



c/o Bank of England
Threadneedle Street
London
EC2R 8AH

Telephone: (+44) (0)20 7601 3918
Fax: (+44) (0)20 7601 5226

Email: fmlc@bankofengland.co.uk
Website: www.fmlc.org

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Investment Funds Team
Conduct Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

dp12_01@fsa.gov.uk

Dear Sirs

Issue 145: Implementation of the Alternative Investment Fund Managers Directive (the "AIFM Directive"):¹ the definition of Collective Investment Scheme

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risk and to consider how such issues should be addressed.

The FMLC has reviewed the discussion paper published by the Financial Services Authority (the "FSA"), *Implementation of the Alternative Investment Fund Managers Directive* (the "Discussion Paper"), with interest.² Notwithstanding the lapsed deadline for responses to the Discussion Paper, the FMLC believes it important to raise certain issues of legal uncertainty with the FSA.

Prominent amongst the aforementioned issues is the definition of Collective Investment Scheme ("CIS") under the Financial Services and Markets Act 2000 ("FSMA"). It is on the definition of CIS that the present letter focuses. The FMLC intends, however, to provide the FSA with a broader paper on the subject of the implementation of the AIFM Directive in due course. Thank you for your forbearance while the FMLC prepares a considered response.

The definition of CIS³

Given that the AIFM Directive will regulate CIS operators and that implementation of the AIFM Directive is likely to require amendments to FSMA, the FMLC believes that the implementation of the AIFM Directive represents a sensible juncture at which to address legal uncertainties arising from the definition of CIS under section 235 of FSMA.

¹ Directive 2011/61/EU.

² See <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf>.

³ In July 2008, the FMLC published a paper entitled "Operating a Collective Investment Scheme" and in November 2011, the FMLC published a letter to HM Treasury regarding the definition of CIS. The present letter draws on these publications, both of which can be accessed at <http://www.fmlc.org/Pages/papers.aspx>.

Further details in this letter are taken from the following article which is to be published in the April 2012 edition of Butterworths Journal of International Banking and Financial Law – "Collective investment schemes: a missed opportunity?" (Michael Brindle QC, Joanna Perkins and Nicola Minervini).

The FMLC believes that the following terms found in section 235 of FSMA, in particular, give rise to legal uncertainty: (i) “arrangements”, (ii) “day-to-day control” and (iii) “operator”. The Committee acknowledges that UK financial markets have developed certain strategies to reduce the negative impact of such uncertainty. The FMLC argues, nevertheless, that clarification of the law in this area would be of benefit to the wholesale financial markets.

(i) “arrangements”

The courts considered this term in *The Russell–Cooke Trust Company v. Elliott*⁴ and *FSA v. Fradley and Woodward*.⁵ Neither judgment, however, provided clarity as to what constitutes a single “arrangement” as opposed to a set of “arrangements”. Financial markets participants continue, as a result, to encounter significant difficulty in structuring investment schemes to ensure that they do not fall within the term “arrangements”.

Section 235 of FSMA requires that “arrangements” relate to “property of any description, including money”. Owing to the wide scope of the term “property”, the requirement described does little to clarify the term “arrangements”.

Section 235 also requires that the purpose or effect of an arrangement be to “enable persons taking part in the arrangements to participate in or receive profits or income”. There is, however, no stipulation that such persons receive profits or income directly. As a result, this requirement has only a modest limiting effect on the term “arrangements”.

(ii) “day-to-day control”

Under section 235(2) of FSMA, participants must not have “day-to-day control” over management of the relevant property. By way of guidance, the final clause of section 235(2) includes a statement to the effect that questions as to the existence of “day-to-day control” should not be answered by reference to an assessment of whether or not participants “have the right to be consulted or to give directions”. Since the right to give directions is normally accepted as an indication of legal control, the aforementioned clause serves, in fact, to create further uncertainty regarding the term “day-to-day control”.

The FMLC welcomes the efforts of the FSA, in its Perimeter Guidance Manual (“PERG”),⁶ to clarify the meaning of “day-to-day control”. In the Committee’s view, however, the guidance does not resolve the uncertainty. PERG states that control is “the power, from day-to-day, to decide how property is managed”. This does not make clear whether, bearing in mind the final clause of section 235(2), the fact of giving directions on a daily basis amounts to “day-to-day control”. Nor is it clear from PERG whether the control of property which requires little management on a day-to-day basis (eg. a fixed term debenture) can fall within the meaning of “day-to-day control”.

The FMLC notes that “day-to-day control” has been equated with “minding the shop” by the courts. Such an interpretation evokes a practical conception of the phrase. This judicial approach may, therefore, lend credence to the view that the legislative intention behind the final clause of section 235(2) is to draw a distinction between (i) the right or power to exercise control (which is *not* to be seen as indicative of “day-to-day control”) and (ii) the actual exercise of control. Such legislative intention could be seen as incompatible with PERG which, in contrast, focuses on “the power...to decide”.

The FMLC notes that uncertainty also persists as to whether “day-to-day control” can be delegated (and, if so, to whom) and whether *all* participants are required to have “day-to-day control” in order for an arrangement to fall outside section 235(2).

⁴ [2001] NPC 69, [2001] All ER (D) 300 Mar, [2001] All ER (D) 197 (“*Elliott*”).

⁵ [2005] EWCA Civ 1183, [2006] 2 BCLC 616 (“*Fradley*”).

⁶ PERG 11.2, questions 6 and 9.

(iii) "operator"

Neither "operator" nor "operate" are defined in FSMA. Uncertainty exists, following *Fradley* and *Elliot*, as to the proper distinction between an "operator" and a mere service provider.

Professional firms provide a variety of services to CISs. It is not uncommon for one firm to provide the management services for a CIS, whilst another provides the administrative services. In general, firms providing administrative services are not "authorised persons" for the purposes of carrying out "regulated activities" under FSMA. Firms performing management functions are, in contrast, "authorised persons".

Operating a CIS is a "regulated activity". It remains unclear, however, whether a professional firm providing administrative services only to a CIS is an "operator" for the purposes of section 235. There exists, therefore, a danger that the authorisation requirement under FSMA could be triggered by a professional firm, that is not authorised, providing administrative services to a CIS. Those operating such a firm could, as a result, face criminal sanctions.

The FMLC also identifies uncertainty with regard to the term "operator" in the context of investment companies. In-house functions for a CIS will, in general, be performed by different business lines within the same investment company. Uncertainty exists as to whether each of these business lines can constitute an "operator", or whether it is the investment company, as a whole, which constitutes the "operator".

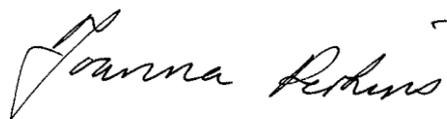
The definition of CIS and the implementation of the AIFM Directive

The FMLC believes that the issues detailed above are of importance and merit consideration. It is the view of the FMLC that the implementation of the AIFM Directive, in which the FSA will, of course, play an important role, offers an opportunity to reduce legal uncertainty as regards the definition of CIS.

For your information, please find enclosed a copy of an FMLC paper, published in 2008, regarding the definition of CIS (this paper is referred to in footnote 3 above).

I would be very happy to discuss any of the issues raised above with you further. Please do not hesitate to contact me if you would like further information or if you would like to arrange a meeting.

Yours faithfully



Joanna Perkins
FMLC Director

Enc: FMLC paper