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

06 June 2012

Jonathan Faull
Director-General
Directorate-General Internal Market and Services
European Commission
1049 Brussels
Belgium

Dear Mr Faull

Issue 145: Implementation of the Alternative Investment Fund Managers Directive (the "AIFM Directive"): the meaning of "undertaking" in Article 4.1(a) of the AIFM Directive and the identification of "letter-box" entities

The remit of the Financial Markets Law Committee (the "FMLC" or the "Committee"), established by the Bank of England, 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 risks, and to consider how such issues should be addressed.

This is the third time that the FMLC has produced a submission regarding the AIFM Directive. The Committee published a paper on the subject in 2010 and sent a letter regarding the Directive to the European Securities and Markets Authority ("ESMA") in November 2011.[1] Further to the FMLC's two previous publications, the present letter raises a new point, regarding the meaning of "undertaking", and returns to the issue of the identification of letter-box entities which was raised in the letter to ESMA.[2]

Article 4.1(a) of the AIFM Directive: the meaning of "undertaking"

Article 4.1(a) of the AIFM Directive defines the term AIFs. The FMLC notes that this is an exceptionally important provision as it demarcates the regulatory perimeter of the AIFM Directive. The Article provides, *inter alia*, that AIFs means "collective investment undertakings" which satisfy certain criteria.

The term "undertaking" is not defined or clarified in the AIFM Directive. On its face, the word could have a very wide meaning. It is used in various parts of European law but does not represent a settled, autonomous concept: in the context of competition law, jurisprudence of the European Court of Justice gives what may be considered a broad meaning to the term;[3]

---

1 FMLC paper entitled *AIFM Directive: Legal Risks – Analysis of certain core areas of the Alternative Investment Fund Managers Directive which are capable of giving rise to significant legal uncertainty* (January 2010).

Letter to Verena Ross, Executive Director of ESMA, regarding ESMA's draft technical advice to the European Commission on possible implementing measures of the AIFM Directive (4 November 2011).

The above letter and paper can be downloaded at http://www.fmlc.org/Pages/papers.aspx. In due course after publication, all FMLC publications can be accessed at the aforementioned webpage.

2 The FMLC is grateful to Tamasin Little of SJ Berwin LLP for her contribution to this letter.

3 See, for example, *Klaus Höfner and Fritz Elser v Macrotron GmbH* [1991] ECR I-01979.

the UCITS Directive sets out types of entity and arrangement that qualify as "undertakings", in the context of the term "undertakings for collective investment", without giving any definition of the term.[4]

The FMLC believes that Article 4.1(a) gives rise to legal uncertainty because, as drafted, it is unclear to which entities the term might apply. It is not for the FMLC to comment on the policy merits of drawing the regulatory perimeter in one place rather than another. The Committee believes, however, that without further clarification, the term "undertaking" could serve to bring a wider array of arrangements than intended within the AIF concept (and thereby make such arrangements subject to the AIFM Directive). Notwithstanding the fact that such arrangements do not appear to fall within the plain or ordinary meaning of the term "undertaking", the FMLC believes, in particular, that a number of capital markets instruments, such as traded warrants, could be found to be AIFs.

A lack of clarity as to the entities falling within the meaning of "undertaking" could also give rise to divergent interpretations of Article 4.1(a) amongst member states. This would, as a result, lead to the unequal treatment of AIFMs in different parts of the Union.

In light of the foregoing, the FMLC argues that legal certainty would be increased by the introduction of a definition for the term "undertaking". In support of this aim, the FMLC proposes the definition below.

> An Undertaking means
>
> (a) a body corporate or partnership, or
>
> (b) an unincorporated association carrying out a trade or business (which includes, for the avoidance of doubt, a unit trust and/or a common fund constituted by contract and managed by a management company or companies).

This draft derives from the types of entity and arrangement set out in Article 1.3 of the UCITS Directive and the definition of "undertaking" found in Section 1161(1) of the UK Companies Act 2006. The UK definition has operated in English law since the UK Companies Act 1989 came into force. It was introduced as part of the amendments made to the UK Companies Act 1985 to implement the Seventh Company Law Directive which, whilst using the term "undertaking" frequently, does not define it.

The proposed wording provides an inclusive definition which is intended minimally to exclude those arrangements which do not appear to have been intended to fall under the Directive (such as capital markets financial instruments). To avoid any risk of the exclusion of examples of "undertakings" which are recognised and long established in the context of undertakings for collective investment, the definition also refers to specific entities set out in the UCITS Directive.

The identification of "letter-box" entities

The following discussion restates comments made by the FMLC with regard to ESMA's draft technical advice on implementing measures for the AIFM Directive. The Commission's implementing measures, drafted in light of ESMA's advice, have not yet been published. The FMLC is, however, given to understand that, with regard to the particular point in the advice discussed below, the Commission's measures will follow ESMA's advice. The FMLC, therefore, takes the view that the following point continues to have validity and that it should be considered in the context of the Commission's preparation of its implementing measures.

[4] Article 1(3) of Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

Recital 9 of the AIFM Directive states that

> the provision of investment services by [investment firms authorised under Directive 2004/39/EC) and established in a third country] in respect of AIFs should never amount to a de facto circumvention of this Directive by means of turning the AIFM into a letter-box entity, irrespective of whether the AIFM is established in the Union or in a third country.

Similarly, Article 20(3) of the AIFM Directive prohibits an AIFM from delegating its functions to a third party or a sub-delegate "to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity."

ESMA provided advice to the Commission as to the circumstances in which an AIFM should be considered to have become a letter-box entity. ESMA set out two such circumstances, the first of which is where an AIFM "no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation." Neither the description of this circumstance nor the explanatory text thereto set out the criteria to be fulfilled to evidence "necessary expertise and resources" in connection with effective supervision and management of risk.

The FMLC believes that if ESMA's advice is reflected in the Commission's implementing measures it will be unclear to which entities the circumstance applies. The FMLC believes that the circumstance could be found to apply to a wider array of entities than intended by the AIFM Directive. Such entities would be vulnerable to disciplinary action by a domestic regulator for breach of the AIFM Directive. By way of example, quoted investment trusts (which commonly have third party investment managers, third party administrators and non-executive boards of directors) could, *prima facie*, be found to fit within the described circumstance.

Uncertainty as to the entities to which the circumstance applies could also lead to the inconsistent interpretation of Article 20.3 across the Union and the consequential uneven treatment of AIFMs.

The FMLC, therefore, believes that the Commission's implementing measures, as well as confirming that an AIFM which actively undertakes the supervisory responsibilities will not be a letter-box, should set out the criteria for assessing the "necessary expertise and resources" of an AIFM in connection with effective supervision and management of risk.

The FMLC is given to understand that the Commission's implementing measures with regard to letter-box entities may introduce a further circumstance, not found in ESMA's advice, pursuant to which an AIFM will be deemed to be a letter box where it delegates considerably more operations than it carries out itself. The FMLC notes that, without clear guidance as to how the existence of such circumstance is to be measured (for example by reference to the volume of tasks and/or by reference to the substance and importance of tasks), legal uncertainty could arise from the introduction of this circumstance. The circumstance's introduction might also unintentionally prevent AIFMs from playing an essentially supervisory role when delegating tasks.

I would be delighted discuss any of the points raised in this letter with you further. Please do not hesitate to contact me if you should like to arrange a meeting.

Yours sincerely

Joanna Perkins
FMLC Director