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AIFMD Impact on European Hedge Fund Industry

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AIFMD Impact on European Hedge Fund Industry

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Abstract of master's thesis

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Abstract

Hedge funds have emerged as prominent players in the global financial markets during past few decades. Their trading has a sizeable impact on markets, as they trade more actively than mutual funds and constantly seek profit opportunities in less liquid markets. They have, however, faced significant headwinds since the financial crisis, as their returns have deteriorated and new regulatory measures have been introduced, even though no study directly linked the cause of the crisis to hedge funds. In Europe, the answer was the Alternative Investment Fund Managers' Directive (AIFMD).

Although the directive targets alternative investment fund (AIF) industry as whole, it was originally designed to regulate hedge funds and private equity. The directive is a comprehensive regulatory overhaul, which brings the previously lightly regulated AIF-industry under strict supervision. It seeks to harmonize alternative investment regulation across Europe, with the objectives of enhancing investor protection, mitigating systemic risk and facilitating cross-border distribution of funds.

The purpose of this study is to assess the impact of AIFMD on European hedge fund industry. The impact assessment is conducted by qualitatively assessing some of the latest industry surveys on the topic. The results are interpreted alongside a thorough examination of the content of the directive. The study takes a pragmatic approach to the subject, and practical consequences of the most important provisions are provided.

Some of the key findings of this research are following. The directive has a overwhelmingly negative impact on smaller hedge funds, as the borders of entry to the industry are substantially increased, and due to increased costs, the directive is almost an existential threat to some funds. Larger funds, however, may stand to benefit from the directive as they have the infrastructure in place accommodate the costs and take advantage of the benefits such as the AIFMD passport. As the directive has been in force for only a short period of time, it's impact on systemic risk and investor protection remains ambiguous. As such, the hedge fund industry as whole, also remains skeptical on the directive.

Keywords AIFMD, impact assesment, hedge funds, alternative investments, financial regulation

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List of Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AUM	Assets under management
CA	Competent authorities
CDR	Commission Delegated Regulation
EC	European Commission
EEA	European Economic Area
ESMA	European Securities and Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services Authority
GFC	Global Financial Crisis
IOSCO	International Organization of Securities Commissions
LTCM	Long Term Capital Management
MiFID	Markets in Financial Instruments Directive
NAV	Net asset value
NPPR	National private placement regime
OTC	Over-the-counter
PWG	President's Working Group
SEC	U.S. Securities and Exchange Commission
UCITS	Undertakings for the Collective Investment of Transferable Securities
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America

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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.[1] This translates to slightly over three trillion dollars of investable funds.[2] Although this amount is small relative to the total assets[3] 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. Accordingly, hedge funds have become crucial providers of liquidity and drivers of price formation in global financial markets.[4]

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.[5] 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.[6]

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[7], 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 to in order to meet investor redemption

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[3] For instance Vanguard, the largest mutual fund in the world, has over three trillion AUM. *See* https://about.vanguard.com/
[4] Working Document of the Commission Services (DG Internal Market) Consultation Paper on Hedge Funds.
[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
[7] G.Gorton et al. *Regulating the Shadow Banking System,* Brookings Papers on Economic Activity 279, 2010

demands.[8] Others support the assertion that hedge funds not only reduced the detrimental effects of the crisis but even boosted economic recovery.[9][10]

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.[11] The Asian financial crisis was a prime example of hedge fund herding behaviour[12], risks generated from massive leveraged short sales and subsequently fire sales stemming from deleveraging. [13] 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.[14]

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 the entire financial system.[15] Second was the implosion of Lehman Brothers, which marks the dawn of GFC. Third was the large-scale fraud perpetrated by Bernard Madoff[16], which brought into question, in particular, the integrity of some of the industry practices.[17] 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.[18]

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[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
[10] Dirk A. Zetzsche (ed.), *The Alternative Investment Fund Managers Directive*, Wolters Kluwer, Law & Business, 2012, pp. 21-36
[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[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.[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.[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). [22]

Although the directive's scope is broader in the sense that the definition[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).[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

[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.
[20] AIMFD, Recital 2
[21] EC, Commission staff working document; *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, depositories, leverage, transparency and supervision*, 2012
[22] For more details *see* Ch. 3.2.2 on AIFMD objectives
[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.
[24] Zetzsche, supra at 10, 2012, pp. 1-19

are AIFMD compliant by now[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 being far-reaching and ambiguous. Nevertheless, the directive garnered significant attention ex-ante implementation, and some of these studies[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 a wider perspective on the subject, some context behind the motivations of the directive is initially examined. Thus, chapter two provides an overview of 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 reasoning behind the shift from indirect, i.e. industry self-regulation to direct regulation is provided. 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 a particularly pragmatic approach to the subject matter. Practical consequences of the provisions are included, which form the basis for the impact assessment in chapter five. The impact assessment is conducted by studying some of the latest industry surveys on the topic, alongside interpreting the content of the directive. It must be, however, acknowledged that there are some dispersion between the results of the surveys.[27]

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

[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

[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.

[27] More on the constraints to the assesment *See* Ch. 5, 5.1 Methodology

risks and investor protection. Chapter six concludes, 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. This category also includes private equity, venture capital, real estate, oil & gas, timber, etc.

[33] Zetzsche, 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. *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 31.

[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.

[44] UK Hedge Fund Working Group, *Hedge Fund Standards Consultation Paper - Part 1*, p.33.

2.2. Hedge fund characteristics

The following section evaluates hedge fund characteristics in further detail. Further examination of the characteristics is necessary, in order to provide context for the research on the impacts of the directive.

2.2.1. Hedge fund strategies, performance, and compensation

Although the term hedge fund 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

[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, 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.

will move in a favourable direction. In some cases, there is an underlying reason[49], why the favourable relative price changes are thought to be inevitable, while in other cases the trade is more purely speculative.[50] Event driven[51] 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. [52]

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.[53] 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%.[54] Although hedge fund returns were delivered with lesser volatility, it must be noted that the returns would be higher without the relatively high fees the funds charge.

As such, low returns, alongside high-performance fees have led to significant redemptions requests.[55] 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.[56]

[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, due to temporary issues such as flight to quality, in anticipation of the spread to converge when the markets calm down. The risk is, that these 'temporary' issues might last longer than the arbitrageur stays solvent.
[50] Presidents working group*, Report of The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, 1999, hereafter PWG
[51] An example of an 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. If 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, technological advances and decline in retail order flow (i.e. professionals are betting against each other).
[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

2.2.2. Hedge fund structures and counterparties

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.[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.[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 are institutions, such as pension funds, fund of funds[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.[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.[61] In general, the most common 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. [62]

The stand-alone fund is the quintessential 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

[57] EC, supra at 4
[58] Lhabitant, supra at 31. pp. 90.
[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 a drawback.
[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* http://www.barclayhedge.com/research/educational-articles/in-depth-articles/starting-a-hedge-fund.html
[61] Lhabitant, 2007, supra at 31, pp 85.
[62] For instance Jersey has long list of fund types such as Recognized funds, Unclassified funds, Listed Funds, Expert Funds, Private placement funds etc. Conversely Cayman Islands have exempted funds, licensed funds, administrated funds etc. For more details *See* Gordon Casey, *The Cayman Edge: How to Set up a Cayman Fund*, 2015

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 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 class B shares which might trade equities and bonds alike. [65]

A hedge fund can be either closed-ended or open-ended.[66] However, the distinction between an open-end and a closed-end hedge fund is not as black-and-white as it is in the mutual-fund sector. Virtually all hedge funds allow their investors to liquidate their positions at some horizon; in this sense, they are all quasi-open-ended. At the same time, most hedge funds put some restrictions on withdrawals, and thus do not represent as pure case as open-end mutual funds.[67] Hedge funds may employ a quarterly or annual redemption constraint, exercise gating[68] provisions or engage in side pocketing[69] agreements with their investors.

Lastly, the hedge fund business model depends vastly on its service provider network.[70] Operating through service providers allows smaller number of personnel to access a wider skill base. In return

[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, which might invest to equities 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 62, 2015; Ogier, *Segregated Portfolio Companies in the Cayman Islands,* 2011
[65] On more details on operational and organizational structures of hedge funds *see* Lhabitant, 2007, 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.
[67] Jeremy C. Stein, *Why Are Most Funds Open-End? Competition and the Limits of Arbitrage*, Harvard University and NBER, 2003
[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 during market turmoil, or when a hedge fund is in a sudden drawdown to prevent run on the fund.
[69] 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.
[70] See Appendix 2: Typical hedge fund service provider network.

service providers receive specified fee from the fund pursuant to various agreements.[71] 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.[72]

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. [73] 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.[74]

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.[75] 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 is the largest hedge fund jurisdiction for the fund itself and fund administration, as significant tax and regulatory advantages exist for hedge fund domiciled in Cayman.[76] Other popular locations are the British Virgin Islands and Bermuda. They attract both UK and US funds, as the countries benefit from historical ties to the UK and geographical proximity to the US.[77]

[71] Lhabitant, supra at 31, pp. 90
[72] Id.
[73] PWG, supra at 50, 1999
[74] AIFMD, Article 21, 1
[75] *See* Appendix 3: Hedge fund domiciliation by AUM
[76] *See* Fund Associates, *White paper Offshore Hedge Funds Vs. Onshore Hedge Funds*, 2008
[77] TheCityUK, *Hedge Funds Report*, 2013; D. Clarkson et al., *Domiciles of alternative investment funds*, Oliver Wyman, 2014

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 partly 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, has historically lead to a better risk-return trade-off[80], 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 spreads.

[78] Id.
[79] Id.
[80] Theoretically, the 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. During the financial crisis, in aggregate, many hedge funds were heavily correlated to global stock markets thus the diversification benefits remained limited in some cases.
[82] EC, supra at 4

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[83] 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.[84]

Despite their widely acknowledged benefits, hedge funds can pose risks to the financial system. Although their role in causing financial instability is highly contested, some consider that hedge funds' size and leverage, their interconnectedness with banks and prime brokers and the likelihood of herding may increase systemic risks.[85]

Furthermore, in certain circumstances, their trading activities may be destabilising. These actions, instead of stamping unfair valuations, might lead to significant market panics.[86] However, it is very difficult to draw the line between seemingly manipulative trades and rational economic behaviour.[87] 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.[88]

[83] Gating can be very beneficial at times of distress, as a measure preventing unnecessary deleveraging stemming from panicking investors' redemption requests.
[84] As noted by Nabilou and 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 thus 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 risks and investor protection. Lastly, at the end of the chapter, brief discussion on the possible regulatory approaches is provided.

2.4.1. Systemic risk

Systemic risk[90] 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 may 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 of particular systemic relevance. Studies have concluded that hedge funds trading activities did not cause the Asian financial crisis, nor did they seemingly contribute to systemic risk build-up during it.[93] The failure of LTCM (and other famous failures such as Amaranth) were also absorbed by the financial system without long-

[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 Danıelsson, 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 financial markets, which 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, 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 *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] For detailed accounts on the crisis *see* Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, FSF, 2000 and Eichengreen et al., supra at 87, 1998

term market disruption.[94] However, the financial crisis led to re-assessment of this viewpoint, and it was widely recognized that hedge funds market behaviour and size may have systemic implications.

Thus, the financial crisis forms logical base for assessing whether hedge funds transmit systemic risk. The failure of LTCM also acts as an excellent, yet isolated example of risks associated with the combination of leverage, position concentration, and lack of regulatory oversight and risk management, which could have led to system-wide contagion from a single hedge fund. Some of these issues were highlighted during the financial crisis as well.

Long-Term Capital Management

The collapse of LTCM precipitated the first in-depth assessment by policymakers[95] 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.[96]

LTCM had an 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.[97] 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.[98]

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. Consequently the funds principals decided to branch away from its trademark strategies and venture into new areas such as taking directional equity trades in various markets. 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

[94] 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

[95] 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.

[96] Bullman, supra at 28, 2008

[97] The spread convergence arbitrage, was nearly 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. In addition once other participants realized the chance for risk free profits, 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.

[98] PWG, supra at 50, 1999.

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.[99][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[101] 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 (Fed). This was arguably[102] the right thing to do given the possible system-wide repercussions what an uncontrolled collapse of the fund could have caused. [103]

Default by the fund could have created significant systemic risks, as the counterparties would have had to quickly move 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 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 — 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.[104]

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[99] Lhabitant, supra at 31, 2007, pp. 155-160
[100] PWG, 1999, supra at 50.
[101] 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.
[102] 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 the 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. 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 the Fed, no taxpayer money was actually used. *See* Lhabitant, supra at 30, pp. 155-160; John Authers, *The Short View; Moral Hazard*, 2008, The Financial Times; David Shirref, *Lessons From the Collapse of Hedge Fund, Long-Term Capital Management*, Berkeley, 2009
[103] PWG, 1999, supra at 50.
[104] Id.

There were multiple reasons which lead to the collapse of the fund. 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[105], its impressive track record, and the opportunity for the fund's investors and counterparties to profit from a significant relationship with LTCM. [106]

There was also 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. [107] 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.[108] Others claim LTCM had in fact done that.[109] 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.[110] There was an assumption that the portfolio was sufficiently diversified across world markets to produce low correlation, but as previously mentioned, LTCM was replicating practically same credit spread trade in most of the markets it was trading. 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[111].

Global Financial Crisis

Charles River Associates (CRA), among others[112], 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, they also concluded that regarding credit channel the systemic repercussions remained minimal.[113]

[105] 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.
[106] Id.
[107] Interestingly, despite of LTCM's overreliance on VaR, and its acknowledged shortcomings, it still remained one of the main models for risk calculations 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.
[108] Shirref, supra at 102, 2009
[109] Sebastian Mallaby, *More Money Than God; Hedge Funds and the Making of a New Elite*, 2010, pp. 230
[110] Id, pp. 237.
[111] Id.
[112] *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
[113] CRA, supra at 92, 2009

The limited impact on credit channel can be attributed to the fact that lending by prime brokers to hedge funds is/was subject to prudential rules. [114][115] There were 1500 hedge fund failures during 2008[116], yet the systemic repercussions remained limited. Neither did the collapses of larger funds cause substantial risk transmission. CRA 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.[117]

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 stand-alone 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 suggests 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).[118]

With regards to the market channel, there were 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 of these funds recognized few large funds were deleveraging, a fire sale was triggered to meet margin calls and to reduce risk. This prompted commentary that systemic risk from hedge funds had increased, partly from leverage and partly for the simple reason that funds might deleverage simply due to positioning.[119][120]

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[114] 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

[115] 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

[116] Mallaby, supra at 109, 2010

[117] CRA, supra at 92, 2009

[118] Id; this conclusion was also backed up by the High-level Group on Financial Supervision and the Turner Review.

[119] 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

[120] 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

The risks to the 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. As a consequence, hedge funds faced significant redemption requests from investors, which contributed to the domino effect as they were forced to sell their positions further.[121] There were also some hedge funds short selling[122] to already falling markets, while others found exotic[123] ways to bet against the collapse of the 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.[124] 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."[125] The substantial decline in gross assets of hedge funds indeed suggests that deleveraging created systemic risks.[126]

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 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.[127] Yet it was widely known that some industry practices such as lack of disclosure, and lack of independence

[121] This lead to imposition of gates and suspensions. EC, supra at 4.
[122] Which was one of the reasons of short selling curbs across the globe.
[123] 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
[124] EC, supra at 4.
[125] CRA, supra at 92, 2009; Similar conclusions were made by the High Level Group on Financial Supervision and in the Turner Review.
[126] 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.
[127] The Financial Stability Forum, Recommendations and Concerns Raised by Highly Leveraged Institutions: An Assessment, FSF, 2002

of funds valuator may lead to fraudulent activity and conflict of interests. In addition, the increasing retailization[128] caused concerns to regulators.[129]

The financial crisis brought to light shortcomings with investor protection in an unprecendented scale and acted also as a catalyst for more regulation.[130] The lack of transparency and disclosure exposed investors to larger than expected losses.[131] Investors were often hurt by hedge funds excercising their rights to deny redemptions by gates and lock-ups. In addition, valuation of illiquid assets may have favoured hedge funds managers in some cases, in a sense that some funds were slow to adjust the value of their assets down. And lastly, the Bernard Madoff's grand scale Ponzi scheme lead to unprecedented losses, and highlighted the issues with lack of separation in custodial services.[132]

Lack of transparency; fraud, valuation, and conflict of interests

There were many notable fraud cases with hedge funds long before Madoff, albeit not in a similar scale. During 2000-2005, there were over 52 fraud cases, with only five cases[133] accounting for 1.5 billion of lost capital.[134] Most common types of fraud are an overstatement of performance, payment of excessive and undisclosed commissions, and misappropriation of client money.[135] Many of the fraud cases could have been avoided with stricter disclosure standards and separation of custodial services.

In addition valuation has been a particularly problematic topic before the financial crisis and during it.[136] Despite the importance of accurately valuing the assets in a hedge fund's portfolio, no uniform

[128] 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
[129] See Id.
[130] "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.
[131] IOSCO, 2009, supra at 36
[132] 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. Zetzsche 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
[133] See Appendix 6: Selected hedge fund disasters and losses
[134] Majed R. Muhtaseb and Chun Chun Yang "Portraits of five hedge fund fraud cases", Journal of Financial Crime, 2008, pp. 179 – 213;
[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] 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

standards existed before the financial crisis.[137] The fundamental problem with valuation is the attempt to provide a single number to determine what an illiquid or derivative asset is worth.[138] Thus there is a risk, that when a hedge fund manager values the assets in its fund according to a model that it developed, that the performance fee is, in part, determined by a model that overvalues the fund's assets.[139]

The fact that valuations are often conducted by independent administrators may have served to alleviate this risk. 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. Thus, the manager may remain the person in charge of valuation even though formally that position has been externalized, causing significant conflict of interests.[140]

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[141] agreements are not disclosed promptly.[142] 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 make their performance fees. This could lead to market instability as investors are badly informed, and managers take riskier positions to increase potential returns.[143]

Retailization

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. *See* Lhabitant, supra at 31, 2007 pp 52-53.

[137] 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 and IOSCO had also released its principles for valuation. *See* IOSCO, *Principles for the Valuation of Hedge Fund Portfolios*, 2007

[138] Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 2009

[139] Sklar, supra at 139, 2009.

[140] Kaal, supra at 140, 2009

[141] 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. Sklar, supra at 139, 2009

[142] IOSCO, supra at 36, 2009

[143] Id; Investment in their own funds by managers may however help to mitigate some of the conflicts of interest as it can align the interest of the manager with the investor.

Although not considered a major issue in Europe[144], 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. Retail investors are also sometimes indirectly involved with hedge funds, without to their knowledge.[145][146] As highlighted by Edwards; "most of the complexities related to hedge funds such as – information asymmetries, potential conflicts of interest and disparate investor capabilities – are well-understood by many investors, but are clearly not understood by all retail investors".[147] Therefore there may be a case for regulatory intervention if such investors start investing in hedge funds en masse.

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 approach comes down fundamentally always, whether hedge funds should be regulated directly or indirectly.[148]

Direct regulation mainly relies on the threat of law by using command-and-control[149] regulatory instruments.[150] Conversely, 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

[144] 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
[145] Financial services authority, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT, FSA, 2005
[146] 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. Ordinary investors had also 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 139, 2009.
[147] Franklin R. Edwards, *"Hedge Funds: Creators of Risk?"*, Presented at Federal Reserve Bank of Atlanta Financial Markets Conference, Columbia Business School 2003,
[148] 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
[149] 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
[150] *See* Nabilou and M. Pacces, 2015 supra at 12.

(quasi) self-regulatory organizations in cooperation with the regulators, effectively minimizing the regulators' direct intervention.[151]

The pre-financial crisis era contained substantial debate whether hedge funds should be directly regulated or not. However,, as previously desciribed, before the crisis it was widely held that the objectives of hedge fund regulation could be achieved by indirect regulation, and after the crisis the regulatory stance gradually shifted towards direct regulation.[152] The main reasons coincide with the objectives of financial 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.[153] Furthermore, the evidence from financial crisis seemed to justify a paradigm shift[154] 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 should hedge funds be regulated.[155] With AIFMD the approach chosen is regulating the manager. This is arguably one of the most consistent[156] ways of regulating hedge funds.

[151] Jip Kim, supra at 148, 2014
[152] Jip Kim, supra at 148, 2014
[153] 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 failure of systemically important financial institution, which in turn would cause market wide problems, that would affect the real economy.
[154] *See* Ch. 3, 3.2 AIFMD background
[155] There are still arguments that indirect regulation would yield overall better response. *See* Nabilou and M. Pacces, supra at 11, 2015
[156] *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).[157] 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.[158]

Quaglia points out that the EU-level regulation could be theoretically described as a competition between two regulatory paradigms, market-shaping, and market-making paradigm.[159] 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 the financial crisis, the long-standing goal of the advocates of regulation had been a directive regulating hedge funds.[160] However, at Union level regulation was left to 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.[161]

Several member states had national regulatory regimes in place, though. These regimes typically involved registration requirements and oversight of hedge fund managers, as well as structural separation of the hedge fund manager and the custodian.[162] In countries such as in France and

[157] EC, Report of the Alternative Investment Expert Group: Managing, Servicing and Marketing Hedge Funds in Europe, European Commission Internal Market and Services DG, 2006, pp.16
[158] Zetzsche, supra at 10, 2012 pp. 1-19
[159] Lucia Quaglia, *The 'Old' and 'New' Political Economy of Hedge Fund Regulation in the European Union*, West European Politics, 34:4, 2011, pp. 665-682
[160] Id.
[161] *See* PWG, supra at 50, 1999; See FSF, supra at 95, 2000: IOSCO, *Hedge funds and Other Highly Leveraged Institutions*, Report of the Technical Committee, 1999
[162] EC, supra at 157, 2006

Germany, the fund itself was a (quite strictly) regulated onshore vehicle, although often it could be domiciled in a third country. On the other hand, the UK naturally preferred a lighter regime[163]. [164]

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.[165] European Parliament produced several reports on the possibility and reasoning of regulating hedge funds and private equity (including the Rasmussen[166] and Lehne[167] reports), as the regulatory atmosphere was turning towards more alternative investment fund specific regulation.

3.2.1. Political process behind AIFMD

Quaglia provides evidence that the political motivations[168] 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,[169] 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

[163] 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.
[164] Quaglia, supra at 159, 2011
[165] Id.
[166] European Parliament (EP), *Report of the European Parliament with Recommendations to the Commission on Hedge Funds and Private Equity*, A6- 0338/2008.
[167] European Parliament (EP), *Report of the European Parliament with Recommendations to the Commission on Transparency of Institutional Investors*, A6- 0296-2008
[168] Quaglia emphasises that this assessment on the motivations of AIFMD was enhanced even further by the fact there were purely domestic political 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 159, 2011
[169] 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.

regulation[170], 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.[171]

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 information on an ongoing basis to supervisors or regulators. They should be subject to oversight to ensure that they have adequate risk management.[172] In addition other jurisdictions developed similar frameworks to regulate managers of AIFs, in particular, the US with the Dodd-Frank Act.[173] The consensus reached was seen as a victory for France and Germany, which advocated the need for a comprehensive regulatory architecture in the face of resistance from the UK, where most of the European hedge funds are based.[174] 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.[175] Thus, the scope of the directive was much broader than originally envisioned.

Although some alternative views[176] about financial services regulation began to emerge in the 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 the UK".[177] After intense lobbying from industry, the US and the UK, the draft directive was partly revised[178] during the Swedish presidency of the EU that began in July 2009.[179] 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[180].[181]

[170] Alongside AIFMD, the financial crisis unleashed a number of new European asset management directives, such as IORPD, UCITSD 4, MiFID 2.
[171] Quaglia, supra at 159, 2011.
[172] AIMFD, Recital 89
[173] 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
[174] Quaglia, supra at 159, 2011
[175] Commission of the European Communities (CEC) (2009a). Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers, 30 April
[176] 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
[177] Paul Marshall, *Europe's classic exercise in closet protectionism*, The Financial Times, 2009
[178] 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.
[179] According to Zetzsche, some initial drafts of the directive were even leaked, which led to aggressive lobbying by certain participants. *See* Zetzsche, supra at 10, 2012, pp. 1-19
[180] *See* Appendix 7: AIFMD Timeline
[181] Quaglia, supra at 159, 2011.

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 entering into force. On other hand, 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.[182] 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 the 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.[183] 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.[184] According to Aremendia, the implementation of AIFMD-CDR, has achieved a great deal by making the regime far more workable than many in the industry had anticipated.[185]

3.3. AIFMD Objectives

The general objective of AIFMD, is to provide an internal market for AIFMs and a harmonized 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

[182] Zetzsche, supra at 10, 2012, pp. 1-19
[183] AIFMD, Article 47, 4, (a)-(c)
[184] Zetzsche, supra at 10, 2012, pp. 1-19; Treaty of Lisbon, *Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European community*, 2007/C 306/01, available at; http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:C2007/306/01&from=EN
[185] Mirzha de Manuel Aremendia, *Implementing the AIFMD: Success or failure?*, ECMI Commentary No. 34, 2013

have their registered office in a third country (non-EU AIFMs).[186] 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 a high level of investor protection, enhancing management of micro-prudential risks while ensuring overall market efficiency. The objectives can be further separated into level 2 issues which include the calculations of leverage and AUM for instance[187].[188]

Zetzsche 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. [189] 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.[190] 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.[191]

[186] AIMFD, Recital 4
[187] *See* Appendix 8; The objectives of AIFMD
[188] EC, Commission staff working document; *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, depositories, leverage, transparency and supervision*, 2012
[189] Zetzsche, supra at 10, 2012 pp. 1-19
[190] Id.
[191] id.

4. Content of AIFMD

4.1. Scope and definition

According to AIMFD, alternative investment funds[192] (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.[193] Thus, AIFMD basically takes "one-size-fits-all" approach as it includes all funds which raise capital[194] from a number of investors[195] with a defined investment policy[196]. 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 *almost all* hedge fund structures.

Unsurprisingly, AIFMs' means legal persons whose regular business is managing one or more AIFs.[197] 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.[198]

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.[199] 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.[200]

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[192] 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.
[193] AIMFD, Article 4, 1, (a)
[194] 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, *Scope of the AIFMD*, Baker & McKenzie, 2013
[195] 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.
[196] 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.
[197] AIMFD, Article 4, 1, (b)
[198] AIMFD, Recital 21
[199] AIFMD, Article 2,1, (a)-(c)
[200] Association of the Luxembourg fund industry (ALFI), *The alternative investment fund managers directive, Luxembourg implementation*, 2013

AIFMD provides for a limited number of exemptions (including grandfathering[201] 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.[202] 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.[203] 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[204] vehicles, which invest private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with the Directive.[205] 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 the regulatory radar as well.[206]

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

[201] 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.
[202] For comprehensive list *see* AIFMD, Article 2,3
[203] AIFMD, Article 3,2, (a) and (b)
[204] 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
[205] AIFMD, article 3, 1
[206] *See* IOSCO, supra at 36, 2009

competition.[207] 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 main objectives of AIFMD. [208] The directive requires that all member states ensure no AIFMs manage or market AIFs unless they are authorized in accordance with the directive.[209] The managers are subject to a general prohibition which will be lifted once they are authorized. Authorization may be withdrawn if the competent authorities see it compromised. [210]

Application for authorization is submitted to the national competent authorities.[211] 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. With regards to AIFs, information requirements concern, for example, 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.[212]

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 a buffer. Member States shall require that an AIFM, which is an internally managed AIF has an initial capital of at least EUR 300 000.[213] Where an AIFM is appointed as external manager of AIFs, the AIFM shall have an initial capital of at least EUR 125 000.[214] 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

[207] 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
[208] AIFMD, Recital 2
[209] AIFMD, Article 6,1 and Recital 18
[210] AIFMD, Article 11
[211] AIFMD, Article 7.1
[212] AIFMD, Article 7.2 and 7.3
[213] AIFMD, Article 9.1
[214] AIFMD, Article 9.2

not, however, exceed EUR 10 million.[215] These funds are required to be invested in liquid assets or assets readily convertible to cash in short them and cannot include speculative positions.[216] AIFMs must also cover potential professional liability risks trough either additional own funds to cover risks from professional negligence or hold an appropriate professional indemnity insurance against such risks.[217] 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.[218]

Practical consequences

In order to be authorized, 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. In addition, the ability of investors to learn about the persons effectively conducting the investment process may be inhibited by the fact that hedge funds transcend multiple jurisdictions.[219] With AIFMD, it should be easier for investors to assess who is factually behind the business.[220]

The requirement to invest 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.[221] 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. Conversely, 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.[222]

[215] AIFMD, Article 9.3
[216] AIFMD, Article 9.8
[217] AIFMD, Article 9.9 a-c;
[218] PWC, *The AIFM: Getting authorised*, 2013; AIFMD-CDR, Recital 35; See also appendix for example on calculations for minimum regulatory capital and own funds.
[219] *See* Zetzsche, supra at 10, 2012, pp. 109-135
[220] It's notable that huge losses, and even frauds tend to be asymmetrically caused by unregistered hedge funds. For instance David Mobley's Maricopa was not registered nor audited. *See* Edwards, supra at 135, 2000
[221] However, this asymmetry is alleviated by the fact that hedge funds typically employ high watermark i.e. they won't be able to charge performance fees without profits. Furthermore, most successful managers invest substantial amounts of own capital in the fund. Thus they have a high incentive to mitigate losses as it's extremely difficult to claw back to profitability from a high drawdown.
[222] PWC, supra at 218, 2013; an example would be a hedge fund using many offsetting hedges, which enlarges its gross asset base.

4.3. Operating conditions

AIFMs will have several new obligations related to operating conditions.[223] 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.[224] The operating principles require for instance that AIFM will act with due diligence and care, honesty, comply with regulations, ensure fair treatment of investors[225] and act in the best interests of the AIFs they manage.[226] In terms of conflict of interests, AIFMs are required to maintain and operate effective organizational 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.[227]

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[228] 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.[229] 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 organization and the nature, scope and complexity of their activities.[230]

[223] AIFMD, Articles 12-20
[224] *See* Zetzsche, supra at 10, 2012, pp. 159-199
[225] 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
[226] AIFMD, Article 12, 1, (a)-(f)
[227] AIFMD, Article 15
[228] AIFMD, Article 13, 1
[229] AIFMD, ANNEX II, 2; *See* ESMA guidelines for role of the remuneration committee. ESMA, *Guidelines on sound remuneration policies under the AIFMD*, 2013, pp. 15
[230] AIFMD, ANNEX II

Practical consequences

The typical hedge fund remuneration structure, where the manager is rewarded with significant performance fee on good years and no clawback in bad years, may encourage excessive risk-taking.[231] While investment to fund by the manager may serve to alleviate high risk-taking, the asymmetry remains, if the manager does not have a significant proportion of his wealth invested in the fund. In addition, in a low-return environment, certain hedge fund still continue employing controversial remuneration practices, without delivering alpha. [232] Thus, it is reasonable AIFMD reigns these practices. As the hedge funds have to comply with the requirements of ANNEX II reporting, it is likely that excessive risk taking is controlled externally. Some of the controversial remuneration practices are also reigned, as according to ESMA, measures such as golden parachutes and guaranteed bonuses are inconsistent with AIFMD.[233]

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.[234] Thus AIFMD provides uniform standards with valuation for the first time in Europe. The key issues and provisions to consider with regards to valuation are: [235]

- 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[236] from portfolio management and

[231] FSA, supra at 113, 2009
[232] The common hedge fund fee structure has lately received some significant criticism. *See* Madison Marriage, *Oaktree founder attacks hedge fund fees*, The Financial Times, 2015; Steve Denning, *How Hedge Funds Transfer Wealth From Investors To Managers*, Forbes, 2013; *See* also ref. 55 and 56
[233] ESMA, supra at 229, 2013, pp. 2
[234] AIFMD, Article 19, 1
[235] Matheson, *AIFMD Factsheet: Valuation*, 2014
[236] This terminology is crucial part of AIFMD. In practice "functional" and "hierarchical" separation means for instance, separate personnel and separate supervision.

remuneration policies, and other measures ensure that conflict of interests are mitigated.[237] In addition the directive explicitly implies that external valuer cannot delegate the valuation function to a third party.[238] Furthermore delegating valuation tasks to external valuer does not allow for the circumvention of the AIFM's responsibilities or liability.[239] 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.[240]

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. [241] In addition, AIFMs are required to provide a description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets.[242] 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.[243]

Practical consequences

Ensuring proper valuation is key for providing understanding on the riskiness of hedge funds assets In addition ensuring the independence of valuer is important for preventing frauds and ensuring the funds assets are not overvalued. Although many of the procedures with regards to valuation – such as ensuring valuer independence – were somewhat applied by fund managers[244], 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.

[237] AIFMD, Article 19,4, (a) and (b)
[238] AIFMD, Article 19,6
[239] AIFMD-CDR, Article 75, (a)
[240] Matheson, supra at 235, 2014
[241] AIFMD, Article 19,3
[242] ALFI, supra at 200, 2013
[243] AIFMD, Article 19,2
[244] AIMFD, Recital 29

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 a trend in how risk management is regulated and effectively conducted by asset managers.[245] AIFMD follows this changing trend, and sets risk management besides portfolio management, as the core business function of AIFMs.[246] 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.[247]

According to AIFMD, AIFM should never be authorized to provide portfolio management without also providing risk management or vice versa.[248] The provisions of AIFMD and AIFMD-CDR convey rules on establishing adequate risk management systems which are understood as both organizational 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. [249]

AIFMs are required to functionally and hierarchically[250] separate the functions of risk management from the operating units, including from the functions of portfolio management.[251] 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. [252] These risks include, *inter alia*, the typical market, liquidity, credit, counterparty and operational risks. [253] 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.[254]

[245] BNY Mellon, *Risk Roadmap: Hedge Funds and Investors Evolving Approach to Risk*, 2012
[246] AIFMD-CDR, Recital 86
[247] KPMG, *AIFMD RISK MANAGEMENT*, 2014
[248] AIFMD, Recital 21
[249] *See* ALFI, *Risk Management under the Alternative Investment Fund Managers Directive*, 2014
[250] On conditions when risk management function is "functionally" and "hierarchically" separated see AIFMD-CDR, Article 42, (a)-(b).
[251] AIFMD, Article 15, 1
[252] AIFMD, Article 15, 2
[253] 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.
[254] 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.[255] Furthermore, AIFMs need to ensure regular reporting on risk management matters to internal governing bodies and investors. The AIFMD stresses in many cases the principle 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 an annual basis, while systemically relevant AIFM should report at least on a quarterly basis.[256]

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. [257] Considering the shortcomings in risk management during the financial crisis – particularly due to imperfect risk measurement[258] 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 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.[259]

4.3.4. Liquidity management

Issues with regards to the illiquidity of assets during crisis times have been well documented. Even extremely liquid markets can dry during the times of serious shock (as witnessed by US short-term

[255] AIFMD, Article 15, 2
[256] ALFI, supra at 249, 2014
[257] Sophia Grene, *Hedge funds split over AIFMD risk management rules*, The Financial Times, 2014
[258] Arguably the most maligned metric in risk measurement is Value at Risk (VaR). 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
[259] Zetzsche, 2012, supra at 10, pp. 265-331

credit markets during the financial crisis). Many sources[260] 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[261] 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.[262] Thus, AIFMD requires that AIFMs ensure that the investment strategy, the liquidity profile, and the redemption policy are consistent.[263] With regards to asset liquidity risk management AIFMD seeks to establish new standards in order to ensure that AIFMs apply appropriate liquidity management systems[264], adopt procedures that enable AIFM to monitor AIF's liquidity risk and regularly conduct stress tests under normal and exceptional conditions. [265] The delegated regulation contains more specific rules on redemption policies and 'special arrangements'.[266] 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.[267]

The investment strategy, liquidity profile and redemption policy of each AIF managed by an AIFM shall be considered to be *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.[268] 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.[269]

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[260] Philip E. Strahan, *Liquidity Risk and Credit in the Financial Crisis*, Federal Reserve Bank of San Fransisco, 2012; Marcia Millon Cornet, Jamie John McNutt, Philip E. Strahan, Hassan Tehranian, *Liquidity Risk Management and Credit Supply in The Financial Crisis*, 2010; Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 2008, NBER Working Paper No. 14612

[261] Madison Marriage, *Hedge funds close the gate before investors can bolt*, The Financial Times, 2013

[262] Zetzsche, supra at 10, 2012, pp. 253-264

[263] AIFMD, Article 16.2

[264] Regarding liquidity management systems *see* AIFMD-CDR, Article 47,1

[265] AIFMD, Article 16,1

[266] 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.

[267] AIFMD-CDR, Recital 59

[268] AIFMD-CDR, Article 49,1

[269] AIFMD-CDR, Article 49,2

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[270], yet it is undeniable that overarching principle must be the fair treatment of investors acknowledging that the redemption of shares is a fundamental right.[271] 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 the investor. This should prevent AIMFs from employing some of the more controversial[272] 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.[273]

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.[274] 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.[275] The underlying idea is that cross-border delegation of portfolio management activities allows greater access to different markets and investor bases.

[270] 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. Conversely, investors can keep losing money due to them.
[271] Zetzsche, supra at 10, 2012 pp. 253-264
[272] 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 109, 2010, pp. 425
[273] Zetzsche, supra at 10, 2012 pp. 253-264
[274] AIFMD-CDR, ANNEX IV
[275] Mark Browne, *Delegation of investment management under the AIFMD*, AIMA, 2013

AIFMD continues to allow delegation, however with certain restrictions. The overarching principles are outlined in AIFMD 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. 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*.[276]

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.[277] 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.[278]

Core functions i.e. risk management and portfolio management can be only delegated under strict conditions.[279] 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.[280]

- 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. [281]

- 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.[282]

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.[283] The following non-exhaustive list provides

[276] AIFMD, Recital 30
[277] AIFMD, Article 20,1
[278] AIFMD-CDR, Article 76
[279] AIFMD Article 20,2 and AIFMD-CDR, Article 78
[280]AIFMD, Article 20, 1, (c)
[281] AIFMD, Article 20, 1, (d)
[282] AIFMD, Article 20,1,(e) and Article 20,2
[283] A&L Goodbody, *AIFMD – Delegation of Functions*, 2013

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.[284]

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, 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.[285]

Practical consequences

In summary, the key prohibition of letter box entity is important 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. 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 an amendment to existing contractual agreements and extensive additional documentation evidencing how the applicable requirements are being met.[286]

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.[287] In addition, the crisis triggered failures of famous prime brokers and depositaries, such as RBS and Fortes, which

[284] AIFMD-CDR Article 82 (a)-(d)
[285] A&L Goodbody, supra at 283, 2013,
[286] Browne, supra at 275, 2013
[287] Zetzsche, supra at 10, 2012 pp. 109-135 and 447-454

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.[288] Thus, AIFMD Recital 2 outlines that recent developments underline the crucial need to separate asset safe-keeping and management functions, and to segregate investor assets from those of the manager.[289] 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.[290] Prior to the adaptation of AIFMD, Member States enjoyed significant discretion as whether appointment of depositary was required and which entities could act as depositary.[291] 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 ensure asset custody. AIFMD, however, appoints numerous additional tasks to the depositary.[292]

The depositary has both safekeeping and oversight function. However, a depositary acts not only as custodian but also as a sort of monitor of the fund. In the 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.[293]

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[294].[295] In practice, most of the depositaries will be credit institutions i.e. banks or investment firms with regulatory permission to act as custodian.[296] The AIFMD stipulates that the fund's the fund's prime

[288] Id.
[289] AIFMD, Recital 2
[290] AIFMD, Article 21, 1
[291] Zetzsche, supra at 10, 2012 pp. 409-445
[292] AIFMD, Article 21
[293] Richard Frase and John Young, *The role of depositary under the AIFM directive*, Dechert LLP, 2013
[294] UCITSD, Article 23, 3
[295] AIFMD, Article 21,3 (a)-(c)
[296] Frase and Young, 2013, supra at 293

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.[297]

The directive greatly alternates the established industry practice by introducing strict liability of depositaries.[298] Depositaries 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.[299]

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 related to custodial services will be avoided. Harmonization of depositary rules makes the service more transparent and comparable, which should also reduce regulatory arbitrage and increase legal certainty. [300] 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 Siena[301], 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 politics[302], and influential viewpoints were sidelined[303] 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.[304] All this adds to costs and risks for depositaries, which are passed to hedge funds.

[297] AIFMD, Article 21,4
[298] AIFMD, Article 21,12 and AIFMD, Recital 44
[299] AIFMD, Article 21, 12 and AIFMD, Recital 44 and 46
[300] Zetzsche, supra at 10, 2012, pp. 409-445.
[301] Zetzsche, supra at 10, 2012, pp. 455-487
[302] Apparently, then French Finance Minister Christine Lagarde's letter to Charlie McGreevy directly influenced the depositary liability provisions. The 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.
[303] "Depositary liability, as contemplated under the AIFMD, was not within purview of the G20 commitment, although a link is sometimes made". Id.
[304] Shane Bret, *AIFMD Depositary: Developing an operational model*, AllAboutAlpha, 2014

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.[305] 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.[306] AIFM is also required to report the competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIFs it manages.[307]

Practical consequences

The measures will add to the 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 competitive edge.

4.5. Special provisions on leverage

High leverage has been typically associated with 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[308] it may contribute to financial instability.[309] Thus, 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

[305] AIFMD, Articles 22-24
[306] AIFMD, Article 23, 1, (a)-(p)
[307] AIFMD. Article 24, 1
[308] Such as asset concentration, illiquidity, and significant correlation of strategies.
[309] For thorough discussion on the subject see Ch. 2, 2.4.1 Systemic Risk

AIFMs employing leverage.[310] 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.[311]

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 into the hedging and netting techniques used by the manager; therefore both methods are to be used in conjunction.[312] 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.[313] An AIFMD, with a leverage ratio of over three times its NAV calculated by the commitment method, is considered to be leveraged on a substantial basis.[314] Special reporting requirements are imposed on such funds.[315]

AIFMD also includes provisions regarding maximum leverage employed by the AIFM. [316] AIFMs are required the 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. [317] Should an AIFM or group of AIFMs pose a substantial risk to financial stability and integrity of the financial system, AIFMD empowers competent authorities to set limits on leverage.[318] 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.[319]

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

[310] AIFMD, Recital 49
[311] AIFMD, Article 4, 1, (v)
[312] AIFMD-CDR, Recital 12
[313] AIFMD-CDR, Recital 14
[314] AIFMD-CDR, Recital 132
[315] AIFMD-CDR, Articles 110 and 111
[316] AIFMD, Article 15, 4
[317] AIFMD, Article 15, 4
[318] AIFMD-CDR, Recital 133
[319] AIFMD, Article 25,8

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[320] – may open the door on speculation against them. If other participants know there is a distressed participant[321] in a certain market, they will seek to position against it, in anticipation of liquidation. This by itself could create sources of 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 the threat of leverage limits on certain market conditions could lead to turmoil.[322] 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.[323] AIFMD regulates active marketing to professional investors[324] 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).[325] Practically AIFMs marketing in EU will have to comply fully with AIFMD, or rely on national private placement[326] regimes (NPPR) and reverse solicitation[327].

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

[320] AIFMs need to report principal markets only to regulators though.
[321] 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
[322] Zetzsche, supra at 10, 2012, pp. 557-574
[323] *See* Appendix 10: Marketing in EU under AIFMD
[324] For definition *see* MiFID Annex 2
[325] AIFMD, Article 43,1
[326] Defined as the sale of securities to a relatively small number of select investors as a way of raising capital.
[327] The first draft of the AIFMD proposed a prohibition on reverse solicitation. However, this prohibition was ultimately removed from the final AIFMD. *AIFMD Factsheet: Private Placement Post-AIFMD*, 2013

cross-border sale of AIF units to professional investors.[328] 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.[329]

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.[330] In addition, appropriate cooperation arrangements are required to be in place by 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.[331]

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 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).[332] 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. [333]

Private placement

AIFMD allows EU member states to maintain their private placement regimes both for non-EU AIFs managed by EU AIFMs[334] and for EU AIFs managed by non-EU AIFMs.[335] 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[336], but will still be subject to all the reporting obligations and third country rules regarding exchange of information.[337] Member states also are given the discretion to impose stricter rules.[338] However, the private placement regime might be abolished in the future in

[328] Zetzsche, supra at 10, 2012 pp. 367-406
[329] AIFMD, Article 32, 1 and 2
[330] AIFMD, Article 34, 1, (a)
[331] AIFMD, Article 34, 1, (b)
[332] AIFMD, Article 35, 2, (b)
[333] AIFMD, Article 35, 2, (c)
[334] AIFMD, Article 36
[335] AIFMD, Article 42
[336] AIFMD, Article 36, 1, (a)
[337] AIFMD, Article 36
[338] AIFMD, Article 36,1

case ESMA and EC decide to extend the passport to non-EU AIFMs (three years after legislation has been adopted to extend passport).[339]

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.[340] 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.[341] 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.[342]

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.[343] 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.[344] 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.[345]

However, AIMFs still need to exercise particular caution with reverse solicitation.[346] 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

[339] AIFMD, Recital 63
[340] 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
[341] ESMA, *ESMA publishes letter from European Commission on AIFMD passport*, 2016
[342] Linklaters, *AIFM Directive*, 2015
[343] AIFMD, Recital 70
[344] AIFMD, Article 4, 1, (x)
[345] Matheson, *AIFMD Factsheet: Private Placement Post-AIFMD*, 2013
[346] For instance even distributing business cards, will be likely considered marketing i.e. "trap of soliciting reverse". See Bill Prew, *AIFMD: the ongoing challenge with reverse solicitation in Europe*, Hedge fund intelligence, 2015

reverse solicitation took place, provided that the confirmation is obtained before the offer or placement takes place. However, AIFMs should not be able to rely upon such confirmation if it has been obtained to circumvent the requirements of AIFMD.[347]

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.[348]

The AIFMD passport was intended to be a simple and cost-efficient process enabling AIFMs 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[349] that there is no consistency amongst member states, making use of the AIFMD passport a complicated, time-consuming and expensive process.[350]

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.[351] 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.[352] Some national regulators have issued guidance, but the border remains blurred as reverse solicitation may be interpreted differently from jurisdiction to

[347] FCA, *Financial promotion and related activities,* The Perimeter Guidance Manual, Chapter 8, 8.37.11 (2)
[348] Zetzsche, supra at 10, 2012, pp. 367-406
[349] ESMA, supra at 340, 2015, pp.54
[350] Victoria Younghusband, *AIFMD Passport – National Private Placement Regime lives on*, Charles Russel Speechlys, 2015
[351] ESMA, supra at 340, 2015, pp.54
[352] Prew, supra at 346, 2015

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 offense 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. [353]

Despite the negativity surrounding the AIFMD marketing regime, some notable benefits can be attained if the industry embraces the passport. Once authorized under AIFMD, the cross-border distribution will become significantly easier[354] 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. [355]

[353] Id.
[354] ESMA, supra at 340, 2015, pp.55
[355] 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[356], Multifonds[357], Deloitte[358] and a qualitative survey conducted by IFI Global[359]. 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[360] and Preqin[361].

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 a result the Preqin survey has been used as the 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 an impact on the responses. Finally, it is very likely that unbiased results could have been attained with

[356] 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

[357] 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,

[358] 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

[359] 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

[360] Multifonds, *Part3: The impact of AIFMD and convergence survey*, 2014

[361] Preqin, *Global Hedge Fund Managers Respond to the AIFMD*, 2014

a detailed survey on hedge fund industry as a 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).[362] 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.[363] 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.[364] Furthermore, it is particularly notable that the private placement regimes remain important particularly for Asia & rest of the world.

Fig. 1: Hedge Fund Manager AIFMD Compliance Status by Manager Headquarters

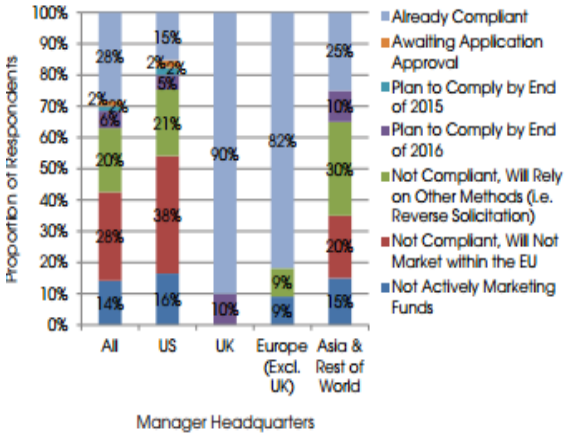
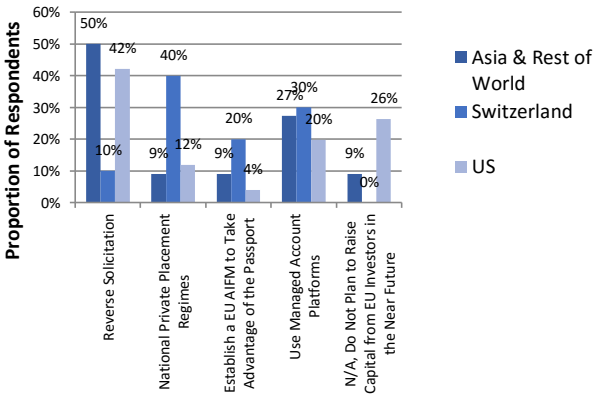


Fig. 2: How non-EU-based managers intend to raise capital from EU-based investors in the next 18 months



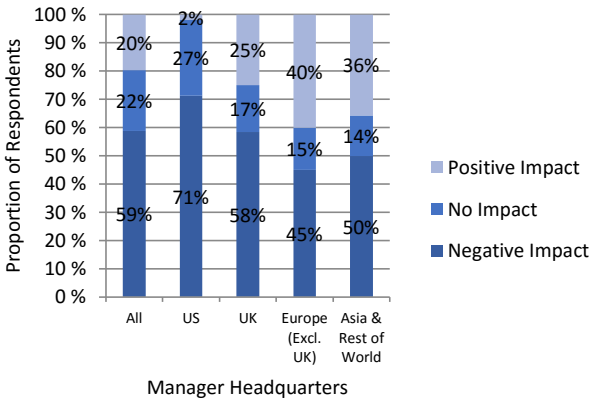
Source: Preqin

[362] Preqin, supra at 356, 2015
[363] Sophia Grene, *AIFMD: Hedge funds drag their feet over EU regulation deadline*, The Financial Times, 2014
[364] 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 356, 2015

The results support the conclusions that AIFMD, from this part, is reducing competition[365] and investors choice in EU, by excluding[366] part of the US funds from accessing the EU market. A survey conducted by IFIGlobal arrived at a similar conclusion.[367] 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.[368]

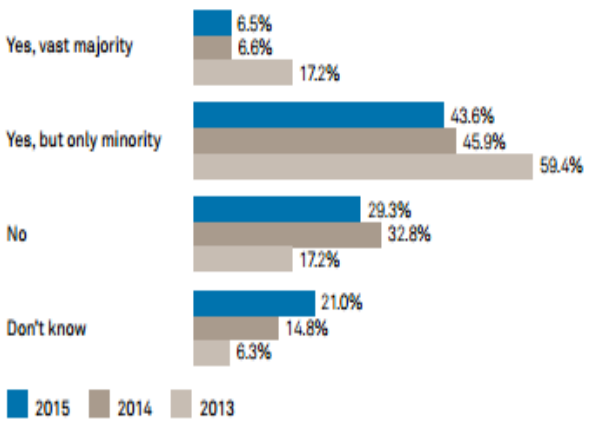
Although the industry has been more negative with regards to AIFMD earlier, the overall opinion remains uniformly negative (Fig. 3). However it is clear that European managers (excluding the UK) are least bearish on AIFMD – this can be explained by the fact that regulations have been traditionally stricter 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



Source: Preqin

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



Source: Multifonds

Furthermore, UK managers exhibit more negative perception than their European peers. UK has by far the largest[369] 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.

[365] 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

[366] 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

[367] IFIGlobal, supra at 359, 2014

[368] Id.

[369] 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

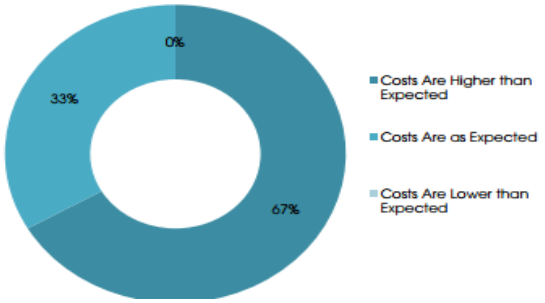
Doubts over the cost of complying with AIFMD have been one of the main sources of concern for hedge funds (Fig. 7), and the presumed high-cost levels have often been seen as the touchstone for the Directive's ultimate success or failure.[370] In addition to AIFMD, hedge funds have had to comply with numerous other costly regulations[371]. According to AIMA, MFA, and KPMG[372], 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.[373] 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).

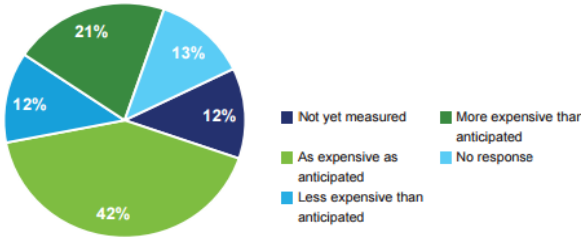
[370] Multifonds, supra at 360, 2014
[371] See Appendix 11: Impact of regulations in terms of compliance costs
[372] KPMG/AIMA/MFA, *The cost of compliance*, 2013
[373] Multifonds, supra at 360, 2014

Fig. 5: Fund Managers Experience to Date of Costs of AIFMD compliance



Source: Preqin

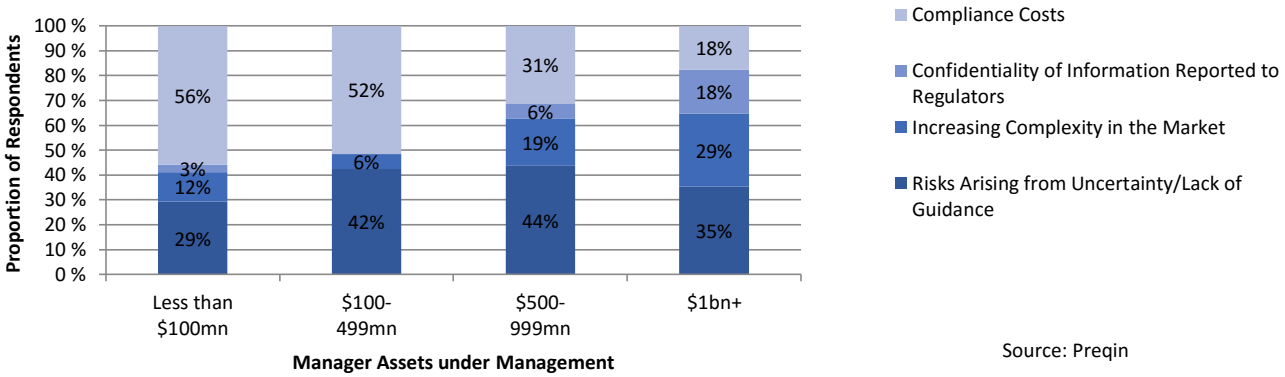
Fig. 6: How in line with expectations are the on-going costs for producing AIFMD reports?



Source:Deloitte

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.[374]

Fig. 7: Primary Concern Fund Managers Have Regarding the AIFMD by Manager Assets under Management



Source: Preqin

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.

[374] Preqin, supra at 356, 2015

Managers interviewed with AUMs below $1 bn say that AIFMD has increased their cost base from 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. [375]

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.[376]

Fig. 8: Challenges of AIFMD

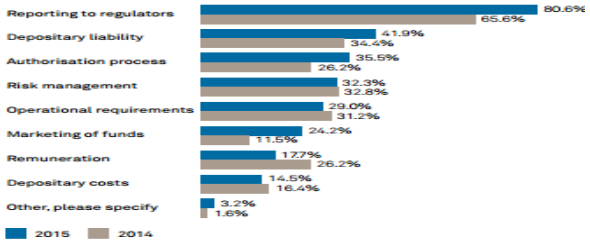
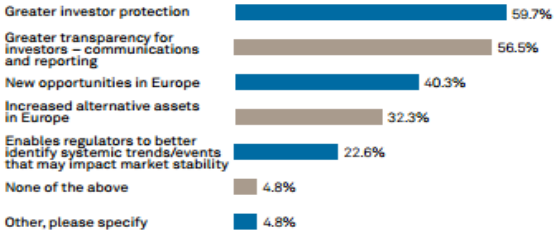


Fig. 9: Benefits of AIFMD



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.[377] 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 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 perception. Unfortunately, however, such information was not available at the time of the research to confirm this hypothesis.

[375] IFIGlobal, supra at 359, 2014
[376] Id.
[377] Id.

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 AIFMD but also investor demand[378] 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.[379]

Fig. 10: Convergence of traditional and alternatives

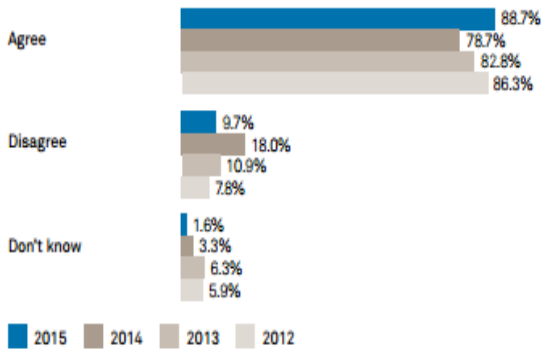
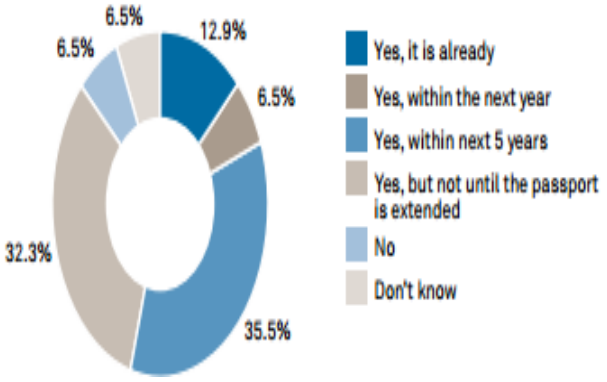


Fig. 11: AIFMD becoming an international brand



Source: Multifonds

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.[380] However, due to the requirement of case-by-case assessment,

[378] 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
[379] Jonathan Boyd, *Convergence of long only and hedge funds to accelerate under AIFMD – survey*, Investment Europe, 2012
[380] AIFMD, Recital 71

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.

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, cross-border fund distribution and funds by size is evaluated.

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 organizations.[381] 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[382], 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[383] 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

[381] IFIGlobal, supra at 359, 2014
[382] BNY Mellon, supra at 211, 2014
[383] IFIGlobal, supra at 359, 2014

market efficiency[384] in certain markets. For instance, larger fund outlets often ignore less liquid 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 one-size-fits-all approach. First, by leveling the playing field, AIFMD ensures fair and uniform treatment of AIFMs across EEA. Second, aggregation effects from smaller funds may cause systemic risks.[385] 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[386], that only systemically important hedge funds should be brought under regulatory oversight. The fact that smaller hedge funds managed to deleverage[387] in a more orderly manner than larger funds during the financial crisis suggests the aggregation effect is also exaggerated.

Impact on cross-border distribution

On the surface, one of the main benefits 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 a European context. As described by PWC survey[388] on institutional investors, AIFMD hands a competitive advantage to EU funds. There are also 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[389] 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

[384] 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.
[385] AIFMD, Recital 17
[386] G20, supra at 18, 2009
[387] 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 109, 2010, pp. 372
[388] *See* ref. 376
[389] *See* Ch. 5, 5.2 Compliance status and extraterritorial questions, Fig. 1.

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. 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.[390] 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.[391] 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.[392]

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 controversial 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.

[390] *See* Ch. 4, 4.6 Marketing
[391] 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
[392] OpenEurope, supra at 26, 2009

It was outlined by EC, that hedge funds do not always provide sufficient information for investors to assess the risks of their investments.[393]AIFMD remedies this situation. By allowing some knowledge on hedge fund strategies[394], 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.[395] 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 the impact of the directive on systemic risk remains equivocal. This conclusion emerges from that fact that despite 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 the risk of a backlash. Thus, the border for intervention should remain high.[396] Second, evidence[397] from the 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 pre-emptive 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.[398] Considering these point of views, it is no wonder the industry remains sceptical on the systemic risk provisions.

[393] EC, supra at 4
[394] To author's knowledge, AIFMD remains flexible in a sense that if a strategy is extremely information sensitive, minimal disclosure is enough.
[395] IFIGlobal, supra at 359, 2014, pp.9
[396] See also Ch. 4, 4.5 Leverage and systemic risk
[397] *See* Ch. 2, 2.4,1 Systemic risks
[398] Lo, supra at 120, 2008, pp. 5

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[399]and liquidity management practices, the directive ensures consistency. It is also notable that without comprehensive data on hedge-fund characteristics 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. [400] AIFMD 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 ideal[401] 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 a constant dialogue with the industry participants and as outlined by Dorsenfeir, voluntary deleveraging[402]. This should prevent chaotic fires sales which could stem from the imposition of outright leverage restrictions. As such, despite 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.

[399] 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. *See* IFIGlobal, supra at 359, 2013
[400] Lo, supra at 120, 2008, pp. 3
[401] 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 359, 2013
[402] *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 typically 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[403], available it was difficult 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 hard 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

[403] 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 excessive 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.

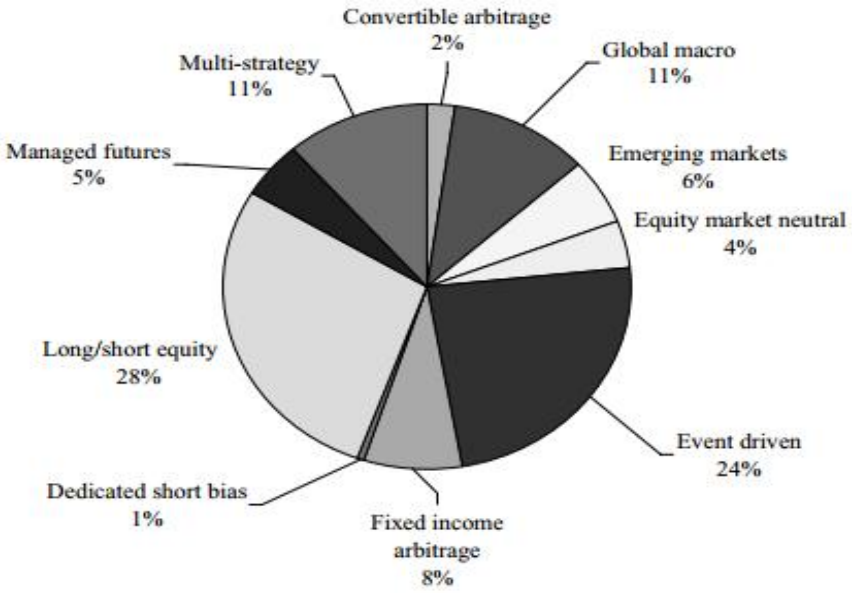
Thus, the ultimate conclusion of this thesis is that despite investor protection and systemic risk remaining convincing themes for hedge fund regulation, as it currently stands, the directive remains

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".[404] Despite righteous intentions, AIFMD does not fulfill the criteria.

[404] Lo, supra at 120, 2008

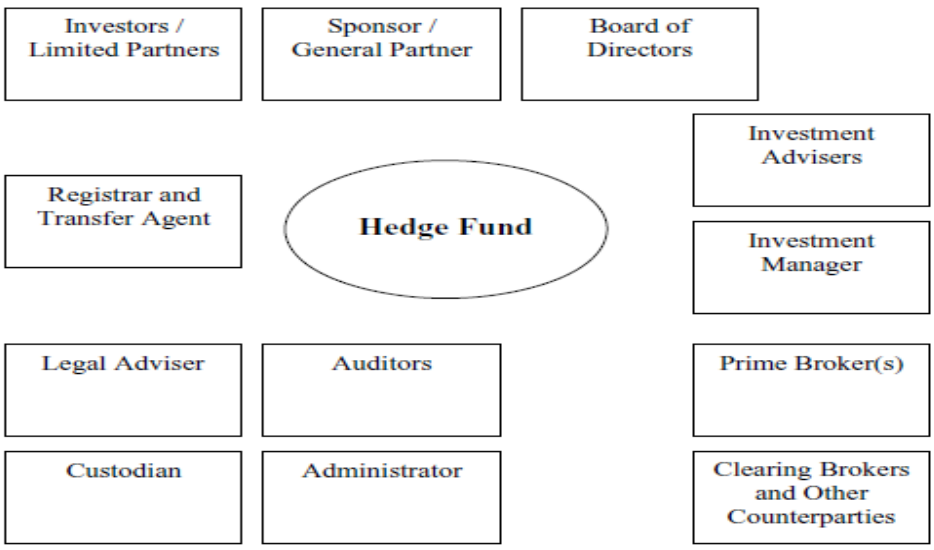
7. Appendices

Appendix 1: Breakdown of hedge fund strategies



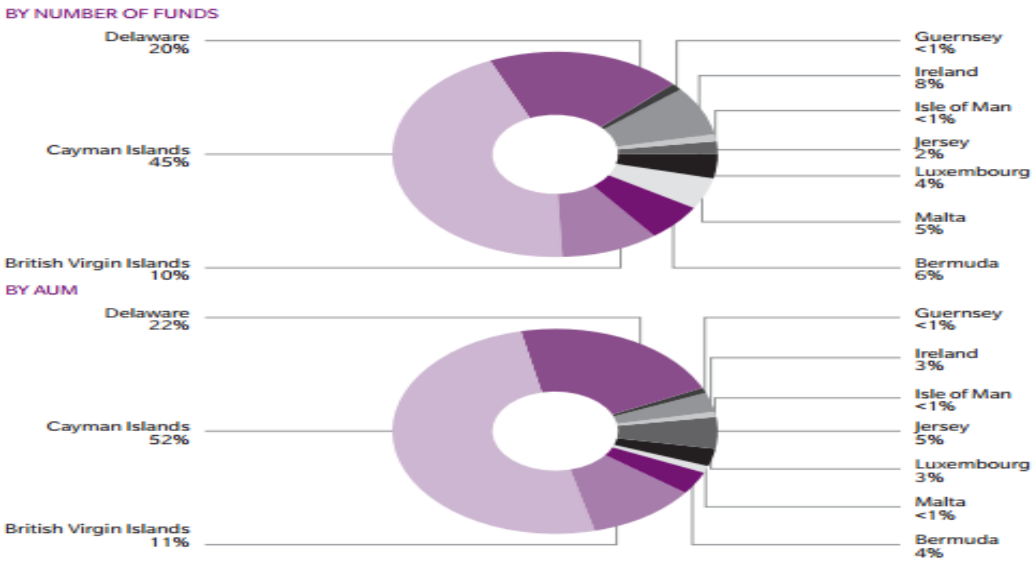
Source: Francois-Serge Lhabitant, *Handbook of Hedge Funds*, 2007, pp. 160

Appendix 2: Typical hedge fund network



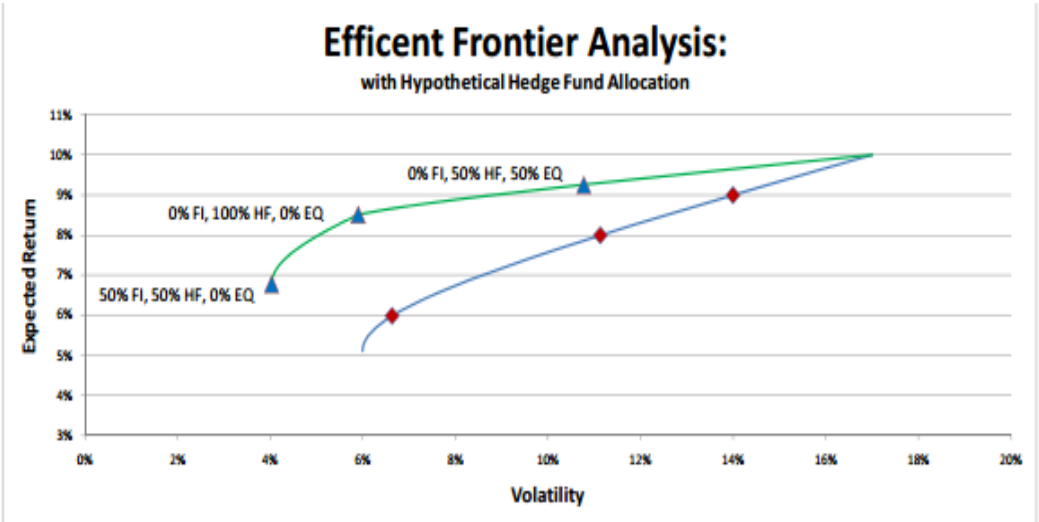
Source: Francois-Serge Lhabitant, *Handbook of Hedge Funds*, 2007, pp. 160

Appendix 3: Hedge fund domiciliation



Source: Oliver Wyman, *Domiciles of Alternative Investment Funds*, 2014

Appendix 4: Efficient frontier analysis with hypothetical hedge fund allocation



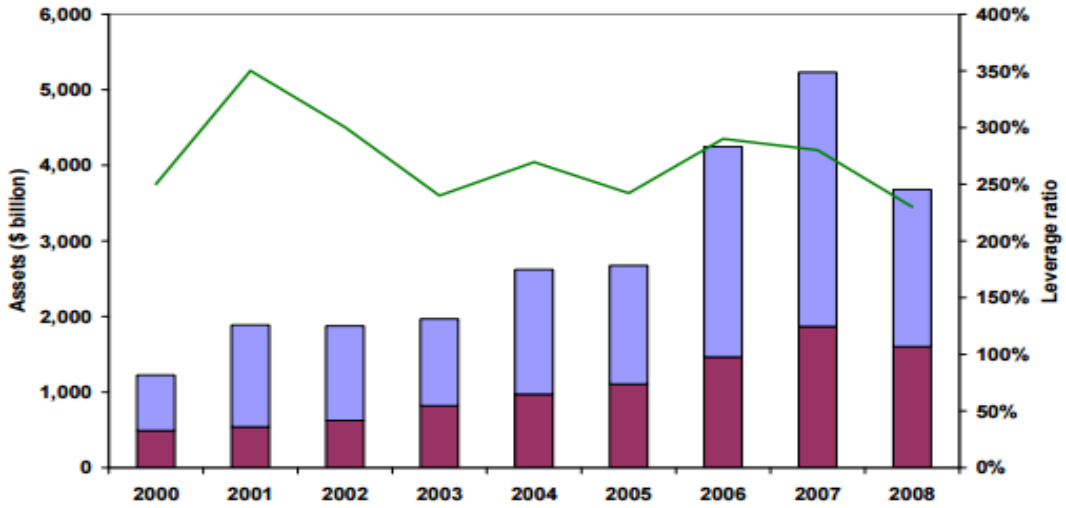
HF: Return of HFRI Fund Weighted Composite Hedge Fund Index 2000 to 2007

EQ: Return of SP500 2000 to 2007

FI: Return of US treasuries from 2000 to 2007

Source: John Linder, Neil Rue and Allan Emkin, *Hedge Funds in an Institutional Portfolio*, 2011 Pension Consulting Alliance Inc.

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



Source: Charles River Associates, *Impact of the proposed AIFM Directive across Europe*, 2009

Appendix 6: Selected hedge fund disasters and losses

Fund	Strategy	Year	Est. Loss (US$, mn)	What went wrong?
Amaranth	Multistrategy	2006	~6,400	Excessive exposure to energy prices
Long-Term Capital Management	Fixed-income arbitrage	1998	3,600	Excess leverage during Russian default crisis
Tiger Management	Macro	2000	2,600	Bad bet on yen lost US$ 2 billion
Soros Fund	Macro	2000	2-5,000	Major losses on Internet and technology stocks
Bear Stearns funds	CDOs	2007	1,565	Losses in subprime
Sowood Capital Management	Multistrategy	2007	1,500	Losses in loans and CDS
Fenchurch Capital	Fixed-income arbitrage	1995	1,264	Failed shift from US-only to European markets
Princeton Economics Inter'l	Macro	1999	950	Market losses, fraud
Vairocana Ltd.	Fixed-income arbitrage	1994	700	Market losses, bet on falling rates
Lipper	Convertible arbitrage	2001	700	Market losses, fraud
Askin Capital Management	Fixed-income arbitrage (mortgage-backed)	1994	660	Failed hedge, market losses, margin calls
Bayou Fund	Multistrategy	2005	657	Fraud
Lancer	Long/short equity	2003	600	Fraud
Beacon	Fixed income arbitrage	2002	500	Losses on mortgage derivatives, failed to mark to market
Manhattan Investment Fund	Long/short equity	1999	400	Fraud
MotherRock	Energy fund	2006	230	Loss from natural gas market
Global Systems Fund	Macro	1997	125	Wiped out by collapse of Thai baht
Dillon Reed Capital Management	MBS	2007	123	Losses in mortgage securities
Argonaut Capital Management	Macro	1994	110	Market losses
Basis Capital Yield Alpha Fund	Multistrategy	2007	80+	Losses in subprime
Maricopa Investment	Long/short equity	2000	59	Market losses, fraud
Cambridge Partners	Long/short equity	2000	45	Fraud
HL Gestion/Volter	Managed futures	2000	40	Market losses, regulatory intervention
Ashbury Capital Partners	Long/short equity	2001	40	Fraud
ETJ Partners	Relative value	2001	21	Market losses, fraud
Ballybunion Capital	Long/short equity	2000	7	Fraud

Source: Roger W. Ferguson, JR, Philip Harlman, Fabio Panetta and Richard Portes, *International Financial Stability*, Geneva reports on the World Economy 9, 2007

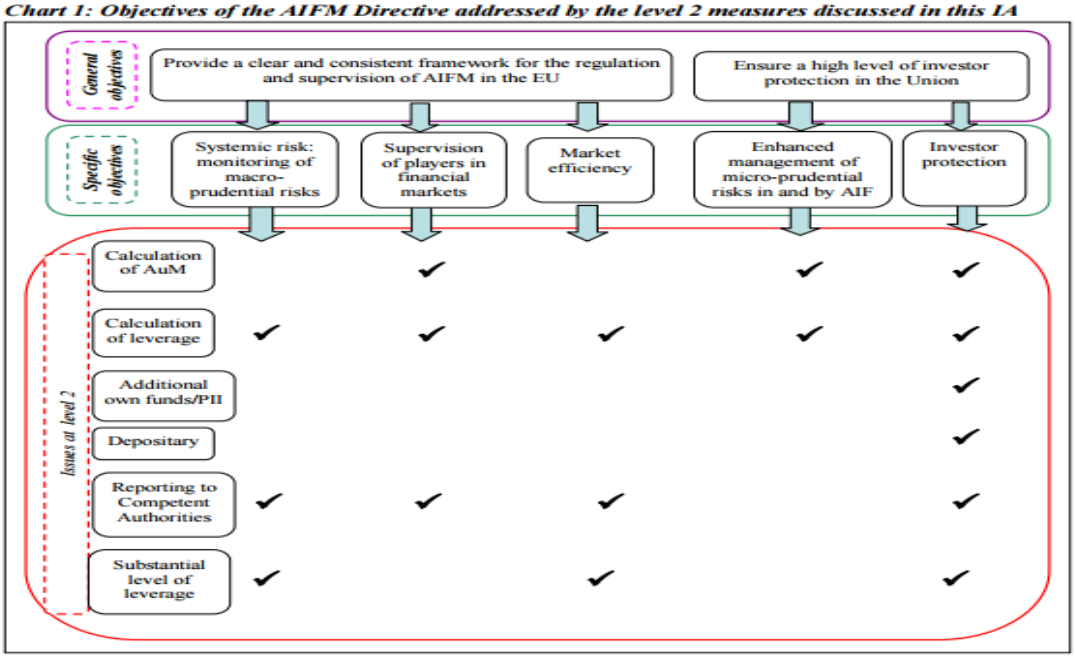
Appendix 7: AIFMD Timeline

Date	*Event*	
21 July 2011	Entry into force of the AIFMD (Art. 70 AIFMD)	
22 July 2013	Deadline for Member States to implement AIFMD in domestic legislation (Art. 66(1) AIFMD)	
22 July 2014	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).	**EEA entities**[92] Passport available, no national placement **TC entities**[93] No passport, national placement available
22 July 2015	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)	
22 October 2015	Having regard to the recommendations made by EMSA, the EC decides whether to extend the EEA passport to third country entities (Art. 67(6) AIFMD)	**EEA entities** Passport available no national placement **TC entities** Passport may be available national placement available
22 July 2017	The EC starts a review of the AIFMD (Art. 69 AIFMD)	
22 October 2018	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)	
22 January 2019	The EC decides, based on ESMA's advice, whether to terminate the national placement regime (Art. 68(6) AIFMD)	**EEA entities/TC entities** National placement may be terminated Passport available

Source: Dirk A. Zetzsche (ed.), *The Alternative Investment Fund Managers Directive*, Wolters Kluwer, Law & Business, 2012, pp. 1-19

Appendix 8: The objectives of AIFMD

Chart 1: Objectives of the AIFM Directive addressed by the level 2 measures discussed in this IA



Source: EC, *Commission staff working document; 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, depositories, leverage, transparency and supervision*, 2012

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

Own funds = (€5,000,000,000 - €250,000,000)*0.02% = €950,000

Own funds (for professional liability risks) = €5,000,000,000*0.01% = €500,000

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

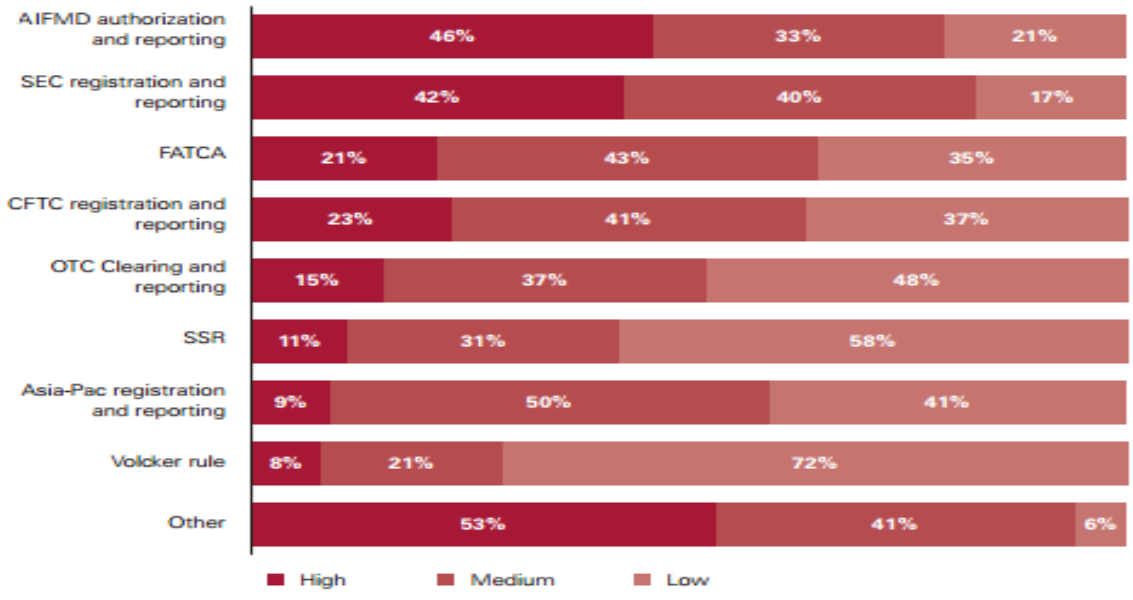
Source PWC, *The AIFM: Getting authorised*, 2013

Appendix 10: Marketing in EU under AIFMD

Scenarios	Access to EU market	AIFMD requirements
EU AIFM EU AIF	Via EU passport from July 2013/2014	Full regime of the AIFMD
EU AIFM Non-EU AIF	Via private placement from 2013 to 2018	Full regime of the AIFMD, except certain aspects of depositary requirements (+ local registration)
	Can use EU passport from 2015 to 2018	Full regime of the AIFMD
Non-EU AIFM	Via private placement from 2013 to 2015	Transparency and controlling interest requirements (+ local registration)
EU AIF	Can use EU passport from 2015 to 2018	Full regime of the AIFMD
Non-EU AIFM	Via private placement from 2013 to 2018	Transparency and controlling interest requirements (+ local registration)
Non-EU AIF	Can use EU passport from 2015 to 2018	Full regime of the AIFMD

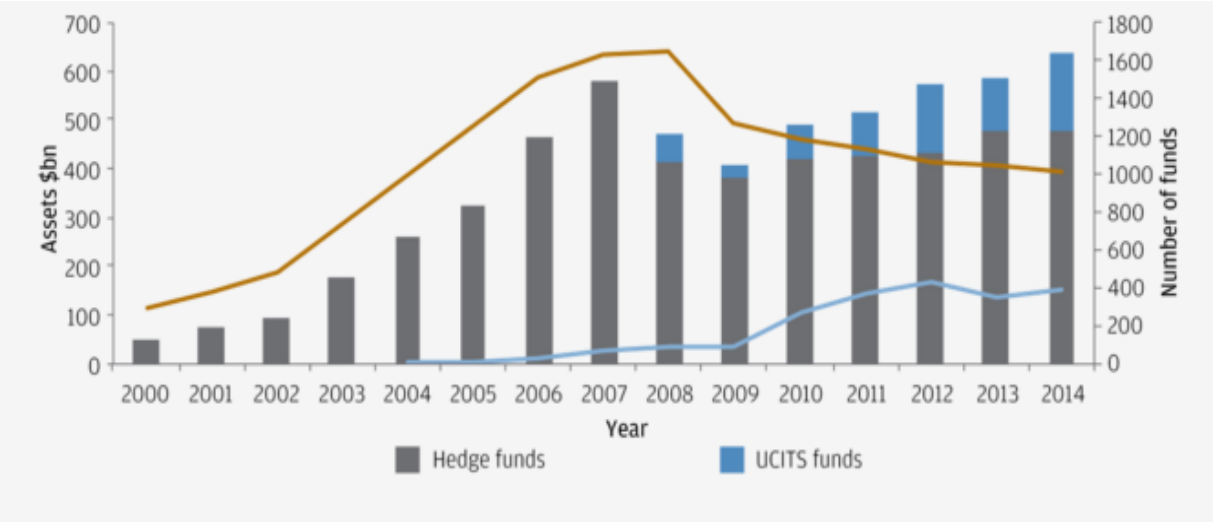
Source: PWC, *Strategy, marketing and distribution*, 2013

Appendix 11: Impact of regulations in terms of compliance costs



Source: KPMG International, *The cost of compliance*, 2013

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