being taken by HMT, and where the approach taken by the FCA simply reflects the HMT position. However, we should note that if the Treasury amends the definition to fully track the AIFMD definition and relate only to offerings on behalf of or at the initiative of the AIFM there may need to be some guidance, possibly at a European level, on whether, or in what circumstances, marketing at the initiative or on behalf of the AIF itself, when that AIF has an external AIFM, would or would not be deemed to be at the initiative of the AIFM. This will be relevant for passporting purposes.

A related question is whether if an AIF directly appoints a placing agent to market it, but this appointment is made or deemed to be made "at the initiative of" the AIFM, the AIFM should be regarded as having delegated the AIFM function of marketing and therefore as remaining responsible for it. Our view is that although case by case analysis would be required, the AIFM would not be responsible unless it did in fact undertake responsibility for the marketing function and then appoint the placing agent. If the placing responsibility was given to the placing agent directly by the AIF we do not believe the AIFM can be treated as having delegated its own function, even if the marketing could be regarded as undertaken at its initiative.

Subject to those general comments we have the following comments:

4.1 8.37.4G(2) – We consider the phrase "made available" to be too wide, as it could catch genuine "passive marketing" (on which we have separate comments – see below). It might be clearer to say that although the fact that interests in the AIF are available for investment is not itself conclusive evidence that there has been or will be an offer or placing, there cannot be an offer or placing until the interests in the AIF are in fact available for investment.

4.2 8.37.5G – Whilst in many respects the FCA's suggested approach to the issue of draft documentation is helpful and constructive, it opens up the risk, if this interpretation is adopted by other Member States, that UK firms will face barriers to prevent preliminary communications with potential investors. Whilst the UK proposes to ensure that its financial promotion regime permits such communications, there can be no certainty that this will be the case in other Member States. If this is to be the interpretation that is adopted by the FCA then we think it is essential that the FCA works through ESMA to ensure not only that other Member States take the same approach, but that other Member States permit preliminary communications to persons who are within the class of persons to whom a fund may be marketed. In addition, we are concerned that the proposed approach will lead to significant delays in marketing and would urge the FCA to develop a procedure which enables some preliminary clearance to be obtained so that the final documentation can be swiftly approved. Otherwise it is likely that some managers will think they need to seek approval on the basis of pro forma documents for preliminary marketing and then submit "material change" notifications, which would be an inherently clumsy process using excessive FCA time.

4.3 We agree that it would be an indirect placing or offer where a placing agent or underwriter purchases interests in order to distribute them to a wider investor base and this is done on behalf or at the initiative of the AIFM (as the terms placing agent and underwriter indicate). However where an investor, such as a discretionary manager, purchases interests on behalf of its clients or there are other purchases followed by broader distribution without the AIFM arranging, requesting or otherwise encouraging the subsequent sales we do not consider that should amount to an indirect placing or offering. It would be helpful if guidance could make this clear, together with the general proposition that secondary trading without the encouragement of the AIFM will not amount to an direct or indirect offer or placing by or at the initiative of the AIFM.

4.4 8.37.8G reflects the HMT Draft Regulations which we believe are an incorrect interpretation of the AIFMD. The provisions operate as a restriction which could prevent a non-EU AIFM marketing AIF to, say, UK nationals who are resident outside the EEA. Although marketing itself is defined as marketing to an EEA registered or domiciled investor, Article 2(1)(c) of the AIFMD (and also Recital 13) only applies to non-EU AIFM where their marketing is in the Union. The same applies to disclosure under Article 23 and marketing under Articles 31, 32, 35, 36, 37, 39, 40 and 42. Each

appears to have a territorial limitation imposed in addition to the restriction to EU investors in the definition of marketing itself. We think it is important that this is reflected in the Regulations and the FCA Rules.

4.5 This point also links up with the question of how offers to agents are to be regarded for the purposes of the marketing restrictions. If an offer is made to an EEA (or US) investment manager is that an offer to an investor registered or domiciled in the EEA (or US) even though in each case the underlying clients of the manager may be a mixture of EEA and US investors. We suggest that unless and until the AIFM actually deals directly with any underlying client of the manager/agent the offer should be regarded as made to the investment manager/agent. Again it would be useful to have guidance on this question

4.6 8.37.10G – The draft guidance on passive marketing is in our view unnecessarily narrow, our concern relates in particular to the final sentence of 8.37.10(4). Just because an investor has had a previous involvement with the AIFM does not mean that that investor could not make an approach of its own initiative in relation to another fund, or indeed that an investor who is currently invested in one fund could not of its own initiative seek to make a further investment in that same fund. We think that the phrase "no previous involvement with the AIFM" is an unnecessary restriction. For example, an investor could have an investment in an existing fund whose investment profile is directed within Europe. If the investor is aware that the manager also operates an "India" fund, we see no reason why there could not be an approach by the investor at its own initiative to invest in that fund. Similarly, we think that the sentence in 8.37.10G(3):

> "Only communications which are solicited by the investor should be considered to have occurred at the initiative of the investor"

is also unnecessarily restrictive if it is meant to apply to each separate communication. In our view the issue is how the relevant part of the communication chain is commenced, and how genuinely it is on the investor's initiative that the offer or placing is made. We think that this sentence, which links to some of the wording in the financial promotion regime, should be deleted. We do not think that the financial promotion regime is relevant to the concept of passive marketing, it is there to provide protection in relation to invitations and inducements that constitute financial promotions.

In view of the fact that:

a) retail investors will continue to be fully protected by the financial promotion (and scheme promotion) regime so that the passive marketing regime will be principally relevant in relation to offers or placings with professional investors; and

b) the passive marketing exemption was inserted into the Directive in order to ensure that EEA professional investors continued to have access to those funds world wide that they wished to invest in;

we suggest that the passive marketing exemption covers a much wider range of circumstances where the investor positively requests that an offer should be made to it than is suggested in the draft PERG 8.37.10 (including where it requests access to documents in a website which is not open access but is restricted to professional investors).

Scope Questions and Answers

Question 2.10

(i) We think this answer is helpful but incomplete, though we recognise that it reflects ESMA draft guidance and subsequent FCA Q&A give a fuller picture. We agree that when capital is invested by a person or body of persons who are "internal investors" that this is not likely to be raising capital for the purpose of the AIF definition. We think it follows from this that if all of the investors are internal investors, save for one external investor, then the logical result is that there has still not been a capital raising. We believe, therefore, that the penultimate paragraph should be rephrased:

> "However, the presence of the internal investors alongside other investors does not mean that there is no capital raising."

Moreover we find the proposition, taken from the ESMA draft, that investment by the AIFM itself should be regarded in the same way as other external capital illogical and unrealistic (as is to some extent made clear in later Q&A, notably Q2.52). The fact that there is a specific group exemption for situations when the only investors are the AIFM and members of its group does not mean that any investment by the AIFM in other circumstances will amount to capital raising.

(ii) Question 2.10 of the draft amendments to the Perimeter Guidance addresses the meaning of "capital raising" for the purposes of the definition of "AIF" or "alternative investment fund". The definition requires that an AIF "raise[s] 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 draft answer focuses on certain situations in which an entity may receive capital from connected persons which do not constitute "raising capital" for the purposes of the definition of AIF (such as investments by the governing body of the relevant entity or its manager, and which could include carried interest entities or similar, and the formation of entities which may broadly be described as "family offices").

But the draft answer does not take account of the fact that the definition of AIF also requires that (a) there is a capital raising from a number of investors and (b) that capital raising must made for the purposes of investment in accordance with a defined investment policy for the benefit of those investors. There are numerous entities which may not have been formed as investment entities but which, over time, have become investment vehicles without having an investment policy or having raised capital for the purposes of investment (whether or not in accordance with a defined investment policy) and which therefore are not AIFs and should not be within the scope of the Directive.

For instance, it is relatively common for a company to be formed for the purpose of operating a family-owned business, with the is later being sold and the proceeds of sale invested by the company for the benefit of the family members. Accordingly, the company may have become an investment vehicle, but without any new capital being raised or the company having an investment policy. It should be clear that these types of vehicles should not be "AIFs" as defined in the Directive.

Accordingly, it would be very helpful if the draft answer should make clearer that the definition of AIF requires that capital is raised from a number of investors for investment in accordance with a defined investment policy, perhaps by reference to the example given above.

Further, it would also be very helpful if the draft answer clarified that the capital raising must be in relation to "new money", that is that secondary sales of securities of the entity by its security holders which do not raise any new money for the entity are not "capital raising" for that entity.

Question 2.12 It also remains our view that the ESMA draft guidance repeated here is fundamentally misconceived and that where as a matter of fact there is a single investor (whether or not coupled with internal investors who should be disregarded) the putative AIF should not be regarded as having raised capital from a number of investors. If provision in constitutional documents is required to clarify classification then the appropriate course would be to reverse the burden of proof and indicate that an entity can be and continue to be an AIF, even though it has only one member, if its constitution expressly states that it has raised/proposes to raise capital from a number of investors.

Questions 2.18 to 2.23 are broadly helpful in suggesting a line of approach, but the explanation given in Q2.23 as to why the answer to Q2.18 is not applicable to all types of undertakings to which the AIFMD is meant to apply, is extremely confusing. In particular, we find the sentence:

> "The way to reconcile this is to say that the AIFMD treats a fund as investing if its ultimately underlying assets are investments in the sense of financial instruments such as shares and debt securities"

as not being a helpful distinction to distinguish a fund from an ordinary company with general commercial purposes, where the ordinary company is the holding company for a group, nor, indeed in a number of other situations where, for instance, a financial sector institution is acting as a broker dealer or investment bank as identified in Q2.57.

Question 2.37 – we are aware that the Joint Associations Committee on Retail Structured Products has suggested that raising capital by way of securitisation is not within the scope of the AIFMD, whether or not this specific exclusion applies. We would hope that the answer to Q2.37 will ultimately reflect any further developments which reflect these comments.

Question 2.59 – we fundamentally disagree with the answer to this question, which we believe is both wrong as a matter of law, and extremely unhelpful. MiFID Recital 15 provides that MiFID does not apply to collective investment undertakings and their managers and depositaries, whether co-ordinated at Community level or not, as they are subject to specific rules directly adapted to their activities. MiFID refers to collective investment undertakings. The AIFMD applies to a specific form of collective investment undertaking, namely one that raises capital and invests in accordance with a defined investment policy and does not fall within one of a number of exclusions and exemptions under the AIFMD. These are not necessary characteristics of a collective investment undertaking of itself within the meaning of MiFID. We also note that the AIFMD itself states that it does not apply to funds, and (e.g. Recital 7) that it does not apply to all managers of funds. If the FCA's approach were correct it will mean that on 22nd July 2013 there will be firms who are currently authorised to operate collective investment schemes and whose activities are treated as falling within MiFID Article 2(1)(h), which will, without more, need to be authorised to carry on the MiFID activity of managing investments. If this were really intended then there should have been much greater publicity than has been the case, indeed there has been none. We believe there has been no such publicity, because this is not the correct approach. A collective investment undertaking may be within the scope of the exclusion from MiFID and yet not within the scope of the AIFMD. If it is, in the UK, it may be a collective investment scheme and its operator authorised accordingly.

Question 3.10 We agree that the general partner of a limited partnership is normally an external AIFM. However we believe that this answer should address the fact that limited

partnership agreements and structures are very flexible and the detailed terms of a particular limited partnership may be such that some limited partnerships are internally managed, e.g. by a committee of several general partners or because there is express provision to that effect. Clearly this presents an authorisation problem if the relevant partnership does not have legal personality but we do not believe that the fact that the AIFM will sometimes not be able to become authorised should prevent the FCA in this question recognising the possibility that the constitutional documents of a limited partnership may sometimes create an internally managed partnership even though normally the general partner would be an external AIFM.

If you 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, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
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