AIFMD Impact on European Hedge Fund Industry

Business Law
Master’s Thesis
Aatu Kokkila
2015
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<th>Description</th>
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<tbody>
<tr>
<td>AIF</td>
<td>Alternative Investment Fund</td>
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<tr>
<td>AIFM</td>
<td>Alternative Investment Fund Manager</td>
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<tr>
<td>AUM</td>
<td>Assets under management</td>
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<tr>
<td>CA</td>
<td>Competent authorities</td>
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<tr>
<td>CDR</td>
<td>Commission Delegated Regulation</td>
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<tr>
<td>EC</td>
<td>European Commission</td>
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<tr>
<td>EEA</td>
<td>European Economic Area</td>
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<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
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<td>FSA</td>
<td>Financial Services Authority</td>
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<tr>
<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<tr>
<td>LTCM</td>
<td>Long Term Capital Management</td>
</tr>
<tr>
<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
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<tr>
<td>NAV</td>
<td>Net asset value</td>
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<tr>
<td>NPPR</td>
<td>National private placement regime</td>
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<tr>
<td>OTC</td>
<td>Over-the-counter</td>
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<tr>
<td>PWG</td>
<td>President’s Working Group</td>
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<tr>
<td>SEC</td>
<td>U.S. Securities and Exchange Commission</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertakings for the Collective Investment of Transferable Securities</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom of Great Britain and Northern Ireland</td>
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**Websites**

Barclay Hedge Alternative investment database


Managed Funds Association

[https://www.managedfunds.org/](https://www.managedfunds.org/)
1. Introduction

1.1. Background

Hedge funds have gained political and economic prominence during the past three decades. Economically, hedge funds have grown over 50-fold globally in terms of assets under management (AUM) since 1990. This translates to slightly over three trillion dollars of investable funds. Although this amount is small relative to the total assets under management by mutual funds, it is large enough to move markets, and in the aftermath of the financial crises, big enough to concern regulators. In recent years, trading by hedge funds has accounted for over 50% of the daily trading volume in equities markets. They also account for over 80% of credit derivative trading and have close ties to financial institutions due to their prime broker relationship. Hedge funds have evolved from being a fringe player to a crucial provider of liquidity and driver of price formation in global financial markets.

However, since the Global Financial Crisis (GFC), hedge funds have faced significant headwinds. Their returns have significantly deteriorated due to increased competition and fewer trading opportunities, which makes it hard to justify the generous remuneration structures they employ. In addition, regulators worldwide have started to pay them increased attention and have introduced among other measures, registration requirements, limits on leverage, and more disclosure. Nevertheless, no study or regulator directly linked the cause of the GFC to hedge funds.

Opinions on the impact of hedge funds on the creation and progression of the crisis are highly diverse. On one side critics argue hedge funds as prominent players in the unregulated shadow banking system, contributed in a substantial manner to the formation of the speculative bubble in American mortgage market and thus created along with other things the preconditions for financial crisis, others claim while they didn’t cause the crisis they amplified the impact especially through the use of leverage, speculative short selling and sudden fire sales in order to meet investor redemption

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1 Lucia Quaglia, The ‘Old’ and ‘New’ Political Economy of Hedge Fund Regulation in the European Union, 2011 West European Politics, 34:4, pp. 665-682
3 For instance Vanguard, the largest mutual fund in the world, has over three trillion AUM. See https://about.vanguard.com/
5 Yogi Dewan, There are too many hedge fund billionaires, Financial Times, 2015
6 Indeed, the famous De Larosière Report deemed that hedge funds didn’t play a major part in creating the crisis. However, they did play their part in worsening it, notably through transmission function by massive selling of shares and short-selling transactions. See The High-level Group on Financial Supervision in the EU: Report. February 2009, pp. 24
demands. Others support the assertion that hedge funds not only reduced the detrimental effects of the crisis but even boosted economic recovery.

Politically, the activity of hedge funds had come into the spotlight long before the financial crisis, due to the role they played in the Asian financial crisis in 1997 and after the failure of Long-term capital management (LTCM) in the US in 1998. The Asian financial crisis was a prime example of hedge fund herding behaviour, risks generated from massive leveraged short sales and subsequently fire sales stemming from deleveraging. The LTCM case brought forward to regulatory attention the systemic risks posed by overleveraged funds. Despite the aforementioned events, hedge funds remained largely unregulated or minimally regulated prior to GFC.

There were three important events which shifted the regulatory atmosphere towards pro-regulation. First, the failures of two Bear Stearns hedge funds, which were majorly invested in the US subprime mortgage market, reheated the discussion on hedge fund leverages and potential repercussions hedge fund failures can cause to the overall stability of entire financial system. Second was the implosion of Lehman Brothers, which marks the dawn of GFC. Third was the large-scale fraud perpetrated by Bernard Madoff, which brought into question, in particular, the integrity of some of the industry practices. The events combined caused massive amounts of investments to vanish into thin air and resulted in unprecedented amounts of new regulation. The new approach was underlined by G20 in the 2009 London summit, where the leaders agreed that systemically important hedge funds would be brought under regulatory oversight for the first time.

8 IOSCO, Hedge Funds Oversight; Final Report 7 n, 2009
9 H.B. Shadab, Hedge Funds and the Financial Crisis, No. 34 Mercatus on Policy, 2009
11 Quaglia, supra at 1, 2011
12 Herding happens when funds mimic other funds or financial institutions while their own private information or proprietary models suggest other behaviour. See Hossein Nabilou and Alessio M. Pacces, The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation, 6 Wm. & Mary Bus. L. Rev. 183, 2015
13 Quaglia, supra at 1, 2011
14 Although there was no direct European legislation on the funds themselves, the various service providers within the hedge fund industry were subject, to varying degrees, to numerous European Directives. See Ch. 3, 3.1 on Hedge fund regulation prior to AIFMD also Ch. 2, 2.3 Hedge fund regulation for rationale behind minimum regulation approach
15 The bankruptcy of Bear Stearns could be only averted by regulator-initiated and –sponsored acquisition through JP Morgan Chase. There was little collateral damage to the financial system at the time though. See Zetzsche, 2012, supra at 10.
16 It is a common misperception that Madoff operated a hedge fund or series of hedge funds, even among policymakers. There was never a “Madoff fund” and Madoff never claimed to be a hedge fund manager. See G. Gregoriou & F. Lhabitant, Madoff: A riot of Red Flags, EDHEC Business School, 2009
17 Both the Madoff fraud and collapse of Lehman highlighted existing differences between EU member states with regard to depositaries’ safekeeping duties and liabilities, thus EC developed a strong desire to clarify and harmonize the depositary function at EU level. See Ch. 4, 4.1 Depositary and Zetzsche, 2012, pp. 409-446
18 London summit, Leaders’ statement, 2009
In Europe, the answer was the Alternative Investment Fund Managers’ Directive (AIFMD, 2011/61/EU), which was enacted to regulate in particular the fund managers\textsuperscript{19}, instead of the funds itself. It establishes common requirements governing the authorization and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the Union.\textsuperscript{20} The overarching objective of AIFMD, as specified by the European Commission, is to create a comprehensive and secure framework for the supervision and prudential oversight of AIFMs in the EU.\textsuperscript{21} More specifically, in response to the financial crisis, the directives objectives include but are not limited to enhancing investor protection by providing a common approach to protecting AIF investors and systemic risk oversight by improved monitoring of macro-prudential risks by competent authorities (CA). \textsuperscript{22}

Although the directive’s scope is broader in the sense that the definition\textsuperscript{23}, alternative investment fund (AIF), encompasses other investment funds than hedge funds, the primary target of the directive were hedge funds and to a lesser extent, private equity. For the AIF industry, the AIFMDs definition of its scope came as a surprise. Regulation originally designed to regulate hedge funds and private equity became applicable to all investment funds that did not qualify as UCITS under the Undertakings for Collective Investment in Transferable Securities Directive (UCITSD, 2009/65/EC).\textsuperscript{24} Thus, AIFMD can be viewed as an attempt to bring whole shadow banking system under Union level regulation.

1.2. Research purpose and structure of the study

 Granted, the regulatory content behind the terms AIF, AIFM and AIFMD includes provisions relating to multiple industry participants, the content of this research is chosen deliberately in the form which is most relevant to hedge fund industry. Thus, some of the provisions which affect hedge funds to lesser extend and other AIF’s in particular are not discussed. As most of the European hedge funds

\textsuperscript{19} Why did AIFMD choose to regulate managers instead of the funds and the product? Great number of hedge funds are based in offshore tax havens and thus lie outside Europe’s jurisdiction, whilst the manager of funds is located in EU. Thus regulating the manager yields overall better regulatory response.

\textsuperscript{20} AIMFD, Recital 2


\textsuperscript{22} For more details see Ch. 3.2.2 on AIFMD objectives

\textsuperscript{23} AIFMD doesn’t define hedge funds, which is, prima facie - surprising. However in light of the concept of AIFMD it is quite logical. First it regulates the manager, not the fund, second it encompasses practically all funds which are not UCITS and fulfil the criteria. On this basis it’s clear a definition was neither useful nor necessary. Besides, there exists fundamental problem that it is practically impossible to provide exhaustive definition on hedge funds.

\textsuperscript{24} Zetzsche, supra at 10, 2012, pp. 1-19
are AIFMD compliant by now\textsuperscript{25}, some impact assessment can be made, which is the ultimate purpose of the study. Thus, this research seeks to contribute to existing literature on AIFMD in a sense that there are very few if any, impact assessments made post-implementation. This might be result of the impacts yet remaining far-reaching and ambiguous. Nevertheless, the directive garnered significant attention ex-ante implementation, and some these studies\textsuperscript{26} have indeed been taken into account with preparations of this thesis. However since then, it seems that the attention has somewhat waned.

In order to provide wider perspective on the subject, some context behind the motivations of the directive is initially examined. Thus chapter two provides an overview on hedge funds and their regulation. The main characteristics of the industry are examined alongside discussion about the definitional issues relating to hedge funds. Afterwards, the question whether hedge funds actually need to be regulated is addressed. Two prominent pro-regulation themes emerge from this discussion, i.e. systemic risks and investor protection. They are discussed in further detail to provide context for chapter three, which proceeds to explain the (often political) motivations and objectives behind AIFMD.

Thereafter the content of AIFMD is discussed in chapter four. In particular provisions on authorization, operating conditions, transparency requirements, leverage and marketing are chosen under further scrutiny. This study takes particularly pragmatic approach on the subject matter. Practical consequences of the provisions are included, which form the basis for the impact assessment in chapter five. However, it must be noted that since the directive has been in force for such a short period of time, the analysis remains on a general level.

The impact assessment is conducted by studying some of the latest industry surveys around the topic, combined with an analysis of the impacts of the directive. However, it must be acknowledged that there is some dispersion between the results of the surveys, which may be attributed to the fact that AIFMD doesn’t seem to affect the larger funds as adversely as smaller funds.\textsuperscript{27}

Finally, an analysis of the impacts of the directive is followed. The discussion is based on the content in chapter four and the results of the industry surveys. The focus is on the impact of the directive on

\textsuperscript{25} Survey conducted by Preqin in June 2015 indicated that 82\% of EU managers are AIFMD compliant and of which 90\% is in the UK. See Preqin, The 2015 Preqin Global Hedge Fund Report, July 2015

\textsuperscript{26} For instance Charles River Associates, Impact of the Proposed AIFM directive across Europe, CRA Project No. D14806, 2009; Europe Economics, Ex-ante Evaluation of the proposed Alternative Investment Fund Directive, 2009; Open Europe, The EU’s AIFM Directive; Likely impact and best way forward, 2009; EC, supra at 21, 2012; Also Dirk A. Zetzsche (ed.), The Alternative Investment Fund Managers Directive, Wolters Kluwer, Law & Business, 2012, which is not really an impact assessment, but is the most comprehensive overall evaluation on the directive to date. The work is extensively cited throughout the study.

\textsuperscript{27} More on the constraints to the analysis See Ch. 5, 5.1 Methodology
funds by size, cross-border distribution, systemic risk and investor protection. This also concludes the theme since chapter two and three revolving around the systemic risks and investor protection. Chapter six concludes and where also some de lege ferenda analysis is incorporated.
2. Overview of hedge funds and their regulation

2.1. The definitional issue

Alfred Winslow Jones is credited with pioneering the hedge fund movement in 1949, when he coupled the concepts of leveraging and short selling into an investment technique known as hedging.\(^{28}\) Although this did not eliminate risk, it did hedge the risk i.e. somewhat neutralize the effects of systematic risk\(^{29}\). However, the original meaning of the term “hedge fund” bears little resemblance to the hedge funds we have today. The variety of products which label themselves hedge funds is so diverse that the use of the term "hedge fund" is actually a misnomer.\(^{30}\)

The term "'hedge fund' is neither a legally defined term. The disagreement over a standard definition of hedge funds reflects the exponential growth in the number of products in existence.\(^{31}\) AIFMD, nor any other European directive directly defines “hedge funds”.\(^{32}\) As notified by Dorsenfeir\(^{33}\), it’s clear that exhaustive definition for hedge funds is almost impossible to provide, and for instance for a piece of legislation such as AIFMD\(^{34}\) – could be even counterproductive. By nature, some hedge funds might not be covered by the definition creating regulatory loopholes.\(^{35}\) However, if they can’t be broadly defined then there must be a way of recognizing them. Thus IOSCO\(^{36}\) for instance, has provided following characteristics for evaluating whether the company is a hedge fund:

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\(^{28}\) The term hedge fund was introduced 1966 Fortune article by Loomis, Carol J. “The Jones Nobody Keeps Up With.” Fortune (April 1966). The article caused a brief surge in hedge fund investment, but despite generating decent returns Hedge funds didn’t gain prominence until the 1980s’. See T. Bullman, Hedge Funds And The Definition Challenge Part 1, Mondaq, 2008

\(^{29}\) Defined as the risk of overall market movements (caused for instance, by shift in global economic data) having impact on the price of an asset.

\(^{30}\) Id; It’s a common misconception that hedge funds always “hedge” risk. Strictly speaking, hedging actually means the taking of two positions that offset risk so that regardless of the market events or market circumstances the risk bearer is left with a no win/no loss situation. Such hedging is often used by business’ to counter assumed effects from currency movements. Id.

\(^{31}\) Francois-Serge Lhabitant, Handbook of Hedge Funds, Wiley Finance,2007, pp. 25

\(^{32}\) Hedge funds reside in a category of investment known as alternative investments in the AIFMD terminology. This category also includes private equity, venture capital, real estate, oil & gas, timber, etc.

\(^{33}\) Zetsche, 2012, supra at 10, pp. 557-574

\(^{34}\) The scope covers almost all hedge fund structures, without having to provide a laborious definition. See Ch. 4, 4.1 AIFMD scope and definition.

\(^{35}\) One frequently used definition is “any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public”. See Financial Stability Forum (FSF), Report of the Working Group on Highly Leveraged Institutions, 2000. However the definition is dated, as in some cases hedge funds are indeed available to public in the form of so called ‘Newcits’ i.e. hedge funds wrapped in UCITSD framework. More on Newcits see Steve Johnson, US hedge Funds move into ‘Newcits’, Financial Times, 2013; Filippo Stefanini et al., Investing in UCITS Compliant Hedge Funds, 2010

\(^{36}\) IOSCO, Hedge Funds Oversight: Final Report 7 n, 2009
• Borrowing and leverage restrictions, which are typically included in collective investment schemes related regulation, are not applied, and many (but not all) hedge funds use high levels of leverage. 37

• Derivatives 38 are used, often for speculative purposes, and there is an ability to short sell securities. 39

• More diverse risks or complex underlying products are involved. 40

• Significant performance fees 41 (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee.

• Investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually. 42

• Often significant ‘own ‘funds are invested by the manager.

However, IOSCO Task Force also acknowledges that despite the broad characteristics described above, it is difficult to define hedge funds on a universal basis, given their different legal and business structures – not only across different jurisdictions but even within a single jurisdiction. 43 As a result hedge funds are easier to recognize than to define as stated by UK Hedge Fund Working Group.44

37 However, with the introduction of AIFMD, leverage restrictions apply to hedge funds as well. Nevertheless the leverage restrictions entailed by UCITSD are stricter. On calculating leverage for both UCITS and AIFs see Princeton Financial Systems, Leverage calculation for UCITS and AIF, 2014
38 The range of derivatives available to hedge funds is much wider than what consist traditional put and call options available for typical mutual funds. These contain for instance OTC-derivatives such as swaps and various exotic options.
39 Short selling allows hedge funds to profit from falling asset prices or hedge risk if the fund wishes to maintain long exposure. Selling stocks short is typically executed on margin. See Lhabitant, 2007, supra at 28.
40 Hedge funds use variety of legal forms to optimize their taxation, such as offshore companies, which are typically unusual in the asset management industry.
41 The typical industry standard is the 2/20 structure, i.e. 2% management fees and 20% fee on profits. This is notably different to mutual funds which do not typically charge fees from profits.
42 Unlike mutual funds, hedge funds are not statutorily required to allow shareholders to redeem their shares daily and their redemption frequency may vary from one month to several years. See FSF, supra at 35, 2000
43 IOSCO, 2009, supra at 36.
2.2. Hedge fund characteristics

The following section evaluates hedge fund characteristics in further detail. Understanding the hedge fund characteristics is crucial in order to evaluate what kind of form hedge fund regulation should take.

2.2.1. Hedge fund strategies, performance and compensation

Although the term hedge funds is often used generically, it is essential to emphasize that hedge funds are not a homogenous group. As hedge funds have gained size and popularity, they have deviated from the original Alfred W. Jones’ model and are now following a plethora of investment strategies with different expected and realized risk and returns.45 Hedge funds strategies can be categorized in many ways, for instance by the instruments they trade, the location of markets, or whether fund trades on systematic or discretionary basis.46,47 In any case, most hedge funds goal is to deliver absolute returns or alpha (risk-adjusted returns or the excess return of a hedge fund relative to a benchmark return). Thus, hedge funds aim to profit from market fluctuations whether it’s a rising or declining market.

Some of the most popular hedge fund strategies are, global macro, long/short equities, relative-value, event driven and multi-strategies.48 Global macro funds tend to make leveraged directional investments in global currency, bonds, equities and commodity markets on a discretionary basis. Long/short equities is the most popular strategy; these funds typically maintain long and short exposure in equity and equity derivatives structures. Relative-value refers to the practice of taking offsetting positions in two related securities in the hopes that the price gap between the two securities will move in a favourable direction. In some cases, there is an underlying reason, why the favourable

45 Lhabitant, supra at 31, pp.159-161
46 With discretionary approach the strategy relies on the skill of the fund manager when making investment decisions, whilst with systematic approach the fund utilizes computer models for the majority of its trades. Both approaches are sometimes cited to describe the industry as whole (See Preqin, Discretionary vs Systematic: Two Contrasting Hedge Fund Approaches, 2014) and sometimes generally refer to managed futures trading (See Lhabitant, supra at 31, pp. 352-354).
47 See Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, 2003
48 Some other popular strategies include distressed securities funds, dedicated short, convertible bond and fixed income arbitrage, managed futures, emerging markets, equity market neutral funds and activist funds. See Appendix 1 on breakdown of hedge fund strategies by popularity.
49 For instance short dated on-the-run treasury bonds often trade at premium compared to the less liquid and longer dated off-the-run treasuries, as investors tend to price a premium for liquidity. Typically, a relative value arbitrageur might try to buy the off-the-run treasuries and short the on-the-run treasuries when the spread diverges significantly.
relative price changes are thought to be inevitable, while in other cases the trade is more purely speculative. Event driven funds build positions in anticipation of high impact events on company value such as corporate transactions and earnings announcements. Many funds run multi-strategies, which may combine several investment policies.

Hedge funds managers’ ability to perform well is based on information advantage. When strategies become public knowledge they tend to stop working, in particular arbitrage strategies. Thus more competition erodes profit opportunities, as it becomes difficult to attain information advantage. The gradual increase in the amount of hedge funds has steadily contributed to declining returns. While hedge funds used to outperform indices consistently pre-financial crisis and even during the crisis, along the past five years they haven’t fared so well. During 2010-2014 hedge funds returned on average 7.71% compared to SP500 13.05%. However hedge fund returns were delivered with much less volatility, yet it must be also noted that the returns would be higher without the relatively high fees the funds charge.

Low returns, alongside high-performance fees have led to significant redemptions requests. Many funds have altered the typical 2/20 fee structure and made it more flexible (in terms of adjusting the fees downwards), in case they are unable to deliver the promised returns. Indeed, particularly newly established funds tend to have much smaller management fees and performance fees in comparison to established funds.

due to temporary issues such as flight to quality, in anticipation of the spread to converge in time when the markets calm down. The risk is, that these ‘temporary’ issues might last longer than the arbitrageur stays solvent.

51 An example of event driven merger arbitrage strategy would be following. During mergers the stock prices typically do not trade at the agreed merger price, reflecting uncertainties with regards to the finalization of the merger. Merger arbitrage fund wound conduct its research and seek to exploit this price gap if it sees that the deal has very high probability to be executed. This kind of position taking could be considered speculative as the hedge fund cannot really be certain whether the prices will converge, i.e. there might be an obstacle which prevents the merger from happening. In any case once the merger is finalized the hedge fund profits the spread from the deal.
52 For detailed descriptions on hedge fund strategies and examples of trades see Lhabitant, supra at 31, 2007. See also Connor and Lasarte, supra at 47, 2003, who have grouped hedge funds strategies under four broad themes, namely long/short funds, event driven, tactical trading and relative value.
53 There are many other reasons which have contributed to decline in returns; low return environment in terms of low nominal interest rates, technological advantages and decline in retail order flow (i.e. professionals are betting against each other) can be seen as having major impact on hedge funds returns.
54 Preqin, Preqin Global Hedge Fund Report, 2015
55 Mary Childs and Lindsay Fortado, Investors pull $15bn from hedge funds, 2016, The Financial Times
56 Madison Marriage, Hedge fund performance fees decline sharply, 2015, The Financial Times
The principal actors in a hedge fund are (1) the hedge fund manager and investors (2) the fund itself (3) various network of service providers such as the fund administrator, the prime broker and the depositary.\textsuperscript{57} Contrary to mutual funds, which tend to be large integrated monolithic structures with a large number of staff, a typical hedge fund business is small, at least at the outset. Most hedge funds operate through a network of external service providers to which certain functions are delegated.\textsuperscript{58}

During the outset of the industry, hedge fund investors used to be mainly high net worth individuals, seeking for higher returns than traditionally are possible. However nowadays the primary investors to hedge funds are institutions, such as pension funds, fund of funds\textsuperscript{59} and endowments. In relation, the hedge fund structure is often chosen in order to optimize taxation and particularly prevent double taxation of investors. The structure may also be chosen to facilitate investor investment in only one part of the hedge funds strategy, i.e. for instance funds bond strategy without carrying risk from equities or illiquid investments.

Thus, the attraction of the different structures depends on both the residence and often, more importantly, the tax status of the investor.\textsuperscript{60} Hedge funds domiciled outside the United States are typically structured as offshore open-ended companies. Most offshore funds maintain their custody and administration in the offshore country, while hedge fund manager is located in the US or Europe.\textsuperscript{61} In general the most typical hedge fund structures are stand-alone funds, master-feeder funds and umbrella funds. However, hedge fund structures may vary decisively with regards the jurisdiction of the hedge fund, and typical offshore locations have come up with their various forms of hedge fund structures.\textsuperscript{62}

\textsuperscript{57} EC, supra at 4
\textsuperscript{58} Lhabitant, supra at 30. pp. 90.
\textsuperscript{59} The definition of fund of fund is rather self-explanatory, they invest in number of hedge funds, mutual funds etc. They are also sometimes included in the general categorization for hedge fund strategies. They are generally considered an effective vehicle for risk diversification, however the layering of fees (the hedge fund charges a fee from the fund of fund, and the fund of fund charges a fee from investors) is often considered problematic.
\textsuperscript{60} Not only are offshore hedge fund structures necessary for targeting offshore clients, but in the United States for instance, they appeal in particular to US tax-exempt investors who wish to avoid unrelated business income tax (UBIT). See Barclay Hedge Alternative Investment Database, \textit{Starting a hedge fund}, available at: \url{http://www.barclayhedge.com/research/educational-articles/in-depth-articles/starting-a-hedge-fund.html}
\textsuperscript{61} Lhabitant, 2007, supra at 31. pp 85.
\textsuperscript{62} For instance Jersey has long list of fund types such as Recognized funds, Unclassified funds, Listed Funds, Expert Funds, Private placement funds etc. On the other hand Cayman Islands have exempted funds, licensed funds, administrated funds etc. For more details \textit{See} Gordon Casey, \textit{The Cayman Edge: How to Set up a Cayman Fund}, 2015;
The stand-alone fund is the most common fund structure, which practically consists of one fund, with one set of investors, making investments directly to the fund. Hedge fund manager might also create several stand-alone funds to accommodate different strategies (mirror funds), although more often than not the more advantageous way is to create a master-feeder structure. Master-feeder is probably most common structure after the stand-alone fund, and is typically employed by the larger funds. In practice master-feeder fund consists of offshore and onshore fund, and each of these funds are available for those investors for whom the specific fund makes the most sense from a tax and regulatory standpoint.63 These funds subsequently invest all their money in the master fund, which then makes investments in accordance with the strategy. Umbrella fund is a fund which operates multiple strategies under one fund. Investors into typical umbrella fund might, for example, subscribe for class A shares, knowing that A shares will only participate in investments into bonds.64 Thus these investors wouldn’t be exposed risk related to say, class B shares which trade equities and bonds alike.

63 Sean Dailey, Is it time to revisit your hedge fund structure?, Chadbourne & Parke LLP, 2013
64 Naturally the fund structure needs to be organized so that the investor doesn’t carry risk from Class B shares then, which might investment to equity for instance. This is done by segregated portfolio companies (in Cayman Islands, for instance), which allows separate investments while protecting each class or portfolio, from the liabilities of the other portfolios within the fund. See Casey, supra at 57; Ogier, Segregated Portfolio Companies in the Cayman Islands, 2011
65 On more details on operational and organizational structures of hedge funds see Lhabitant, supra at 31, pp. 85-119
66 Closed ended hedge fund is a fund with shares that are not redeemable and will usually close and return funds to the investors, together with the return on their investment, after an agreed period of time. The funds may also allow trading of the fund’s shares depending on its policies. Pure open ended funds shares are redeemable at any time.
68 Hedge funds may lock-up shares i.e. limit the maximum percentage of the funds overall capital that can be withdrawn on a scheduled redemption date. Gating provisions are typically exercised instance during market turmoil or generally when hedge fund is in a sudden drawdown to prevent run on the hedge funds.
69 Hedge funds often use so called side pocket functions to mitigate risks stemming from illiquid investments and investor redemption demands. Side pocket is a type of account used in hedge funds to separate illiquid assets from other more liquid investments. This allows wider investment on illiquid assets and acts as cushion when investors demand redemptions; they might be able to receive redemptions from the liquid investments but the side pocket investment remains until it’s liquidated.
Lastly, the hedge fund business model depends vastly on its service provider network. Operating through service providers allows smaller number of personnel to access a wider skill base. In return service providers receive specified fee from the fund pursuant to various agreements. The most important service providers are the fund administrator, the prime broker and depositary. The primary role of the administrator of the fund is to provide back-office support, by taking responsibility for the operations, administrative, accounting and valuation services. However the level and scope of work involved varies substantially depending on the type of hedge funds covered, their sophistication and the activities already covered by the prime broker.

The prime brokerage service includes the following services; clearance and recordkeeping; providing intraday credit to facilitate foreign exchange payments and securities transactions; providing margin credit to finance purchases of equity securities; and borrowing securities from investment fund managers on behalf of hedge funds to support the hedge funds’ equity short positions, thus allowing investment funds to avoid direct exposure to hedge funds. They may also provide the hedge fund with various levels of other services, such as research and capital introduction. Pre-AIFMD, particularly in the Anglo-Saxon world, hedge funds typically centralized their custodial with the prime broker. However, AIFMD separates the prime brokerage and custodial services and requires all hedge funds to appoint a depositary who’s in charge, *inter alia*, of custodial services and supervision of the fund.

2.2.3. Hedge fund domiciliation

As previously mentioned, hedge funds are primarily managed from an onshore location, whilst the fund is typically established in an offshore location. The main advantage to setting up offshore is tax neutrality; the idea is that investors don’t get inappropriately saddled with the fund’s tax burden. Thus, the Cayman Islands are the largest hedge fund jurisdiction for the fund itself and its administration, as significant tax and regulatory advantages exist for hedge fund domiciled in Cayman. Other popular locations are the British Virgin Islands and Bermuda. They attract both UK

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70 See Appendix 2: Typical hedge fund service provider network.
71 Lhabitant, supra at 31, pp. 90
72 Id.
73 PWG, 1999, supra at 50.
74 AIFMD, Article 21, 1
75 See Appendix 3: Hedge fund domiciliation by AUM
and US funds, as the countries benefit from historic ties to the UK and geographical proximity to the US.77

The US is the largest centre for hedge funds, managing close to 70% of global assets at the end of 2012, down from 83% a decade earlier. Europe followed with 21% and Asia with most of the remainder. TheCityUK estimates that around 42% of global hedge fund assets were managed from New York, down from over a half a decade earlier. London remains by far the largest centre for hedge funds in Europe. Around 600 funds located in the UK managed some 85% of European-based hedge funds’ assets. The largest seven hedge funds in Europe were all headquartered in London in 2012.78

In addition, Ireland and Luxembourg are particularly popular jurisdictions for hedge fund administration and registration in Europe. For instance, around 40% of global hedge funds are estimated to be administered in Ireland.79

2.3. Benefits and adverse effects of hedge funds to financial markets

During regular market conditions, hedge funds provide significant benefits for financial markets. They facilitate risk distribution, provide liquidity and contribute to efficient pricing of securities and thus to further global integration of markets. However, when markets are distressed hedge funds interconnectedness to their counterparties and their market behaviour may magnify the turmoil.

Hedge funds provide a platform for substantial risk diversification for investors. Including hedge funds in portfolios of traditional assets, such as stocks and fixed income, leads to better risk-return trade-off80, as hedge funds strive to generate returns regardless of adverse market conditions and thus are often uncorrelated to the broader market.81

Hedge funds often trade actively and employ a wide spectrum of different strategies. These trading activities contribute to the efficient functioning of financial markets by deepening market liquidity and enhancing the price discovery process.82 They trade a multitude of instruments such as OTC-derivatives, creating markets for supply and demand to meet in otherwise illiquid markets. Benefits from added liquidity are realized as lower transaction costs, namely by tightening of the bid-ask

77 TheCityUK, Hedge Funds Report, 2013; D. Clarkson et al., Domiciles of alternative investment funds, Oliver Wyman, 2014
78 Id.
79 Id.
80 Efficient frontier, as in Harry Markowitz’ Nobel Prize winning modern portfolio theory, shifts to the up and left. See Appendix 4: Efficient frontier Analysis with hypothetical hedge fund allocation.
81 However it must be acknowledged that the correlation to broader market indices is heavily dependent of hedge funds strategy in question.
82 EC, supra at 4
spreads. As hedge funds constantly seek for new profit opportunities – by often taking contrarian positions – they help to correct prices of over/undervalued securities and allocate capital on locations where it’s most efficiently used.

The mechanisms used to lock up capital in hedge funds (such as gates and side-pocket arrangements) enable them to sustain their contrarian positions further. Such a function can potentially smooth market volatility and reduce the number and magnitude of asset price bubbles. Partly because of all these benefits, some argue that markets have become more resilient in times of distress since the emergence of hedge funds as major market participants.

Despite their widely acknowledged benefits, hedge funds can pose risks to the financial system and may at times contribute to financial instability. Although their role in financial instability is highly contested, some consider that hedge funds’ size and leverage, their interconnectedness with banks and prime brokers and the likelihood of hedge funds’ herding may undermine financial stability.

In certain circumstances, particularly in less developed markets, their actions can be destabilising. These actions, instead of stamping unfair valuations, might lead to significant market panics. However, it is very difficult to draw the line between seemingly manipulative trades and rational economic behaviour. Yet during the financial crisis, there were fears that the hedge fund short-selling could drive the stock price of systemically relevant financial institutions to exaggeratedly low levels and thereby undermine their viability, which prompted the introduction of temporary curbs on the practice in many jurisdictions around the world.

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83 Gating for instance, can be very beneficial at times of distress, as a measure preventing unnecessary deleveraging, stemming from investors herding behaviour.
84 As duly noted by H. Nabilou and M. Pacces, the severity of the recent financial crisis and the collapse of several hedge funds during the crisis shed substantial doubts on these claims. See H. Nabilou and M. Pacces, 2015 supra at 11; also Lloyd Dixon et al., *Hedge Funds and Systemic Risk*, 2012, pp. 47–49.
85 Id.
86 During the Asian financial crisis, macro funds sold Asian currencies such as Thailand baht short. These bear raids may have contributed to the crisis, although generally studies have concluded that hedge funds were not the culprits of the crisis. Hedge funds were not the only market participants shorting the Asian currencies. Banks proprietary desks tended to mimic the same behaviour. Similar events occurred during the European Exchange Rate Mechanism Crisis (ERM), when hedge funds piled on shorting the likes of British pound, in anticipation of the breakup of the mechanism. See Lhabitant, 2007, supra at 31, pp. 327-346
87 Counterargument to latter could be that the Asian economies were already fundamentally vulnerable and hedge funds helped the markets to create the necessary adjustment. In similar vein many commentators consider that the ERM was a economic failure. Thus one might argue, such adjustments would and should occur, were there hedge funds or not. See Evan Davis, *Lessons learned on Black Wednesday*, BBC News, 2002; Barry Eichengreen and Donald Mathieson (with B. Chadha, A. Jansen, L. Kodres, and S. Sharma), *Hedge Funds and Financial Market Dynamics*, IMF, 1999
88 Nabilou and M. Pacces, 2015 supra at 11.
2.4. Hedge fund regulation

The main objectives of financial regulation are often considered to be investor (customer) protection, ensuring market integrity and mitigating systemic risks.\(^89\) Thus, in this chapter their relation with hedge funds is discussed. The topics are examined individually, although they do overlap in certain cases. For instance, issues associated with transparency may relate to both systemic risk control and investor protection. Lastly, at the end of the chapter, the rationale behind the shift from indirect to direct regulation is provided.

2.4.1. Systemic risk

Systemic risk\(^90\) from hedge funds may be transmitted through two major channels as distinguished by the ECB\(^91\); the market and the credit channel. Market channel relates to trading activities of hedge funds in the capital markets. Risks can be transmitted through market channel due to hedge fund herding, forced deleveraging or short selling into already collapsing markets. The credit channel relates to the fact that hedge funds are often counterparties in trades or as lenders of banks. A failure of large hedge fund could create systemic impact if the lenders of that hedge fund were unable to recover their loans from the hedge fund and were themselves systemically important institutions.\(^92\)

Nevertheless hedge funds have not traditionally been considered to be of particular systemic relevance. This view was prevalent, despite the famous failure of Long-Term Capital Management (LTCM). The failure of LTCM (and other famous failures such as Amaranth\(^93\)) were absorbed by the

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\(^89\) See Ana Maria Fagetan, *Regulation of hedge funds in the US, the UK and the EU*, Queen Mary University London, 2012; Rene M Stulz, *Hedge Funds: Past, Present, Future*, 2007; Jon Danielsson, Ashley Taylor and Jean–Pierre Zigrand; *Highwaymen or Heroes: Should Hedge Funds be Regulated?*, London School of Economics, 2004

\(^90\) For the purposes of this study systemic events and systemic risks are defined followingly; Systemic event refers to the release of bad news about a financial institution, or even its failure, or the crash of a financial market leads in a sequential fashion to considerable adverse effects on one or several other financial institutions or markets, e.g. their failure or crash. Systemic risk can therefore be defined as the risk of systemic event occurring, that affects a considerable number of financial institutions or markets in a strong sense, thereby severely impairing the general well-functioning (of an important part) of the financial system. However, it’s important to distinguish that systemic risks and events can have different meanings and connotations in separate circumstances. For detailed high-level definitions on systemic events and risks in strong and narrow sense See Oliver De Bandt and Philip Hartmann, *Systemic Risk*, European Central Bank Working Paper No. 35, 2000

\(^91\) ECB, “*Hedge funds and their implications for financial stability*”, Occasional paper series No. 34, 2005, pp. 28.

\(^92\) In order to mitigate this risk, most lending from credit institutions to hedge funds is conducted on a collateralised basis (i.e. the broker is given assets of the hedge fund as security against the loan advanced). Nonetheless, it can be difficult for credit institutions to recoup their money when a collapse is so complete that the value of the collateral is impaired. See Charles River Associates, *Impact of the Proposed AIFM directive across Europe*, CRA Project No. D14806, 2009

\(^93\) Unlike LTCM, that was rescued and subsequently wound down, Amaranth Advisors actually collapsed after it lost $6.5 billion in September 2006 on wrong-way bets on natural gas prices. See Bullman, supra at 28, 2008
financial system without long-term market disruption. Thus it wasn’t until the financial crisis which caused the regulatory stance to shift.\textsuperscript{94}

Hence, the financial crisis forms a logical base for assessing systemic risk transmission from hedge funds. In addition, the collapse of LTCM also acts as an excellent example of the risk associated with combination of leverage, position concentration, lack of oversight and risk management, which may lead to a system-wide contagion from a single hedge fund. Thus those events are further examined here. Likewise the Asian financial crisis of 1998 could have been evaluated here as well, however several studies have concluded that hedge funds didn’t play a significant role on creation of the crisis, nor did they transmit systemic risk during the crisis.\textsuperscript{95}

\textit{Long-Term Capital Management}

The collapse of LTCM precipitated the first in-depth assessment by policymakers\textsuperscript{96} on the potential systemic risks posed by hedge fund industry. LTCM was bailed out of nearly $5 billion of losses made as a result of the Russian default and subsequent devaluation of the rouble in late 1998. LTCM evidenced the ability of a single hedge fund to affect an entire economy's financial stability.\textsuperscript{97}

LTCM had impressive track record over the period of 1994-1997 net of fees, of approximately 40 percent in 1995 and 1996, and slightly less than 20 percent in 1997, which was achieved with low levels of volatility. LTCM sought to profit from a variety of trading strategies, focusing in particular on fixed income spread trades, such as relative value and convergence trades.\textsuperscript{98} Due to its spectacular returns, the funds’ capital had grown from 1.25 billion to 7.3 billion by 1997, and its assets to 120 billion implying 16:1 leverage.\textsuperscript{99}

However, by 1997 the standard spread bets of LTCM had become overcrowded, thus it became increasingly difficult for LTCM to maintain such high performance with its soaring capital. Thus the funds principals decided to branch away from its trademark strategies and venture into new areas

\textsuperscript{94} However, it should be also emphasized, that the financial crisis was not actually a —hedge fund crisis. Hedge funds were affected by the crisis, like many other financial market participants, which also lead to a significant contraction of the sector. See IOSCO, 2009, supra at 36.


\textsuperscript{96} Much of the part is based on the Presidents Working Group report on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management. PWG, Supra at 50. 1999.

\textsuperscript{97} Bullman, supra at 28, 2008

\textsuperscript{98} The spread convergence arbitrage, was a true form of arbitrage as the profits were almost risk free. The hindrance was that, the strategy needed to accommodate massive amounts of leverage as the misalignments in prices were small and thus required often time. In addition once other participants realized the chance for risk free profits in the markets such inefficiencies tended to disappear. Thus LTCM also used different relative value strategies, where it was practically speculating that spreads return to historical averages, for instance between emerging markets and developed markets fixed income securities, which entailed a much larger risk.

\textsuperscript{99} PWG, supra at 50, 1999.
such as taking directional equity trades on various market. They also returned 2.7 billion of equity capital to investors, but maintained the size of the funds positions which led to tremendous increase in leverage. Using the January 1, 1998, equity capital figure of $4.8 billion, this level of assets implied a balance-sheet leverage ratio of more than 25:1. LTCM had also engaged in various off-balance sheet transactions in derivatives, to total a notional amount of more than a trillion dollars. In total the fund had more than 60 000 trades in its books and leverage to 500:1.\textsuperscript{100}

The LTCM Fund’s size and leverage, as well as the trading strategies that it utilized, made it vulnerable to the extraordinary financial market conditions that emerged following Russia’s devaluation of the rouble and the default of Russia’s government on August 17 1998. Russia’s actions sparked a flight to quality\textsuperscript{102} in which investors avoided risk and sought out liquidity. As a result, risk spreads and liquidity premiums rose sharply in markets around the world (LTCM had earlier deemed that quality liquid investments were overpriced in comparison, to lower quality investments and that the spread between them should narrow). The pervasiveness of the widening of risk spreads confounded the risk management models employed by LTCM and other participants. Both LTCM and other market participants suffered losses in individual markets that greatly exceeded what conventional risk models, estimated during more stable periods, suggested were probable. Eventually LTCM was bailed out by the consortium, which consisted major creditors organized by the Federal Reserve. This was arguably\textsuperscript{103} the right thing to do given the system-wide repercussions and costs an uncontrolled collapse of the fund could have caused.\textsuperscript{104}

First of all, default by the fund would have created a significant systemic risks, as the counterparties would have had to quickly to limit their exposures. These risk-limiting moves may have required the liquidation or replacement of positions and collateral in the many markets where the LTCM Fund held sizable positions at depressed prices. LTCM itself estimated that its top 17 counterparties would have suffered various substantial losses — potentially between $3 billion and $5 billion in aggregate

\textsuperscript{100} Lhabitent, supra at 31, 2007, pp. 155-160
\textsuperscript{101} PWG, 1999, supra at 50.
\textsuperscript{102} Flight to quality occurs when investors shift their allocations from risky assets to less riskier assets, such as from stocks to bonds or even cash.
\textsuperscript{103} Initially Warren Buffet along with Goldman Sachs and American International Group offered to buy off LTCM for 250 million and inject 3.75 billion in to the fund. However, LTCM’s principals declined the offer. Four days after 14 banks led by FED offered to buy 90% of LTCM for 3.65 billion – a much better valuation for the existing partners. This caused many authoritatively sources, such as ex-Fed Chairman Paul Volcker to highlight the issues with regards to moral hazard since the Bailout gave LTCM comfort that the FED will come in and broker a solution, even it it doesn’t commit funds. It is, however possible to argue also that market solution was found. In the end the consortium recovered its money with modest profit and according to federal reserve no taxpayer money was actually used; Lhabitent, supra at 30, pp. 155-160; John Authors, The Short View; Moral Hazard, 2008, The Financial Times; David Shirref, Lessons From the Collapse of Hedge Fund, Long-Term Capital Management, Berkeley, 2009
\textsuperscript{104} PWG, 1999, supra at 50.
— and shared this information with the fourteen firms participating in the consortium. The firms in
the consortium saw that their losses could be serious, with potential losses to some firms amounting
to $300 million to $500 million each.\(^{105}\)

The second primary issue came down to the fact that how did the LTCM achieve such high amount
of leverage? It is notable that the information LTCM disclosed to its counterparties was not nearly
adequate considering the complexity of its operations. For instance information such as balance sheet
and income statements did not reveal meaningful details about the Fund’s risk profile and
concentration of exposures in certain markets. The minimal level of disclosure was tolerated because
of the stature of its principals, its impressive track record, and the opportunity for the Fund’s
investors and counterparties to profit from a significant relationship with LTCM. \(^{107}\)

Lastly, there was a profound problem with LTCM’s risk management. Some sources argue that
LTCM relied too much on theoretical market-risk models and not enough on stress-testing, gap risk
and liquidity risk. \(^{108}\) Furthermore, the over-reliance on Value at Risk (VaR), which rely on historical
data has been cited as one of the key reasons for its collapse. \(^{109}\) Others claim that, LTCM had in fact
done that. \(^{110}\) Looking back on LTCM’s history, Eric Rosenfeld, one of the founders of LTCM,
considers the failure to anticipate trader-driven correlation to be the fund’s central error. \(^{111}\) There was
an assumption that the portfolio was sufficiently diversified across world markets to produce low
correlation, but as previously mentioned, most markets LTCM was replicating basically the same
credit spread trade. In August and September 1998 credit spreads widened in practically every market
at the same time, causing LTCM’s positions to collapse in value. If LTCM had foreseen this
possibility, its risk calculations would have come out differently. \(^{112}\)

\(^{105}\) Id.
\(^{106}\) LTCMs founders included Myron S. Scholes and Robert C. Merton who were both Nobel Prize winners. Scholes
also coined the famous Black and Scholes option pricing model with Fischer Black.
\(^{107}\) Id.
\(^{108}\) Interestingly, despite of LTCM’s overreliance on VaR, and its acknowledged shortcomings, it still remained one of
the main models to calculate risk before financial crisis. In the financial crisis aftermath it was acknowledged that VaR
by itself its insufficient metric and should be supplemented with other metrics.
\(^{109}\) Shirref, supra at 103, 2009
\(^{110}\) Sebastian Mallaby, More Money Than God; Hedge Funds and the Making of a New Elite, 2010, pp. 230
\(^{111}\) Id, pp. 237.
\(^{112}\) Id.
Global Financial Crisis

Charles River Associates (CRA), among others\textsuperscript{113}, investigated whether hedge funds were a source of systemic risk during the financial crisis. Their notable conclusion was that hedge funds transmitted systemic risk through deleveraging i.e. through the market channel. However, their evidence also concluded, that regarding credit channel, the systemic repercussions remained minimal.\textsuperscript{114}

The limited impact on credit channel can be attributed to the fact that lending by prime brokers to hedge funds is subject to prudential rules.\textsuperscript{115}\textsuperscript{116} There were 1500 hedge fund failures during 2008\textsuperscript{117}, yet the systemic repercussions remained limited. Neither did the collapses of larger funds cause substantial risk transmission, which is also evident from the CRA, who examined the most notable failures, such as the failure of Peloton ABS Master Fund, Carlyle Capital Corporation and Bearn Stearns Asset Management (BSAM). They concluded that only the collapse of BSAM hedge funds appeared to have had more significant implications on the financial system.\textsuperscript{118}

According to CRA, there were two important points to be made regarding BSAM. The BSAM funds were distinctive because they were associated with a systemically important bank whereas the majority of hedge fund managers are standalone firms which are not owned by a systemically important bank. The problem might then be thought of as poor investment management and decision making by Bear Stearns, which contributed to a loss of confidence in the bank that later forced its sale (to JP Morgan in March 2008). This is rather different from a credit channel problem. For the hedge industry as whole, CRA also suggest that while hedge funds had to deleverage during the autumn of 2008, the industry overall managed to do so without damaging its bank counterparties (in the sense that debt was paid back on demand without significant loss to lenders).\textsuperscript{119}

With regards to the market channel, there were independent problems with hedge funds already during the onset of financial crisis. During the “quant quake” in August of 2007, a number of highly successful and leveraged quantitative long/short equity market neutral funds lost between 5 to 30\% in a single day due to deleveraging led by their models. Apparently, there were no other fundamental reasons to deleverage except that once the models recognized few large funds were deleveraging, the

\textsuperscript{113} See The High-level Group on Financial Supervision in the EU Report, supra at 6, 2009; The Turner Review, A regulatory response to the global banking crisis, FSA, 2009
\textsuperscript{114} CRA, supra at 92, 2009
\textsuperscript{115} After the collapse of LTCM, most prime brokers had also required full collateralization of hedge fund transactions. See Wulf A. Kaal, Hedge fund regulation via Basel III, Vanderbilt journal of transnational law, 44:389, 2011
\textsuperscript{116} It was also recognized by the EC, that this indirect approach to the regulation of hedge fund activity appears to have been effective in mitigating risks to the banking system. See EC, supra at 4
\textsuperscript{117} Mallaby, supra at 110, 2010
\textsuperscript{118} CRA, supra at 92, 2009
\textsuperscript{119} Id; This conclusion was also backed up by the High-level Group on Financial Supervision and The Turner Review.
The risks to market channel were yet again demonstrated after the financial crisis ignited. As the markets suddenly started falling, hedge funds collateral deteriorated and borrowing ratios were breached. This lead to margin calls and forced deleveraging. Furthermore, due to slumping asset prices, hedge funds faced significant redemption requests from investors, which forced them to sell their positions further. And lastly there were some hedge funds who were short selling to already falling markets, while others found exotic ways to bet against the collapse of economy. All in all, as noted by EC, ‘this pro-cyclical behaviour’ may have undermined financial stability and contributed to a deepening of the crisis. Thus, as also concluded by CRA; “the extent of this selling does appear to have been sufficiently non-trivial to have contributed to a vicious circle of declining prices and for this selling to have had an impact on overall financial markets”. The substantial decline in gross assets of hedge funds indeed suggests that deleveraging created systemic risks.

2.4.2. Investor protection

Before the financial crisis, the consensus was that hedge funds investors do not need extra protection, and the market works fine on the basis of caveat emptor. This was due to the belief that investors in hedge funds are high net worth individuals or institutional investors who are sophisticated enough to conduct their due diligence on the hedge funds. Moreover, in the view of the influential Financial

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120 For comprehensive overview on the “Quant quake” see Amir E. Khandani and Andrew W. Lo, What happened to the quants in August 2007?, MIT, 2007
121 On a separate note, Lo emphasises that the events of August 2007 are not particularly relevant about the efficacy of quantitative investing as the losses were more likely the result of a fire sale liquidation of quantitatively constructed portfolios rather than the specific shortcomings of quantitative methods. See Andrew W. Lo, Hedge funds, Systemic Risk and the Financial Crisis of 2007-2008, Written Testimony of Andrew W. Lo, Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform, 2008
122 This lead to imposition of gates and suspensions. EC, supra at 4.
123 Which was one of the reasons of short selling curbs across the globe.
124 The credit default swap (CDS) market practically ballooned slightly before financial crisis, as hedge funds were looking for a leveraged way to bet on the collapse of housing markets. John Paulson, a hedge fund manager, reportedly made over 14 billion on betting against the US subprime mortgage market via CDS’s. Gregory Zuckerman, Profiting From the Crash, The Wall Street Journal, 2009
125 EC, supra at 4.
126 CRA, supra at 92, 2009; Similar conclusions were made by the High Level Group the Turner Review.
127 See Appendix 5; Leverage position in the hedge fund industry from 2000 to 2008, which demonstrates that the gross assets of hedge funds declined significantly more than the net assets.
Stability Forum, direct regulation could have favoured a form of moral hazard inducing investors and counterparties to reduce their normal due diligence and relax their risk management standards. The financial crisis, however, exposed some shortcomings in investor protection. First, the lack of transparency may expose investors to larger than expected losses. In relation, as with all funds, if a lack of transparency is combined with poor systems and controls it can amplify the risk with regards to market integrity i.e. market abuse and fraud. In particular lack of transparency with regards to valuation policies and conflict of interests are particularly problematic. Second, the increasing retailization of hedge funds has made the distinction between who is “sophisticated” and who’s not in reality more difficult.

Lack of transparency; fraud, valuation and conflict of interests

Bernard Madoff’s grand scale Ponzi scheme is typically outlined as one of the primary events shifting the mood towards more regulation. However, hedge fund fraud existed long before Madoff. Most common types of fraud are overstatement of performance, payment of excessive and undisclosed commissions, and misappropriation of client money. During 2000-2005, there were over 52 fraud cases, with only five cases accounting for 1.5 billion of lost capital. Many of the fraud cases could have been avoided with stricter disclosure standards and separation of custodial services.

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128 The Financial Stability Forum, Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment, FSF, 2002
129 “Given the asymmetry of information and power between investor and hedge fund, the pre-crisis argument that investor due diligence is enough has worn out”. See IOSCO, 2009, supra at 33.
130 This chapter focuses on transparency from investor protection perspective.
131 IOSCO, 2009, supra at 36
132 Meaning the increasing availability of hedge fund products and how and to whom they are available. See William H. Donaldson, Testimony Concerning Investor Protection Implications of Hedge Funds, Chairman, U.S. Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, 2003
133 See Id.
134 It’s also notable, with the benefit of hindsight, that it was quite clear that many Madoff investors conducted extremely relaxed due diligence; despite some of the red flags being known, they chose to ignore them. See Dirk A. Zetsche ed. 2012, pp. 409-445; Erin E. Arvedlund, Don’t Ask, Don’t Tell: Bernie Madoff Attracts Sceptics in 2001, Barron’s, 2001; G. Gregoriou & F. Lhabitant supra at 16, 2009
135 For instance David Mobley, founder Maricopa International Investments administered a Ponzi scheme and conducted over 59 million offence. He sent investors false statements and monthly performance figures, while misappropriating investor money for his own use. See Gina Edwards, Mobley: Investors still reeling from shock of fraud allegations, Naples Daily News, 2000. From 1996 through 2005, Samuel Israel and Daniel Marino misappropriated, dissipated and lost tens of millions of dollars of their clients’ money that was invested in the Bayou Fund, and its successors. Investors deposited more than $450 million into the Funds over the course of their existence. See SEC, SEC CHARGES SAMUEL ISRAEL III, DANIEL E. MARINO, BAYOU MANAGEMENT, AND BAYOU FUNDS FOR DEFRAUDING HEDGE FUND INVESTORS AND MISAPPROPRIATING INVESTOR ASSETS, 2005
136 See Appendix 6: Selected hedge fund disasters and losses
In addition valuation has been particularly problematic topic.\textsuperscript{138} Despite the importance of accurately valuing the assets in a hedge fund's portfolio, no uniform standards exist for doing so.\textsuperscript{139} The problem with valuation is the attempt to provide a single number to determine what an illiquid or derivative asset is worth, what it might be sold for and over what period.\textsuperscript{140} Furthermore, a system by which each hedge fund manager values the assets in its fund according to a model that it developed can expose investors to the risk that the performance fee is, in part, determined by a model that overvalues the fund's assets.\textsuperscript{141}

Thus it has become industry practice to carry out valuations and NAV assessments by independent administrators. However, an independent administrator is usually paid by the hedge fund manager and may not understand all of the positions and strategies employed by the manager. The administrator may not have the understanding of complex securities products required to value the positions appropriately, and the manager may remain the person in charge of valuation even though formally that position has been externalized, causing significant conflict of interests.\textsuperscript{142}

There are also a number of other conflict of interests. For example, a conflict may arise if the hedge fund manager utilizes fund assets to pay for prime brokerage services such as capital introduction and marketing that benefit the fund manager as compared to the investors. In addition in some cases side latter\textsuperscript{143} agreements are not disclosed promptly.\textsuperscript{144} Also managers may be incentivised to have higher leverage to capital ratios than optimal for the fund as this could increase the likelihood for them to

\textsuperscript{138} Most enforcement actions instituted by the SEC against hedge funds from 1999-2004 involved a valuation problem. Typical case on valuation related fraud would be Springer Asset Management, which misrepresented the performance of its Apollo Fund, by overvaluing privately held internet security called Citi411.com, which also constituted 70\% of the fund's holdings. The fund even increased the valuation of Citi411.com during 2000-2002, from 1$ a share to 5.5$ a share, despite the crash in similar publicly traded internet stocks. Lhabitant, supra at 30, 2007 pp 52-53.

\textsuperscript{139} Ryan Sklar, Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflict of Interests, Fordham Law Review, 2009; The Financial Stability Forum had previously called on the hedge fund industry to deliver improvements with respect valuation techniques. In response, self-regulatory codes had been developed, which detail recommended practice. However EC emphasizes that it is not yet clear whether these have had a material impact on the robustness of the internal processes of hedge funds, particularly in stressed conditions. See EC, supra at 4.

\textsuperscript{140} Wulf A. Kaal, Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability, 2009

\textsuperscript{141} Sklar, supra at 139, 2009.

\textsuperscript{142} Kaal, supra at 140, 2009

\textsuperscript{143} At times hedge fund managers give preferential treatment to certain fund investors, typically those who they want to invest in any new hedge funds the manager may be opening. By entering into a "side letter" agreement, a hedge fund manager can agree to provide a favoured investor with specified preferences that are not available to all the hedge fund's investors. Preferential treatment may take the form of superior investment opportunities and more favourable redemption terms. Although side letters can help hedge fund managers attract large investors to the fund-thereby benefiting all the fund's investors-they also have the propensity to work disadvantages on those investors not receiving preferential treatment. Hedge fund managers may be reluctant to disclose their presence, however, fearing that their non-preferred investors would discontinue their investment in the fund upon knowledge of these preferential arrangements. Sklar, supra at 139, 2009

\textsuperscript{144} IOSCO, supra at 36, 2009
make their performance fees. This could lead to market instability as investors are poorly informed, and managers take riskier positions to increase potential returns.\textsuperscript{145}

\textit{Retailization}

Although not considered a major issue in Europe\textsuperscript{146}, retailization is, in particular, a problem in the US. This is due to increased number of US residents qualifying as accredited investors, thus often de facto unsophisticated investors may invest in hedge funds – investors who are incapable of evaluating the risks related to the products. Most of the real world complexities such as information asymmetries, potential conflicts of interest and disparate investor capabilities – are well understood by many investors, particularly more financially sophisticated ones, but are clearly not understood by all retail investors.\textsuperscript{147}

Retail investors are also sometimes indirectly involved with hedge funds, without their knowledge, which has caused concern for regulators.\textsuperscript{148,149} However this point of view seems far-fetched, since investing is inherently risky and institutional fund managers are typically well qualified in diversifying risk.\textsuperscript{150}

2.4.3. Regulatory approach

In principle there are two ways of regulating hedge funds, indirect or direct regulation. This approach can be further divided into regulating fund only, regulating manager only, regulating both fund and manager, regulating the investors or regulating the counterparties approach. However, the regulatory

\textsuperscript{145} Id; Investment in their own funds by managers may however help to mitigate some of the conflicts of interest in relation to investors as it can align the interest of the manager with the investor.

\textsuperscript{146} AIFMD may bring a sea change to ‘retailization’ as hedge funds will be generally permitted to offer their products, under strict conditions, to retail investors as well. See Ch. 5, 5.2.4 Convergence is inevitable

\textsuperscript{147} Franklin R. Edwards, “Hedge Funds: Creators of Risk?”, Presented at Federal Reserve Bank of Atlanta Financial Markets Conference, Columbia Business School 2003,

\textsuperscript{148} Financial services authority, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT, FSA, 2005

\textsuperscript{149} For instance public employees of San Diego County, California and the State of New Jersey, as well as employees of 3M, lost pension dollars in the wake of Amaranth's meltdown. Furthermore ordinary investors had contributed significant capital to Bernard Madoff's scam - investors who became indirectly exposed to the fraud by investing in hedge funds and funds of funds that invested with Madoff. Additionally, numerous schools, pension plans, and charitable foundations had invested with Madoff. See; Craig Karmin, Pension Managers Rethink Their Love of Hedge Funds, The Wall Street Journal, 2007; Sklar, supra at 140, 2009.

\textsuperscript{150} For instance the losses for San Diego Fund were only around 1% of its capital due to Amaranth, and the Fund returned 16% in 2006. See Id.
The approach comes down fundamentally always, whether hedge funds should be regulated directly or indirectly.  

Direct regulation mainly relies on the threat of law by using command-and-control regulatory instruments. On the other hand with indirect regulation, securities regulators refrain from directly exercising their regulatory power or authority. Thus the regulators wait to see what the relevant market players do in the marketplace, encouraging them to regulate themselves by relying on best practices or guidelines for the funds, fund managers, and their counterparties, made and released by (quasi) self-regulatory organizations (“SRO”) in cooperation with the regulators, effectively minimizing the regulators’ direct intervention.

The pre-financial crisis era contained substantial debate whether hedge funds should be directly regulated or not. However it was widely held that the objectives of hedge fund regulation could be achieved by indirect regulation, as previously described. This was highlighted by the influential FSF in 2000 when it adopted a series of high-level recommendations focused on systemic risks and market dynamics concerns raised by highly leveraged institutions (HLI). However, since the crisis the regulatory stance has gradually shifted towards direct regulation. The main reasons coincide with the objectives of hedge fund regulation. In order to make the system more robust during times of distress, it’s necessary to regulate hedge funds, even if they weren’t the main culprits of the crisis from systemic perspective. Furthermore, the evidence from financial crisis seemed to justify a paradigm shift for policymakers towards more strictly regulated hedge fund industry. Thus, the question gradually shifted from whether indirect or direct regulation is the right approach to how

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151 For detailed discussion on the different approaches See Eun Jip Kim, Rethinking Hedge Fund Regulation: Focusing on the U.S., the U.K., and Korea, Maurer School of Law: Indiana University, 2014
152 Command-and-control instruments are the most traditional methods of effecting a behavioural change in the subjects of regulation. A command is “an order backed by threats.” Therefore, the non-compliance or violation of such an order triggers coercive sanctions on the part of the state. In this method of regulation, the law uses traditional rules to further certain policy objectives; See John Austin, The province of Jurisprudence Determined, 1832, pp. 18-37
153 See Nabilou and M. Paccès, 2015 supra at 12.
154 Jip Kim, supra at 151, 2014
155 SeeIOSCO, Hedge Funds and Other Highly Leveraged Institutions, Report of the Technical Committee, 1999; See Id. Also on the definition of HLI, which is quite similar to hedge funds, however not all hedge funds are HLI’s.
156 Jip Kim, supra at 151, 2014
157 Even if hedge fund collapses didn’t really contribute to the crisis, regulators have generally taken a pre-emptive stance in the post crisis environment. This is based on the viewpoint that there remains risks that collapse of a large hedge fund or myriad of smaller hedge funds, could cause the failure of systemically important financial institution, which in turn would cause market wide problems that would affect the real economy.
158 See Ch. 3, 3.2 AIFMD background
should hedge funds be regulated. With AIFMD the approach chosen is regulating the manager. This is arguably one of the most consistent ways of regulating hedge funds.

159 There are still arguments that indirect regulation would yield overall better response. See Nabilou and M. Pacces, 2015 supra at 11
160 See ref. 19
3. Introduction to AIFMD

3.1. Hedge fund regulation in EU prior to AIFMD

Although there was no direct European legislation on the funds themselves, the various service providers within the hedge fund industry were already subject, to varying degrees, to numerous European Directives including the Market Abuse Directive, Capital Adequacy Directive, Money Laundering Directive, the Capital Requirement Directive, the Prospectus Directive (PD) and the Markets in Financial Instruments Directive (MiFID). The directives also covered parts of hedge fund and alternative investment fund industry. In particular many assets managers of AIF’s were licensed for portfolio management under MiFID, while the sales of fund units that qualified as securities were subject to the PD.162

Quaglia points that the EU-level regulation could be theoretically described as competition between two regulatory paradigms, market-shaping and market-making paradigm.163 The countries embracing the market-shaping paradigm prioritised consumer protection, financial stability and veiled protectionism. The countries adopting the market-making paradigm privileged competition, market efficiency and financial innovation. Market-making paradigm was particularly advocated by the UK and the ‘market-shaping’ paradigm supported by Mediterranean countries and, in several instances, Germany. In fact, even prior to financial crisis, the long-standing goal of the advocates of regulation had been a directive regulating hedge funds.164 However, at Union level regulation was left at member states discretion. This was in line with UK’s preference and with recommendation’s issued by the international bodies such as IOSCO and financial stability forum (FSF). In addition, Presidents Working Group in the US had had recommended indirect regulation.165

Several Member States had national regulatory regimes in place though. These regimes typically involved registration and oversight of hedge fund managers, as well as structural separation of the hedge fund manager and the custodian.166 In countries such as in France and Germany, the fund itself was a (quite strictly) regulated onshore vehicle, although often it could be domiciled in a third country.

162 Zetzsche, supra at 10, 2012 pp. 1-19
164 Id.
165 See PWG, supra at 50, 1999; See FSF, supra at 95, 2000: IOSCO, supra at 155, 1999
166 EC, supra at 161, 2006
On the other hand the UK (which host’s four-fifths of all hedge funds in the EU) naturally preferred a lighter regime\textsuperscript{167, 168}.

3.2. AIFMD background

The financial crisis gave the attempt to regulate hedge funds in the EU new momentum. The crisis did not substantially alter the configuration of interests concerning hedge fund regulation in the EU. However, it did impinge upon existing regulatory paradigms because it was seen as implicitly validating the ‘market-shaping’ approach exposed by the pro-regulation countries.\textsuperscript{169} European Parliament produced several reports on the possibility and reasoning of regulating hedge funds and private equity (including the Rasmussen\textsuperscript{170} and Lehne\textsuperscript{171} reports), as the regulatory atmosphere was turning towards more AIF-specific regulation.

3.2.1. Political process behind AIFMD

Quaglia provides evidence that the political motivations\textsuperscript{172} of Germany and France, backed by some members of the European Parliament (EP), were the driving forces in the redesign of EU regulation. Their actions were also motivated by institutionally-shaped economic interests,\textsuperscript{173} but were also informed by their ‘market-shaping’ regulatory approach concerning financial services. The global financial crisis partly discredited what could be labelled as the ‘British model’ of financial services regulation\textsuperscript{174}, which had been the established model in the EU since the late 1990s and had informed a large part of the EU rules adopted prior to the global financial crisis.\textsuperscript{175}

After protracted negotiations, During the April 2009 summit in London, G20 Leaders agreed that hedge funds or their managers should be registered and should be required to disclose appropriate

\textsuperscript{167} The British Financial Services and Markets Act (2000) merely required hedge fund managers to be authorised FCMA, Section 19. Hedge funds were also subject to oversight of FSA.
\textsuperscript{168} Quaglia, supra at 163, 2011
\textsuperscript{169} Id.
\textsuperscript{172} Quaglia emphasises that this assessment on the motivations of AIFMD was enhanced even further by the fact there were purely domestic reasons – such as forthcoming general elections in Germany and President Sarkozy’s attempt to increase his political capital in France – that motivated German and French political leaders to be seen as tough in regulating hedge funds and private equity funds. See Quaglia, supra at 163, 2011
\textsuperscript{173} An interest-based account would focus on the costs and benefits of hedge fund regulation for the main stakeholders, in particular the large member states. According to this explanation, member states are keen to set in place EU rules that are in line with their domestic regulatory approach and do not create comparative disadvantages or adjustment costs for national industry and the public authorities. Id.
\textsuperscript{174} Alongside AIFMD, the financial crisis unleashed a number of new European asset management directives, such as IORPD, UCITS 4, MiFID 2.
\textsuperscript{175} Quaglia, supra at 163, 2011.
information on an ongoing basis to supervisors or regulators. They should be subject to oversight to ensure that they have adequate risk management.\textsuperscript{176} In addition other jurisdictions developed similar frameworks to regulate managers of AIFs, in particular, the US with the Dodd-Frank Act.\textsuperscript{177} The consensus reached was seen as a victory for France and Germany, which championed the need for a comprehensive regulatory architecture in the face of resistance from the UK, where most of the European hedge funds are based.\textsuperscript{178} In June 2009, the European Commission presented its proposal for the draft directive on AIFMs, which included managers of hedge funds, private equity funds and real estate funds, hence practically covering all collective investment vehicles which are not UCITSD.\textsuperscript{179} Thus the scope of the directive was much broader, than originally envisioned. Although some alternative views\textsuperscript{180} about financial services regulation began to emerge in UK as well, it took a highly critical stance on the directive. The original draft was highly criticized for being “politically driven effort to place obstacles in the way of an industry that is almost exclusively based in the US and UK”.\textsuperscript{181} After intense lobbying from industry, the US and the UK, the draft directive was partly revised\textsuperscript{182} during the Swedish presidency of the EU that began in July 2009.\textsuperscript{183} An agreement between the Council of Ministers and the EP was eventually reached in late October 2010, and the directive entered into force in 2013\textsuperscript{184}.\textsuperscript{185}

3.2.2. Regulatory technique and ESMA powers

The regulatory process follows the so-called ‘Lamfalussy’ approach. According to this process, the EC may adopt measures as binding technical standards, which are ‘implementing technical standards’ and ‘regulatory technical standards’. Regulatory technical standards are ‘delegated acts’. The Parliament and Council may raise objections to the delegated act and therefore prevent the act from

\begin{footnotesize}
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\item \textsuperscript{176} AIMFD, Recital 89
\item \textsuperscript{177} The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. 111-203, H.R. 4173), Title IV, also known as the Private Fund Investment Advisers Registration Act of 2010
\item \textsuperscript{178} Quaglia, supra at 163, 2011
\item \textsuperscript{180} The Turner review acknowledged that authorities should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds) to allow assessment of overall system-wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant. See FSA, supra at 113, 2009
\item \textsuperscript{181} Paul Marshall, \textit{Europe’s classic exercise in closet protectionism}, The Financial Times, 2009
\item \textsuperscript{182} There were many dubious provisions and overlaps with other directives with the initial draft, such as outright ban on reverse solicitation and restrictions to short selling.
\item \textsuperscript{183} According to Zetzche, some initial drafts of the directive were even leaked, which lead to aggressive lobbying by certain participants. See Zetzche, supra at 10, 2012, pp. 1-19
\item \textsuperscript{184} See Appendix 7: AIFMD Timeline
\item \textsuperscript{185} Quaglia, supra at 163, 2011.
\end{itemize}
\end{footnotesize}
entering into force. Conversely, implementing technical standards cannot be overturned by the Parliament or Council. ESMA is empowered to draft both kinds of binding technical standards which the Commission may subsequently adopt. Moreover, the AIFMD foresees ESMA guidelines which have binding effect upon the supervisory authorities within the EU.186 ESMA also has the power to request competent authorities to prohibit marketing in the EU of non-authorized AIFs, impose management related restrictions on non-EU AIFMs in case of concentration of risk in a specific market or when their activities potentially constitute an important source of counterparty risk to systematically relevant institutions.187 These powers are significant considering the broad and ambiguous wording of the directive.

The AIFMD framework consists of several legislative acts. The basis constitutes the AIFMD which has been implemented as a national bill by Member States. Since the AIFMD principles are rather vague, the directive is complemented by the Commission Delegated Regulation (AIFMD-CDR). The AIFMD-CDR takes direct effect in the EU Members States, pursuant to the process contemplated under the Lisbon Treaty.188 The implementation of the Directive by the European Commission, in the form of AIFMD-CDR, has achieved a great deal by making the regime far more workable than many in the industry had anticipated.189

3.3. AIFMD Objectives

The general objective of AIFMD, is to provide an internal market for AIFMs and a harmonised and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs, including those which have their registered office in a Member State (EU AIFMs) and those which have their registered office in a third country (non-EU AIFMs).190 The objectives are further detailed in the Commission impact assessment. The specific objectives of the directive are monitoring of macro-prudential risks i.e. systemic risk, supervising the participants of financial markets, granting high level of investor protection, enhancing management of micro-prudential risks while ensuring

186 Zetzsche, supra at 10, 2012, pp. 1-19
187 AIFMD, Article 47, 4, (a)-(c)
189 Mirzha de Manuel Aremendia, Implementing the AIFMD: Success or failure?, ECMI Commentary No. 34, 2013
190 AIMFD, Recital 4
overall market efficiency. The objectives can be further separated into level 2 issues which include the calculations of leverage and AUM for instance.\footnote{See Appendix 8; The objectives of AIFMD} \footnote{EC, Commission staff working document; \textit{Impact assessment accompanying the document commission delegated regulation supplementing Directive 2011/61/EU of the European Parliament and of the Council with regards to exemptions, general operating conditions, depositaries, leverage, transparency and supervision}, 2012}

Zetsche et al. have distinguished the “between the lines” objectives of AIFMD. The first is risk management in a wider sense, with two dimensions to risk management, systemic risk and investor protection.\footnote{Zetsche, supra at 10, 2012 pp. 1-19} These objectives were directly influenced by the financial crisis and the subsequent paradigm shift with regards to financial regulation in general. The second political objective is the addition of another feature to the single market by granting access to the markets of all Member States, subject to strict requirements. The idea was to prevent externalities from profits and losses materializing on different members states.\footnote{Id.} The third objective may have been the protection of the highly regulated, AIFMD-compliant European fund industry from lesser regulated competitors from third countries, in particular from the US. Lastly, due to the fact that access to the single market coincides with the exchange of tax information, one objective might have been putting pressure on offshore domiciles.\footnote{id.}
4. Content of AIFMD
   4.1. Scope and definition

According to AIMFD, alternative investment funds\textsuperscript{196} (AIF) are defined as collective investment undertakings, including investment compartments thereof, which: use 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; and do not require authorization according to UCITSD.\textsuperscript{197} Thus AIFMD basically takes “one-size-fits-all” approach as it includes all funds who raise capital\textsuperscript{198} from number of investors\textsuperscript{199} with a defined investment policy\textsuperscript{200}. The definition is rather exhaustive – most of the non-UCITSD funds fall under the scope, to such degree that there is no necessity to provide a laborious definition on all the different alternative investments. The scope of the definition also covers \textit{almost all} hedge fund structures.

Unsurprisingly, AIFMs’ means legal persons whose regular business is managing one or more AIFs.\textsuperscript{201} Management of AIFs should mean providing at least investment management services. The single AIFM to be appointed pursuant to this Directive should never be authorised to provide portfolio management without also providing risk management or vice versa.\textsuperscript{202}

The AIFM regime applies to EU AIFMs managing one or more EU AIFs/non-EU AIFs; Non-EU AIFMs managing one or more EU AIFs; Non-EU AIFMs marketing AIFs in the EU.\textsuperscript{203} The only scenario where AIFM does not fall within the scope of the AIFM regime is the situation of a non-EU AIFM managing and/or marketing a non-EU AIF outside the EU given the absence of any relationship with the EU.\textsuperscript{204}

\textsuperscript{196} The terms AIF and AIFM are used liberally throughout the chapter to generally refer to hedge funds, however, it must be emphasized they cover wide array of investment vehicles.
\textsuperscript{197} AIMFD, Article 4, 1, (a)
\textsuperscript{198} Raising capital can take place once (closed-end fund) or on an ongoing basis (open-ended) funds. See Laurent Fessman, Jeremy Muszkatblit and Ramzi Sahli, \textit{Scope of the AIFMD}, Baker & McKenzie, 2013
\textsuperscript{199} An undertaking will not be an AIF if its instruments of incorporation state that the vehicle must have only one investor. Even if an undertaking only has one investor, it will still be considered to raise capital from a number of investors where its rules do not limit the sale of units/shares to a single investor. Id.
\textsuperscript{200} Factors which may indicate existence of defined investment policy; 1. Policy forms part of the rules or instruments of incorporation of the undertaking 2. Undertaking (or manager) has a legal obligation to investors to follow the policy 3. Policy specifies investment guidelines with reference to geographical regions, restrictions on leverage, holding periods or risk diversification. Id.
\textsuperscript{201} AIMFD, Article 4, 1, (b)
\textsuperscript{202} AIMFD, Recital 21
\textsuperscript{203} AIFMD, Article 2.1,(a)-(c)
\textsuperscript{204} Association of the Luxembourg fund industry (ALFI), \textit{The alternative investment fund managers directive, Luxembourg implementation}, 2013
AIFMD provides for a limited number of exemptions (including grandfathering provisions for certain existing fund structures) and also a lighter touch ‘registration’ regime for managers with limited assets under management. The directive does not apply to holding companies, employee participation schemes or employee savings schemes etc. In addition, exemptions are provided for AIFM’s managing smaller AIFs (de minimis threshold) i.e. AIFMs managing AIFs which are not leveraged and without redemption rights for a period of 5 years, and with aggregate assets under management below EUR 500 million and AIFMs managing AIFs whose assets under management, including any assets acquired through the use of leverage, do not exceed EUR 100 million. Such exempted AIFMs are subject to regular reporting and registration requirements with NCA’s only. In terms of relevance to hedge funds, it seems mainly unleveraged funds which manage assets below 100 million may benefit from this, but they also have the chance to “opt in”.

It’s also worth noting regards to exemptions, that investment undertakings, such as family office vehicles, which invest private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with the Directive. Prima facie, it would be unfair and somewhat counterintuitive to bring these AIFMs who by nature, do not manage external investors’ capital or market funds under the scope of the directive. However these private managers have accumulated a lot of wealth and their actions have a major impact on markets. This has prompted some commentary that it’s only a matter of time they are brought under regulatory radar as well.

**Practical consequences**

The one-size-fits all approach of the AIFMD bears several consequences to the industry. First borders of entry for the hedge fund industry are significantly increased. This may have hindering effects on market efficiency, particularly in less liquid European markets. Smaller funds are especially known for investing in such segments where larger funds steer clear of (small-cap stocks for instance). Second, it has also already lead to further consolidation within the industry, and thus reduced

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205 The AIFM Law foresees the following two grandfathering provisions for AIFMs managing closed-ended AIFs: If they do not make additional investments after 22 July 2013, they may continue to manage such AIFs without authorization under the AIFM Law; If their subscription period for investors closed prior to the entry into force of the AIFM Law and if their term expires at the latest in 2016, they may continue to manage such AIFs without authorization under the AIFM Law but must publish an annual report and, when applicable, comply with the disclosure requirements on the acquisition of portfolio companies. Id.

206 For comprehensive list see AIFMD, Article 2,3

207 AIFMD, Article 3,2, (a) and (b)

208 When a hedge fund becomes a family office, all funds are returned to outside investors and the new entity runs the money of the manager and his or her family members alone. Some of the most prominent hedge fund managers such as George Soros and Steven Cohen have chosen to operate under family office due to increased regulatory pressures. See Madison Marriage, *Hedge funds’ move to become family offices is not entirely popular*, The Financial Times, 2015

209 AIFMD, article 3, 1

210 See IOSCO, supra at 35, 2009
competition. Finally, due to wide scope, AIFMD establishes for the first time uniform rules on the industry. This should, in principle reduce legal uncertainty significantly. It should be much harder for hedge funds to circumvent regulation with the adoption of AIFMD.

4.2. Authorization

Providing common requirements for governing the authorization and supervision of AIFMs is one of the objectives of AIFMD. The directive requires that all member states ensure that no AIFMs manage AIFs unless they are authorized in accordance with the directive. Thus the managers are subject to a general prohibition which will be lifted once they are authorized. In addition no EU AIFM should be able to manage and/or market EU AIFs to professional investors in the Union unless it has been authorized in accordance with the Directive. The directive also clearly distinguishes between UCITSD and AIFMD funds as investment firms authorized under UCITSD are not required to obtain authorization. Authorization may be withdrawn if the competent authorities see it compromised. AIFMD is separated into so-called core and noncore operations. The core operations i.e. portfolio and risk management require authorization. However, AIFMD doesn’t require AIFMs to provide non-core services, which gives room for delegation.

Application for authorization is done to the national competent authorities. In order to get the authorization, AIFMs need to provide extensive amounts of information relating to the AIF and AIFM. In terms of AIFM information is required on the persons effectively conducting the business of the AIFM, on the remuneration policies, and information on the identities of AIFM shareholders. In relation to AIFs, information requirements concern the investment strategies, where the master AIF is established if the AIF is a feeder AIF and information on depositary in accordance with article 21 and so on.

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211 According to survey conducted by BNY Mellon and FTI Consulting, five per cent of AIFs surveyed are expected to be closed, merged or sold, potentially resulting in less choice for investors. BNY Mellon, Over 80% of fund managers have yet to seek AIFMD authorisation as July compliance deadline looms, according to new BNY Mellon survey, 2014
212 AIFMD, Recital 2
213 AIFMD, Article 6.1
214 AIFMD, Recital 18
215 AIFMD, Article 6.8
216 AIFMD, Article 11
217 Portfolio management is not defined by AIFMD, however Zetzsche et. al. have concluded that it refers simply to the investment decision itself, constituting the decision to buy and sell assets. Zetzsche, supra at 10, 2012 pp. 159-198
218 AIFMD, Recital 21
219 Non-core services include marketing, compliance, administration etc. See AIFMD, ANNEX I
220 See Zetzsche, 2012, supra at 10, pp. 159-199
221 AIFMD, Article 7.1
222 AIFMD, Article 7.2 and 7.3
The directive also requires minimum regulatory capital for the AIFMs. The minimum regulatory capital measures are intended for control of runs as they act as buffer. Member States shall require that an AIFM which is an internally managed AIF has an initial capital of at least EUR 300,000. Where an AIFM is appointed as external manager of AIFs, the AIFM shall have an initial capital of at least EUR 125,000. Where the value of the portfolios of AIFs managed by the AIFM exceeds EUR 250 million, the AIFM shall provide an additional amount of own funds. That additional amount of own funds shall be equal to 0.02% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million but the required total of the initial capital and the additional amount shall not, however, exceed EUR 10 million. These funds are required to be invested in liquid assets or assets readily convertible to cash in short term and cannot include speculative positions. AIFMs must also cover potential professional liability risks through either additional own funds to cover risks from professional negligence or hold an appropriate professional indemnity insurance against such risks. For calculating regulatory capital requirements, AIFMD CDR specifies that it is the sum of absolute value of all assets with derivative valued at their market price.

Practical consequences

Registration requirements have been already widespread practice across Europe. AIFMD goes much further though, as the directive requires AIFMs to provide extensive amounts of information, for instance about the persons effectively conducting business. This should help the regulators better assess the more dubious hedge fund structures. Typically the issue is that since hedge funds transcend many jurisdictions, which inhibits the ability of investors to learn about the individuals behind their investment. With AIFMD, it should be easier for investors to assess who is factually behind the business.

The requirement to investment own capital in a fund is also a powerful incentive. This mitigates the dilemma between hedge funds receiving performance fees, but not having to pay for losses.
However, many hedge fund managers have voluntarily done this anyway. In addition the capital requirements seem rather superfluous, considering the amounts are not going to meet any larger investor redemption requests for most funds, which are unlevered. On the other hand, for some firms, which use substantial amount of derivatives and sophisticated hedging techniques it will be a considerable increase in their regulatory capital. Depending on their asset base, it may be difficult to set aside such capital.  

4.3. Operating conditions

AIFMs will have several new obligations related to operating conditions. These include general conduct principles, remuneration, conflict of interests, risk management, liquidity management, organisational requirements such as valuation, delegation of AIFM functions and finally provisions on depositary function. The provisions on remuneration, valuation, liquidity management, risk management, delegation and depositaries are discussed in further detail here. Corporate governance issues, such as operating principles and provisions of conflict of interests are only briefly outlined.

The AIFM Law contains several principle-based rules on general operating conditions. In short, the general operating principles that apply to AIFMs are similar to the rules of conduct laid down in the UCITS Directive, which basically constitute the fundaments of fiduciary law. The operating principles require for instance that AIFM will act with due diligence and care, honesty, comply with regulations, ensure fair treatment of investors and act in the best interests of the AIFs they manage. In terms of conflict of interests, AIFMs are required to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.

\[^{233} PWC, supra at 228, 2013; an example would be a hedge fund using many offsetting hedges, which enlarges its gross asset base.\]
\[^{234} AIFMD, Articles 12-20\]
\[^{235} See Zetzsche, supra at 10, 2012, pp. 159-199\]
\[^{236} For instance usage of side letters will still be possible, but AIF has to clearly disclose that with its rules. See AIFMD-CDR, ANNEX IV\]
\[^{237} AIFMD, Article 12, 1, (a)-(f)\]
\[^{238} AIFMD, Article 15\]
4.3.1. Remuneration

AIMFD tries to reign excessive remuneration practices. It imposes a general requirement of installing such remuneration policies that do not encourage risk taking\textsuperscript{239} for those employees of AIFMs whose activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage. AIFMs will also need to establish an independent and competent remuneration committee.\textsuperscript{240} AIFMs will have substantial requirements to comply with the new principles laid down in Annex II, in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.\textsuperscript{241}

\textit{Practical consequences}

The Turner review states that if a hedge fund is remunerated on the basis of a contract which provides for a significant profit share in good years but no claw back in years of poor performance, the fund may have high incentive to pursue strategies which generate strong returns in many years at the expense of small probability of occasional very large loss.\textsuperscript{242} This was indeed evident in the era preceding financial crisis, as high remuneration was a source of high risk taking, which ultimately exposed funds to large losses. While investment to fund by the manager may serve to alleviate this risk-taking, the asymmetry remains, if the manager does not have a significant proportion of his wealth invested in the fund. Thus with the AIFMD and accompanied ESMA guidance on remuneration, hedge funds will be required the take a closer look at their existing remuneration practices and ensure that remuneration schemes do not encourage risk-taking.

The hedge fund fee structure has also lately received significant criticism\textsuperscript{243}. In a low return environment, certain hedge fund still continue employing extremely high fees and some questionable remuneration practices, without delivering alpha. Thus it is reasonable AIFMD also reigns these practices. According to ESMA, measures such as golden parachutes and guaranteed bonuses are inconsistent with AIFMD.\textsuperscript{244}

\textsuperscript{239} AIFMD, Article 13, 1
\textsuperscript{240} AIFMD, ANNEX II, 2; See ESMA guidelines for role of the remuneration committee. ESMA, \textit{Guidelines on sound remuneration policies under the AIFMD}, 2013, pp. 15
\textsuperscript{241} AIFMD, ANNEX II
\textsuperscript{242} FSA, supra at 113, 2009
\textsuperscript{243} Madison Marriage, \textit{Oaktree founder attacks hedge fund fees}, The Financial Times, 2015; Steve Denning, \textit{How Hedge Funds Transfer Wealth From Investors To Managers}, Forbes, 2013; See also ref. 55 and 56
\textsuperscript{244} ESMA, supra at 240, 2013, pp. 2
4.3.2. Valuation

AIFMD requires that appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed.\textsuperscript{245} Proper and independent valuation of assets is one of the foundations for hedge fund business. As described in the investor protection chapter, it’s also one of the aspects where most controversies tend to occur – disclosure of conflict of interests is one of the key problems, alongside the issue that some illiquid investments are particularly hard to value. With regards to AIFMD, the key issues to consider are:\textsuperscript{246}

- which entities are permitted to carry out the valuation function;
- the classification of an external valuation agent;
- the liability provisions in relation to the valuation function; and
- the valuation procedures under the AIFMD;

Valuation function can be either performed by external valuer, who is a legal or natural person independent (or any close links) from the AIF and AIFM or the AIFM itself, provided that the valuation task is functionally and hierarchically independent\textsuperscript{247} from portfolio management and remuneration policies, and other measures ensure that conflict of interests are mitigated.\textsuperscript{248} In addition the directive explicitly implies that external valuer cannot delegate the valuation function to a third party.\textsuperscript{249} Furthermore delegating valuation tasks to external valuer does not allow for the circumvention of the AIFM’s responsibilities or liability.\textsuperscript{250} The external valuation agent is, however, liable to the AIFM for any losses suffered by the AIFM as a result of the external valuation agent’s negligence or intentional failure to perform its tasks. This liability is irrespective of any contractual arrangements providing otherwise.\textsuperscript{251}

With regards to valuation procedures used, AIFMs are required to ensure that the assets are valued and net asset value (NAV) per unit or share is calculated at least once per year. Open-ended funds need to carry out more frequent valuations, whereas closed-ended funds need to carry out valuations when capital increases or decreases.\textsuperscript{252} In addition, AIFMs are required to provide a description of

\begin{footnotes}
\item[245] AIFMD, Article 19, 1
\item[246] Matheson, \textit{AIFMD Factsheet: Valuation}, 2014
\item[247] This terminology is crucial part of AIFMD. In practice “functional” and “hierarchical” separation means for instance, separate personnel and separate supervision.
\item[248] AIFMD, Article 19,4, (a) and (b)
\item[249] AIFMD, Article 19,6
\item[250] AIFMD-CDR, Article 75, (a)
\item[251] Matheson, supra at 246, 2014
\item[252] AIFMD, Article 19,3
\end{footnotes}
the AIF’s valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets. The rules applicable to the valuation of assets and the calculation of the net asset value per unit or share of the AIF are laid down in the law of the country where the AIF is established and/or in the AIF rules or instruments of incorporation.

**Practical consequences**

Ensuring proper valuation is key for providing understanding on the riskiness of hedge funds assets and on the other hand ensuring the independence of valuer is important for preventing the most basic frauds. Although many of the procedures with regards to valuation – such as ensuring valuer independence – were already applied by AIFMs, AIFMD introduces coherent standards on valuation procedures, which are important in order to harmonize the divergent practices across Europe. This should prevent some of the abuses related to valuation. However, the directive fails to address the fact, that sometimes it is extremely difficult to find an external and independent valuer, who has the expertise to value the AIFMs assets though.

4.3.3. Risk management

It is beyond question that the financial crisis perilously highlighted the importance of re-assessing and enhancing risk management practices throughout the entire financial sector, including hedge funds. The crisis subsequently lead to “sea change” of trend in how risk management is regulated and effectively conducted by asset managers. AIFMD follows this changing trend, and sets risk management besides portfolio management, as the core business function of AIFMs. As put by KPMG, risk management is at the heart of AIFMs activity as it is linked to valuation, disclosures, capital and liability issues, etc.

According to AIFMD, AIFM should never be authorised to provide portfolio management without also providing risk management or vice versa. The provisions of AIFMD and AIFMD-CDR convey rules on establishing adequate risk management systems which are understood as both

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253 ALFI, supra at 204, 2013  
254 AIFMD, Article 19,2  
255 AIMFD, Recital 29  
257 AIFMD-CDR, Recital 86  
258 KPMG, *AIFMD RISK MANAGEMENT*, 2014  
259 AIFMD, Recital 21
organisational elements – placing a central role on a permanent risk management function – as well as policies and procedures to measure and manage risks in relation to each AIF.\footnote{See ALFI, Risk Management under the Alternative Investment Fund Managers Directive, 2014}

AIFMs are required to functionally and hierarchically\footnote{On conditions when risk management function is "functionally" and "hierarchically" separated see AIFMD-CDR, Article 42, (a)-(b).} separate the functions of risk management from the operating units, including from the functions of portfolio management.\footnote{AIFMD, Article 15, 1} The AIFM is required to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.\footnote{AIFMD, Article 15, 2} These risks include, \textit{inter alia}, the typical market, liquidity, credit, counterparty and operational risks.\footnote{Market risks are typically related to volatility, caused by unexpected moves in the markets. Liquidity risks rise from investor’s redemptions requests, sudden contractions in liquidity during turmoil and generally from investments on illiquid products. Credit risks arise from widening credit spreads. Counterparty risks are generally related to counterparty default risks. Operational risks include losses from failure of ordinary business processes, for instance failure to value funds assets correctly.} An AIFM shall establish and implement quantitative or qualitative risk limits, or both, for each AIF it manages, taking into account all relevant risks. Where only qualitative limits are set, the AIFM shall be able to justify this approach to the competent authority.\footnote{AIFMD-CDR, Article 44, 1}

AIFMs shall review the risk management systems with appropriate frequency at least once a year and adapt them whenever necessary.\footnote{AIFMD, Article 15, 2} Furthermore, AIFMs need to ensure regular reporting on risk management matters to internal governing bodies and investors. The AIFMD stresses in many cases the principal of proportionality taking into account the structure and complexity of the AIFM and the AIF it manages. Reporting frequency depends on the size and systemic relevance of the AIFM, for instance smaller AIFM might need to report only on annual basis, while systemically relevant AIFM should report at least on quarterly basis.\footnote{ALFI, supra at 260, 2014}

**Practical consequences**

The main change with AIFMD is that it renders risk management a core activity. AIFMs will need to show that their risk function manages counterparty, liquidity and operational risk, as well as the investment risk, what was traditionally the main focus of such function.\footnote{Sophia Grene, Hedge funds split over AIFMD risk management rules, The Financial Times, 2014} Considering the shortcomings in risk management during the financial crisis – particularly due to imperfect risk
measurement understating risks — such rules are a welcome development. The risk management provisions should help the regulators assess the relevant risks with regards to AIFMs, and on the other hand, ensure that appropriate risk management procedures are undertaken by the AIFM. Furthermore, more transparency and risk reporting to investors should help enhance trust in the industry. However, the implementation of the principle of proportionality with regards to different strategies, the size AIFMs, and the relevant risks cannot be emphasized enough. There also remains an argument that changes in risk management were already taking place within the industry.270

4.3.4. Liquidity management

Issues with regards to the illiquidity of assets during crisis times has been well documented. Even extremely liquid markets can dry during the times of serious shock (as witnessed by US short-term credit markets during the financial crisis). Many sources indicate that the financial crisis was characterised as a typical liquidity crisis, initially in excess of it and thereafter total collapse of liquidity. Although lack or abundance of liquidity in hedge funds wasn’t the root of the crisis, they nevertheless are exposed to liquidity risks with regards to their illiquid positions and counterparties. In addition hedge funds have employed for long some controversial strategies to manage illiquid positions and to prevent investor redemptions, which some consider are in a dire need of change.

The two key components for management of liquidity risk are (i) the management of asset liquidity, in particular with illiquid assets and the related valuation problems; and (ii) the management of redemption requests.273 Thus AIFMD requires that AIFMs ensure that the investment strategy, the liquidity profile and the redemption policy are consistent.274 With regards to asset liquidity risk management AIFMD seeks to establish new standards in order to ensure that AIFMs apply appropriate liquidity management systems, adopt procedures that enable AIFM to monitor AIF’s

269 Arguably the most maligned metric in risk measurement is Value at Risk (VaR). Its role within banking and consequently the financial crisis has been well documented. The main issue with VaR and similar metrics is that they use historical data, whilst markets tend to be dynamic and constantly evolving. While such risk measurements might produce adequate results in stable conditions, it typically understates risks related to market turmoil. Hilton states accordingly that VaR shouldn’t be disregarded as useless metric, but understanding the appropriate conditions when the metric performs well, and when not is the key. See Max Hilton, Challenges in risk management, AIMA, 2013
270 Zetsche, 2012, supra at 10, pp. 265-331
272 Madison Marriage, Hedge funds close the gate before investors can bolt, The Financial Times, 2013
273 Zetsche, supra at 10, 2012, pp. 253-264
274 AIFMD, Article 16.2
275 Regarding liquidity management systems see AIFMD-CDR, Article 47,1
liquidity risk and regularly conduct stress tests under normal and exceptional conditions.\textsuperscript{276} The delegated regulation contains more specific rules on redemption policies and ‘special arrangements’.\textsuperscript{277} The use of tools and special arrangements to manage liquidity should be made dependent on concrete circumstances and should vary according to the nature, scale and investment strategy of the AIF.\textsuperscript{278}

The investment strategy, liquidity profile and redemption policy of each AIF managed by an AIFM shall be considered to be \textit{aligned} when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF’s redemption policy and its obligations.\textsuperscript{279} In assessing the alignment of the investment strategy, liquidity profile and redemption policy the AIFM shall also have regard to the impact that redemptions may have on the underlying prices or spreads of the individual assets of the AIF.\textsuperscript{280}

\textit{Practical consequences}

Fire sales and deleveraging stemming from substantial investor redemption requests may pose risks to overall functioning on financial markets. In some cases, provisions on gating and side pockets can help to mitigate these risks\textsuperscript{281}, yet it is undeniable that overarching principle must be the fair treatment of investors acknowledging that the redemption of shares is a fundamental right.\textsuperscript{282} In practice AIFMs will need to abide by a defined policy with respect to redemptions, which shouldn’t prevent hedge funds from employing special arrangements such as gates as usual, however, it must be in the best interests of investor. This should prevent AIMFs from employing some of the more questionable\textsuperscript{283} practices. The decision to suspend an AIF must be in the best interest of all investors and should deal with any conflicts of interests arising between investors wishing to redeem their investments and those investors wishing to maintain their investments in the fund’s portfolio.\textsuperscript{284}

\textsuperscript{276} AIFMD, Article 16,1
\textsuperscript{277} AIFMD-CDR, Article 1, (5); Special arrangements means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impacts the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors. Special arrangements include gates and side pockets for instance. See ref. 68 and 69.
\textsuperscript{278} AIFMD-CDR, Recital 59
\textsuperscript{279} AIFMD-CDR, Article 49,1
\textsuperscript{280} AIFMD-CDR, Article 49,2
\textsuperscript{281} When funds are unable to issue gates and lockdowns sensibly, they may have to sell positions whether they are liquid or not to meet redemptions. The resulting likelihood that the fund is selling at depressed prices will be increased. Thus gates and lockdowns can be particularly useful during periods of turmoil, as it allows funds to look through the volatility. On the other hand, investors can keep losing money due to them.
\textsuperscript{282} Zetzsche, supra at 10, 2012 pp. 253-264
\textsuperscript{283} During financial crisis, one prominent hedge fund was said to have charged a departing investor for a fee for early redemption; then it blocked the redemption, refused to return the fee, and carried on charging a management fee on top of that. Mallaby, supra at 110, 2010, pp. 425
\textsuperscript{284} Zetzsche, supra at 10, 2012 pp. 253-264
With regards to managing asset liquidity, AIFMs need to prove they have adequate liquidity management systems in place and they need to provide, *inter alia*, regulators information on the result of stress tests and how fast the portfolio could be liquidated.\(^{285}\) Placing emphasis on multiple scenario stress testing with regards to asset liquidity is certainly a step forward. This should address the problem that stress testing is based on too narrow, historical scenarios.

4.3.5. Delegation

Hedge funds have for long been used to delegate parts of the business to external entities, due to the cost efficiency of the arrangements and in order to maintain deeper focus on the core activity of the fund, i.e. portfolio management. In addition the delegation model where third party investment managers and advisers are appointed has become increasingly common.\(^{286}\) The underlying idea is that cross-border delegation of portfolio management activities allows greater access to different markets and investor bases.

AIFMD continues to allow delegation, however with certain restrictions. The overarching principles are outlined in recital 30. Subject to strict limitations and requirements, including the existence of (1) *objective reasons*, an AIFM should be able to delegate the carrying out of some of its functions on its behalf in accordance with this Directive so as to increase the efficiency of the conduct of its business. Subject to the same conditions, sub-delegation should also be allowed.\(^{287}\) AIFMs should, however, remain responsible for the proper performance of the delegated functions and compliance with this Directive at all times, i.e. the AIFM cannot turn into (2) a *letter-box entity*.\(^{288}\)

AIFMs are required to notify competent authorities before the delegation agreements become effective and they must be able to justify the delegation structure on objective reasons.\(^{289}\) These objective reasons include for instance costs savings, optimising of business functions and processes, the expertise of the delegate in administration or in specific markets or investments and access to delegates global trading activities.\(^{290}\)

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\(^{285}\) AIFMD-CDR, ANNEX IV

\(^{286}\) Mark Browne, *Delegation of investment management under the AIFMD*, AIMA, 2013

\(^{287}\) Although see AIFMD-CDR, Recital 90; The requirements applying to the delegation of the task of carrying out functions on behalf of the AIFM should apply *mutatis mutandis* where the delegate sub-delegates any of the functions delegated to it and also in the case of any further sub-delegation.

\(^{288}\) AIFMD, Recital 30

\(^{289}\) AIFMD, Article 20,1

\(^{290}\) AIFMD-CDR, Article 76
Core functions i.e. risk management and portfolio management can be only delegated under strict conditions. Whilst AIFMD retains the possible of, say European AIFM delegating its portfolio management to US investment manager, the agreement is subject to following provisions:

- It must be conferred only on undertakings which are authorised or registered for the purpose of asset management and subject to supervision or, where that condition cannot be met, only subject to prior approval by the competent authorities of the home Member State of the AIFM.

- In addition cooperation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking must be ensured.

- No delegation can be conferred on the depositary or any other entity whose interest may conflict with those of the AIFM or the investors of the AIF.

One of the most important provisions regarding delegation in the AIFMD-CDR is Article 82 which sets out when an AIFM will be deemed to be a letter box entity, as a consequence of the amount of delegation it has entered into in respect of an AIF. The following non-exhaustive list provides examples when AIFM will be deemed letter box entity and will not be considered to be manager of AIF;

- The AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;

- The AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice; and

- The AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself.

However, an AIFM will be able to delegate a number of portfolio management functions and a number of risk management functions, while at the same time retaining some of each and,

291 AIFMD Article 20.2 and AIFMD-CDR, Article 78
292 AIFMD, Article 20, 1, (c)
293 AIFMD, Article 20, 1, (d)
294 AIFMD, Article 20.1,(e) and Article 20.2
296 AIFMD-CDR Article 82 (a)-(d)
accordingly, not fall into the trap of being considered a letter-box entity. This will require a degree of analysis on a case by case basis.\textsuperscript{297}

**Practical consequences**

In summary, the key prohibition of letter box entity is justified in a sense that (1) the delegate has become responsible for AIFM functions (2) thus there are often other underlying principles behind these delegation structures than objective reasons, in some cases the goal of circumventing the law. From the purposes of the directive and to ensure effective enforcement it is necessary to have such provisions. In addition the existing delegation model should continue to be effective for AIFM’s, under AIFMD but compliance with the relevant requirements contained in the Regulation will entail amendment to existing contractual agreements and extensive additional documentation evidencing how the applicable requirements are being met.\textsuperscript{298}

4.3.6. Depositary

The financial crisis triggered a throughout re-assessment of the depositary function within EEA. The failure of European Madoff funds to have depositaries is routinely reeled out as an example of the necessity of assets safe keeping in light of the severe losses caused to investors.\textsuperscript{299} In addition, the crisis triggered failures of famous prime brokers and depositaries, such as RBS and Fortes, which were bailed by their respective governments. These events, combined with the collapse of Lehman, triggered significant fund assets losses throughout EU, which also highlighted existing differences between member states with regards to depositaries’ safekeeping duties and liabilities.\textsuperscript{300} Thus AIFMD recital 2 outlines that recent developments underline the crucial need to separate asset safekeeping and management functions, and to segregate investor assets from those of the manager. With this reasoning, AIFMD introduces a similar depositary function to AIFs, as has been employed by UCITS since UCITS I.

AIFMD requires AIFMs to appoint a single depositary for each AIF it manages.\textsuperscript{301} Prior to adaptation of AIFMD, Member States enjoyed significant discretion as whether appointment of depositary was required and which entities could act as depositary.\textsuperscript{302} AIFs obligations and assets were typically held by the prime broker, the AIF itself or at a credit institution, and thus depositary’s tasks was just to

\textsuperscript{297} A&L Goodbody, supra at 301, 2013,
\textsuperscript{298} Browne, supra at 286, 2013
\textsuperscript{299} Zetzsche, supra at 10, 2012 pp. 109-135 and 447-454
\textsuperscript{300} Id.
\textsuperscript{301} AIFMD, Article 21, 1
\textsuperscript{302} Zetzsche, supra at 10, 2012 pp. 409-445
ensure asset custody. AIFMD, however, appoints numerous additional tasks to the depositary.\textsuperscript{303} For instance, the directive greatly alternates the established industry practice by introducing strict liability of depositaries in case of loss of assets under its custody.\textsuperscript{304}

The depositary has both safekeeping and oversight function. However, a depositary acts not only as custodian but also as a sort of monitor or auditor of the fund. In this latter role, it ensures that the fund’s assets are held independently of the investment manager, that the fund’s accounting records are reconciled (where appropriate) with third-party records, and that investors’ entitlements are correctly calculated. Ultimately, it seeks to safeguard against fraud, book-keeping errors and conflicts of interest between the manager and the fund.\textsuperscript{305}

The depositary can be a credit institution, an investment firm which complies with certain capital adequacy rules and that is authorised to safe keep assets, or another category of institution that is subject to prudential regulation and ongoing supervision and which, falls within the categories of institution determined by Member States to be eligible to be a depositary under UCITSD.\textsuperscript{306} \textsuperscript{307} In practice most of the depositaries will be credit institutions i.e. banks or investment firms with regulatory permission to act as custodian.\textsuperscript{308} The AIFMD stipulates that the fund’s manager cannot act as depositary and that the fund’s prime broker can only act as depositary if it has functionally and hierarchically separated the performance of its depositary function of the depositary function from the prime brokerage function.\textsuperscript{309}

AIFMD also introduces a strict liability standard for depositaries as they will be liable to the AIF and its shareholders for loss by the depositary or a third party delegate of financial instruments in its custody. Where financial instruments are lost, the depositary will be obliged to return a financial instrument of identical type or the corresponding value to the AIF without undue delay. The depositary will not be liable where it can demonstrate that the loss was as a result of undue delay caused by an external event beyond its reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary.\textsuperscript{310}

\textsuperscript{303} AIFMD, Article 21
\textsuperscript{304} AIFMD, Article 21,12 and AIFMD, Recital 44
\textsuperscript{305} Richard Frase and John Young, The role of depositary under the AIFM directive, Dechert LLP, 2013
\textsuperscript{306} UCITSD, Article 23, 3
\textsuperscript{307} AIFMD, Article 21,3 (a)-(c)
\textsuperscript{308} Frase and Young, 2013, supra at 305
\textsuperscript{309} AIFMD, Article 21,4
\textsuperscript{310} AIFMD, Article 21, 12 and AIFMD, Recital 44 and 46
Practical consequences

The main benefits from the AIFMD depositary provisions come from increased investor protection due to added harmonization. With the enhanced standards for monitoring, safekeeping and oversight of assets, investors should be able to rest assured that most market abuses will be avoided. Harmonization of depositary rules makes the service more transparent and comparable, which should also reduce regulatory arbitrage and increase legal certainty. 311 This could help drive the prices down for the services in the long term, despite the industry initially complaining about the costs and complexity of the provisions.

However, the depositary liability provisions exhibit a multitude of problems. As demonstrated by Siena312, the provisions transfer risk to financial intermediaries. Thus the provisions might end up being counterproductive, as the concentration of risk on few large financial intermediaries increases risks to financial stability. Furthermore, the provisions were directly influenced by politics313, and influential viewpoints were sidelined314 in the process. In addition, assets such as contract rights (OTC-derivatives), are not, by their legal nature always capable of being safe-kept. Furthermore, the liability chain includes all sub-custodial agents and prime brokers, which greatly extends the scope of the liability.315 All this add into costs and risks for depositaries, which are passed to hedge funds.

4.4. Transparency requirements

AIFMD enhances transparency through various provisions as described in the earlier chapters, from remuneration to risk management. The specific transparency requirements of AIFMD are particularly related to investor disclosure and submitting annual reports.316 AIFMs are obliged to submit annual reports to member state authorities and investors on request. AIFMs are also required to disclose information to investors about investment strategy, and the objectives, types of assets AIFM is going to invest, usage of leverage and other important information.317 AIFM is also required to report the

312 Zetzsche, supra at 10, 2012, pp. 455-487
313 Apparently, the then French Finance Minister Christine Lagarde’s letter to Charlie McGreevy directly influenced the depositary liability provisions. The depositary liability provisions were hurriedly pushed through in the way of French model (which was arguably one of strictest in the EU), without listening to alternative views. See Id.
314 “Depositary liability, as contemplated under the AIFMD, was not within purview of the G20 commitment, although a link is sometimes made”. Id.
315 Shane Bret, AIFMD Depositary: Developing an operational model, AllAboutAlpha, 2014
316 AIFMD, Articles 22-24
317 AIFMD, Article 23, 1, (a)-(p)
competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIFs it manages.\textsuperscript{318}

\textit{Practical consequences}

The measures will add to transparency of the otherwise opacious industry. More disclosure on hedge funds strategies, leverage and financials should lead to smoother due diligence process for investors and at the same time enhance trust in the industry. However, there are also drawbacks to more investor disclosure. Some hedge fund strategies are extremely information sensitive, so even slight disclosure on strategies and types of assets may result in the fund losing its competitive edge.

4.5. Special provisions on leverage

High leverage has been typically associated as a source for systemic risk build-up. Pre-financial crisis era witnessed some extraordinary leverage with certain financial institutions. Some hedge funds were highly leveraged as well. However it must emphasised that leverage is not a perfect proxy for risk, yet combined with other factors\textsuperscript{319} it may contribute to financial instability.\textsuperscript{320} In any case, AIFMD conveys that given it is possible for an AIFM to employ leverage and, under certain conditions, to contribute to the build-up of systemic risk or disorderly markets, special requirements should be imposed on AIFMs employing leverage.\textsuperscript{321} Leverage is defined as any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means.\textsuperscript{322}

AIFMD-CDR stipulates two methods for calculating leverage, gross method and commitment method. Information should be provided by both methods. The gross method gives the overall exposure of the AIF whereas the commitment method gives insight in the hedging and netting techniques used by the manager; therefore both methods are to be used in conjunction.\textsuperscript{323} When calculating the exposure, all positions of the AIF should initially be included, including short and long assets and liabilities, borrowings, derivative instruments and any other method increasing the exposure where the risks and rewards of assets or liabilities are with the AIF, and all other positions that make up the net asset value.\textsuperscript{324} An AIFMD, with a leverage ratio of over three times it NAV

\textsuperscript{318} AIFMD, Article 24, 1
\textsuperscript{319} Such as asset concentration, illiquidity and significant correlation of strategies.
\textsuperscript{320} For thorough discussion on the subject see Ch. 2, 2.4.1 Systemic Risk
\textsuperscript{321} AIFMD, Recital 49
\textsuperscript{322} AIFMD, Article 4, 1, (v)
\textsuperscript{323} AIFMD-CDR, Recital 12
\textsuperscript{324} AIFMD-CDR, Recital 14
calculated by the commitment method, is considered to be leveraged on substantial basis. Special reporting requirements are imposed on such funds.

AIFMD also includes provisions regarding maximum leverage employed by the AIFM. AIFMs are required to set a maximum level of leverage which they may employ, taking account for instance the size of the AIF, the investment strategy and any other interlinkage or relevant relationships with other financial services institutions which could pose systemic risks. Should an AIFM or group of AIFMs pose a substantial risk to financial stability and integrity of financial system, AIFMD empowers competent authorities to set limits on leverage. ESMA may also determine that the leverage employed by an AIFM, or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system and may issue advice to competent authorities specifying the remedial measures to be taken, including limits to the level of leverage, which that AIFM, or that group of AIFMs, are entitled to employ.

Practical consequences

More disclosure on leverage ought to help in monitoring and assessing its implications on market stability. As AIFMD requires funds to provide information on the leverage and concentrations they manage, regulators possibly have a chance to react pre-emptively before hedge fund positioning and leverage becomes unsustainable. However, this assumes that regulators are able to take a proactive stance. Thus, the ultimate impacts are rather ambiguous.

More disclosure on large funds leverage, in conjunction with the knowledge of its strategies and principal markets it trades, may open the door on speculation against them. If other participants know there is a distressed participant in a certain market, they will seek to position against it, in anticipation of liquidation. This by itself could create sources for financial instability. In similar vein restricting hedge funds’ ability to use leverage could increase economic instability, because certain investment strategies, which smooth out volatility, require high leverage to be effective. Lastly, even

\[\text{325 AIFMD-CDR, Recital 132}\]
\[\text{326 AIFMD-CDR, Articles 110 and 111}\]
\[\text{327 AIFMD, Article 15, 4}\]
\[\text{328 AIFMD, Article 15, 4}\]
\[\text{329 AIFMD-CDR, Recital 133}\]
\[\text{330 AIFMD, Article 25, 8}\]
\[\text{331 AIFMs need to report principal markets only to regulators though.}\]
\[\text{332 Knowledge over LTCM’s positions caused otherwise non-correlated markets to exhibit substantial correlations. One of the most profound examples is the following. Long-Term had a small position in hurricane bonds, securities that permit insurers to sell the risk of a hurricane; the day Meriwether’s confidential letter leaked to investors about the funds distress was leaked, the bonds plummeted 20 percent, even though the probability and cost of hurricanes was utterly unaltered. Donald McKenzie, An engine, not a camera, how financial models shape markets, 2006, p. 234}\]
the threat of leverage limits on certain market conditions could lead to turmoil. As the regulators are well aware of the facts, the border for intervention might remain extremely high. It is thus questionable, whether the special provisions on leverage will help in controlling systemic risk.

4.6. Marketing

AIFMD practically sees two separate marketing regimes run in parallel during a defined period of time, one of EU AIFs and EU AIFMs and another related to third country (TC) AIFs and AIFMs. AIFMD regulates active marketing to professional investors in the EU of both EU AIFs, and non-EU AIFs managed by EU and non-EU AIFMs (although AIFMs may market to retail investors under member states discretion). Practically AIFMs marketing in EU will have to comply fully with AIFMD, or rely on national private placement regimes (NPPR) and reverse solicitation.

AIFMD also introduces EU-wide passport for marketing of AIF similar to the principles of UCITSD and MiFID. The AIFMD passport may relate to (1) the cross-border management of AIFs, or (2) the cross-border sale of AIF units to professional investors. An authorized EU AIFM may market units or shares of an EU AIF that it manages to professional investors in another Member State as soon as it has submitted a notification to the competent authorities of its home Member State in respect of each EU AIF that it intends to market.

EU AIFM managing non-EU AIF, without marketing in EU will also be almost fully subject to AIFMD provisions, except requirements related to depositaries and annual reports. In addition, appropriate cooperation arrangements are required to be in place between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the third country where the non-EU AIF is established in order to ensure an efficient exchange of information.

If the AIFM managing non-EU AIF wishes to market in EU as well, the directive brings it under stricter provisions. For instance, AIFM will be subject to the depositary requirements. In addition the

333 Zetzsche, supra at 10, 2012, pp. 557-574
334 See Appendix 10: Marketing in EU under AIFMD
335 For definition see MiFID Annex 2
336 AIFMD, Article 43, 1
337 Defined as the sale of securities to a relatively small number of select investors as a way of raising capital.
338 The first draft of the AIFMD proposed a prohibition on reverse solicitation. However, this prohibition was ultimately removed from the final AIFMD. It is important for AIFMs to maintain records which clearly prove that the investment was a reverse solicitation and to take advice if any doubt exists as to whether it is possible to categorise an approach as a reverse solicitation See; Matheson, AIFMD Factsheet: Private Placement Post-AIFMD, 2013
339 Zetzsche, supra at 10, 2012 pp. 367-406
340 AIFMD, Article 32, 1 and 2
341 AIFMD, Article 34, 1, (a)
342 AIFMD, Article 34, 1, (b)
third country where the non-EU AIF is established cannot be listed as a Non-Cooperative Country and Territory by Financial Action Task Force (FATF).\textsuperscript{343} AIFMD also requires that the third country where the non-EU AIF is established has signed an agreement with the home Member State of the authorised AIFM which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters, including any multilateral tax agreements.\textsuperscript{344}

**Private placement**

AIFMD allows EU member states to maintain their private placement regimes both for non-EU AIFs managed by EU AIFMs\textsuperscript{345} and for EU AIFs managed by non-EU AIFMs.\textsuperscript{346} However, most non-EU AIFMs marketing EU-AIFMs are frozen out currently, and they need to rely fully on private placement regimes in order to market in EU. AIFMs using the private placement regimes, will not be subject to the depositary requirement\textsuperscript{347}, but will still be subject to all the reporting obligations and third country rules regarding exchange of information.\textsuperscript{348} Member states also are given discretion to impose stricter rules.\textsuperscript{349} However, the private placement regime might be abolished in the future in case ESMA and EC decide to extend the passport to non-EU AIFMs (three years after legislation has been adopted to extend passport).\textsuperscript{350}

As of June 2015, ESMA has concluded that the passport should be extended to Guernsey and Jersey, and also to Switzerland following certain amendments to relevant Swiss legislation. However, ESMA advises delaying the decision with regards to U.S., Hong Kong and Singapore, due to concerns related to competition, regulatory issues and a lack of sufficient evidence to properly assess the relevant criteria.\textsuperscript{351} EC has backed up this assessment and has asked ESMA to complete its assessment of the regimes of the USA, Hong Kong, Singapore. In addition ESMA is to assess the extension of passport to Japan, Canada, Isle of Man, Cayman Islands, Bermuda and Australia by 30 June 2016.\textsuperscript{352} Thus it will be at earliest during 2019, when ESMA will ultimately issue technical guidance advising whether or not the private placement regime should be terminated.\textsuperscript{353}

\textsuperscript{343} AIFMD, Article 35, 2, (b)
\textsuperscript{344} AIFMD, Article 35, 2, (c)
\textsuperscript{345} AIFMD, Article 36
\textsuperscript{346} AIFMD, Article 42
\textsuperscript{347} AIFMD, Article 36, 1, (a)
\textsuperscript{348} AIFMD, Article 36
\textsuperscript{349} AIFMD, Article 36,1
\textsuperscript{350} AIFMD, Recital 63
\textsuperscript{351} ESMA, ESMA’s Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, 2015; Linklaters, AIFMD: Extension of Passport., 2015
\textsuperscript{352} ESMA, ESMA publishes letter from European Commission on AIFMD passport, 2016
\textsuperscript{353} Linklaters, AIFM Directive, 2015
Reverse solicitation

With regards to reverse solicitation, there is no common understanding what it means, although it is often referred as investors approaching the fund manager for investment, which does not consist of marketing in the sense of AIFMD, and would be thus excluded from the scope of AIFMD. However, reverse solicitation is not defined by the directive. AIFMD defines marketing as direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or investors domiciled or with registered office in the union. The words “at the initiative of the AIFM” mean that reverse enquiries by investors will not be caught under the definition; thus “passive” marketing by AIFMs would not be considered to be “marketing” under the AIFMD. The words “direct or indirect” and “or on behalf of the AIFM” indicate that the AIFM would be considered to be “marketing” even if all actual marketing activity was carried out in the EU solely by a marketing or distribution agent.

However, AIMFs still need to exercise particular caution with reverse solicitation. According to FCA guidance for instance, a confirmation from the investor that the offering or placement of units of shares of the AIF was made at its initiative, should normally be sufficient to demonstrate that reverse solicitation took place, provided that the confirmation is obtained before the offer or placement takes place. However, AIMFs should not be able to rely upon such confirmation if it has been obtained to circumvent the requirements of AIFMD.

Practical consequences

Although the passport regime has proven in many cases to enhance single market with the UCITSD and is thus generally one of the principal carrots of the directive, the AIFMD marketing provisions exhibit several complications. As noted by Zetzsche et al., the AIFMD third country rules look like a power struggle, as third countries wishing to market or manage AIFs are forced under EEA law. This is a sign that particularly at times of crisis an attitude may be created which focuses less on quality and more on political and economic influence, a recipe which weakens AIF brand worldwide.

The AIFMD passport was intended to be a simple and cost-efficient process enabling AIMFs to manage and market EU AIFs in another member state, much like the UCITS passport. However,
ESMA notes from the various submissions in response to its call for evidence that there is no consistency amongst member states, making use of the AIFMD passport a complicated, time-consuming and expensive process.

The ESMA decision to delay the extensions of passport seems reasonable under this viewpoint. Ironically, this comes partly from the fact, that if ESMA was to extend the passport, it would be likely that the NPPR’s would be abolished in three years. And many participants in the fund industry prefer working under the NPPR’s. They have indicated that NPPR’s allow the Member States to set the standards imposed according to the needs of their national market and that they should remain for an indefinite period. Many funds thought, that the extensions of passport to non-EU AIFMs if the full requirements of AIFMD were imposed, had the potential to lead to significant market disruption if this was a precursor to switching off the NPPR. The general conclusion from ESMA’s summary of responses is that in case the passport was extended, it should run in parallel with the NPPR’s.

Lastly, with regards to reverse solicitation, if consistency is to be achieved, further guidance is needed from ESMA and competent authorities. Some national regulators have issued guidance, but the border remains blurred as reverse solicitation may be interpreted differently from jurisdiction to jurisdiction. For any managers with an interest in European investors, the risk of reliance of reverse solicitation being non-compliant with the AIFMD marketing provisions is something which managers must be alert to. The fines for non-compliance are subject to regulatory discretion but constitute a criminal offence in some countries. Currently, the only way to address the risk is to become fully compliant directive or use the various national private placement regimes.

Despite the negativity surrounding the AIFMD marketing regime, some notable benefits can be attained if the industry embraces the passport. Once authorized under AIFMD, cross-border distribution will become significantly easier to both non-EU and EU AIFM’s. Enhanced competition would likely benefit investors. Large number of respondents to ESMA believed that the extension of passport would increase the range of possible investment opportunities for EU investors, resulting in increased investor’s choice.

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360 ESMA, supra at 351, 2015, pp.54
362 ESMA, supra at 351, 2015, pp.54
363 Prew, supra at 357, 2015
364 Id.
365 Id.
366 Id.
5. Impact assessment

5.1. Methodology

The following impact assessment is twofold – initially industry response to the directive is examined, followed by analysis of the main impacts of the directive. The impacts are manifold and are discussed in the light of the industry surveys and AIFMD objectives. The follow-up analysis also takes into account the interplay of various subjects discussed in the earlier chapters.

Most of the analysis on the industry response is based on surveys conducted by Preqin\(^{367}\), Multifonds\(^{368}\), Deloitte\(^{369}\) and a qualitative survey conducted by IFI Global\(^{370}\). The results have been interpreted in order to assess the impact on the industry. These surveys have been conducted during 2014-2015, i.e. post AIFMD transposition thus the results are quite fresh. However, some earlier surveys are also addressed to provide depth and width to the assessment. Additional, albeit slightly dated surveys include earlier surveys by Multifonds\(^{371}\) and Preqin\(^{372}\).

There are some notable restraints with the chosen methodology. First the surveys, apart from Preqin surveys, include AIFMs from private equity and real estate as well, with the addition of service providers, which means that the results are likely slightly distorted due to industry specific factors. Second, responds are particularly crowded with larger funds – no direct survey on AIFMD impact on small to mid-size funds could be found. Third, as result the Preqin survey has been used as main source for the analysis, since it focuses solely on hedge funds of different size, and seems to be most unbiased with regards to fund size. Fourth, the timing and the sample groups clearly have had impact on the responds. Finally, it is very likely that unbiased results could have been attained with a detailed

\(^{367}\) In July 2015 Preqin conducted a survey exclusively on 150 global hedge fund managers representing $380bn in assets under management. Preqin, Preqin Special Report; AIFMD in the Hedge Fund Industry, 2015

\(^{368}\) Survey conducted by Multifonds was carried out in Q2 2015 and received 62 responses from the global fund administration industry, including global custodians/ fund administrators (31%), asset managers (29%), third-party administrators (18%) and a mix of both traditional and alternative funds, including hedge funds, commodities, private equity, real estate, long only/mutual funds and unit trusts. Thus albeit hedge funds are largest participants of asset managers on the survey, the survey has admittedly mainly targeted the service provider side. This may have resulted in more optimistic picture with regards to AIFMD. Multifonds, Part4: The impact of AIFMD and convergence survey, 2015.

\(^{369}\) The Deloitte survey was conducted on over 150 registered/authorized AIFMs. The overwhelming majority of participants in survey fell with the category of the Universal Manco, i.e. funds where a single entity holds both UCITSD and AIFMD license and can offer management company services for both fund segments. The principle objective of the survey was to assess the reporting experience from the first cycle of AIFMD reporting. Deloitte, AIFMD reporting survey, 2015.

\(^{370}\) The survey was conducted on Managers with dedicated alternative assets of $197 billion, and an overall AUM of approximately $2.5 trillion. Interviews were also conducted with London based fund lawyers as well as a number of fund governance firms and consultancies. 73 organisations participated in the survey of which 71% were managers and 41% hedge funds. IFIGlobal, The impact of AIFMD – Research survey 2014, 2014

\(^{371}\) Multifonds, Part3: The impact of AIFMD and convergence survey, 2014

\(^{372}\) Preqin, Global Hedge Fund Managers Respond to the AIFMD, 2014
survey on hedge fund industry as whole. This could be a subject for another study. In particular, a field study would be necessary to confirm some of the conclusions drawn here.

5.2. Survey results
5.2.1. Compliance status and extraterritorial questions

Preqin survey indicated that 82% of EU managers are AIFMD compliant and of which 90% are in the UK (Fig. 1).\(^{373}\) Thus the implementation process in EU had gone pretty smoothly, despite the earlier concerns that the industry would be collectively struggling to meet the deadlines.\(^{374}\) However, current compliance status highlights the fact that US managers, are by a large, choosing either not to operate in EU or are preferring to use reverse solicitation for fundraising (Fig. 2). The fact that only a few US managers are looking to establish an EU based AIFM to take advantage of the passport seems to signal that the passport, has not garnered the enthusiasm some authorities may have visioned.\(^{375}\) Furthermore, it is particularly notable that the private placement regimes remain important particularly for Asia & rest of the world.

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\(^{373}\) Preqin, supra at 367, 2015

\(^{374}\) Sophia Grene, *AIFMD: Hedge funds drag their feet over EU regulation deadline*, The Financial Times, 2014

\(^{375}\) However, this could be also attributed to the fact that some managers are applying a wait and see approach and observe how their peers are faring in EU. Preqin, supra at 367, 2015
The results support the conclusions that AIFMD, from this part, is reducing competition and investors choice in EU, by excluding part of the US funds from accessing the EU market. A survey conducted by IFIGlobal arrived at a similar conclusion. The results highlight the danger of ‘Fortress Europe’ developing in the EU’s alternative fund industry as a result of AIFMD. This approach might be welcomed by some EU-based funds, but it will be of little benefit to the investors.

Although the industry has been more negative with regards to AIFMD earlier, the overall opinion remains uniformly negative (Fig. 3). However it is clear that European managers (excluding UK) are least bearish on AIFMD – this can be explained by the fact that regulations have been traditionally stricter in the continental Europe and they may benefit from the fact that it’s harder for non-EU funds to market in EU. In line with the previous analysis, US managers exhibit by far most negative perception on the directive (over 70%).

**Fig. 3: Fund Managers’ Perceptions of the Effect Status by Manager Headquarters**

Although the UK has by far the largest hedge fund industry in EU, which was used to the lax regulation prior to the crisis. Thus with the introduction of AIFMD, there was a danger it would result in an exodus of EU managers, particularly UK from EU. However, according to Multifonds, fully fledged exodus does not look set to occur (Fig. 4). In fact, the threat of EU managers choosing to set up offshore structures to avoid the additional costs of AIFMD for non-EU investors has declined significantly since 2013.

**Fig. 4: Will EU managers choose to set up offshore structures to avoid costs of AIFMD**

Furthermore, UK managers exhibit more negative perception than their European peers. UK has by far the largest hedge fund industry in EU, which was used to the lax regulation prior to the crisis. Thus with the introduction of AIFMD, there was a danger it would result in an exodus of EU managers, particularly UK from EU. However, according to Multifonds, fully fledged exodus does not look set to occur (Fig. 4). In fact, the threat of EU managers choosing to set up offshore structures to avoid the additional costs of AIFMD for non-EU investors has declined significantly since 2013.

376 Separate poll on institutional investors opinion by PWC and UBS highlights that AIFMD is perceived to hand competitive advantage to EU based funds see; PWC, UBS Fund Services & PwC survey reveals institutions’ changing attitude on alternatives, 2014

377 The Financial times also reported that several US based funds are pulling out from EU. See Steve Johnson, AIMFD: US hedge funds shy away over EU regulation, The Financial Times, 2015

378 IFIGlobal, supra at 370, 2014

379 Id.

380 Around 80% of EU based hedge fund managers are located in UK. See Ch. 2, 2.3 Hedge fund domiciliation
Still, around 50% of the respondents see that a minority or more of hedge funds will set up an offshore structure to avoid costs of AIFMD. The results highlight the fact that despite some AIFMs pulling out of UK, the directive may also offer significant benefits for them. Once authorized, cross-border distribution becomes significantly easier for them.

5.2.2. Compliance costs and the primary concerns

Doubts over the cost of complying with AIFMD have been one of the main sources of concern for hedge funds (Fig. 7) and the presumed high-cost levels have often been seen as the touchstone for the Directive’s ultimate success or failure.\(^{381}\) In addition to AIFMD, hedge funds have had to comply with numerous other costly regulations\(^{382}\). According to AIMA, MFA and KPMG\(^{383}\), AIFMD is proving to be the costliest, right beside SEC registration and reporting requirements.

The compliance costs with AIFMD are associated with one-off costs during the initial stages of authorization and the continuous costs for ensuring adequate reporting and compliance. In particular, costs from depositary and reporting have been considered the primary sources of costs, according to earlier Multifonds survey.\(^{384}\) In a similar vein, the survey indicated that the ultimately the costs will be passed to investors.

As of 2015, it seems that the compliance costs have been higher than expected or as expected for the hedge fund industry (Fig. 5). However separately, Deloitte survey indicates that reporting costs have been broadly in line with expectations (Fig 6.). The survey was however conducted on larger funds which, tend to have high resources for compliance. In any case, in terms of larger funds, it appears that the high level of costs that some feared have not materialized. This has probably also contributed to the fact that fewer hedge funds are likely to establish offshore structures to avoid the costs (Fig. 4).

\(^{381}\) Multifonds, supra at 371, 2014
\(^{382}\) See Appendix 11: Impact of regulations in terms of compliance costs
\(^{383}\) KPMG/AIMA/MFA, *The cost of compliance*, 2013
\(^{384}\) Multifonds, supra at 371, 2014
It is notable that only 18% of funds larger than 1bn report compliance costs as their primary source of concern. For larger funds, risks arising from uncertainty and lack of guidance are the primary concerns. These are primarily related to reverse solicitation for non-EU managers, and for EU-managers to the variation in the implementation of the rules in the law of different EU member states. Some managers fear that regulatory bodies will make examples of firms which are inadvertently on the wrong side of regulation, with larger managers having more to lose if they are found breaking the EU laws.\(^{385}\)

However, compliance costs are particularly important to smaller hedge fund managers; 56% of managers with less than $100mn in AUM cited compliance costs as their greatest concern about the AIFMD (Fig. 7). The costs disproportionally burdening smaller hedge funds is underlined by IFIGlobal. It paints a particularly gloomy picture in particularly in relation to smaller managers. Managers interviewed with AUMs below $1 bn say that AIFMD has increased their cost base from

\(^{385}\) Preqin, supra at 367, 2015
between 33% to 50%. The consensus is that a London-based hedge fund manager needs a minimum of $250 million in AUM to get to break even in even the simplest strategies. Hardly anyone in this category sees any compensating benefits from this increased expenditure. 386

5.2.3. Main challenges and benefits of AIFMD

The main challenge from AIFMD continues to be reporting to regulators (Fig. 8). In addition issues related to depositary liability, authorization process and risk management pose major challenges. The results are not surprising, in a sense that these provisions are the primary source administrative burden and costs.387

**Fig. 8: Challenges of AIFMD**

**Fig. 9: Benefits of AIFMD**

Source: Multifonds

It’s notable that AIFM industry as whole considers that greater investor protection and added transparency are the main benefits of AIFMD (Fig. 9). However, according to IFIGlobal, not one survey responded highlighted investor protection as a benefit.388 Thus, it is difficult to determine whether the industry sees AIFMD meeting its objective with regards to investor protection.

With regards to the ability of AIFMD to prevent market instability and build-up of systemic risk respondents to Multifonds survey did not exhibit the high confidence levels. Given that the AIFM industry as whole has been more optimistic about the impact of the directive, it seems appropriate to assume that hedge funds would have exhibited even more depressed confidence levels. Unfortunately, however, such information was not available at the time of the research to confirm this hypothesis.

5.2.4. Convergence is inevitable

One of the key findings from the Multifonds survey is that fund managers expect significant convergence between long-only and hedge funds (Fig. 12). The convergence is a direct result of

386 IFIGlobal, supra at 378, 2014
387 Id.
388 Id.
AIFMD but also investor demand\textsuperscript{389} for regulated hedge funds. Institutional investors expect higher risk management, transparency and liquidity resulting in hedge funds that have more traditional, long-only fund characteristics. Similarly, retail orientated hedge funds, i.e. newcits, are driving traditional funds to incorporate hedge fund characteristics such as performance fees. These drivers aligned with the AIFMD have accelerated the convergence.\textsuperscript{390}

With such ongoing convergence comes the question whether AIFMD will rival UCITS as a dominant vehicle for cross-border funds. Overall AIFM industry seems to support this viewpoint, as 87\% of respondents believe that AIFMD will at some point rival UCITS as a global ‘de facto’ international standard (Fig. 13). The UCITS brand is the main European framework for retail investors, but over the years has been used by institutional investors and, in the absence of another regulated vehicle, its structure has been extended to cater for alternative strategies.

With its foundations now in place, AIFMD offers a viable alternative for regulated alternative structures within the EU. While originally addressed to professional investors, AIFMD also has the capacity to target the retail sector.\textsuperscript{391} However, due to the requirement of case-by-case assessment, it’s likely that only certain strategies may be marketed. Yet in any case, the provisions allow AIFM diversity whether they want to be regulated under AIFMD, UCITSD or both.

\textsuperscript{389} Since 2009, compound annual growth in UCITS absolute return funds has been 47\% compared to only 5\% for offshore hedge funds. See Appendix 12: Growth in the hedge fund sector
\textsuperscript{390} Jonathan Boyd, Convergence of long only and hedge funds to accelerate under AIFMD – survey, Investment Europe, 2012
\textsuperscript{391} AIFMD, Recital 71
5.3. Analysis of the main impacts of the directive

This section seeks to analyse the main impacts of the directive, in light of the industry surveys and the themes discussed in the previous chapters. In line with the goals of this research, the impact on systemic risk, investor protection, and cross-border fund distribution are evaluated. In addition, following key issue is highlighted from the industry surveys; the impact on funds by size.

*Impact on funds by size*

AIFMD brings the era of alternative investment fragmentation to an end, which has a significant impact on funds by size. The results of IFIGlobal survey suggest that the AIFMD winners are managers that have UCITS fund ranges and/or multi-billion organisations.\(^392\) These funds have the capacity and infrastructure in place to benefit from the AIFMD and comply with the costs. On the other hand, the traditional hedge fund boutiques are likely to suffer greatly.

For larger funds the directive is more of an opportunity, than a threat. The newly emerging AIFMD-compliant funds and universal Mancos will be able to tap larger investor base and thus increase the assets under management within the industry. This is likely to increase competition and convergence between large fund houses. Convergence may lead to increased investors choice, from this part, as more investors can access previously hedge fund-like strategies.

Further consolidation is also evident\(^393\), as smaller funds are acquired by larger outfits. The positive impact will be increased investor protection and transparency, as assets are concentrated under well-regulated entities. Yet, asset concentration might also build systemic risk by increasing correlation of strategies.

As overwhelmingly suggested by the surveys, smaller funds are significantly burdened by the costs of the directive. The one-size-fits-all approach of AIFMD leads to barriers of entry and even to market exit\(^394\) in some cases. This will stunt innovation as it’s significantly harder to establish a start-up fund. Furthermore, decreased competition with regards to niche strategies is likely, which will reduce market efficiency\(^395\) in certain markets. For instance, larger fund outlets often ignore less liquid

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\(^392\) IFIGlobal, supra at 370, 2014  
\(^393\) BNY Mellon, supra at 211, 2014  
\(^394\) See IFIGlobal, supra at 370, 2014  
\(^395\) Effects from hedge funds market inefficiency seeking behaviour can impact the real economy significantly. An example would be a long short/equities fund, who buys under-priced and shorts overpriced SME companies. By driving prices towards rational levels, hedge funds help to allocate capital to the firms who use it most productively. Larger fund outfits, do not often trade such markets as it’s not efficient for them to allocate capital on smaller companies.
markets for SME shares. Thus, one of the primary negative consequences of the directive remains its impact on small hedge funds.

There are three primary arguments supporting this approach. First, by levelling the playing field, AIFMD ensures fair and uniform treatment of AIFMs across EEA. Second, aggregation effects from smaller funds may cause systemic risks. Third, the directive emphasises the application of the principle of proportionality, to soften the blow in some cases. However considering the overwhelmingly negative response from the hedge fund industry, it can be concluded that the principle of proportionality is not being applied in a sufficient manner. Furthermore, the directive contradicts the principles outlined in G20, that only systemically important hedge funds should be brought under regulatory oversight. The fact that smaller hedge funds managed to deleverage in a more orderly manner than larger funds during the financial crisis suggests the aggregation effect is also exaggerated.

**Impact on cross-border distribution**

One of the main carrots of the directive is that once compliant, EU AIFMs will be able to market across EEA. Thus, according to the Multifonds survey, the view of the AIFM industry is that AIFMD may rival UCITSD as a dominant vehicle for cross-border distribution. However, the results must be interpreted in European context. As described by PWC survey on institutional investors, AIFMD hands competitive advantage to EU funds. Furthermore, there are some significant problems with regards to AIFMD third country rules, possible abolition of the NPPRs and reverse solicitation.

First of all, survey results from Preqin highlight that US managers are partly avoiding the EU market. As US is the largest domicile for hedge fund managers, the third country provisions restricting non-EU AIFMs from access to passport significantly reduce investor’s choice, market efficiency and competition across EEA. Second, also according to Preqin, various third countries prefer working under the NPPR’s, confirming that the abolition of NPPRs, would lead to a significant market disruption. Third, it does not help that the rules on reverse solicitation are not harmonized at EU level. Respondents to Preqin survey highlight that reverse solicitation remains primary method for obtaining clients from EU – lack of guidance with regards to it, is a primary concern to larger non-EU funds.

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396 AIFMD, Recital 17
397 G20, supra at 18, 2009
398 Rock Creek Capital, calculated that hedge funds with assets under $1 billion were down a relatively modest 12 percent in 2008. Meanwhile the funds that Rock Creek tracked with $1 billion to $10 billion in assets were down 16 percent, and those with more than $10 billion were down 27 percent. Mallaby, supra at 110, 2010, pp. 372
399 See ref. 376
400 See Ch. 5, 5.2 Compliance status and extraterritorial questions, Fig. 1.
Thus obtaining clients by reverse solicitation, continues to pose a risk. The industry has repeated calls for clarification, to no avail.

Thus as it currently stands, the AIFMD impact on cross-border distribution appears to be net negative. The implementation has been far from smooth. And the rules continue to exhibit protectionist elements. Yet the passport regime has undoubtedly potential. It has already likely increased competition between EU-AIFMs and allowed for further deepened the single market. The subsiding negativity of UK funds also to reflects this.

**Impact on investor protection**

Whilst the industry opinion with regards to investor protection remains mixed, a look at the provisions suggests that AIFMD counters the issues related to investor protection laid out in chapter 2 of this research. AIFMD can prevent market abuse, increase transparency and enhance the code of conduct rules on the industry. In the long term, the directive may improve the battered reputation of the industry and contribute to better understanding of alternative investment among politicians, media and the general public. At the same time, more disclosure will assist in distinguishing unscrupulous managers.

AIFMD should significantly decrease the chances of market abuse, such as fraud. By harmonizing the depositaries AIFMD prevents the selling of black-box investment strategies. In addition by standardizing redemption policies, AIFMD has a chance at increasing investor protection in a sense that gates and lock ups will not be issued arbitrarily. AIFMD further reigns some of the questionable practices such as excessive remuneration. Some of the rules are even self-explanatory, as they are necessary, such as the fiduciary rules e.g. conflict of interests, fair treatment of investors and the disclosure on persons conducting the business.

It was outlined by EC, that hedge funds do not always provide sufficient information for investors to assess the risks of their investments. AIFMD remedies this situation. By allowing some knowledge

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401 See Ch. 4, 4.6 Marketing
402 However hedge fund industry is already quite global in nature, thus the net positive effects from single market deepening could be much less profound compared to other AIFMs. It is likely that private equity and real estate markets will exhibit significant deepening with the AIFMD. These views were already expressed in the Europe Economics ex-ante impact assessment, and seem to have been clarified by the surveys. See Europe Economics, supra at 26, 2009
403 OpenEurope, supra at 26, 2009
404 EC, supra at 4
on hedge fund strategies, leverage and risks, it should be easier for investors to assess whether the risk/return relationship of a fund is feasible for them.

However, with some investor protection provisions, it certainly remains debatable whether AIFMD reaches too far. This is a symptom of political influence on legislation, which is particularly evident with the depositary liability (and separately, with the marketing provisions). Furthermore, on a more ideological level, the directive does little to promote freedom of choice. Many investors have expressed that they did not need more information than they were already getting and that they were perfectly happy how the funds operate currently. Lastly, the trade-off between investor protection and burdening smaller funds may be excessive.

Impact on systemic risk

The view taken in this research, is that it’s too early to determine the success of AIFMD with regards to systemic risk. The impact remains equivocal. This conclusion emerges from that fact that despite of sound intentions, without regulatory discretion, the directive may do more harm than good.

First, the leverage limits are unlikely to lead to any beneficial impacts. Regulatory intervention with regards to limiting leverage also, ought to increase risk of a backlash. Thus, the border for intervention should remain high. Second, evidence from financial crisis and the collapses of Amaranth and LTCM provides that indirect regulation by regulating service providers is typically enough to limit the repercussions on systemically important financial institutions. Thus, the reasoning for preemptive action with regards to credit channel risks seems unjustified. Third, one of the direct consequence of the directive, is consolidation and convergence of funds. Increased correlation of strategies and asset concentration may increase systemic risk. Considering these point of views, it is no wonder the industry remains sceptical on the systemic risk provisions.

Yet it must be noted, that despite the shortcomings, the directive might still be a step forward, subject to some reservations. By harmonizing the risk and liquidity management practices, the directive ensures consistency. It’s also notable that without comprehensive data on hedge-fund characteristics

405 To author’s knowledge, AIFMD remains flexible in a sense that if a strategy is extremely information sensitive, minimal disclosure is enough.
406 IFI Global, supra at 370, 2014, pp.9
407 See also Ch. 4, 4.5 Leverage and systemic risk
408 See Ch. 2, 2.4.1 Systemic risks
409 Lo, supra at 121, 2008, pp. 5
410 However, with regards to industry view, there is a great deal of doubt as to whether AIFMD’s risk management provisions are really a compliance matter (some sort of box-ticking exercise) or something potentially more fundamental – possibly even bringing about a step-change in the way that portfolio management decisions are monitored and made. See IFI Global, supra at 370, 2013
such as assets under management, leverage, counterparty relationships, and portfolio holdings, it is virtually impossible to draw inferences about the systemic risks posed by hedge funds.⁴¹¹ AIFMD certainly remedies this situation and ensures consistency in data collection throughout the EEA which was not evident before the directive. The competent authorities will have the power to assess the implications of asset concentration, leverage, liquidity and the positioning of hedge funds for the first time. In an ideal⁴¹² situation, with the access to this wide array of data, competent authorities and ESMA will be to identify risks and take necessary action to react pre-emptively to market channel problems.

Such action ought to consist of constant dialogue with the industry participants and as outlined by Dorsenfeir, voluntary deleveraging⁴¹³. This should prevent chaotic fires sales which could stem from the imposition of outright leverage restrictions. As such, despite of all the pessimism, AIFMD might help in softening the blow during future crises, while ensuring there won’t be such a hard landing from deleveraging as during the last crisis.

⁴¹¹ Lo, supra at 121, 2008, pp. 3
⁴¹² Alternative view on this is that regulators have too much data due to data overlaps, and they won’t be able to identify any threats. An example of this reporting is manager surveyed by IFIGlobal, who claims he has to report certain trades 11 different times, since he uses a lot derivative instruments. See IFIGlobal, supra at 370, 2013
⁴¹³ See Zetzsche, supra at 10, 2012, pp. 557-574
6. Conclusions

In the introduction section of this study, it was outlined that there are only a few, if any post-implementation impact assessments made on the impacts of the AIFM directive on European hedge fund industry. The goal of this research was to partly fill this gap by examining the latest industry response to the directive while interpreting the results alongside the content of the directive. The findings were analysed in particular from the perspective of AIFMD impact on systemic risk, investor protection, cross-border fund distribution, and funds by size.

To fully comprehend the various factors influencing the recent hedge fund regulation in the form of AIFMD, the study also examined the background behind the directive and provided an overview of the hedge fund industry. It was demonstrated that hedge funds as a group are heterogeneous with regards to structures, risks and strategies, which makes them difficult to regulate. They also bring significant benefits in terms of market efficiency, liquidity, and risk distribution. As only sophisticated investors invest in them, there were compelling reasons to leave the industry at the mercy of self-regulation.

However, the financial crisis led to thorough re-assessment of financial regulation, which coincided with a paradigm shift in hedge fund regulation from indirect to direct regulation. It was concluded, that in line with objectives of AIFMD and financial regulation in general, systemic risk oversight and investor protection were the most compelling reasons for hedge fund regulation.

With the evidence\textsuperscript{414}, available it was too early to determine the impact of the AIFM directive on systemic risk. As regulators have access to a wide array of relevant data, there is a chance they can identify systemic risk build-up and react to relevant market channel risks in an orderly fashion. Yet it is difficult to determine whether regulators will actually be able to use this data to their benefit. Furthermore, without extreme discretion, regulatory intervention may even amplify risks.

The impact on investor protection may be one of leading benefits of the directive. Whilst remaining burdensome for the industry, harmonization of some divergent practices such as depositaries, remuneration, valuation and risk management are likely to enhance market integrity and prevent

\textsuperscript{414} It must be noted that since the directive has been in force for such a short period of time, and due to data constraints, some of the conclusions stated here remain far-sighted. A more detailed study should be carried out to substantiate some of the claims.
excessive risk-taking. Investors also stand to benefit from increased transparency and disclosure which is likely to lead to smoother due diligence process.

Although it was acknowledged, that prudent regulation of hedge funds is necessary, the directive exhibits some externalities which are of little benefit for achieving its objectives. In particular, the trade-off between investor protection and excess burdening of smaller hedge funds is too high. Thus in order to reap the full benefits from the industry, while retaining its objective with regards to systemic risk and investor protection, certain amendments should be made.

More convincing exemptions should be provided with regards to smaller funds and the different risk profile of hedge funds should be recognized. Thus, funds below 500 million in gross notional exposures, should be fully exempt from the directive. This threshold should be enough from systemic risk perspective, given that there’s little evidence smaller funds – even if leveraged – transmit systemic risk. The risks associated with aggregation effect and failures of such funds are countered by indirect regulation of service providers. Furthermore, the directive should distinguish between low-risk and high-risk strategies more convincingly. Strategies, such as merger arbitrage, which are less volatile and pursue steady absolute returns, should be exempt from some of the burdening provisions, such as functional and hierarchical separation of risk management and some of the reporting obligations such as risk reporting.

Allowing NCA’s to impose stricter rules and registration requirements, ought to be enough for such funds in line with the pre-existing system. This would ensure market efficiency and significantly decrease the borders of entry to the industry. Thus, this ‘de facto’ de-harmonization should counter the negative consequences of the one-size-fits-all approach.

Furthermore, the extraterritorial rules of AIFMD continue to exhibit negative consequences. Despite facilitating cross-border distribution within EEA, as it currently stands, the third country rules significantly inhibit the directives chance of increasing investor’s choice, market efficiency and competition across EEA. Allowing US funds access to the European market, should be of paramount importance from this perspective. In addition, in case the passport was extended to the US and other third countries, it should run in parallel with the national private placement regimes indefinitely. This would ensure that hedge funds are not forced under EU law and also prevent market disruption. And lastly, the rules on reverse solicitation ought to be clarified at Union level as soon as possible, in order to reduce legal and business uncertainty for the AIFM industry.

Thus, the ultimate conclusion of this thesis is that despite investor protection and systemic risk remaining convincing themes for hedge fund regulation, as it currently stands, the directive remains
flawed. A more feasible piece of hedge fund regulation – both economically and in terms of impacts – could have been probably better achieved with much longer consultation period and without political influence. As put by Andrew Lo; “Financial markets do not need more regulation; they need more effective regulation”. Despite righteous intentions, AIFMD does not fulfil the criteria.
7. Appendices

Appendix 1: Breakdown of hedge fund strategies

![Hedge fund strategy breakdown](image)


Appendix 2: Typical hedge fund network

![Hedge fund network diagram](image)


Appendix 3: Hedge fund domiciliation
Appendix 4: Efficient frontier analysis with hypothetical hedge fund allocation

HF: Return of HFRI Fund Weighted Composite Hedge Fund Index 2000 to 2007
EQ: Return of SP500 2000 to 2007
FI: Return of US treasuries from 2000 to 2007

Appendix 5: Leverage position in the hedge fund industry from 2000 to 2008

Appendix 6: Selected hedge fund disasters and losses

<table>
<thead>
<tr>
<th>Fund</th>
<th>Strategy</th>
<th>Year</th>
<th>Est. Loss (US$, mm)</th>
<th>What went wrong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amaranth</td>
<td>Multistrategy</td>
<td>2006</td>
<td>~6,400</td>
<td>Excessive exposure to energy prices</td>
</tr>
<tr>
<td>Long-Term Capital Management</td>
<td>Fixed-income arbitrage</td>
<td>1998</td>
<td>3,600</td>
<td>Excess leverage during Russian default crisis</td>
</tr>
<tr>
<td>Tiger Management</td>
<td>Macro</td>
<td>2000</td>
<td>2,600</td>
<td>Bed bet on yen lost US$ 2 billion</td>
</tr>
<tr>
<td>Soros Fund</td>
<td>Macro</td>
<td>2000</td>
<td>2.5-6,000</td>
<td>Major losses on Internet and technology stocks</td>
</tr>
<tr>
<td>Bear Stearns Funds</td>
<td>CDOs</td>
<td>2007</td>
<td>1,565</td>
<td>Losses in subprime</td>
</tr>
<tr>
<td>Sowood Capital Management</td>
<td>Multistrategy</td>
<td>2007</td>
<td>1,300</td>
<td>Losses in loans and CDS</td>
</tr>
<tr>
<td>Fenchurch Capital</td>
<td>Fixed-income arbitrage</td>
<td>1995</td>
<td>1,264</td>
<td>Failed shift from US-only to European markets</td>
</tr>
<tr>
<td>Princeton Economics Inter'l</td>
<td>Macro</td>
<td>1999</td>
<td>950</td>
<td>Market losses, fraud</td>
</tr>
<tr>
<td>Valeocana Ltd</td>
<td>Fixed-income arbitrage</td>
<td>1994</td>
<td>700</td>
<td>Market losses, bet on falling rates</td>
</tr>
<tr>
<td>Lipper</td>
<td>Convertible arbitrage</td>
<td>2001</td>
<td>700</td>
<td>Market losses, fraud</td>
</tr>
<tr>
<td>Askin Capital Management</td>
<td>Fixed-income arbitrage (mortgage-backed)</td>
<td>1994</td>
<td>660</td>
<td>Failed hedge, market losses, margin calls</td>
</tr>
<tr>
<td>Bayou Fund</td>
<td>Multistrategy</td>
<td>2003</td>
<td>657</td>
<td>Fraud</td>
</tr>
<tr>
<td>Lancer</td>
<td>Long/short equity</td>
<td>2003</td>
<td>600</td>
<td>Fraud</td>
</tr>
<tr>
<td>Beacon</td>
<td>Fixed-income arbitrage</td>
<td>2002</td>
<td>500</td>
<td>Losses on mortgage derivatives, failed to mark to market</td>
</tr>
<tr>
<td>Manhattan Investment Fund</td>
<td>Long/short equity</td>
<td>1999</td>
<td>400</td>
<td>Fraud</td>
</tr>
<tr>
<td>MotherRock</td>
<td>Energy fund</td>
<td>2006</td>
<td>230</td>
<td>Loss from natural gas market</td>
</tr>
<tr>
<td>Global Systems Fund</td>
<td>Macro</td>
<td>1997</td>
<td>125</td>
<td>Wiped out by collapse of Thai baht</td>
</tr>
<tr>
<td>Dillon Reed Capital Management</td>
<td>MBS</td>
<td>2007</td>
<td>123</td>
<td>Losses in mortgage securities</td>
</tr>
<tr>
<td>Argonaut Capital Management</td>
<td>Macro</td>
<td>1994</td>
<td>110</td>
<td>Market losses</td>
</tr>
<tr>
<td>Bates Capital Yield</td>
<td>Multistrategy</td>
<td>2007</td>
<td>80+</td>
<td>Losses in subprime</td>
</tr>
<tr>
<td>Alpha Fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Macro Press Investment</td>
<td>Long/short equity</td>
<td>2000</td>
<td>59</td>
<td>Market losses, fraud</td>
</tr>
<tr>
<td>Cambridge Partners</td>
<td>Long/short equity</td>
<td>2000</td>
<td>95</td>
<td>Fraud</td>
</tr>
<tr>
<td>HRI Gestion/Voker</td>
<td>Managed futures</td>
<td>2000</td>
<td>40</td>
<td>Market losses, regulatory intervention</td>
</tr>
<tr>
<td>Ashbury Capital Partners</td>
<td>Long/short equity</td>
<td>2001</td>
<td>10</td>
<td>Fraud</td>
</tr>
<tr>
<td>FTJ Partners</td>
<td>Relative value</td>
<td>2001</td>
<td>11</td>
<td>Market losses, fraud</td>
</tr>
<tr>
<td>Ballyman Capital</td>
<td>Long/short equity</td>
<td>2000</td>
<td>7</td>
<td>Fraud</td>
</tr>
</tbody>
</table>

## Appendix 7: AIFMD Timeline

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>21 July 2011</td>
<td>Entry into force of the AIFMD (Art. 70 AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 July 2013</td>
<td>Deadline for Member States to implement AIFMD in domestic legislation (Art. 66(1) AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 July 2014</td>
<td>Deadline for AIFMs to submit an application for authorization to their Competent Authorities (Art. 61(1) AIFMD). Member States must provide to the Commission and ESMA certain information regarding the marketing of AIFs to retail investors on its territory (Art. 43(2) AIFMD).</td>
<td></td>
</tr>
<tr>
<td>22 July 2015</td>
<td>ESMA issues an opinion to the European Parliament, Council and Commission whether to extend the EEA passport to third country entities (Art. 67(1) AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 October 2015</td>
<td>Having regard to the recommendations made by EMISA, the EC decides whether to extend the EEA passport to third country entities (Art. 67(6) AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 July 2017</td>
<td>The EC starts a review of the AIFMD (Art. 69 AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 October 2018</td>
<td>EMSA issues an opinion on the functioning of the EEA passport with regard to third country entities and the termination of the country-by-country placement regime (Art. 68 AIFMD)</td>
<td></td>
</tr>
<tr>
<td>22 January 2019</td>
<td>The EC decides, based on ESMA’s advice, whether to terminate the national placement regime (Art. 68(6) AIFMD)</td>
<td></td>
</tr>
</tbody>
</table>
Appendix 8: The objectives of AIFMD

![Chart: Objectives of the AIFM Directive addressed by the level 2 measures discussed in this IA](chart)


Appendix 9: Calculation for minimum regulatory capital

**Example**

If we assume an external AIFM with a total value of portfolios of managed AIFs of €5 billion, which uses own funds to meet its professional liability risks then it would need to hold the following regulatory capital:

Initial capital = €125,000

\[
\text{Own funds} = (€5,000,000,000 - €250,000,000) \times 0.02\% = €950,000
\]

\[
\text{Own funds (for professional liability risks)} = €5,000,000,000 \times 0.01\% = €500,000
\]

AIFM’s total regulatory capital requirements = €1,575,000

Appendix 10: Marketing in EU under AIFMD

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Access to EU market</th>
<th>AIFMD requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU AIFM</td>
<td>Via EU passport from July 2013/2014</td>
<td>Full regime of the AIFMD</td>
</tr>
<tr>
<td>EU AIF</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU AIFM</td>
<td>Via private placement from 2013 to 2018</td>
<td>Full regime of the AIFMD, except certain aspects of depositary requirements (+ local registration)</td>
</tr>
<tr>
<td>Non-EU AIF</td>
<td>Can use EU passport from 2015 to 2018</td>
<td>Full regime of the AIFMD</td>
</tr>
</tbody>
</table>

Source: PWC, Strategy, marketing and distribution, 2013

Appendix 11: Impact of regulations in terms of compliance costs

![Impact of regulations in terms of compliance costs](image)

Appendix 12: Growth of the European hedge fund industry

Source: J.P. Morgan, *Can AIFMD act as catalyst for growth of the European hedge fund industry*, 2015