The AIF test now tested in Court !

A court in Rotterdam has recently taken a stand on what constitutes a «number of investors» - one of the few key elements to qualify as an AIF.

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On 26 April 2017, a trial court in Rotterdam gave its interpretation of the «number of investors» element of the «alternative investment fund» definition. In doing so, the Dutch court had to consider ESMA's Guidelines on key concepts of the Directive on Alternative Investment Fund Managers (the «AIFMD»),[1] and give an opinion as to whether an investment vehicle invested by a sole shareholder shall (or not) be regarded as an alternative investment fund ("AIF") and hence be subject to (or not) the Dutch AIFMD legal regime.

The Legal Background

A decade ago, in the aftermath of the global financial crisis, the member states of the European Union («**EU**») decided to establish a framework capable of addressing certain risks associated with investment funds whose managers historically had not been subject to prudential supervision. In 2011, the European legislator adopted a harmonised and stringent regulatory and supervisory framework for the activities of alternative investment fund managers («**AIFM**») within the EU.

Under the AIFMD (as transposed under the national laws of all EU member states), any investment vehicle that qualifies as an AIF must be managed by an AIFM who will be subject to the AIFMD. As a result, it is now the responsibility of the management body of any collective investment undertaking established in the EU or being marketed to EU investors to perform an "AIF test"[2] in order to assess whether the investment structure in question qualifies as an AIF and whether, as a consequence, it must be managed by an entity that is either registered with its national competent authority as a "registered" AIFM (or small AIFM) or as an "authorized" AIFM (fully subject to AIFMD).

To run the AIF test, the governance body of the relevant vehicle has to look at the definition of an AIF under the AIFMD. According to said directive, an entity may normally be deemed to qualify as an AIF when said entity is 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.

What is understood by «a number of investors»?

In order to facilitate a uniform interpretation of the definition of AIF within the EU, ESMA published its guidelines on key concepts of the AIFMD in August 2013.[3] In the guidelines, ESMA opines that an undertaking which is not prevented by its national laws, the rules or instruments of incorporation, or any other provision or arrangement of binding legal effect, from raising capital **from more than one** investor should be regarded as an undertaking which raises capital from a number of investors. According to ESMA, this should be the case even if the investment structure **in fact only has one investor**.[4]

Moreover, even if an undertaking is prevented from raising capital from more than one investor, it should still be regarded as an undertaking which raises capital from a number of investors if: (a) *the sole investor invests capital which it has raised from more than one legal or natural person with a view to investing it for the benefit of those persons; and (b) the sole investor itself consists of an arrangement or structure which in total has more than one investor*.[5]

This criteria could, for example, be fulfilled by master-feeder structures, fund-of-funds structures, or arrangements where the sole investor is not acting for itself, but rather as a nominee acting as agent for more than one investor.[6]

Background to the Rotterdam Case

The dispute in question in the Rotterdam[7] case arose between a manager of three undertakings and the Dutch regulator of the financial sector (*Autoriteit Financiële Markten*). In essence, the Dutch regulator had come to the conclusion that the manager was in breach of the law by managing - without an AIFM license - three separate collective investment undertakings which, in the view of the Dutch regulator, qualified as AIFs.

The Dutch asset manager disagreed, arguing that none of the three undertakings under its management qualified as an AIF within the meaning of the AIFMD. In particular, the manager took the view that the «*number of investors*» element of the AIF test was not satisfied because each of the undertakings in question had only ever had one investor and there had never been any offer made to more than one investor to invest in each of the undertakings.

In support of his view, the manager was able to provide the court with written corporate resolutions of the respective boards of management of the three investment undertakings, demonstrating that the management had resolved not to admit any new investor in the respective undertaking.

The Dutch manager relied on the language of the ESMA Guidelines according to which an undertaking that is not prevented by any arrangement of binding legal effect from raising capital from more than one investor should be regarded as an AIF. Conversely, entering into an arrangement of binding legal effect prohibiting the raise of capital from additional investors would be sufficient to the purpose of avoiding an AIF qualification under AIFMD. Typically, regulatory advisors in Luxembourg also advise to follow this approach and recommend such a restriction to be directly included in the constitutional document of the investment undertaking asserting its non-AIF status.

For the Dutch regulator, the resolutions by the management were not sufficient to constitute an «arrangement of binding legal effect», as required by the ESMA Guidelines, because the manager could, at any given point in time, reverse the management body decision taken in this regard. Without any sufficient arrangement of binding legal effect in place, any single investor vehicle - according to the Dutch regulator - would always have to be regarded as an AIF provided that the remaining elements of the definition of AIF are also met.

The Dutch court's ruling: "number of investors" is a fact-specific concept

The *Rechtbank Rotterdam* - a trial court - decided in favour of the manager and interpreted the AIF test rather liberally. For the court, the simple fact that the undertakings in question each (i) had only one investor, (ii) had never offered units to additional investors and (iii) had taken management decisions not to admit additional investors was sufficient to fail the AIF test and hence fall outside the AIFMD.

Comment on the Court's decision

It is our view that the decision of the Dutch court is worthy of praise and should be welcomed by the asset management industry for its liberal "substance-over-form" approach. Indeed, it is safe to say that the asset management industry did not welcome ESMA's departure from the more restrictive initial definition of «AIF» by opining that "raising capital" means to "procure the transfer or the commitment of capital by **one or more** investors", so that a combined reading of "raising capital from a number of investors" could principally be interpreted as "raising capital from **one or more** investors".

Based on the legally binding definition of an AIF under the AIFMD, one may argue that the absence of any attempt to procure capital commitments from **more than one** investor should be sufficient in asserting the fund-of-one and consequently non-AIF status of the undertaking in question, irrespective of whether there exists a formal prohibition on raising funds from more than one investor. Moreover, in the case at hand, the management boards of each of the three undertakings had clearly resolved that no further fund raising was expected.

The Dutch regulator was probably right in arguing that the management boards of the single-investor undertakings could easily reverse their decisions and admit more investors in the future and that therefore the investment structure was potentially not limited to one investor. Yet it will be difficult to reconcile such a view with the language of the ESMA Guidelines: If one were to follow the Dutch regulator's view on the board resolutions, one would also have to accept that the same would be true in the case of investor restrictions contained in articles of association - a document explicitly mentioned by ESMA as one that would be legally binding.

The single investor - as the sole shareholder - could easily change the articles in the future, given that no other shareholders would be there to oppose such a decision. Thus, the resolutions taken by the management boards in the case at hand may very well qualify as a legally binding prohibition for the purpose of the ESMA Guidelines.

Ultimately, however, the Dutch court's ruling, in failing to elaborate further on the particular circumstances of the case (at least in the published version), may have created further uncertainty in an area of regulatory law where criminal sanctions may be imposed on a defaulting party in cases of non-compliance.

Without knowledge of the particular circumstances of the case, one could perhaps infer that an asset manager, with three single-investor funds under management, was in fact part of an investment structure that was set up in order to allow the three investors in question to participate in a pooled bundle of underlying assets, which would otherwise be regarded as one single investment structure using parallel segregated silos - a scenario that the European Commission arguably wanted to avoid?[8]

Impact for Luxembourg

It is indeed regrettable that this decision was not appealed in The Netherlands so that we could have had the possibility of learning the views of a higher Dutch court on such a critical interpretation for the asset management industry as that of the AIF definition.

It will therefore be difficult to rely on this isolated court decision in the case of other similar disputes that industry players in Luxembourg may face in the context of AIF classification. In the meantime, it is still highly recommended for asset managers to make sure to include the necessary restrictions in the constitutional documents of their managed funds if the manager wishes to have comfort that such «fund-of-one» entities fall outside the scope of the AIFMD.

1) Directive 2011/61/EU as published in the Official Journal of the European Union of 1 July 2011, L 174/1.
2) Cf. Question 1.a) of the CSSF Frequently Asked Questions (version 11, 6 July 2017) concerning the Luxembourg Law of 12 July 2013 on alternative investment fund managers, available at www.cssf.lu.
3) ESMA/2013/611 of 13 August 2013.
4) Paragraph 17 of the ESMA Guidelines on key concepts of the AIFMD.
5) Paragraph 18 of the ESMA Guidelines on key concepts of the AIFMD.
6) Paragraph 19 of the ESMA Guidelines on key concepts of the AIFMD.
7) Rechtbank Rotterdam, Decision of 26 April 2017, Case Number ROT 16/6874 and ROT 16/7425, published in Jurisprudentie Ondernemingen & Recht (JOR) 2017/262 (with note E.J. van Praag) and available at www.rechtspraak.nl (ECLI:NL:RBROT:2017:3150).
8) Cf. Question / Answer No. 3 in the Q&A on the AIFMD published by the European Commission, available at https://ec.europa.eu/info/sites/info/files/aifmd-commission-questions-answers_en.pdf.