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FINANCIAL MARKET REGULATION THROUGH THE AIFMD

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Acronyms

ABS Asset-Backed Securities.

AIF Alternative Investment Fund.

AIFM Alternative Investment Fund Manager.

AIFMD Alternative Investment Fund Manager's Directive.

AIMA Alternative Investment Management Association.

ATVP Slovene Securities Market Agency.

AUM Assets under management.

CIMA Cayman Islands Monetary Authority.

CRR Capital Requirements Regulation.

CSSF Commision de Surveillance du Secteur Financier.

ELTIF European Long-term Investment Fund.

ESMA European Securities and Markets Authority.

ESRB European Systemic Risk Board.

FATCA Foreign Account Tax Compliance Act.

FATF Financial Action Task Force.

FCA Financial Conduct Authority.

FDI Financial Derivative Instrument.

FiSMA Financial Services and Markets Act.

FSA Financial Services Authority.

FSOC Financial Stability Oversight Council.

GAAP Generally Accepted Accounting Principles.

HFWG Hedge Fund Working Group.

IFRS International Financial Reporting Standards.

IOSCO International Organization of Securities Commissions.

IPO Initial Public Offering.

LBIE Lehman Brothers International Europe.

MFN Most favoured nation.

MIFID Markets in Financial Instruments Directive.

MoU Memorandum of Understanding.

MSR Member State of Reference.

NAV Net Asset Value.

NCA National Competent Authority.

NCCT Non-Cooperative Country and Territory.

OECD Organisation for Economic Co-operation and Development.

PD Prospectus Directive.

PE Private Equity.

PII Professional Indemnity Insurance.

PRA Prudential Regulation Authority.

REIT Real Estate Investment Trust.

SE Societas Europaea.

SEC US Securities and Exchange Commission.

SPV Special Purpose Vehicle.

UCITS Undertakings for Collective Investment in Transferable Securities.

UCITSD Undertakings for Collective Investment in Transferable Securities Directive.

VAR Value-at-Risk.

VC Venture Capital.

Summary

The adoption of the Alternative Investment Fund Managers Directive marks a decisive step by the European Union in the regulation of financial markets. The financial crisis of 2008 has shown that fragmented regulation among Member States, which had been in force at that time, was not sufficient to address the possible systemic risk this sector of the economy could pose to the economy and investors' savings. Therefore, a policy shift provided the necessary impetus for drafting a better system, which had been in preparation in various committees and expert groups. The policy shift had also been signalled by the International Organisation of Securities Commissions and especially by the G20 decisions of 2008 and 2010.

The subject-matter of the AIFMD are managers of open- and closed-ended funds, which are not regulated by the UCITS or MiFID frameworks. It applies to managers, which are based in the EU, and managers outside the EU, who either manage EU established funds or market in the EU funds, which are established outside the EU. When a manager lawfully registers with the competent national authority in a Member State, he receives a 'passport', which enables him to market his funds in other Member States. In the spirit of the internal market, the authorisation in a Member State in compliance with EU Law gives him the permission to provide services to investors from other Member States.

It is disputed, whether such regulation is necessary to achieve the goal of a stable financial system and if it is able to produce tangible results. On the one hand, it was clearly conceived in a hurry and under pressure to exploit the public outcry over the financial crisis. On the other hand, it seized the opportunity to set a foot in the door of a segment of the financial system, which had previously escaped any attempt of reform and therefore opened the possibility to establish sensible rules. Still, new rules should be drafted carefully in order to not make the regulatory landscape unattractive.

The cornerstone of any successful fund is its compliance with the division of depositary and asset management functions. Only this strict division prevents the otherwise welcomed aggressive deal-making conduct of managers to turn against its own investors leading to unsolicited use of assets or other fraudulent activities. This problem is less of a concern when investors are mainly high net-worth individuals, who can more easily cope with losses and increases when institutional investors, eg pension funds, have a significant stake in the fund.

The AIFMD incorporates the most recent knowledge and puts into law all known best practices. The goal of this Master Thesis is to explore the AIFMD measures, their implementation, and impact on the financial system as a whole and in various jurisdictions, taking into account all peculiarities of said jurisdictions.

Zusammenfassung

Mit der Einführung der Richtlinie über die Verwalter alternativer Investmentfonds (AIFM-Richtlinie) beginnt ein neues Kapitel in der Regulierung von Finanz- und Kapitalmärkten in der Europäischen Union. Die Finanzkrise aus dem Jahre 2008 hat bewiesen, dass die fragmentierte Gesetzgebung in den Mitgliedstaaten, die damals die Regel war, nicht ausreichend ist, um Risiken für Investoren und das Finanzsystem auf sich nehmen zu können. Darum gab es einen Politikwechsel, der bessere Vorschriften hervor gebracht hat. Die waren schon seit einiger Zeit in Vorbereitung bei Expert-gruppen. Einen Politikwechsel signalisierte auch die Internationale Organisation der Wertpapieraufsichtsbehörden (IOSCO) und insbesondere die G20 in den Entscheidungen von 2008 und 2010.

Der Inhalt der AIFM-Richtlinie umfasst Verwalter von offenen und geschlossenen Investmentfonds, die nicht von UCITS oder MiFID Richtlinien geregelt werden. Es wird auf diejenige Verwalter angewendet, die aus der EU stammen oder aus einem Drittstaat und dabei entweder in der EU ansässige Investmentfonds verwalten oder in der EU nicht-EU ansässige Fonds vermarkten. Wenn ein Verwalter sich bei der entsprechenden Marktaufsichtsbehörde eines Mitgliedstaates registriert, bekommt er einen EU-Pass, der ihm ermöglicht seine Fonds in anderen Mitgliedstaaten zu vermarkten. Im Sinne des Binnenmarktes ermöglicht das Befugnis in einem Mitgliedstaat dem Verwalter den Zugriff zu Investoren in anderen Mitgliedstaaten.

Es ist umstritten, ob solche Regeln nötig sind, um das Ziel eines stabilen Finanzmarktes zu gewährleisten. Einerseits ist die Richtlinie in gewisser Eile eingeführt worden – mit dem Ziel die öffentliche Meinung gegenüber der Finanzindustrie zu nutzen und neue Vorschriften hervor zu bringen. Andererseits nutzte man die Gelegenheit um einen Fuß in die Tür zu setzen in ein Segment der Finanzindustrie, der vorher jeglichen Reformversuchen entkommen hatte und damit die Möglichkeit sinnvolle Vorschriften einzuleiten. Trotzdem müssen jegliche Reformen behutsam vorgenommen sein, um den Markt für Alternative Investmentfonds nicht negativ zu beeinflussen.

Der Grundstein aller erfolgreichen Investmentfonds ist die Trennung von den Aufgaben von Verwahrstellen und Vermögensverwalter. Nur solche strenge Trennung vermeidet, dass sich die aggressive Vorgehensweise der Verwalter nicht auf die Investoren richtet und dabei eine unaufgeforderte Nutzung von Vermögen erbricht. Das Problem war früher — als die Anleger meist vermögende Privatpersonen waren — nicht so wesentlich, hat aber wegen immer mehr Institutionellen Investoren an Bedeutung zugenommen.

Ziel dieser Masterarbeit ist die Regelung der AIFM zu erforschen, dessen Implementierung und Auswirkung auf das Finanzsystem, sei es international, auf der Ebene der EU oder in verschiedenen Mitgliedstaaten.

1 Common AIFMD measures

1.1 Introduction and principles

In response to the global financial crisis of 2008 the leaders of the G-20 convened at the London Summit in April 2009. They discussed the steps to be taken in order to re-establish positive economic developments. One of the key priorities was the stabilisation and proper functioning of the global financial system.¹ With regards to hedge funds and other unregulated funds it was agreed that proper regulation should be put into place.

The G-20 initiative was followed by the establishment of the Task Force on Unregulated Financial Entities by the IOSCO, which consulted a comprehensive study. The main findings of the study are the six high level principles of hedge fund regulation.

- Funds and managers should be subject to mandatory registration.
- Registered managers should be subject to organisational and operational standards, conflict of interest mitigation, conduct of business rules, investor disclosure and prudential regulation.
- Prime Brokers and banks, which provide funding or services to hedge funds, should be subject to registration and supervision. They should have proper risk management systems in place and monitor their risk exposure to hedge funds.
- Managers and prime brokers should provide regulatory information for systemic risk analysis purposes.
- Regulators should observe and encourage good practices.
- Regulators should maintain the exchange of information among themselves to facilitate the oversight of globally active funds and managers, and to help identify systemic and other risks in a cross-border context.²

¹G-20, London Summit – Leaders’ Statement (April 2, 2009) (<http://www.g20.utoronto.ca/2009/2009communique0402.pdf>).

²International Organization of Securities Commissions, Hedge Funds Oversight, Final Report (June 2009) (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf>) 8–16.

These principles are the skeleton of every recent alternative investment fund law. Consequently, the EU enacted the Alternative Investment Fund Manager Directive in 2011,³ which builds on these principles and extends them, most notably with rules on depositary liability⁴ and the passport regime.⁵ Member States had been obliged to transpose the AIFMD into national law⁶ by 22 July 2013. The Commission, in turn, issued several regulations with the most notable being Regulation 231/2013.⁷ An important interpreter of EU law is ESMA. Although its Technical advice⁸ and Q&A⁹ are not legally binding, the competences of ESMA under the AIFMD and the comprehensiveness of its guidelines make ESMA documents an important source of law.

1.1.1 Definition of Hedge Funds

There is no agreed and consistent definition as to which types of funds the term ‘hedge fund’ applies. Nevertheless, the IOSCO recognizes, that there are certain aspects of behaviour and properties, which are inherent to hedge funds.¹⁰ The following paragraphs provide indications that should be taken into account, when assessing if a certain fund is a hedge fund.

Mutual funds regulation, for the most part, imposes restrictions on funds with regards to borrowing and leverage. Hedge funds are not required to comply with any leverage and borrowing restriction. Therefore, many hedge funds will use leverage extensively. Although the use of leverage is not a necessary element of hedge fund behaviour, it still is a strong indicator, that the fund in question is a hedge fund.

The fee, which is paid to the manager, is calculated by a combination of a percentage of assets under management and a performance fee. The performance fee is a significant factor in the manager’s behaviour. The higher the return of a fund in a given year, the higher is the performance fee paid to the manager. These remuneration policies give rise to concerns over risk behaviour, because high yield investments are usually the ones which are more

³Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L174/1.

⁴See section 1.7.3.

⁵See section 1.2.

⁶See section 3.

⁷Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [2013] OJ L83/95.

⁸European Securities and Markets Authority, ESMA’s technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379 (November 16, 2011).

⁹European Securities and Markets Authority, Questions and Answers (July 21, 2014).

¹⁰International Organization of Securities Commissions, Hedge Funds Oversight, Consultation Report (March 2009) (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf>) 6–7.

risky. This gives incentive to only invest in risky assets. Were these performance fees not in place, the managers would be more risk averse.

Investors are usually only permitted to redeem their assets at certain pre-defined moments in time. This is dependent upon the policy of each fund and may include quarterly, semi-annually or annually redemptions. In the meantime, access to funds is restricted. In contrast, mutual funds offered to retail investors will have rules obliging the fund manager to provide frequent redemption.

A strong indication is also the use of manager's own funds. A significant portion of the assets of a fund may be comprised of assets of the manager. By investing its own money the manager shows his faith in the success of the fund and aligns his interests with the interests of investors. A significant portion of own funds is not usual for big retail funds.

The type of investment is one of the most prominent indicators of a hedge fund. The use of derivatives, short-selling, unlisted companies and other complex financial products are often tied exclusively to hedge funds. While some mutual funds may allow the use of these instruments to some extent, hedge funds are the ones, which have no restrictions to the amount of these instruments and techniques used.

1.2 Passport regime

The challenge the EU Passport has to solve is how to give AIFMs a way to access investors in the whole EU, while at the same time be regulated by an NCA, which has its competence in just a single Member State. Because the Treaties require the freedom to provide services and the free movement of capital across Member States, AIFMs have to be able to engage in their activities as if there were no internal borders. This also means there should be no additional financial burden imposed on AIFMs acting beyond their home or host Member State.

When the structure of a fund involves solely EU entities, a passport is not required. A properly authorised EU AIFM with an EU AIF under management is free to market its funds to professional investors¹¹ in all Member States, subject only to notification to the home NCA.¹² A passport is therefore only required, when the fund structure incorporates entities outside the EU, may it be a non-EU AIFM, non-EU AIF or both.

AIFMs, which are not subject to full AIFMD compliance (eg less AuM, as in section 1.3) do not enjoy the benefits of the passport. However, there is the possibility to opt for full AIFMD compliance, which in turn enables the use of the passport.¹³

¹¹ AIFM Directive (see n. 3) Article 4(1)(ag).

¹² *ibid.*, Articles 32-33.

¹³ Commission Implementing Regulation (EU) No 447/2013 of 15 May 2013 establishing the procedure for AIFMs which choose to opt in under Directive 2011/61/EU of the European Parliament and of the Council

1.2.1 National or private placement regime

Alongside the passport regime non-EU AIFMs may also use the private placement regime, which will coexist with the passport at least until 2019.¹⁴ These national regimes enable Member States' NCAs to independently conclude cooperation agreements with third countries, which enable non-EU AIFMs and non-EU AIFs to market themselves in the territory of that Member State.¹⁵

These cooperation agreements have the objective of securing proper systemic risk oversight and the observance of international standards.¹⁶ For example, non-EU AIFs may employ excessive leverage, of which risk is then born by investors in the EU. NCAs are therefore entitled to receive information about leverage of non-EU AIFs and to exercise their competences under the AIFMD.¹⁷ In detail, these agreements need to provide for the exchange of information for the purposes of supervision and enforcement, a way to obtain necessary information for performing NCAs duties under the AIFMD, and the ability for EU NCAs to carry out on-site inspections.¹⁸

However, these agreements are concluded between NCAs and not countries, and are therefore not international treaties. They do not create new legal obligations, but serve the purpose of efficient compliance with the AIFMD and other relevant law, such as the Data Protection Directive.¹⁹ ESMA helps to facilitate the signing of these agreements by providing template MoUs.²⁰ The passport regime will not come into effect until 22 July 2015, so until that moment the national placement is the only way to market non-EU AIFs.²¹ After that date, the national regime will be gradually phased out. On advice of the ESMA, the Commission may make such a decision in early 2019.²²

Additionally, such third country has to be FATF compliant. The national placement regime cannot be established, where the third country is on any of the NCCT lists.²³

[2013] OJ L132/1.

¹⁴Dirk A Zetsche and Daniel Litwin, "The AIFMD's Cross-Border Dimension and Third Country Rules" in Dirk A Zetsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 407.

¹⁵Lodewijk van Setten and Danny Busch, *Alternative Investment Funds in Europe* (Oxford University Press 2014) 118.

¹⁶eg the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.

¹⁷Zetsche and Litwin (see n. 14) 385.

¹⁸ESMA's technical advice, ESMA/2011/379 (see n. 8) 241.

¹⁹Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data [1995] OJ L281/31, Articles 25-26.

²⁰European Securities and Markets Authority, ESMA publishes signed AIFMD cooperation agreements (October 18, 2013) (<http://www.esma.europa.eu/news/ESMA-publishes-signed-AIFMD-cooperation-agreements>) visited on April 3, 2015.

²¹Setten and Busch (see n. 15) 117.

²²Zetsche and Litwin (see n. 14) 405.

²³AIFM Directive (see n. 3) Article 36(1)(c) and 42(1)(c).

The key feature of the national placement regime is that it exempts non-EU AIFMs from complying with the AIFMD in its entirety.²⁴ But the provisions on annual reporting, disclosure to investors and reporting to the NCA, where the AIFs are being marketed still apply. Additionally, where such fund is to acquire a controlling stake in a non-listed company, the requirements of Article 26(1) AIFMD have to be complied with. Other information, relevant under the AIFMD, is exchanged between the respective NCAs under the cooperation agreement in order to lessen the burden on non-EU AIFMs.

1.2.2 Passport conditions

The passport regime incorporates a management and a marketing passport. The management passport enables non-EU AIFMs to manage AIFs established in a Member State. In absence of an additional marketing passport, only the right to market AIFs in that Member State is granted. The marketing passport permits the marketing to investors in the whole EU in all possible scenarios:

- An EU-AIFM managing a non-EU AIF,²⁵
- a non-EU AIFM managing an EU-AIF,²⁶ and
- a non-EU AIFM managing a non-EU AIF.²⁷

Third country entities have to be assigned to a host Member State, the MSR. In situations, where either the AIFM or the AIF are EU-based, it is the home Member State of that AIFM or AIF. If both are based outside the EU, a determination of the MSR has to be made.²⁸ The NCA of the MSR will then issue control over the entities, in cooperation with the third country NCA.²⁹

A third country has to fulfil certain requirements in order to be included in the passport regime.³⁰ First, a cooperation agreement has to be concluded between the third country and the MSR or home Member State. Zetzsche and Litwin write that there is a difference between cooperation agreements for national placement regimes and agreements for the passport regime, because of the differing text in the AIFMD. In contrast, subsequent developments in the Regulation and ESMA documents lead to the conclusion both types of cooperation

²⁴ibid., Article 42(1)(a).

²⁵ibid., Article 35.

²⁶ibid., Article 39.

²⁷ibid., Article 40.

²⁸See Commission Implementing Regulation (EU) No 448/2013 of 15 May 2013 establishing a procedure for determining the Member State of reference of a non-EU AIFM pursuant to Directive 2011/61/EU of the European Parliament and of the Council [2013] OJ L132/3.

²⁹AIFM Directive (see n. 3) Articles 34-42.

³⁰Zetzsche and Litwin (see n. 14) 391.

agreements are essentially equal. In fact, the already concluded MoUs cover both regimes and do not distinguish between them.³¹ The second condition, the FATF compliance, is also equal to the national placement regime.

The third condition is that there is a tax agreement between the third country and the MSR, which fully complies with Article 26 of the OECD Model Tax Convention on Income and on Capital, in other words, an information exchange agreement.^{32,33} For marketing purposes, such an agreement has to exist with each Member State to be subject to marketing activities. The purpose of this provision is to enable an adequate level of information exchange, which is ‘foreseeably relevant ... to the administration or enforcement of the domestic law concerning taxes of every kind.’³⁴ So, for tax purposes, third countries are required to respect Member States’ laws in connection with the AIFMD. ‘Foreseeable relevance’ means the request for information does not give a basis for ‘fishing expeditions,’ where the authorities start an undirected and broad investigation with hopes of finding relevant information. In practice, a request may only be made for a specific taxable person and a tax authority may not request from another tax authority all information regarding its citizens. Relevance has to be established in advance, but it is not against the Convention, if the so obtained information proved irrelevant.³⁵

Further developments in this field will bring about an automated exchange of holders of accounts in other jurisdictions (the Common Reporting Standard). The term account, as used in the agreements, includes shares in a fund and AIFMs have the obligation to disclose the investors to its tax authority.³⁶ All major on- and offshore fund jurisdictions will have such a system put in place by the end of 2017 or 2018.³⁷ The United States will not participate in these agreements due to their own FATCA³⁸ information exchange system, which will include reciprocal reporting obligations and thus function in a similar way.³⁹

The fourth condition, which applies only to non-EU AIFMs, is the supervision of a MSR. The first step in fulfilling the condition is the determination of the MSR (see Table 1.1), which is the scope of Regulation 448/2013. A non-EU AIFM has to notify all NCAs, that

³¹ESMA MoU (see n. 20).

³²AIFM Directive (see n. 3) Articles 35(2)(c), 37(7)(f), and 40(2)(c).

³³Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital 2010 (Full Version) (OECD Publishing 2012) (<http://dx.doi.org/10.1787/9789264175181-en>) visited on April 14, 2015.

³⁴*ibid.*, M-62.

³⁵*ibid.*, C(26)-2.

³⁶Organisation for Economic Co-operation and Development, Standard for Automatic Exchange of Financial Account Information in Tax Matters (OECD Publishing 2014) (<http://dx.doi.org/10.1787/9789264216525-en>) visited on April 14, 2015, Section II.

³⁷Organisation for Economic Co-operation and Development, AEOI: Status of Commitments (March 6, 2015) (<http://www.oecd.org/tax/transparency/AEOI-commitments.pdf>) visited on April 14, 2015.

³⁸Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (United States, 2010).

³⁹OECD Automatic Exchange Implementation (see n. 37).

Table 1.1: MSR determination

Situation	Member State of Reference
Non-EU AIFM managing an EU AIF without passport.	The MS of the EU AIF.
Non-EU AIFM managing several EU AIFs in different MS without passport.	The MS with the most AIFs or the MS with the largest amount of AuM.
Non-EU AIFM with one EU AIF marketed in different MS.	The home MS of the AIF or one of the MS subject to marketing.
Non-EU AIFM marketing one non-EU AIF in different MS.	One of the MS subject to marketing.
Non-EU AIFM marketing several different EU AIFs	The MS, where the AIFM intends to develop effective marketing for most AIFs or the home MS of all AIFs.
Non-EU AIFM marketing several EU and non-EU AIFs	The MS, where it intends to develop effective marketing for most AIFs.

could potentially have competence.⁴⁰ These NCAs then have to inform ESMA and come to an agreement which of them is the MSR.⁴¹ Any subsequent change of the marketing strategy may not affect the choice of MSR except when it occurs within 2 years of the authorisation of the AIFM. A detailed procedure for the change of the MSR is made available.⁴² The rules of MSR determination mean the roles of MSR's will be held by MS, where large financial centres are situated. A specialisation of a smaller MS to provide these services is therefore less likely.

1.2.3 Conclusion

Financial services are closely regulated, which leads to additional issues, when regulations have to provide for the inclusion of the fundamental freedoms of the internal market. The goal of the passport regime, as the name suggests, is the attainment of an effective internal market for alternative investment funds, where AIFMs are free to market their

⁴⁰ AIFM Directive (see n. 3) Article 37(4).

⁴¹ Regulation 448/2013 (see n. 28) Article 1(7).

⁴² AIFM Directive (see n. 3) Article 37(4).

funds throughout the EU. The Directive goes beyond the internal market with the possibility to include non-EU entities. Although it means EU law has to be applied extraterritorially, third country entities are given an effective entry to the EU market and the free movement therein.

1.3 Calculation of assets under management

Article 3 AIFMD provides exceptions for its applicability and one exception is connected with the total value of assets under management (AuM). If it is under 100 million euros for leveraged open-ended funds or 500 million euro for unleveraged closed-ended funds with no redemption right for 5 years after the initial investment, there is no duty to register under the AIFMD. The directive further sets out to balance the lower levels of risk associated with these funds with the regulatory burden of the AIFMD, so some provisions still apply. This way, smaller funds are given a less stringent regime, which in turn entails less expenses, while providing adequate regulation.⁴³

So, small AIFMs are required to register with the Competent Authority of their home Member State to provide for macro-prudential monitoring, while micro-prudential monitoring is exercised on larger AIFMs.⁴⁴ During and after registration, information has to be provided regarding the AIFs under management; the investments strategies at the time of registration; the various instruments, which are being held by the AIF in order for the Competent Authority to be able to effectively monitor systemic risk; and if the thresholds of Article 3 AIFMD are being exceeded for more than three months.

The goal of the Regulation is to complement the Directive with more detailed provisions on this particular topic. The Directive leaves open all methods of calculating AuM. Without further specification, managers could be able to freely choose their method of calculating AuM. This would very likely lead to managers choosing such a method, which showed the lowest possible value, thereby watering down the goals of the Directive. This uncertainty would also lead to the use of a multitude of methods of calculation, thus prohibiting the establishment of a level playing field.⁴⁵ This is why the Regulations sets out to establish the way AuM is calculated.

⁴³European Commission, 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 (December 19, 2012) 9.

⁴⁴Dirk A Zetzsche, "Scope of the AIFMD" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive: European Regulation of Alternative Investment Funds* (Kluwer Law International 2012) 67.

⁴⁵Impact assessment, AIFM Regulation (see n. 43) 10.

1.3.1 Possible methods of calculation

There are three possible ways of calculating the AuM. The first one is the Net Asset Value (NAV). It uses the same methods as the valuation of companies. The amount of assets is subtracted by the amount of liabilities, while producing a balance sheet using national accounting requirements.⁴⁶ This is a convenient and cheap method of calculation for the AIFM, but it goes against Article 3(2) AIFMD, which provides that the calculation shall include assets, which are acquired through the use of leverage. This method is therefore contraindicative, because it subtracts assets, where it should have been adding them. Also, it could enable AIFs that incorporate big leverage on relatively modest assets to come under the radar of the AIFMD. The conflict with the AIFMD and the possible circumventions prevent this method to be viable.⁴⁷

The second possible method is the usage of total AuM using market value (premium) of financial derivative instruments (FDIs). With this method the liabilities are not deducted, thereby considerably widening the scope of AIFMD applicability with regards to leveraged funds. FDIs are valued at their market value, ie the amount the fund would receive if those instruments were sold. This method has the added benefit that it does not entail additional operating costs, as it can be easily deducted from NAV data, which funds are calculating on a daily basis.

The third method is the usage of total AuM where the underlying exposure of FDIs is used. Because the AIFMD requires the addition of assets acquired with leverage, the leverage embedded in FDIs has to be used. In the previous method the market value (premium) of a FDI was used, whereas in this method the exposure of a given FDI is included.⁴⁸ This method even further narrows the applicability of small AIFM provisions. It adequately addresses the situation, where AIFMD regulation could be circumvented by using lower priced FDIs instead of underlying assets, which would still yield the same return, albeit with a lower total AuM footprint. The downfall of this method is the increased cost of performing these calculations on a regular basis.

1.3.2 Conclusion

In the Regulation⁴⁹ the third method is used. While the first option has proven to be inadequate, the choice of the third method over the second one is justified by equally treating AIFs that incorporate FDIs and those who not, thereby removing incentives to use

⁴⁶US Securities and Exchange Commission, Net Asset Value (<http://www.sec.gov/answers/nav.htm>) visited on January 18, 2015.

⁴⁷Impact assessment, AIFM Regulation (see n. 43) 18.

⁴⁸For example, with an option to buy 100 shares, the market value of those underlying 100 shares is used, and not the market value (premium) of the single option.

⁴⁹AIFM Regulation (see n. 7) Article 2.

FDIs extensively. This view has also been backed by the ESMA.⁵⁰

The frequency of AuM calculation is determined by the proximity of AuM to the thresholds set out in the Directive.⁵¹ Once the value of AuM is close to a threshold, a Manager should make assessments more frequently.⁵² If the AuM exceeds the relevant threshold, the AIFM should determine, whether this breach is of a temporary nature. If it deems not so, the AIFM should start authorisation procedures within 30 days of that determination, which in turn result in full AIFMD compliance. If, on the other hand, such situation is of a temporary nature, this matter should be notified to the competent authority without delay. The AIFM should provide proper reasoning as to why it deems the breach of the threshold is only temporary. If a situation cannot be held that it would last for less than three months, a temporary nature cannot be established. Similarly, if after three months of the initial breach a new AuM calculation does not yield a result below the threshold, an application for authorisation has to be made. An exception in this situation can be made, if the AIFM can prove that the reasons for the breach have been mitigated or otherwise removed.⁵³

1.4 Calculation of leverage

The use of leverage is one of the most influential factors to systemic risk. It reduces the margin of error asset managers have and exposes the fund to liabilities, which are not backed by investors' assets. During the Great Recession, the fragmented oversight throughout the European Union has proven ineffective to make a systemic risk assessment for the entire EU and to properly curb rising levels of leverage throughout the financial industry. AIFMs have not been sufficiently transparent towards regulators on key data for effective macro-prudential risk assessment – the regulators neither knew about nor had proper instruments to manage leverage. The differences between national legislations meant some Member States had at least some reporting obligations in place, whereas other Member States had no reporting obligations at all, making effective EU-wide oversight impossible.⁵⁴ For this reason rules on monitoring leverage with the goal of managing systemic risks have been made exclusive competence of the EU.

National Competent Authorities are given the power to impose restriction on leverage upon a certain AIFM, where the stability and integrity of the financial system may be

⁵⁰Impact assessment, AIFM Regulation (see n. 43) 20.

⁵¹AIFM Directive (see n. 3) Article 3(2).

⁵²AIFM Regulation (see n. 7) Article 3.

⁵³*ibid.*, par. 4.

⁵⁴European Commission, Commission staff working document accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC, Impact Assessment (April 30, 2009) 18.

threatened. Upon consultation with the ESRB, the ESMA shall have the power to direct national Competent Authorities to issue restrictions on AIFMs and to specify the necessary remedies.⁵⁵

Leverage is defined by the AIFMD as any method by which exposure of an AIF is increased, may it be through borrowing of cash or securities, leverage originating in the invested derivatives or any other mean.⁵⁶ The method under which leverage is calculated is very important, because only a uniform method is able to give investors and NCAs proper information. The investors need comparable indicators to make investment decisions and NCAs need them to make a correct assessment of systemic risk, market risks, and risks to the growth of the economy.⁵⁷ Leverage information has to be reported to NCAs, if it is employed on a substantial basis. For each AIF the type of leverage has to be reported and its extent.⁵⁸ The legal term ‘leverage on a substantial basis,’ which requires this additional reporting obligations is said to exist for AIFs, which have their exposures calculated with the commitment method⁵⁹ at least three times greater than their NAV.⁶⁰

1.4.1 Possible methods of calculation

Generally, leverage is calculated by dividing the exposure of a fund with its NAV.⁶¹ While NAV is a rather uniform calculation, there are many options to calculating exposure. The first option is the VaR method. VaR is the maximum loss a fund may experience in a given time (mostly one day) and at a given confidence level (usually 99%).⁶² The VaR method of calculating leverage compares the VaR of the AIF with the VaR of an unleveraged reference portfolio. The ratio between both VaRs would be the exposure of an AIF. The use of VaR does not incur any additional cost to the AIFM, as it is already calculated on a regular basis for purposes of risk management and investor disclosure. Nonetheless, the VaR method gives questionable results. Despite being used with UCITS funds, their managers are still additionally required to calculate leverage. Also, shorting necessarily incorporates leverage, therefore it is not possible to construct an unleveraged reference portfolio. Although the VaR is important in risk management and investor disclosure, its implementation as a measure of exposure has too many drawbacks to be considered useful.⁶³

⁵⁵ AIFM Directive (see n. 3) Recitals 49-51.

⁵⁶ *ibid.*, Article 4(1)(v).

⁵⁷ Impact assessment, AIFM Regulation (see n. 43) 10.

⁵⁸ AIFM Directive (see n. 3) Article 24(4).

⁵⁹ See below.

⁶⁰ Peter McGowan, “The European Commission adopts AIFMD implementing regulation” (2013) 14(1) *The Journal of Investment Compliance* 19, 24.

⁶¹ AIFM Regulation (see n. 7) Article 6(1).

⁶² Christophe Pérignon and Daniel R Smith, “Diversification and Value-at-Risk” (2010) 34(1) *Journal of Banking & Finance* 55, 1.

⁶³ Impact assessment, AIFM Regulation (see n. 43) 23.

The second option is the gross method.⁶⁴ The exposure of an AIF equals the sum of all assets with the addition of the absolute values of liabilities. This means liabilities are counted towards exposure and not subtracted.⁶⁵ Derivatives are valued by the market value of the underlying asset and not the market value of the derivative. The gross method gives the highest result of all methods and despite not excluding certain arrangements (discussed below) it can serve as a tool for NCAs to assess the overall leverage of AIFs on a macroeconomic level.

The third option is the commitment method.⁶⁶ The exposure generated by derivatives, cash, and borrowings is calculated the same as with the gross method. The difference is some netting and hedging arrangements are being excluded, because although they may be constructed with derivatives or other leveraged instruments, their combined effect on exposure is lower than the exposure of their individual parts. If, for example, an AIF owns stock and buys put options on the same stock, the overall exposure would be lowered, because the put option offsets the loss a stock could incur.⁶⁷ Similarly, a $\delta = 0$ portfolio would show no exposure under the commitment method while having a very large exposure under the gross method. The commitment method is widely used with UCITS funds.

The fourth option is the advanced method, which is proposed by the ESMA. The AIFM itself is said to have the best position of calculating exposure, therefore the reporting obligation should be of the gross method, the commitment method and the AIFM's own method, if the AIFM deems it would give a better result.⁶⁸ The downside of this method is that it could yield artificially low results, if the AIFMs would set themselves out to lower their regulatory oversight. In the end, this method was rejected, because the primary purpose of these metrics is not to show the leverage profile in light of investor protection, but to provide a metric for NCAs to determine systemic risk, which is only possible, if the methods are applied in the same way for all AIFMs and the data is comparable.⁶⁹

The method put into law is a combination of the second and third options.⁷⁰ Exposure is calculated by both the gross method and the commitment method. In light of the ESMA recommendations, the Commission may require an additional method by 21 July 2015, if it deemed necessary.⁷¹

⁶⁴ AIFM Regulation (see n. 7) Article 7.

⁶⁵ Impact assessment, AIFM Regulation (see n. 43) 22.

⁶⁶ AIFM Regulation (see n. 7) Article 8.

⁶⁷ Impact assessment, AIFM Regulation (see n. 43) 22.

⁶⁸ *ibid.*, 23.

⁶⁹ *ibid.*, 25.

⁷⁰ Frank Dornseifer, "Hedge Funds and Systemic Risk Reporting" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 560.

⁷¹ AIFM Regulation (see n. 7) Article 6(2).

1.5 Additional own funds and professional indemnity insurance

Originating from the Basel II Accords, financial institutions have to mitigate operational risk and AIFMs are no exceptions. These rules are found in Basel II for banks, Solvency II for insurers and for UCITS managers.⁷² Operational risk is defined as ‘risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.’⁷³ However, this definition does not include losses, which are incurred due to adverse market conditions, where the manager has done proper due diligence on the investment.⁷⁴ The law is particularly focused on one part of operational risk – professional liability risk.⁷⁵ It is the risk ‘of loss or damage caused by a relevant person through the negligent performance of activities for which the AIFM has legal responsibility.’⁷⁶ Some examples of such risk include:

- loss of documents, which relate to the legal title of the AIF’s assets;
- misleading statements and misrepresentations made to the AIF or the investors;
- legal and regulatory non-compliance;
- a breach of duty of skill and care, fiduciary duties, or a breach of confidentiality;
- not having a mechanism for the prevention of fraudulent actions in place;
- improper asset valuation, business disruption, and other similar failures.⁷⁷

If, in these situations, a loss occurred, the investor or the AIF would have a claim against the AIFM. Due to their size in relation to AIFs it is not expected AIFMs could have the necessary funds to cover these losses. For this reason, the AIFMD gives two options, either AIFMs set aside additional funds, which are sufficient enough to cover losses, or obtain a professional indemnity insurance.⁷⁸

If the AIFM chooses to employ own funds to cover professional liability risks, the amount provided should not be less than 0.01% of AuM. This amount includes assets acquired through leverage and the market value of all derivatives. After 3 years of successful operation

⁷²Gregory Walker, “The Liability Insurance of the AIFM” in Dirk A Zetsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 205.

⁷³Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1, Article 4(1)(52).

⁷⁴AIFM Regulation (see n. 7) Recital 33.

⁷⁵*ibid.*, Article 13(1).

⁷⁶*ibid.*, Article 12(1).

⁷⁷*ibid.*, Article 12(2).

⁷⁸AIFM Directive (see n. 3) Article 9(7).

with properly recorded historical loss data the NCA may lower the required amount to 0.008% of AuM. If not, this amount may also be raised above 0.01% of AuM.⁷⁹

If professional liability risks are to be covered by indemnity insurance (PII), the covered amount should at least be 0.7% of AuM for an individual claim and 0.9% of AuM for aggregate claims per year. Any excess shall be covered by additional own funds.⁸⁰ The required amounts are higher for insurance, because it is perceived to be more uncertain than own funds.⁸¹

According to some,⁸² the values for PII and own funds are ill-conceived. Insurers usually require an excess of 1%, which is covered by the AIFM, ie from own funds. If the insured amount is 0.9% of AuM, a 1% excess on that amount equals 0.009% of AuM. This is close to the amount an AIFM has to put aside if it opts for own funds instead of PII. So, by choosing PII the AIFM will in practice have to set aside own funds in the same amount it would have if it opted to use own funds. AIFMs therefore have no incentive to use PII.

1.6 Transparency

Rules on transparency and disclosure govern the relationship between investors and the AIFM. The goal is to protect the investor from unnecessary risk and to achieve this goal, certain obligations are imposed upon AIFMs. Throughout the investing landscape, providing good disclosure is key to a well-functioning capital market. Since the US Securities Act of 1933 there has been a tightly regulated procedure to disclose important information before a purchase of securities may be carried out. These principles of disclosure have spilled over on investment fund regulation. And such as with a purchase of stock, disclosure obligations can be divided in two parts: disclosure before the investment and reporting obligations during the timespan of the investment.

The AIFMD provides detailed rules as to what has to be disclosed to the investor prior to his investment.⁸³ First of all, the ‘information should be clear, reliable, readily understandable and clearly presented.’ This also precludes window-dressing activities.⁸⁴ The contents of disclosure should comprise of the objective or the AIF and investment strategies of the AIF. The investment strategies have to include the type of invested assets, any techniques of investing, the use of leverage, and all connected risk that may arise out of those strategies. A change of the maximum leverage threshold has to be notified to investors without undue

⁷⁹ AIFM Regulation (see n. 7) Article 14.

⁸⁰ *ibid.*, Article 15.

⁸¹ *ibid.*, Recital 35.

⁸² Walker (see n. 72) 209.

⁸³ AIFM Directive (see n. 3) Article 23.

⁸⁴ AIFM Regulation (see n. 7) Recital 124.

delay.⁸⁵ Next, all legal entities, comprising the fund structure, and their interplay have to be described. Together with a choice of law and legal remedy provisions with regards to the jurisdiction(s) of the AIF and AIFM, the investor should be informed of the legal actions that are available to him against the AIF or AIFM. The identities of all the participants in the functioning of the fund have to be disclosed: the AIFM, the AIF, the depositary, the auditor, prime broker, and any other service provider, together with any delegation arrangements. Further, a description of the procedure of asset valuation has to be provided, including for hard-to-value assets. The investor has to be informed of his redemption rights both in normal and exceptional circumstances, together with a description of the liquidity management systems put in place.⁸⁶ Anytime the liquidity management changes, any new arrangements are put in place, or a side pocket is created, investors have to be immediately notified.⁸⁷ Any fees, which will or might be imposed to the investor have to be disclosed. As mentioned in section 1.9, a disclosure of all types of preferential treatment that is not given equally to all investors has to be presented to assure the equal treatment of investors. To enable the assessment of performance, the latest annual report has to be provided together with latest the NAV and share price. If available, historical data on fund performance has to be disclosed.

Because AIFs issue securities to investors, it has to be observed, whether general securities law obligations of providing a prospectus, such as the PD, apply.⁸⁸ In this case, all requirements of the AIFMD have to be observed in addition to the requirements of the PD.⁸⁹ The PD exempts its applicability to ‘collective investment undertakings other than the closed-end type,’⁹⁰ which means that open-ended AIFs are not required to publish a prospectus in accordance with the PD. In addition, the AIFMD does not include a template approach for prospectuses and key investor information, as it is known from UCITS and PD. Member States are free to impose such rules on their own, but only for retail investors.⁹¹ If there are no disclosure obligations in the PD or the MiFID (eg with professional investors), the disclosure requirements of the AIFMD still apply.

⁸⁵ibid., Article 109(2).

⁸⁶See sections 1.10.1 and 1.10.

⁸⁷AIFM Regulation (see n. 7) Article 108(3)(b).

⁸⁸Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64.

⁸⁹AIFM Directive (see n. 3) Article 23(3).

⁹⁰Prospectus Directive (see n. 88) Article 1(2)(a).

⁹¹Dirk A Zetzsche and David Eckner, “Investor Information, Disclosure and Transparency” in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 335.

1.6.1 Annual reports

The issuance of annual reports under the AIFM regulatory regime is the most important instrument for investor protection.⁹² They ensure investors remain properly informed about the AIF's financial conduct, performance, and risk profile.⁹³ The data contained in the annual report should be materially relevant, reliable, comparable, and clear.⁹⁴

The minimum requirements for the content of an annual report are a balance-sheet, an income and expenditure account, a report on the activities, any change in data that is subject to disclosure, and the sum of all remunerations paid to AIFM staff, broken into fixed and variable pay. Additionally, the sum of remunerations paid to senior management and to staff with a large impact on the risk profile of the AIF has to be included.^{95,96}

In cases, where an AIF is a legal person, general rules on annual reports have to be observed, such as the Company Law Directives. In general, the Directives leave open for Member States to impose different accounting rules for financial institutions, so for a definitive answer Member States' national law has to be observed.⁹⁷ In light of this, the most important question is, which accounting standards are to be applied. The possibilities are national GAAP and IFRS, but some non-EU AIFMs would want for US GAAP standards to be applicable. The AIFMD itself does not prescribe any accounting standard, but there are rules in the TPD⁹⁸ and the IFRS Regulation,⁹⁹ which require the use of IFRS for AIFs, which are listed on regulated markets. For non-listed AIFs, national rules on accounting standards apply,¹⁰⁰ and Member States are free to require national GAAP, IFRS, or even allow US GAAP, as long as the general principles of the AIFMD are observed.¹⁰¹

⁹²Zetzsche and Eckner, "Investor Information, Disclosure and Transparency" (see n. 91) 342.

⁹³Setten and Busch (see n. 15) 99.

⁹⁴AIFM Regulation (see n. 7) Article 103.

⁹⁵AIFM Directive (see n. 3) Article 22(2).

⁹⁶For a more detailed explanation see AIFM Regulation (see n. 7) Articles 104-107.

⁹⁷Zetzsche and Eckner, "Investor Information, Disclosure and Transparency" (see n. 91) 346-347.

⁹⁸Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38, Article 4(3).

⁹⁹Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards [2002] OJ L243/1, Article 4.

¹⁰⁰ESMA's technical advice, ESMA/2011/379 (see n. 8) 218.

¹⁰¹Zetzsche and Eckner, "Investor Information, Disclosure and Transparency" (see n. 91) 348.

1.7 Depositaries

1.7.1 Introduction to the importance of the depositary function

At the moment of the Lehman Brothers collapse, its European hub Lehman Brothers International Europe (LBIE) had been the custodian for securities, which were traded in European time zones and belonged to other Lehman group entities and their clients. This structure had provided the group with economic efficiencies, but its problem of insufficient asset segregation materialised, when LBIE went into administration.¹⁰²

The structure was known as Rascals and worked in a way that when LBIE acquired a security on behalf of an affiliate, it entered into a security lending contract (a repo for debt and a stock loan for equity), where the affiliate lent the security to LBIE. The affiliate had a claim for the security and LBIE had a claim for the purchase price. When the security was subsequently sold to the street (ie third parties), both claims ceased to exist. The Rascals mechanism was invisible to third parties, they all interacted with their respective regional hub, but the regulatory reporting and balance sheets reflected the beneficial ownership of those shares. For debt, repos were entered into automatically without persons signing contracts. The timeframe of the repo was only one day and the value was the marked to market price of the security on that day.¹⁰³ On the following day a new repo was entered into automatically with a new price.

The collapse of Lehman resulted in the termination of the automatic procedure on 23 September 2008, thereby leaving the affiliates with no concluded contract for the securities after the last repo had expired.¹⁰⁴ In the insolvency procedure *In re Lehman*, the administrators of LBIE argued the other Lehman affiliates had no claim for these securities. The decision of the Court did establish a claim of affiliates for those securities, but the nature of the claim was personal and not proprietary. This meant, in the insolvency procedure, the affiliates were not entitled to the securities in full, but merely *pari passu* (and therefore pennies to the dollar) with ordinary creditors.¹⁰⁵

In re Lehman has shown what may happen if there is no proper depositary structure in place. Proper safekeeping of assets would have established stable contractual relationships, which would have resulted in the return of the affiliates assets to their legitimate owner in cases of insolvency. This is only possible, when the depositary is a third person, who is at arm's length with all involved parties and with the legal position of the entrusted assets enabling a proprietary claim. Any deviation of those principles could lead to misappropriation

¹⁰²*In the matter of Lehman Brothers International Europe* [2010] EWHC 2914 (Ch), [2010] All ER 232 [7].

¹⁰³Had there not been daily renewals of repo contracts, parties would have been obliged to adjust the amount of securities according to the margin amount.

¹⁰⁴*In re Lehman* (see n. 102) [9-23].

¹⁰⁵*ibid.* [315].

or loss of securities, particularly in an insolvency procedure.

1.7.2 Depositaries pursuant the AIFMD

The principles put forward in the previous section were included in the AIFMD. A depositary has to be separate from the AIFM and AIF. Although this principle is common practice for hedge funds, where these functions are assigned to investment firms, credit institutions or UCITSD custodians,¹⁰⁶ the AIFMD extends the obligations to PE and VC funds. With those funds, it is possible to appoint a single person (eg lawyer, notary) to perform as a depositary, if the Member State implemented this feature into law.^{107,108}

First and foremost, a depositary has to be entrusted with the assets of the AIF for safekeeping. The depositary should hold in custody all financial instruments capable of being registered 'in a financial instruments account opened in the depositary's books.'¹⁰⁹ Records have to be kept to enable, at any time, the distinguishment of AIF's assets from other assets held in custody by the depositary.¹¹⁰ These financial instruments are transferable securities, money market instruments and units of collective investment undertakings. If these instruments are subject to a collateral arrangement, where the title has been transferred to the collateral taker, they are put outside the depositary's custody.¹¹¹ Conversely, if the AIF is the collateral taker, the instruments are to be entrusted to the depositary for safekeeping. In addition to these assets, all financial instruments capable of physical delivery to the depositary have to be kept in custody.

There are two types of depositary duties relating to assets. The first type is the aforementioned holding in custody. The second type is used for assets, which are neither capable of being held in an account of the depositary nor physically held in custody. For these, the depositary has oversight duties – the duty to verify the ownership of those assets and to maintain records. Examples of such assets include derivatives, cash deposits, shares of privately held companies and interests in partnerships.¹¹² The records have to be kept up to date,¹¹³ which is facilitated by AIFM's obligations to provide the necessary information on an ongoing basis¹¹⁴ and the possibility of the depositary to conduct on-site visits at service

¹⁰⁶ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] OJ L309/32, Article 23.

¹⁰⁷ AIFM Directive (see n. 3) Recitals 32-34.

¹⁰⁸ See section 3.2.4.

¹⁰⁹ AIFM Directive (see n. 3) Article 21(8)(a)(i).

¹¹⁰ Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [2006] OJ L241/26, Article 16.

¹¹¹ ESMA's technical advice, ESMA/2011/379 (see n. 8) 156.

¹¹² AIFM Regulation (see n. 7) Recital 103.

¹¹³ AIFM Directive (see n. 3) Article 21(8)(b).

¹¹⁴ AIFM Regulation (see n. 7) Article 90.

providers.¹¹⁵ Special procedures have to be put in place, which prohibit any changes in the legal status of the assets without the depositary being informed.

There could be situations, where national law prescribes financial instruments have to be registered directly with the issuer or agent. The assets are then not held in custody with the depositary, but he nevertheless has to keep records.¹¹⁶

The depositary has to monitor cash flows. He has to make sure separate cash accounts are opened and all payments of investors are properly booked in these accounts.¹¹⁷ Monitoring tasks are extended to all subscriptions and redemptions, the monitoring of the NAV, and all other operations with AIF's stock.¹¹⁸

For non-EU AIFs a depositary shall be established by the AIFM's choice either in the AIF's country of establishment or the MSR. This is in contrast to the requirements for EU AIFs, where there are no options to choose from and the only permitted location of the depositary is the home Member State of the AIF.¹¹⁹ For having the depositary in the MSR an effective passport regime has to be put in place.

Depositary's duties may be split onto safekeeping obligations and oversight obligations.^{120,121} These in turn have to be performed observing the duty of loyalty and avoiding conflicts of interest. Loyalty is shown by acting in the interest of the AIF and its investors in an honest, fair, professional and independent way.¹²² The management of conflicts of interest is engrained throughout the AIF regulatory landscape.¹²³

The importance of depositary regulation especially comes into light in integrated financial institutions. The AIFMD mandates a functional and hierarchical separation of tasks performed by the *in house* depositary and all other operations of the integrated financial institution. Otherwise, due to high levels of interconnection, there might be a conflict of interest between the AIF and its investors.

1.7.2.1 Primer brokers

If the depositary duties are to be performed by the prime broker, its operations as a depositary have to be functionally and hierarchically separate from its prime broker tasks. In connection, potential conflicts of interest have to be 'properly identified, managed, monitored and

¹¹⁵ESMA's technical advice, ESMA/2011/379 (see n. 8) 165.

¹¹⁶AIFM Regulation (see n. 7) Article 88(2).

¹¹⁷AIFM Directive (see n. 3) Article 21(7).

¹¹⁸*ibid.*, Article 21(9).

¹¹⁹Sebastiaan Hooghiemstra, "Depositary Regulation" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 415-416.

¹²⁰*ibid.*, 417.

¹²¹But only safekeeping duties can be subject to delegation.

¹²²AIFM Directive (see n. 3) Article 21(10).

¹²³See section 1.8.

disclosed to the investors of the AIF¹²⁴

Primer brokers are the key players in facilitating hedge fund investment tactics. They provide leverage, enable trading of derivatives and short selling of securities. In return, prime brokers demand collateral on all assets of the AIF.¹²⁵ These assets are further used for securities lending. The close connection between the AIF and the prime broker creates difficulties in properly performing the function of a depositary.

To better understand problems arising therewith, we must first find there are three models of the relationship AIF – prime broker – depositary. The first model is the traditional hedge fund model developed in the US and UK. There, the AIFM is closely knit with the prime broker and the depositary has a lesser role. Assets are entrusted to the prime broker and the depositary has no oversight over all AIF assets and cannot influence the AIFM. There is no main depositary that holds all assets, custodians are appointed at will by the AIFM and hold only those assets that have explicitly been entrusted. Oversight is being carried out by the board of the AIFM and the fund administrator.

The second model is the depositary model, which is predominant in Switzerland, Liechtenstein and France. This model originates from funds, which had originally operated in the framework of a bank and were then made independent. Those banks had a separate depositary who would keep all assets of the AIF and that depositary became independent when fund management was spun off by banks. The prime broker in this scenario is appointed by the depositary and acts as its sub-custodian. Also, the depositary is liable for the loss of assets by the prime broker. This model is more complex than the first, but provides greater safety for investors.

The third model is the hybrid model used by Ireland, Germany and Luxembourg. As the name suggests it is a mix of both previous models. Both the AIFM and the depositary may appoint a prime broker. The depositary is not obliged to hold all assets, but only those that were not transferred to the prime broker. In this case, when the prime broker is unable to return the assets, the depositary is not made liable.¹²⁶

The AIFMD harmonises the AIF – prime broker – depositary relationship. The first model will cease to exist, the second model will be somewhat relaxed and the hybrid model expanded (by cash flow monitoring and liability for sub-custodians).¹²⁷ We will see whether this levelling of the playing field can bring benefits to the industry and the investor.

¹²⁴ AIFM Directive (see n. 3) Article 21(4).

¹²⁵ Dirk A Zetzsche, "(Prime) Brokerage" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive: European Regulation of Alternative Investment Funds* (Kluwer Law International 2012) 491.

¹²⁶ *ibid.*, 494-500.

¹²⁷ *ibid.*, 525.

1.7.3 Depositary's liability

One of the most prominent and controversial features of the AIFMD is the depositary's liability. In general, depositaries are liable for the loss of financial instruments held in custody. Not for realised losses in their value, but for their complete loss, ie the loss of legal title in the securities. Moreover a loss is only relevant if it has permanent effect; so in cases, where the unavailability of assets lasts for a limited time, there is no liability for loss.¹²⁸ The most common situations where such a loss occurs would be cases of fraud and insolvency procedures. As a result of *In re Lehman* any sub-custodian is made liable in a similar way. For a delegation of this kind a special contract has to be made between the depositary (custodian) and sub-custodian, which gives AIFs the right to claim losses from that sub-custodian – a third party right.¹²⁹ The effect is the same as it were if the sub-custodian had been made trustee of the AIF under English law. The Directive in this respect follows French legal principles, which do not recognise trusts, but still creates a trust-like structure of liability, where the AIF always has a strong claim for its assets. The sub-custodian is strictly liable, whereas the depositary is discharged from liability if he 'exercised due skill, care and diligence and that the specific requirements for delegation are met.'¹³⁰ In any case there is no liability if the loss resulted 'from an external event beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.'¹³¹

It can well be said that liability for sub-custodians has been put in place mainly because of *In re Lehman*. It is also one of the main points of AIFMD criticism.¹³² Still, it serves to cover situations, which had not been envisioned prior the great depression and time will tell, whether they are fit to accomplish their goal.

1.8 Conflict of interest management

Special attention has been given to mitigating conflicts of interests. AIFMs most often employ prime brokers, out of which a lot of conflicts may arise.¹³³ Apart from the previously mentioned difficult asset segregation, prime brokers are very dependant on their clients. This creates the risk that a primer broker may put the interests of the AIFM before the interests of the AIF in order to maintain the AIFM as a client. Similar concerns can be found

¹²⁸ Christophe Clerc and Jacques Deege, "The AIF Depositary's Liability for Lost Assets" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 453.

¹²⁹ AIFM Directive (see n. 3) Recital 45.

¹³⁰ *ibid.*, Article 21(13).

¹³¹ AIFM Regulation (see n. 7) Recital 113.

¹³² John Siena, "Depositary Liability – A Fine Mess and How to Get Out of It" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012).

¹³³ See section 1.7.2.1.

with auditors and administrators, which are essential for safeguarding investors' interests, but are heavily dependant on the AIFM's benevolence to make use of their services.¹³⁴

The duties of AIFMs include an obligation to 'take all reasonable steps to avoid conflicts of interest.'¹³⁵ When conflicts of interest cannot be avoided, they have to be disclosed and continuously monitored. This obligation extends to relations between (i) persons linked to the AIFM and persons linked to its AIF, (ii) AIFs under management of the same AIFM, (iii) the AIF and another client of the AIFM, (iv) persons linked to an AIF and persons linked to an UCITS, where both funds are managed by the same AIFM, and (v) two clients of the AIFM.¹³⁶ Special care has to be given in situations, where a relevant person is likely to make a financial gain or avoid a loss to the detriment of the AIF or its investors. Such a relevant person might also be interested in an outcome of a service or activity, which is distinct from the interest of the AIF or its investors. Similar conflicts may arise, if a relevant person favours interests of another fund or interests of an investor or group of investors over other investors in the AIF.^{137,138}

AIFMs have to address all possible concerns over conflicts of interest. In order to alleviate potential risks every AIFM has to have a conflict of interest policy put in place. There all concerns are identified and all defensive measures put in place.

1.9 Side letters

Side letters are contracts made between the fund manager and an investor, which give preferential treatment to that specific investor. Such an investor usually has a stronger bargaining position as other investors and is able to negotiate such a contract prior to his contribution to the fund.¹³⁹ In hedge funds the additional granted rights include preferential redemption, disclosure of portfolio positions and detailed performance information. Side letters in private equity are heavily influenced by the fact that the investors have their assets locked-in for longer periods of time. They may want to limit the extent of indemnification of the manager or have reduced management fees. An often-used clause is also the 'most favoured nation' principle. It applies the logic of international law to the extent that an investor is entitled to any additional right a subsequent investor is being given in its side

¹³⁴Shelley Horan, "White Collar Crime, Money Laundering and Taxation: The AIFMD and Hedge Funds – An International and Irish Perspective" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 123.

¹³⁵AIFM Directive (see n. 3) Article 12(1)(d).

¹³⁶*ibid.*, Article 14(1).

¹³⁷AIFM Regulation (see n. 7) Article 30.

¹³⁸Setten and Busch (see n. 15) 57.

¹³⁹KB Associates, *The Use of Side Letters by Asset Managers* (April 16, 2014) (<https://www.diliger.com/bulletins/971412033>) visited on February 4, 2015.

letter.¹⁴⁰ With side letters managers are more likely to negotiate significant investments from large investors, who are in a stronger negotiating position.¹⁴¹

The main regulatory concern with side letters is that they are discriminating against other investors and are usually not disclosed. For this reason the AIMA, HFWG and FSA (the latter now FCA) cooperated and issued guidance, which has to be observed by UK-based managers. Disclosure has to be made to existing and future investors about any side letters, which contain 'material terms.' The definition of material terms is:

Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemption rights.¹⁴²

Provisions which are said to be material are preferential redemption rights (eg a shorter notice period for redemptions), 'key man' provisions, redemption gate waivers and rights with regards to detailed disclosure of fund assets. Non-material terms are mostly fee rebates and MFN clauses. If a granted right is also given to all other investors, it is not regarded as a material term of a side letter.¹⁴³

There has been recent caselaw with regards to side letters.¹⁴⁴ The hedge fund Medley Opportunity Fund Ltd. had been receiving a significant number of redemption requests in the years 2008 and 2009. In order to stay afloat it devised restructuring plans and presented them to its investors. Two options were given to investors; the first option meant investors would redeem their shares and immediately receive new shares, albeit with different redemption rights and fees. The second option meant the fund would be wound-up by quarterly pro rata payments in cash. Investors who chose neither and insisted on being paid in full would receive in-kind distributions.

Fintan, one of the investors, had entered in a side letter with the fund and its manager, which ensured all redemptions would be paid in cash and not in-kind. The party to the

¹⁴⁰Ian Levin and Kevin Scanlan, "The downside of side letters" (2006) 7(2) The Journal of Investment Compliance 43, 43-44.

¹⁴¹Thomas S Harman and Dianne M Sulzbach, Hedge Fund Side Letters: Compliance Issues, Policies, and Best Practices (June 2008) (https://www.morganlewis.com/pubs/HedgeFundSideLetters_June2008.pdf) visited on February 4, 2015, 7.

¹⁴²Alternative Investment Management Association, AIMA's Industry Guidance Note on Side Letters (September 27, 2006) (<http://www.aima.org/en/document-summary/index.cfm/docid/5520727E-1DBF-4979-84C80FC279339312>) visited on February 4, 2015.

¹⁴³Peter D Astleford et al., "Hedge fund side letters: guidance for UK managers" (2007) 8(1) The Journal of Investment Compliance 13.

¹⁴⁴Grand Court of the Cayman Islands, *Medley Opportunity Fund Ltd v Fintan Master Fund Ltd and Nautical Nominees Ltd* (June 21, 2012).

agreement was Fintan, but not Nautical Nominees Limited, which held shares of the fund in Fintan's name. In the restructuring process, Nautical chose the second option, quarterly pro rata payments in cash. In 2011 Fintan had become unsatisfied with the wind-up process and instructed Nautical to claim the redemptions as it had been envisioned in the side letter. Medley did not comply and the matter was brought to court.

At first, the claim was rejected because Nautical, who held shares, had not been a party of the side letter. The text of the side letter was not drafted sufficiently wide to include nominees, custodians etc. The court displayed unwillingness to give one shareholder a better position than the others. When Nautical accepted the option it concluded a new agreement and thereby conceded to less than it would have been entitled to in the side letter.¹⁴⁵

The AIFMD requires the AIFM to disclose to investors a description on how a fair treatment is ensured to all investors. With respect to side letters, a disclosure of a preferential treatment of any investor has to be made to all other investors. Such disclosure has to include a description of that preferential treatment, the type of investor being given such a treatment and, if relevant, legal or economic links of that investor to the AIFM or AIF.¹⁴⁶ Side letters also have to be reported to NCAs, in particular favourable treatment regarding disclosure, information, liquidity, fees, and other similar side letter provisions.¹⁴⁷

1.10 Liquidity management and side pockets

Side pockets are a way of AIFMs to manage illiquid assets. Such assets could be unlisted shares, private equity investments, real estate, claims related to court procedures or other investments, rights or assets, which are not easily transferred into cash and paid out to the hedge fund investor. Difficulties arise, when a significant portion of the assets is illiquid and a relatively high number of investors decide to redeem their shares. Without a special agreement, the AIFM has no other option but to dispose of the more liquid assets, which results in the illiquid investments having a greater share in the AIF and thus worsening the position of other investors. Another problem is the valuation of the illiquid assets. The NAV determines the fees paid to the manager and the investors face additional losses in connection with management fees, if the valuation of the illiquid asset is much lower at the time of liquidation than it was when the management fees were determined.¹⁴⁸ Similarly, if

¹⁴⁵Gary Smith, Side Letters: Guidelines from Cayman Court on Who Should be the Parties to Them (<http://www.hg.org/article.asp?id=28288>) visited on February 7, 2015.

¹⁴⁶AIFM Directive (see n. 3) Article 23(1)(j).

¹⁴⁷AIFM Regulation (see n. 7) AIF-specific information to be provided to competent authorities, 23 c) and d).

¹⁴⁸Hedge Fund Law Blog, Hedge Fund Side Pocket Investments (October 21, 2008) (<http://www.hedgefundlawblog.com/hedge-fund-side-pocket-investments.html>) visited on February 20, 2015.

the assets were valued lower at the time they were sold than when they were held by the fund, investors redeeming before the sale had been in a better position than subsequent redeeming investors.¹⁴⁹

The solution is the implementation of side pockets. Illiquid assets are transferred from the fund to a SPV and shares of the SPV are given in return to the fund. Only the investors in the fund at the time of the creation of the side pocket participate in this scheme.¹⁵⁰ This way profit calculation is more just, because the purchasing price is certain. The fund documents have to enable distribution of those SPV assets in kind. So, when an investor redeems its share, he is given cash and shares of the SPV on a pro rata basis, depending on the amount of securitised illiquid assets with respect to all assets of the fund. When the illiquid asset is sold off at a later point in time (eg in an IPO), the investor receives cash for the remaining SPV shares. Similarly, to solve the valuation problem when calculating management fees, the manager is given cash with respect to liquid assets and SPV shares with respect to illiquid assets.

Side pockets may be created without the use of SPVs. In addition to the original AIF a new AIF may be created and then either the illiquid assets or the liquid ones are transferred to the new AIF. Depending on the jurisdiction two new AIFs may be created in place of the original one, with one holding the liquid assets and the other illiquid assets. The result is that the original AIF operates normally, whereas the shares in the side pocket AIF cannot be redeemed until the assets are liquidated. Only old investors participate in this division, new investors are not able to invest in the side pocket AIF, which inherently makes it a close-ended fund.¹⁵¹ The legal form of an AIF determines what is the most appropriate way of establishing side pockets. If the AIF is in the form of a unit-trust, it is beneficial to establish a new fund and transfer the assets. On the other hand, if the AIF is a legal corporate entity with subscribed shares, the use of a SPV is more appropriate. The downside of using separate funds becomes apparent in situations, where an AIF is to be publicly traded on an exchange. By using a SPV and not splitting the fund, the implementation of a side pocket does not affect the exchange listing. This is more important, when a side pocket is used as a type of investment strategy, ie a pro-active approach.

The decision to use side pockets can be either pro-active or re-active. The pro-active approach is used when a hedge fund intentionally invests in illiquid assets and uses private equity investing strategies, which has also been described as the convergence between hedge

¹⁴⁹Günther Dobrauz and Philipp Rosenauer, "Side Pockets als spezielle Instrumente zur außerordentlichen Liquiditätssteuerung von Fund of Hedge Funds" (2010) 33(2) Zeitschrift für Finanzmarktrecht.

¹⁵⁰Ulf Klebeck, "Liquidity Management and Side Pockets" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 254.

¹⁵¹International Organization of Securities Commissions, Principles on Suspensions of Redemptions in Collective Investment Schemes (January 2012) (<https://www.iosco.org/library/pubdocs/pdf/IOSCO367.pdf>) visited on February 16, 2015, 17-18.

funds and private equity.¹⁵² In this scenario, the SPV is created from the onset and used for assets which are inherently less liquid. The re-active approach is used when a former liquid position turns illiquid due to an unforeseen event and the AIFM tries to manage the liquidity of the AIF as a whole.¹⁵³

Side pockets are under close scrutiny of regulators, because they can be a source of fraudulent behaviour. In the US the SEC found a case where fund managers had misappropriated assets in a side pocket. Illiquid investments were transferred to a SPV, but the manager has kept the profits stemming from the sale of the assets from investors. The proceeds were then used to fund other projects than to redeem the investors. This was done contrary to the fund's partnership agreement and offering documents.¹⁵⁴

The AIFMD requires AIFMs to implement liquidity management systems for their AIFs with proper liquidity risk monitoring in normal and in exceptional market conditions (stress testing).¹⁵⁵ Side pockets have to be disclosed, but it is left to national law to decide, whether they may be used or not.¹⁵⁶

1.10.1 Redemption gates

Part of the liquidity management of a fund are also ways of limiting investor redemptions. There are situations in which it is in beneficial to a fund and its investors to maintain restrictions on redemptions. In case of substantial redemption requests, the fund may get into a position, where it has to sell its assets regardless of their price. Such fire sale in turn causes the fund to perform worse and this gives further incentive to other investors to redeem their shares. To prevent this *vicious circle scenario* AIFMs may implement restrictions on redemptions, which mitigate the negative effects of those scenarios.¹⁵⁷ Not only are gates useful in exceptional circumstances, but they may also be beneficial in the ordinary course of business.

A properly construed gate can help retain the liquidity profile of the fund. If suddenly the fund faces a lot of requests, it tends to first sell off more liquid investments. The remaining investors are therefore left with a less liquid fund. A gate would not allow so many redemptions at once and the AIFM would be in a better position to manage the fund's liquidity. For example, there can be a 20% gate imposed on an investor on a yearly redemption period,

¹⁵²Houman B Shadab, "Coming Together after the Crisis: Global Convergence of Private Equity and Hedge Funds" (2009) 29(3) Northwestern Journal of International Law & Business, 603.

¹⁵³Klebeck (see n. 150) 254.

¹⁵⁴US Securities and Exchange Commission, SEC Charges Bay Area Hedge Fund Manager With Misappropriating "Side Pocketed" Assets (2011) (<http://www.sec.gov/news/press/2011/2011-54.htm>) visited on February 16, 2015.

¹⁵⁵AIFM Directive (see n. 3) Article 16.

¹⁵⁶AIFM Regulation (see n. 7) Recital 59.

¹⁵⁷Principles on Suspensions of Redemptions in Collective Investment Schemes (see n. 151) 8.

then an investor may only redeem 20% of his assets in a year.¹⁵⁸ Gates can also prevent the ‘ATM effect.’ More liquid funds tend to have more redemption requests and a redemption gate may level out the number of redemption requests in funds with different liquidity profiles.¹⁵⁹

The legal basis of a redemption gate is in the founding documents (articles of association) of a fund. There can be several types of such gates: a complete refusal of redemptions, limited redemptions over a time period; there are limitations on an investors basis (investor gate) or the whole fund (fund gate). A gate may also be mandatory or elective. With a mandatory gate the manager will usually have the option to waive it. An elective gate, on the other hand, is only triggered when the threshold is reached and the manager chooses to put it in force.

Let’s take a look at what happens if the redemption requests exceed the fund gate. The equitable choice would be *pro rata* payments to investors, but it is important onto what it applies. We might use *pro rata* on the requested amount or *pro rata* on the size of the investment.

For example, we have investors A and B, both redeeming EUR 1 million. A’s investment is EUR 2 million and B’s investment is EUR 10 million. The fund gate is 10%, A and B are the only investors, so they may together redeem EUR 1.2 million. If we used *pro rata* on the requested amount, both A and B would receive EUR 0.6 million. But what if B requested EUR 5 million? In this case, under the same gate, B would get EUR 1 million and A only EUR 0.2 million.

We see that *pro rata* on the requested amount gives investors the incentive to request more than they need. In this case, even A would then want to redeem more to receive an amount closer to what he really expected. This race to the bottom can prove detrimental to the fund. To the contrary, if we used the *pro rata* on the size of the investment, we would come to the same result no matter the size of the redemption request.¹⁶⁰ A would get 0.2 million and B 1 million. This interpretation of *pro rata* redemptions gives no investor the incentive to require more than he is planning to receive.¹⁶¹

Redemption gates in open ended funds can severely impact investors’ rights. Both retail and institutional investors, who are refused access to their assets may in turn face financial difficulties of their own. Gates should be constructed in such a way that they do

¹⁵⁸ After 5 redemption requests there is usually a clean up provision for all remaining assets, because otherwise the investor would never be able to redeem its investment by withdrawing 5 times 20% of the remaining assets and $0.8^5 \cdot 100\% = 33\%$ would remain.

¹⁵⁹ David J Lestz, “Gates, A Primer” (2011) 5(34-35) Bloomberg Law Reports – Securities Law (<http://www.sidley.com/~media/files/publications/2011/09/gates%20a%20primer/files/view%20article/fileattachment/sclr%20%20gates%20a%20primer.pdf>) visited on July 11, 2015, 1.

¹⁶⁰ The sum of both requests still has to be more than the gate allows.

¹⁶¹ Lestz (see n. 159) 4.

not give incentive to additional redemptions. A poorly conceived gate may even accelerate redemption requests of the investors. A good alternative is to use investor gates or staggered redemptions. A 25% investor gate means the investor can redeem all shares in no less than 4 redemption periods. Their advantage is that they are known in advance and do not deteriorate the trust in the fund as a triggering of a fund gate does.

Hedge fund regulation does usually not provide any safeguards, so the investors have to make sure what the policy of each fund is. The AIFMD requires AIFMs merely to disclose the possibility to use redemption rights in exceptional circumstances¹⁶² and to notify when they are put in place.¹⁶³ In addition, AIFMs have to conduct stress tests on a regular basis in order to mitigate difficult liquidity situations, which would trigger a redemption gate.¹⁶⁴

¹⁶² AIFM Directive (see n. 3) Article 23(1)(h).

¹⁶³ AIFM Regulation (see n. 7) Article 108(3)(b).

¹⁶⁴ *ibid.*, Article 48.

2 Connected issues

2.1 Private Equity

At the core of private equity funds lies the private equity deal. It is distinguished by the cooperation of capital and management expertise, which are applied to invested companies and in turn lead to the increase of value of said companies. Subsequently the investment is sold and the fund makes a profit for its investors. The *differentia specifica* in relation to venture capital funds is that private equity invests in businesses at a later stage of the business cycle, ie in established business.¹⁶⁵ Nevertheless, both feature extensive cooperation between the fund managers and the invested companies, with fund managers investing their reputation, know-how, networking relationships, competences and skills in the company. These transfers are the main reason such deals prove successful.

Private equity funds gather private capital and invest it in either private companies or public companies, which are then taken private. Common practice is that the acquired stake amounts to a controlling majority, sometimes in the form of a buyout, where the fund acquires a publicly traded company and takes it private.¹⁶⁶

A structure of a private equity fund will usually follow the general fund structure template. The fund will be a limited partnership, where the investors are being limited partners given a share of the fund, and the general partner is the manager of the fund. The general partner will have a small investment in the fund, which aligns his interests with the interests of the limited partners, but his main source of profit will be the management fees and proceeds of the private equity transaction directly.¹⁶⁷

In the EU the approach is different. Private equity is regarded as a financial activity, not just a business, and must therefore be regulated by financial system authorities.¹⁶⁸ Nonetheless EU countries choose a mix of systems with the US and UK limited partnership system on the one hand, and the traditional regulated asset manager with a fund structure similar to

¹⁶⁵Stefano Caselli, "Chapter 1 - The fundamentals of private equity and venture capital" in Stefano Caselli (ed.), *Private Equity and Venture Capital in Europe* (Academic Press 2010) 4.

¹⁶⁶Jennifer Payne, "Private Equity and Its Regulation in Europe" (2011) 12(4) *European Business Organization Law Review*, 562.

¹⁶⁷*ibid.*, 562.

¹⁶⁸Stefano Caselli, "Chapter 4 - Legal framework in Europe for equity investors" in Stefano Caselli (ed.), *Private Equity and Venture Capital in Europe* (Academic Press 2010) 41.

trusts on the other.¹⁶⁹

2.1.1 AIFMD implementation

So far we have seen that the way private equity funds are structured is influenced mainly on the ways taxation can be escaped on the level of the fund. Otherwise, private equity funds have only had to comply with basic corporate law rules. The AIFMD, with its umbrella approach to regulation, imposes additional obligations, bringing private equity managers closer to investment fund managers. Alleviating provisions include the small AIFM regime¹⁷⁰ and the use of a depositary, who is not a financial institution.¹⁷¹

Private equity managers in some situations use asset stripping of targets. This can happen, if the individual assets of the target are worth more than the value of the company. As this is an unwanted practice the AIFMD tries to limit this behaviour.¹⁷² Special restrictions are imposed on AIFMs acquiring a controlling stake in a non-listed company. For the timeframe of 24 months after the acquisition, there may be no payments to shareholders, which lower the capital under the amount of subscribed capital and there may be no payments to shareholders larger than the profits of the previous year. While this is in place to prevent asset stripping, it may prohibit a debt push down or a dividend recapitalisation.¹⁷³

2.2 Securitisation

2.2.1 Introduction

Securitisation is the transfer of receivables to a SPV, which is financed by the SPV issuing notes (bonds) to investors. The receivables are generally bank loans, eg real-estate, car, credit card or other loans. In light of these criteria we distinguish between RMBS (residential mortgage-backed securities), CMBS (commercial mortgage-backed securities), NPLs (non-performing loans, ie defaulted bank loans), CBOs (collateralised bond obligations, receivables are bonds), CLOs (collateralised loan obligations, receivables are bank loans in the broadest sense), and CDOs (collateralised debt obligations, a mix of loan, bond and other receivables).¹⁷⁴

The parties to such a transactions are usually an originator, the SPV, the arranger, a trustee and the investors. The originator transfers the receivables and is usually a bank. The

¹⁶⁹Caselli, "Chapter 4 - Legal framework in Europe for equity investors" (see n. 168) 59.

¹⁷⁰See section 1.3.

¹⁷¹See section 3.2.4.

¹⁷²AIFM Directive (see n. 3) Article 30.

¹⁷³Mark van Dam and Jérôme Mullmaier, "Impact of AIFMD on the Private Equity Industry" in Dirk A Zetsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 631.

¹⁷⁴Philip Wood, *Law and Practice of International Finance, University Edition* (Sweet & Maxwell 2008) 452.

SPV buys the receivables and issues securities to investors. Most of the time this will be a corporation independent of the originator, with a favourable tax regime, and with its only purpose of executing the securitisation. Because securitisations are complex transactions an arranger is needed. The sale of receivables to the SPV is done before issuing notes to investors, therefore investment banks usually act as arrangers. The trustee's role is to manage the SPV. He keeps track of all payments to investors and makes claims on behalf of investors if problems arise.¹⁷⁵ Credit rating agencies are not direct parties to the securitisation, but are nonetheless one of the most important contributors to the transaction. Because the receivables are transferred out of the bank, its in-house rating and risk management are not applied to the receivables anymore. Therefore a third party has to be conferred with this task and its findings will have great influence on all the pricing and interests and, to a large extent, the success of the securitisation.

A common feature of securitisations is the use of tranches. There are several classes of notes issued, which are senior or junior in relation to each other and each of them receives a credit rating. In an event of non-payment, junior notes will be affected first by not receiving interest. Only if losses are sufficiently high will the senior bondholders be affected. This is called the 'waterfall principle' and its main advantage is that it enables the most senior tranche to have an AAA rating. Therefore a moderately risky portfolio may still achieve an AAA rating for senior notes, while the junior notes would receive a relatively low rating.

2.2.2 Role in the financial crisis

Usage of securitisation transactions had been growing fast in the years prior to the crisis. It was widely used in the form of RMBS in the US and when the real-estate bubble collapsed and it contributed significantly to the 2008 financial crisis that followed, of which consequences are still felt in a lot of countries around the world. It was found that securitisation at large impacted the quality of borrower screening, risk management and rating. These tasks have been transferred from a bank to a rating agency, which created diverging interests. Banks are more influenced by the quality of the receivables and the ability of borrowers to repay the loans, because they have the receivables on their balance sheets. Accurate ratings of creditors provide for efficient use of reservations, which in turn increases the stability and profitability of a bank. Rating agencies, on the other hand, operate on a commission and do not have the losses of the receivables reflected in their balance sheets. Moreover, the rating agency market is oligopolistic, so even if they provide subpar services, there is no competitor in the market who could gain an advantage by provided better services. This

¹⁷⁵Dirk A Zetsche and David Eckner, "Securitizations" in Dirk A Zetsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 533-538.

mechanism poses a systemic risk concern.¹⁷⁶

Regulators have set out to address these negative issues regarding securitisations. The goal is to align the interests of originators, who devise the securitisation, and investors. The originators must not be allowed to remain indifferent as to what happens with the securitisation once the receivables are off its balance sheet. The solution is for the originators to retain a 'significant interest in the underlying assets.'¹⁷⁷ The requirement is that the originator, sponsor, or original lender retains a 5 per cent share in the securitisation.¹⁷⁸ This way, losses are borne by originators to such an extent that it significantly raises the efforts and involvement of originators in the transaction.

2.2.3 AIFMD implementation

The duties imposed on AIFMs are a reflection of the duties in the CRR. The AIFM shall not invest in securitised positions, if the originator has not fulfilled the 5 per cent retention requirement. Additionally, AIFMs are required to perform a due diligence of the securitisation prior to investing in it in order to satisfy itself of its full compliance and familiarise itself with the potential risks.¹⁷⁹

2.2.4 Conclusion

Securitisation is a controversial field in Europe. The idea and procedure originated in the US, it experienced exponential growth in the pre-crisis years, but it has been plagued ever since the market downturn. The ABS issuance in Europe is currently at levels far below the pre-crisis years.¹⁸⁰ Nonetheless, there is a desire to reintroduce it to European capital markets.¹⁸¹ Because of its positive aspects, ie freeing up of banks' balance sheets, raising capital, dispersement of risk and transferability, it has been included in the Capital Markets Union put forward by the European Commission.¹⁸² To once again establish an active securitisation market, which would provide investors with the necessary safety, changes are foreseen in Basel III¹⁸³, together with the previously mentioned rules in the CRR and the AIFMD.

¹⁷⁶Cristina Peicuti, "Securitization and the Subprime Mortgage Crisis" (2013) 35(3) *Journal of Post Keynesian Economics*, 449.

¹⁷⁷CRR (see n. 73) Recital 57.

¹⁷⁸*ibid.*, Article 405.

¹⁷⁹AIFM Regulation (see n. 7) Recital 67 and Section V.

¹⁸⁰Thomas Hale, "Eurozone securitisation prospects remain slim (11 June 2015)" *Financial Times*.

¹⁸¹Association for Financial Markets in Europe, *Funding the EU economy* (July 22, 2014) (<http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=11361>) visited on June 13, 2015.

¹⁸²European Commission, *Green Paper, Building a Capital Markets Union*, COM(2015) 63 final (February 18, 2015) Section 3.3.

¹⁸³Bank for International Settlements, *Basel III Document, Revisions to the securitisation framework* (December 11, 2014) (<http://www.bis.org/bcbs/publ/d303.pdf>) visited on June 13, 2015.

2.3 European Long-term Investment Funds

ELTIFs are a new fund structure put forward by the EU, which tries to encourage long-term investments. The scope of ELTIFs are investments, which are not made available in form of securities (otherwise they would overlap with UCITSD) and offer a steady, low risk income stream. Targeted are infrastructure projects (eg transport, sustainable energy, housing and health), unlisted companies, and listed SMEs¹⁸⁴ – the so-called real economy. The funds are close-ended with a duration of over 5 years¹⁸⁵ and may invest in both equity and debt. At least 70% of the assets have to be invested this way, the other 30% may be invested in UCITSD assets. The leverage is capped at 30%.

The legislative style is interesting, because it departs from the established way of regulating capital markets with directives (AIFMD, UCITSD, MiFID) by using a regulation, which leaves no leeway to Member States. Moreover, Article 1(3)¹⁸⁶ bars Member States from imposing any requirements of their own.

The Regulation is linked to the AIFMD due to the requirement of a manager of an ELTIF to be an authorised AIFM under the AIFMD and that only authorised EU AIFs are eligible for the ELTIF authorisation.

ELTIF is also a structure through which European Investment Bank (EIB) funding will be channeled.¹⁸⁷ The EIB will dedicate funding in infrastructure and SME investments through ELTIF funds, together with private investors. ELTIFs will also serve as a vehicle for investments by the European Fund for Strategic Investments (EFSI).¹⁸⁸

2.4 European Social Entrepreneurship Fund (EuSEF) and European Venture Capital Fund (EuVECA)

The EuSEF¹⁸⁹ and EuVECA¹⁹⁰ Regulations primarily serve the purpose of granting an EU passport to small AIFMs managing social entrepreneurship and venture capital funds. The AIFM may, for these AIFs, also use the designations EuSEF and EuVECA respectively. The AIFM may still use the designations even after exceeding the small AIFM threshold.

¹⁸⁴ Regulation of the European Parliament and of the Council on European Long-term Investment Funds (not yet in force) (March 20, 2015) Recitals 1 and 3.

¹⁸⁵ A beneficial redemption regime is envisioned for retail investors.

¹⁸⁶ ELTIF Regulation (see n. 184).

¹⁸⁷ *ibid.* Recital 31.

¹⁸⁸ European Commission, Communication from the Commission, An Investment Plan for Europe, COM(2014) 903 final (November 26, 2014) 9.

¹⁸⁹ Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds [2013] OJ L115/18.

¹⁹⁰ Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds [2013] OJ L115/1.

EuSEF assets are equity and debt of unlisted undertakings, which have as their primary goal an objective of social character and which use their profits first and foremost to reinvest in their primary goal.¹⁹¹

Venture capital companies under the EuVECA Regulation are defined as unlisted companies with fewer than 250 employees and a turnover of less than EUR 50 million or balance sheet of less than EUR 43 million.¹⁹² The investments themselves may be in form of debt, equity or a variant thereof.

¹⁹¹EuSEF Regulation (see n. 189) Article 3(1)(d).

¹⁹²EuVECA Regulation (see n. 190) Article 3(d).

3 Comparative view

3.1 Austria

Austrian law is comparatively restrictive when it comes to hedge funds. There is no possibility of establishing a hedge fund in its fundamental form as it is common in various other jurisdictions,¹⁹³ but there is an option to establish a fund of hedge funds, which invests in hedge funds established in said jurisdictions.¹⁹⁴ Funds of hedge funds are established as *Anderes Sondervermögen* (hereinafter: Other Funds).¹⁹⁵ Other Funds are similar to unit trusts except they are in co-ownership of the investors. All funds' assets are represented by equal shares, which are securities. Those securities are held by the investors and give them redemption and liquidation rights. An Other Fund has no legal personality, but it has to have its assets separate from the assets of the AIFM and the depositary.¹⁹⁶ Other Funds are allowed to invest in the same type of assets as mutual funds with a one major exception. They may invest in funds, which are not mutual funds and invest in assets that are relatively illiquid, highly volatile, non-diversified, or difficult to value, ie in hedge funds. The exposure to one hedge fund is limited to 10% of AuM of the Other Fund.¹⁹⁷

This fund of hedge fund structure may give rise to issues in certain situations. An Other Fund could receive distributions in-kind from a hedge fund, for example, shares in a side pocket. Such a fund would then hold shares of a limited company, which is a clear violation of the InvFG.¹⁹⁸

The Austrian REIT market is quite developed with 4.8 billion euros in management as of January 2015.¹⁹⁹ REITs have a unit trust structure with the fund being fiduciary owned by the AIFM and split up into equal shares, which are held by investors.²⁰⁰ Some REITs are

¹⁹³Dobrauz and Rosenauer (see n. 149).

¹⁹⁴Martin Oppitz, "Hedgfondsvanlagungen mit 'Compulsory Redemption' und Sachauskehr im Investmentfondsrecht" [2012] (8) Österreichisches Bankarchiv 508.

¹⁹⁵Investmentfondsgesetz (Austrian Investment Fund Act, February 22, 2015) § 166.

¹⁹⁶*ibid.*, § 46.

¹⁹⁷*ibid.*, § 166 Abs 1 Z 3.

¹⁹⁸Oppitz (see n. 194).

¹⁹⁹Vereinigung österreichischer Investmentgesellschaften, Immobilien-Investmentfonds Gesamtmarkt (2015) ([http://www.voeig.at/voeig/internet_4.nsf/sysPages/A4D15CA178A6723BC12575450038A2E0/\\$file/IMMOEntwicklung2015.pdf](http://www.voeig.at/voeig/internet_4.nsf/sysPages/A4D15CA178A6723BC12575450038A2E0/$file/IMMOEntwicklung2015.pdf)) visited on February 23, 2015.

²⁰⁰Immobilien-Investmentfondsgesetz (Austrian Real Estate Investment Fund Act, February 23, 2015).

publicly listed and widely used by retail investors for investing their savings in real-estate.

Despite the restrictive approach to hedge funds, the implementation of the AIFMD enables foreign AIFMs to market their hedge funds in Austria with the passport regime.^{201,202} At the end of 2014, 257 AIFs had been registered to market themselves in Austria, either through Austrian AIFMs or AIFMs from other EEA countries.²⁰³ It will be interesting to see, whether there will be an increase in hedge fund activity in Austria. The AIFMD enables investment management companies in Austria to establish a hedge fund in a friendlier jurisdiction of another Member State (eg Luxembourg) and market it at home.

3.2 Luxembourg

3.2.1 Introduction

Luxembourg is the second largest investment fund centre in the world after the United States. It is home to funds with over 3,5 trillion euro in AuM, predominantly in UCITS funds.²⁰⁴ The share of non-UCITS funds is at 18.9%.²⁰⁵ Luxembourg has been the fastest growing alternative investment fund centre in the past years. While market shares of traditional jurisdictions like Delaware and the Caymans have been in decline, Luxembourg has seen a rise in hedge fund market share from 1.3% in 2008 to 14% in 2014.²⁰⁶ The AIFMD might have contributed to this growth. When it came into force, Luxembourg had already been the top EU jurisdiction when it came to UCITS funds and it had had the most progressive investment fund law of any Member State. Combined with the expertise of regulators and all supporting infrastructure, Luxembourg was poised to establish itself as a top EU market player in alternative investment funds as well. It seems as if it is easier for non-EU AIFMs and AIFs to move to Luxembourg in order to market to EU investors, than it is to obtain an EU passport as a non-EU entity.²⁰⁷

²⁰¹Julia Nicolussi, "Austria" in Dirk A Zetzsche (ed.), *The Alternative Investment Fund Managers Directive* (Kluwer Law International 2012) 684.

²⁰²For the passport regime in general, see section 1.2.

²⁰³Vereinigung österreichischer Investmentgesellschaften, *Ausländische Fonds in Österreich zugelassen - Fondsanzahl* (2014) ([http://www.voeig.at/voeig/internet_4.nsf/sysPages/xB9ED298EF960704AC1257547003AFC9B/\\$file/AuslaendischeFonds2014.xls](http://www.voeig.at/voeig/internet_4.nsf/sysPages/xB9ED298EF960704AC1257547003AFC9B/$file/AuslaendischeFonds2014.xls)) visited on February 23, 2015.

²⁰⁴Commission de Surveillance du Secteur Financier, Newsletter (June 2015) (http://www.cssf.lu/fileadmin/files/Publications/Newsletter/Newsletter_2015/newsletter173eng.pdf) visited on July 3, 2015, 14.

²⁰⁵Commission de Surveillance du Secteur Financier, Annual Report (2013) (http://www.cssf.lu/fileadmin/files/Publications/Rapports_annuels/Rapport_2013/RA2013_EN_full_version.pdf) visited on July 3, 2015, 127.

²⁰⁶PWC, *Hedge Funds Luxembourg* (February 2015) (<https://www.pwc.lu/en/hedge-funds/docs/pwc-hedge-funds-hedge-funds-luxembourg.pdf>) visited on July 3, 2015, 4.

²⁰⁷This may also be connected with the fact that at the time the AIFMD came into force, and also at the time of writing, the EU passport was not yet available.

3.2.2 Legal forms

Luxembourg provides a large array of possible legal forms in which funds may be established. The basic ones are SA (société anonyme, corporation limited by shares) and SARL (société à responsabilité limitée, limited liability company). Further entities are:

SCA Société en commandite par actions – partnership limited by shares. In this structure we have at least one general partner, who has unlimited liability and one or more limited partners, which are shareholders and are liable only up to the sum of their investment. The AIFM is the general partner and the limited partners are investors in the fund. Under the AIFMD this would be an internally managed AIF.²⁰⁸ An advantage of this form is that it is easy issue shares to investors and retain full control of the general partner.²⁰⁹

SCS AND SCS P Société en commandite simple/speciale – limited partnership. The SCS P differs from the SCS by not having a legal personality. The SCS legal forms introduce limited partnerships which closely resemble legal forms of common law countries. There is one or more general partner with unlimited liability and one or more limited partners with limited liability. The SCS forms are very simple, robust and due to the similarity to UK and US forms very popular. There is no requirement for the LPA to be concluded with a public notary and there is no waiting period for registration. The LPA is effective upon signing and the entry into the company registry is purely of informative nature. Only parts of the LPA have to be publicly disclosed and the identities of limited partners are kept confidential.²¹⁰ The main difference in comparison with the SCA is that the participation interests are not freely transferable.²¹¹ All partners have to agree to a transferal or the LPA has to allow such transfers without consent. The SCS are given full tax transparency when acting as a fund and if the general partner has less than 5% of the interest in the SCS.²¹²

FCP Fonds commun de placement en valeurs mobilières. FCPs are unit trusts. They have no legal personality and are part of the AIFM. Like SCAs they are internally managed AIFs under the AIFMD.

²⁰⁸ AIFM Directive (see n. 3) Recital 20, Article 5(1)(b).

²⁰⁹ Association of the Luxembourg Fund Industry, Luxembourg Hedge Funds (2013) (http://www.alfi.lu/sites/alfi.lu/files/files/Publications_Statements/Brochures/Alfi-Hedge-Funds-BAT-web.pdf) visited on July 4, 2015, 11.

²¹⁰ KPMG, Five reasons to opt for the new Luxembourg Limited Partnership (March 2013) (<https://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Documents/Five-reasons-to-opt-for-the-new-Luxembourg-LP.pdf>) visited on July 4, 2015, 4.

²¹¹ Luxembourg Hedge Funds (see n. 209) 11.

²¹² Five reasons to opt for the new Luxembourg Limited Partnership (see n. 210) 9.

All legal forms apart from the FCP can be further defined as SICAV (Société d'investissement à capital variable) or SICAF (Société d'investissement à capital fixe). SICAV is an investment company with variable capital, SICAF is an investment company with fixed capital.

3.2.3 Legal regimes

To the aforementioned legal forms a regime has to be applied in order for them to be able to function as an investment fund. For funds under the AIFMD there are three possible options: the SIF,²¹³ the UCI Part II²¹⁴ and the SICAR.²¹⁵ All are approved and regulated by the CSSF.

The SICAR (Société d'investissement en capital à risque) is an investment vehicle for venture capital and private equity funds. Prior to the implementation of the AIFMD these funds had not needed registration and could have operated in standard legal forms, provided they had been tax transparent. The AIFMD requires in certain situations the registration of such funds. SICAR is thus a layer on corporate forms, which provides for the regulation by the CSSF under the AIFMD.

Funds under UCI Part II are a compromise between hedge funds and mutual fund. They enable the use of leverage, derivatives, short-selling and investments in non-listed companies, but the usage of these techniques and instruments is limited to a certain percentage of the NAV.²¹⁶ In return, retail investors are able to invest in these funds.²¹⁷

SIF funds provide the most lenient investment restrictions. There are no caps on leverage and the use of financial instruments. The only restriction is the dispersement of assets. A SIF may not invest more than 30% of its NAV in the same securities of the same issuer.²¹⁸ Such legislation is comparable to the Cayman Islands.²¹⁹

3.2.4 PFS custodian

The AIFMD envisions that for venture capital funds, private equity funds and REITs a special depositary can be used. For investment funds the depositary has to be a regulated financial institution, but for these funds a less strict regime can be used. National law may allow a lawyer, notary or other similar trustworthy professional to act as depositary.²²⁰

To make use of the AIFMD provision a 'professional depositary of assets other than

²¹³Law of 13 February 2007 relating to specialised investment funds (Luxembourg, 2013).

²¹⁴Law of 17 December 2010 relating to undertakings for collective investment (Luxembourg, 2013).

²¹⁵Law of 15 June 2004 relating to the Investment company in risk capital ("SICAR") (Luxembourg, 2013).

²¹⁶Commission de Surveillance du Secteur Financier, Circular 02/80 (December 2002).

²¹⁷Luxembourg Hedge Funds (see n. 209) 9.

²¹⁸*ibid.*, 9.

²¹⁹See section 3.4.

²²⁰AIFM Directive (see n. 3) Article 21(3)(c)(subpar 3).

financial instruments' has been created.²²¹ These so-called 'PFS Custodians' may also be used for investing in atypical investments, such as wine and art.²²²

The PFS custodian compared to a credit institution has a lower minimum capital requirement (500,000€ versus 730,000€) and is not subject to additional own fund requirements based on the amount of assets under custody.²²³

3.3 Slovenia

Due to Slovenia's size its fund market is accordingly small. Nevertheless, the developed banking system, the strong inclination of consumers towards saving, and the efforts put down by the ATVP have created a competitive UCITS market. It will be interesting to observe, whether alternative funds will follow the success of UCITS funds. While the market may be too small for hedge funds, there certainly is room for REITs, VC funds and private equity. The adoption of the AIFMD has triggered changes in the alternative investment fund legislation described below. An overview of all AIF structures is provided in table 3.1.

3.3.1 Investment Funds and Management Companies Act

The main statute governing investment funds is the Investment Funds and Management Companies Act.²²⁴ The act sets out rules for all types of investment funds and divides them into UCITS and non-UCITS funds. Non-UCITS funds are called alternative retail funds.²²⁵ There are three forms of alternative retail funds, which are the alternative mutual fund, the alternative umbrella fund and the investment company.²²⁶ Under EU law, all forms are AIFs and they have less stringent provisions as UCITS funds on the types of assets they may hold. Apart from UCITS fund assets the alternative retail funds may hold:

- shares of any alternative investment fund under the AIFMD (fund of hedge funds);
- precious metals; and
- real-estate and real-estate SPV.

Both the alternative mutual and alternative umbrella funds are not legal persons, but are part of the AIFM (internally managed AIF) and, taking into account the separation of assets

²²¹Law of 5 April 1993 on the financial sector (Luxembourg, 2013) Article 26-1.

²²²Thibaut Partsch and Ezéchiél Havrenne, "Luxembourg" in Dirk A Zetsche (ed.), *The Alternative Investment Fund Managers Directive: European Regulation of Alternative Investment Funds* (Kluwer Law International 2012) 659.

²²³*ibid.*, 659.

²²⁴Zakon o investicijskih skladih in družbah za upravljanje (ZISDU-3) (Uradni list RS, št. 77/11, 10/12 - ZPre-1C, 55/12 in 96/12 - ZPIZ-2) (Slovenian Investment Funds and Management Companies Act, 2015).

²²⁵Literal translation is 'alternative funds collecting assets from the public.'

²²⁶ZISDU-3 (see n. 224) Article 8(2).

of the AIFM and its AIF, can be regarded as unit trusts. An investor in such AIF receives investment coupons, which are securities. They are issued by the AIFM and represent a share in the AIF. Investment coupons give the holder a right to demand the money value of assets in an AIF from the AIFM and the right to pro rata payments if the AIF is liquidated.

An alternative mutual fund is formed by a registered management company, when appropriate rules of management are adopted, a contract with a depositary is concluded, and when a permit for the management of the fund is issued by the ATVP. In accordance with the EU Internal market principles, AIFMs from other Member States may establish alternative retail funds under Slovene law. Alternative mutual and umbrella funds may only be open-ended with the longest redemption period being one year.

The other type of non-UCITS fund is the investment company. The main difference in relation to the alternative mutual fund is the investment company is a closed-ended fund. It has a legal personality and is in the form of a corporation that may be publicly traded.²²⁷ It has no executive directors, but has a supervisory board. All its operations are done in its name by an AIFM. There has to be a management contract concluded between the AIFM and the investment company. This makes investment companies externally managed AIFs under the AIFMD.²²⁸

3.3.2 Alternative Investment Fund Managers Act

This law is the implementation of the AIFM Directive. Not only does it transpose EU law, it also introduces the special investment fund (hereinafter SIS). SIS is an unrestrictive fund structure, which allows investments in virtually all assets and does not impose any general leverage limitations (ATVP may impose limitations on a case by case basis). It can be used as a vehicle for hedge funds, private equity funds and ELTIFs, but not for venture capital funds. It can follow a unit trust structure akin to mutual funds or it can be established in a corporate form.²²⁹

Venture capital firms, which come under the AIFMD are regulated under the Venture Capital Companies Act.²³⁰ Venture capital funds are legal persons and may be set up as a limited liability company or a limited partnership and are managed by an AIFM. The main feature of this act is that a company, which follows the prescribed conduct of venture capital financing, has its profits tax exempt at the level of the company. There is no double taxation, the only taxes paid from profits of a venture capital deal are dividend taxes paid by the fund shareholders.

²²⁷It shares similarities with investment trusts in the UK.

²²⁸ZISDU-3 (see n. 224) Articles 401-41.

²²⁹Zakon o upravljalcih alternativnih investicijskih skladov (ZUAIS) (Slovenian Alternative Investment Fund Managers Act, 2015) Articles 175-98.

²³⁰Zakon o družbah tveganega kapitala (ZDTK) (Slovenian Venture Capital Companies Act, 2009).

Table 3.1: AIFs in Slovenia

Name	Type	Assets	Leverage
Alternative mutual fund	Mutual fund, unit trust	As UCITS, plus AIF shares, precious metals and real-estate	Up to NAV, like UCITS
Alternative umbrella fund	Umbrella mutual fund, unit trust	As UCITS, plus AIF shares, precious metals and real-estate	Up to NAV, like UCITS
Investment company	Close-ended, corporation	As UCITS, plus AIF shares, precious metals and real-estate	Up to NAV, like UCITS
Special investment fund (SIS)	Hedge fund or PE, unit trust or any corporate form	No restrictions on types of assets	No general restriction on leverage
Venture capital fund	LLC and LP	Venture capital investments	Not relevant

3.4 United Kingdom

When comparing alternative fund regulation in the United Kingdom with other European jurisdictions it can be said the amount of regulation follows the number of managers and the amount of their assets in funds. The sheer volume of regulations, dealing with investment firms and funds is by far the largest of any European country. This goes hand in hand with the amount of AuM managed by UK-based AIFMDs at \$470bn,²³¹ the largest in Europe.

Because of no tax transparency there are no hedge funds domiciled in the UK. Instead the funds themselves are located offshore with the majority of funds established in the Cayman islands,²³² while their managers are based in the UK. The subject of UK laws are therefore in essence only the managers, whereas the funds are subject to regulation in the jurisdiction of establishment. A manager may be established in a wide range of legal forms (partnership, corporation etc),²³³ whereas a fund will usually be established in any corporate form, which has its corporate profits exempt from tax (tax transparency). Otherwise profits from investments would have been double taxed – at the level of the invested corporation and at the level of the fund. These tax-exempt forms are generally present in offshore jurisdictions and are often called exempt companies or international business companies. In the most widely used jurisdiction, the Cayman Islands, all types of funds may be established as a company, partnership or unit trust.²³⁴ Both the fund manager from the UK and the fund domiciled on the Caymans have to be approved by the CIMA with a few minor exceptions. Close-ended funds, most notably private equity and venture capital, do not fall under the ‘mutual fund’ definition and are therefore exempt from registration with CIMA.

In order to allow AIFs and AIFMs access to the EU market via private placement regimes and the passport, the Cayman Islands are reforming their Mutual Funds Law and Securities Investment Business Law.²³⁵ This will provide an opt-in regime for funds and managers, which will make them subject to regulation similar to the AIFMD – the EU Connected Fund and EU Connected Manager. A decision on extra-EU passports will be made by the Commission on 22 July 2015, the changes in Cayman Islands law are coming into effect in August 2015.

The regulator in the UK is the Financial Conduct Authority (hereinafter: FCA). It was created in 2013 by splitting the Financial Services Authority (hereinafter: FSA) into two parts, the FCA and the Prudential Regulation Authority (hereinafter: PRA). This change was

²³¹Financial Conduct Authority, Hedge Fund Survey (March 2014) (<http://www.fca.org.uk/static/documents/hedge-fund-survey.pdf>) visited on February 12, 2015, 4.

²³²*ibid.*, 11.

²³³Financial Services and Markets Act 2000, United Kingdom, Section 40.

²³⁴Mutual Funds Law (Cayman Islands, 2013) §2.

²³⁵Cayman Finance, Cayman Finance Welcomes New Opt-In AIFMD Regime (<http://www.caymanfinance.com/cayman-finance-welcomes-new-opt-in-aifmd-regime/>) visited on July 13, 2015.

envisioned as it was believed the FSA had not coped with the financial crisis sufficiently.²³⁶ Investment fund managers have come under supervision of the FCA, whereas banks and insurers with respect to their prudential supervision have come under the auspices of the PRA. The main task of the PRA is the attainment of financial stability, the main task for the FCA is the well-functioning of financial markets.²³⁷ Special coordination measures have been put in place to enable efficient cooperation between the FCA and the PRA. The Financial Policy Committee of the Bank of England can issue recommendations and directions to the PRA.²³⁸

The AIFMD has been implemented into UK law via the Alternative Investment Fund Managers Regulations²³⁹ in connection with the FiSMA, and further with FCA Rulebooks FUND²⁴⁰ and COLL.²⁴¹ Although I mentioned there were no hedge funds domiciled in the UK, it is worth mentioning there are certain non-UCITS structures, which fall under the AIFMD. These are the Non-UCITS Retail Scheme (NURS) and the Qualified Investor Scheme (QIS). As the name suggests, NURS may be sold to retail investors, whereas QIS are restricted to qualified investors.²⁴² As a consequence, QIS have the least number of restrictions when it comes to investment strategies. They may invest in all kinds of securities, derivatives, funds, real-estate, precious metals and commodities,²⁴³ much in a way a hedge fund would. NURS are somewhere in between the most open QIS funds and restrictive UCITS funds. When it comes to leverage, QIS may use exposure to the extent of 100% of their NAV,²⁴⁴ whereas NURS may only avail themselves of exposure of 10%,²⁴⁵ similar to UCITS funds. Hedge funds, especially in offshore jurisdiction, may not have any limits to exposure.

Due to London being a world financial centre, the United Kingdom has developed a complex system of investment fund law. This section touched upon the basics and several unique aspects to enable an understanding, how the AIFMD affects London's investment fund sector.

²³⁶Eilis Ferran, "The Break-up of the Financial Services Authority" (2011) 31(3) *Oxford Journal of Legal Studies*, 479.

²³⁷Andromachi Georgosouli, "The FCA-PRA coordination scheme and the challenge of policy coherence" (2013) 8(1) *Capital Markets Law Journal*, 63.

²³⁸*ibid.*, 71.

²³⁹Alternative Investment Fund Managers Regulations 2013, United Kingdom.

²⁴⁰Financial Conduct Authority, *Investment Funds Sourcebook* (May 2015).

²⁴¹Financial Conduct Authority, *Collective Investment Schemes* (May 2015).

²⁴²Financial Conduct Authority, *Conduct of Business Sourcebook* (May 2015) 4.12.3.

²⁴³FCA COLL (see n. 241) 8.4.4.

²⁴⁴*ibid.*, 8.4.10.

²⁴⁵*ibid.*, 5.5.5.

3.4.1 Brexit

Before the end of 2017 a referendum on the exit of the United Kingdom out of the European Union is about to be held. If a decision to abandon the European Union was made, this would mean all EU law would overnight cease to apply, including the AIFMD. The question is, what the impact would be on the alternative investment fund industry.

The general requirement of registration and authorisation is part of the global shift in the regulation of alternative investment funds. It is implemented by both the EU and the US and it would be inconceivable if the UK were not to follow the commitments laid down by the G20. So the biggest regulatory burden, the systemic risk reporting and monitoring, is here to stay.

A very big issue would be the loss of the internal market.²⁴⁶ UK-based AIFMs currently have unrestricted access to EU-based investors. If UK AIFMs were to become non-EU AIFMs this access could be brought under question.²⁴⁷ The UK would have to conclude several MoUs with Member States and comply with other passport requirements.²⁴⁸ This also means the UK would in general have to have its alternative investment fund regulation on par with the EU, so the argument of proponents of the Brexit that the City would thus be free from the stifling EU regulator is wrong. Moreover, while having to keep up with EU law, the UK would lose its influence in the decision making in Brussels. So, the efforts of Brexit proponents would not result in more regulatory sovereignty, but the opposite.²⁴⁹

If the AIFM complied with all the rules for obtaining the EU Passport, further requirements would still arise if the AIF is not established in the EU, which is frequently the case with AIFs on the Cayman Islands. A MSR would have to be determined.

It would not be impossible to obtain a result similar to the situation in which UK AIFMs currently are. Although in reality managers are already repatriating funds from offshore to EU jurisdictions.²⁵⁰ This is why I remain sceptical whether managers will choose the more difficult path of keeping the AIF offshore, the AIFM in the UK, and a MSR in the EU. In any case the regulatory burden would be higher and keeping in mind that similar problems would arise throughout the financial industry (MiFID, UCITS), the negative impact of Brexit could be substantial.

²⁴⁶Even if the UK were to become an EFTA country and therefore enjoy the fundamental freedoms, these problems would still exist, similar to Liechtenstein.

²⁴⁷Not to mention that a passport is included in MiFID, so more or less London's entire financial services industry would overnight lose access to one of its biggest markets.

²⁴⁸See section 1.2.

²⁴⁹John Springford and Philip Whyte, The consequences of Brexit for the City of London (May 2014) (http://www.cer.org.uk/sites/default/files/publications/attachments/pdf/2014/pb_city_brexit_js_pw_8may14-8816.pdf) visited on June 22, 2015, 9.

²⁵⁰See section 3.2.

3.5 United States

The origins of hedge funds can be traced back to the 1950s in the US. In the 1990s they became important financial market participants and the US has been the jurisdiction with the highest number of managers and the largest amount of AuM.²⁵¹ This section will explore the legal background of hedge funds and how could they have emerged despite the strict US capital markets and mutual funds legislation.

3.5.1 Investment Advisers Act Exemptions

Up until recently, hedge fund managers have not had to register under the Investment Advisers Act²⁵² due to the so-called private adviser exemption. This exemption was used by advisers who:

- had fewer than 15 clients,
- did not publicly hold itself as an investment adviser, and
- did not advise registered investment companies.

Important to note is that the interpretation of 'fewer than 15 clients' meant a client could also have been a fund. So, a manager could have managed one fund, in which more than 15 investors had their shares, but used the private adviser exemption.²⁵³ This prevented the application of a wide array of Investment Advisers Act provisions. They were not obliged to make certain disclosures to investors, maintain various business records, allow the SEC to review their books, make regular reporting to the SEC, and to have a compliance program with rules of conduct in place. They were, however, subject to provisions on fraudulent and deceptive practices,²⁵⁴ and fiduciary duties.²⁵⁵ This approach was reasonable in a time, when hedge funds were not widespread and the amount of their AuM not significant.²⁵⁶

It became clear that the growing number of hedge funds and growing number of SEC enforcement cases, where investors were defrauded and able to only partially recover their assets meant hedge funds were to increasingly be the subject of regulatory scrutiny and face a change in the legislative landscape. Managers started to market hedge funds not only to wealthy individuals, but to a broader audience, including retail investors, pension funds, universities, endowments, and other charitable organisations. These reasons led

²⁵¹Hal S Scott and Anna Gelpern, *International Finance: Law and Regulation* (Sweet & Maxwell 2012) 961.

²⁵²Investment Advisers Act (United States, 1940).

²⁵³17 CFR § 275.203(b)(3)-1 (2006).

²⁵⁴William K Sjostrom Jr, "A Brief History of Hedge Fund Adviser Registration and its Consequences for Private Equity and Venture Capital Advisers" (2011) 1 Harvard Business Law Review Online, 39.

²⁵⁵*Transamerica Mortgage Advisors, Inc. (TAMA) v Lewis* 444 US 11 (1979).

²⁵⁶US Securities and Exchange Commission, Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333 (2005) (<http://www.sec.gov/rules/final/ia-2333.htm>) visited on February 17, 2015.

the SEC to adopt its regulations to include a look-through rule when counting clients and thus requiring almost all hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940.²⁵⁷

Soon after the look-through rule went into effect, it was challenged in a federal appeals court, which held the SEC acted arbitrarily by declaring the term ‘client’ equal to the term ‘investor.’ The SEC could not change the statutory requirements for investment advisers only by changing the interpretation of a legal text.²⁵⁸ Congress did eventually step in and amend the Investment Advisers Act by the Dodd-Frank Act.²⁵⁹ The private adviser exemption was removed and now registration is required under the Act; not only for hedge funds, but also for private equity funds, however, an exemption for venture capital funds has been put in place.²⁶⁰

3.5.2 Investment Companies Act Exemptions

A hedge fund has to ensure it is not regarded as a mutual fund within the Investment Companies Act of 1940.²⁶¹ Otherwise, it would have to comply with all restrictions imposed on mutual funds – limited leverage, liquid assets, dispersement, no performance based fees to name a few. The first mean to achieve this is the Section 3(c)(1) exemption.²⁶² It is applicable when the securities are not offered to the public and there are no more than 100 US resident investors, which have to be ‘accredited investors’ under Regulation D.²⁶³ In counting the investors the look-through approach is used, which makes the exemptions less suitable for larger hedge funds.

The second option to avoid mutual fund rules is the Section 3(c)(7) exemption.²⁶⁴ In contrast to 3(c)(1) there can be an unlimited number of investors, but the requirements of an ‘accredited investor’ are extended to include a higher net value of the investor set at \$5 million.

3.5.3 Foreign Private Adviser Exemption

This section will examine, what are the regulatory obligations for a hypothetical AIFM in the EU trying to either establish an AIF in the US or to market its non-US AIFs to US

²⁵⁷Registration Under the Advisers Act of Certain Hedge Fund Advisers, Release No. IA-2333 (see n. 256).

²⁵⁸*Goldstein v SEC* 451 F3d 873 (DC Cir 2006).

²⁵⁹Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (United States, 2010) §403.

²⁶⁰Sjostrom (see n. 254) 41.

²⁶¹Scott and Gelpert (see n. 251) 964-66.

²⁶²Investment Companies Act (United States, 1940).

²⁶³17 CFR § 230.501.

²⁶⁴1940 Act (see n. 262).

investors. Much as US based AIFMs, foreign AIFMs used the private adviser exemption, which enabled them to avoid registration with the SEC under the Investment Adviser Act.²⁶⁵

The private adviser exemption has been replaced by a foreign private adviser exemption.²⁶⁶ A foreign private adviser is an investor, who—

- (A) has no place of business in the United States;
- (B) has, in total, fewer than 15 clients *and investors* in the United States in private funds advised by the investment adviser;
- (C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than \$25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title; and
- (D) neither—
 - (i) holds itself out generally to the public in the United States as an investment adviser; nor
 - (ii) acts as—
 - (I) an investment adviser to any investment company registered under the Investment Company Act of 1940; or
 - (II) a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 (15 U.S.C. 80a-53), and has not withdrawn its election.²⁶⁷

It should be observed, how in addition to 15 clients, the term ‘investor’ was added, thereby eliminating the possibility of counting funds as clients. In effect, the Foreign Private Adviser Exemption, due to its stringent conditions, applies only to smaller funds or funds with few US investors, in contrast to the previous exemptions, which encompassed almost all hedge funds.

3.5.4 Private Fund Adviser Exemption

The Investment Advisers Act in its current form provides for additional exemptions. One of those is the Private Fund Adviser Exemption,²⁶⁸ which exempts any investment adviser, who solely advises private funds and has AuM under \$150 million. Despite the absence of registration, advisers still have to maintain proper records and provide timely reports to the SEC.

²⁶⁵ Anne Marie Godfrey et al., “US Financial Reform Law: key changes for non-US advisers and certain investors in hedge and private equity funds” (2010) 11(4) The Journal of Investment Compliance 19, 19.

²⁶⁶ Dodd-Frank Act (see n. 259) §403.

²⁶⁷ IAA (see n. 252) Sec. 202(a)(30) (emphasis added).

²⁶⁸ *ibid.*, Sec. 203(m).

3.5.5 Conclusion

After Dodd-Frank US legislation still provides exemptions from the Investment Companies Act (ie allows hedge fund strategies), but in essence abolishes the exemptions in the Investment Advisers Act, which leads to the general requirement of AIFMs to register with the SEC.

The new law in the US is in line with the same principles which are inherent in the AIFMD. AIFMs have to register and report to the SEC. Based on the collected data the SEC makes a systemic risk assessment. If necessary the FSOC may designate a hedge fund as systemically important, which brings it under Fed oversight. Additionally the FSOC may impose leverage limits on hedge funds posing a threat to systemic risk,²⁶⁹ similar to the AIFMD.

²⁶⁹Scott and Gelpert (see n. 251) 977.

Final words

To say the AIFMD is unnecessary would be at least unfounded. Relying upon years of practice and bitter experiences from the Great Recession, a reform of alternative investment fund regulation has been put forward, incorporating the common decision to require registration and impose regulatory oversight together with the necessary fixes aimed at improving the position of investors.

The AIFMD has put the necessary EU layer on top of alternative investment regulation. Prior to the AIFMD some Member States not only have not permitted the establishment of AIFs, but also prohibited marketing to investors in that Member State. While the AIFMD does not oblige Member States to lay the framework for a full AIF industry, it nevertheless requires them to allow AIFMs from other Member States to market to their investors.

Another important aspect is the prudential regulation. We are not certain that this would prevent future crises to have such a devastating impact. The general idea is to accumulate some information from AIFMs, so that the NCAs and ESMA will have the opportunity to assess, whether the developments in the market pose a threat to the functioning of the financial system. Without reporting obligations regulators would not know, in what state the market was and what to do about it. In the end, the most important figure is the leverage. The Directive and the Regulation go to great lengths to properly define how leverage is calculated, when is the 'leverage on a substantial basis' reached and what are the consequences of exceeding the threshold.

The passport is a feature which, I believe, is the justification why the AIFMD's application is defined as 'all other funds.' Otherwise, venture capital funds, private equity funds and all other funds could be influenced by Member States' policies, which would not necessarily benefit the internal market. And not only within the EU, the passport is also made available to countries outside the EU. These non-EU AIFMs and AIFs could otherwise operate only in Member States which had the necessary legislation put in place. The AIFMD not only solves this problem, but also enables an EU wide passport obtained in only one Member State and valid for the whole EU.

There has been some heated debate around depositaries. The model that the AIFMD puts in place is more in line with established models on the continent (eg Luxembourg) than it is in the UK, where managers with the most AuM are situated. Nevertheless, the

differences seem to be not too difficult to overcome. With the promise of having access to the large EU market, fund centres like the Cayman Islands are quickly adapting to retain their position in the market.

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Annex: Curriculum Vitæ

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High School Diploma, final exam score 32 out of 34, additional subjects Physics and German 2007

Master thesis

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url: <https://www.dropbox.com/s/ix1as40v4id4auo/masterthesis.pdf?dl=0>

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Bachelor thesis

title: *Alternative Patent Dispute Resolution (in Slovene)*

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Work experience

Government of the Republic of Slovenia

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