

**IMPACT OF THE AIFMD ON EUROPEAN HEDGE FUND INDUSTRY:
CASES OF THE UNITED KINGDOM AND FRANCE**

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Abstract

AIFMD is one of the most controversial pieces of the European Union financial regulation. The Directive practically finalizes the process of bringing under the EU-level oversight virtually all types of investment activities. Even though it regulates only alternative investment fund managers, it is argued that AIFMD aimed to extend the supranational supervision over hedge funds and other highly leveraged institutions, despite the inherent problem of absence of their proper legal definition. This thesis will demonstrate, how the European legislator addressed this issue. It will also discuss another challenge of hedge fund regulation in the European Union: historical differences between the approaches of the Member States, as well as their different political and economic objectives. This thesis will demonstrate the major interests and effects of AIFMD on two levels: the European Union and the individual Member States: the United Kingdom and France. After offering an insight into the rigorous requirements of the Directive, the thesis will discuss its implications on hedge funds industry and will argue that at the Union level, AIFMD achieves political goals better than its economic objectives. Finally, this thesis will demonstrate, that the Directive better serves the interests of the French, than the British hedge fund industry.

To: The people of Hungary, who offered me such a warm welcome, and especially to the Central European University community, who opened in front of me exciting new horizons.

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List of Abbreviations

AFG	French Asset Management Association
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD, THE DIRECTIVE	Alternative Investment Fund Managers Directive
AMF	Autorité des Marchés Financiers (Authority of Financial Markets) [Fr.]
COB	Commission des Opérations De Bourse [Commission on the Operations of Stock Exchange) [Fr.]
COMMISSION	Commission of The European Union
DODD FRANK ACT	Dodd-Frank Wall Street Reform and Consumer Protection Act
DP	Discussion Paper
ECJ	European Court of Justice
EEA	European Economic Area
ESMA	European Securities And Markets Authority
EU, THE UNION	European Union
EUR	Euro
EVCA	European Private Equity and Venture Capital Association
FCA	Financial Conduct Authority
FCIMT	Fonds Communs d'Intervention sur les Marches a Terme (Futures and Options Funds) [Fr].
FSMA	Financial Services and Markets Act
FIA	Financial Investment Advisor
FSA	Financial Services Authority
G20	The Group of Twenty Major Economies
HM GOVERNMENT	Her Majesty's Government
HM TREASURY	Her Majesty's Treasury
INC.	Incorporated
INT.	International

IORPD	Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision
J.	Journal
MIFID	Directive on Markets in Financial Instruments
OPCVM ARIA	Organisme De Placement Collectif En Valeurs Mobilières Agréés a Règles d'Investissement Allégés (Undertaking For Collective Investment in Transferable Securities with Simplified Investment Rules) [Fr.]
OPCVM CONTRACTUELS	Organisme De Placement Collectif En Valeurs Mobilières Contractuels (Contractual Undertaking For Collective Investment in Transferable Securities) [Fr.]
PFIA ACT	The Private Fund Investment Advisers Registration Act Of 2010
REV.	Review
SEC	Securities and Exchange Commission
SICAV	Société D'investissement a Capital Variable (Open-Ended Collective Investment Scheme) [Fr.]
TFEU	Treaty On The Functioning Of The European Union
UCITS	Undertakings For The Collective Investment Of Transferable Securities
UCITS DIRECTIVE	Directive on Undertakings for the Collective Investment of Transferable Securities
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America
USD	Unites States Dollar

Introduction

“Regulation is fundamentally about the promotion of economic efficiency”¹

At the time of crisis, regulators are fast to conclude that everything went wrong because of the omissions in administrative oversight.² This was indeed the case in Europe in the aftermath of 2007-2008 crisis where legislators’ response was “unprecedented amount of regulation”³ of financial markets. As a result, the European hedge funds managers, which had not been subject to any supranational rules first fell under the EU-level oversight under the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD).⁴

Despite relatively loose oversight prior to the crisis, the economic and especially political climate in its aftermath indicated that “increased regulation of hedge funds was inevitable”.⁵ Nevertheless, the positions of the major European jurisdictions differed considerably. On one hand the United Kingdom resisted more European Union level intervention, and on the other hand France and Germany strived for tighter supranational regulation. Amid the tensions between these two lines of thinking, the crisis accelerated the action of the European Commission and adoption of AIFMD.

¹ JEFFREY CARMICHAEL, MICHAEL POMERLEANO, *THE DEVELOPMENT AND REGULATION OF NON-BANK FINANCIAL INSTITUTIONS* 22 (The World Bank, Washington D.C. USA, 2002).

² See: CHARLES A. E. GOODHEART, *THE REGULATORY RESPONSE TO THE FINANCIAL CRISIS* 55, (Edward Elgar Publishing Limited, 2009).

³ Angus Duncan, Edmond Curtin, Marco Crosignani, *Alternative regulation: the Directive on Alternative Investment Fund Managers*, 6 (3) CAP. MAR. L. J.326, 326.

⁴ Jose Manuel Barroso explained the goals of AIFMD: “The adoption of the directive means that hedge funds and private equity funds will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system”. Jose Manuel Barroso, *European Commission Statement at the Occasion of The European Parliament Vote on The Directive On Hedge Funds And Private Equity*, Nov. 11, 2010.

⁵ Paul Farrell, Gayle Bowen, Catherine Fitzsimons, *Hedge Funds Feel the Regulatory Pressure*, 2013 IFC Rev. 29, 29, available at: <http://www.walkersglobal.com/Lists/News/Attachments/321/Walkers%20IFC%20Review%202013%20Hedge%20Funds%20Regulatory%20Pressure.pdf> (last visited: Mar. 28, 2014).

AIFMD caused a “storm of controversy”⁶, primarily because of its very broad scope and unprecedented new requirements. The Directive covers the whole range of different vehicles: hedge funds, private equity funds, commodity funds, funds of hedge funds, etc. It introduces new rules on AIFM authorization, delegation of authorities, asset custody and valuation, transparency, managing conflicts of interests, leverage, remuneration policies, etc. The principal novelty for fully compliant AIFMs will be a possibility to obtain the AIFMD “passport” and market the AIFs everywhere in the EU after being authorized by any Member State regulator.⁷

The preamble contains the declared goals of AIFMD, such as creating the Union-level tool for strengthening investor protection and market integrity via added safeguards against systemic risk. It is therefore, possible to distinguish two dimensions: political (single market goals) and economic (investor protection, stability of the market). Due to the expedited tempo of its drafting and lack of public consultation, it is contended that AIFMD was a result of a Franco-German political agenda⁸ which was not backed by profound economic assessment. Thus, it will not bolster stability and economic growth; rather, it is going to harm the alternative investments industry as well as investors. This paper will address these concerns.

⁶ Deloitte, *Responding to the new reality: Alternative Investment Fund Managers Directive Survey*, 3, Jul. 2012, available at: <http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf> (last visited: Mar. 28. 2014).

⁷ Articles 2 (1), 4 (1), 39-42 of AIFMD.

⁸ Mr. Anthony Travers, the Chairman of Cayman Islands Stock Exchange, argued that AIFMD was a “blatant attack of Franco-German axis, which has convinced itself that the City of London is where the roots of the financial crisis lie”. Anthony Travers, *Political intentions behind AIFMD*, Financial Times, Apr. 9, 2012; Yet another commentator called AIFMD “fundamentally flawed, knee-jerk political response”. Neil Griggs, *AIFMD not there yet*, Investment Adviser, May 28, 2012.

Even though it stretches over the different vehicles, it is widely believed that AIFMD was mostly enacted to “tame” hedge funds – the riskiest animals⁹. Therefore, I will focus on the impact of the Directive on the European hedge fund industry. I will argue that AIFMD was chiefly based on political rather than economic considerations and may result in misallocation of limited administrative resources. I will demonstrate that while the Directive may eventually have some positive effects (enhanced single market for financial assets, increased investor trust, more competition), such possible benefits will hardly outweigh the immediate detriments (rise in costs, limited choice for investors, lowered global competitiveness).

It is also argued that AIFMD will have different effects in the EU jurisdictions. While French industry is expected to benefit from the Directive,¹⁰ it is likely that AIFMD will have most adverse effect in the UK¹¹, as London’s position as the leading center for asset management will be impaired by the supranational regulation. This paper will further address these postulates and demonstrate that in post-AIFMD era the UK industry is going to suffer the most detriment.

⁹ See: The article in Financial Times refers to hedge funds as “the main target of the AIFMD”. Chris Flood, *ICI Global warns on EU plans*, Jun. 24, 2012, available at: <http://www.ft.com/cms/s/0/1803739e-bbc0-11e1-9aff-00144feabdc0.html#axzz2vZvr6gyX> (Last visited: Mar. 28, 2014).

¹⁰ See: Stéphan Janin, the representative of the French Asset Management Association AFG stated that “at least France” will benefit from the Directive. Stéphan Janin, *AIFMD, The JOBS Act and Other Key Concerns for U.S. and Foreign Fund Managers*, Regulatory Compliance Webinar series, Jan. 22, 2014, available at: <http://www.parisfundindustry.com/wp-content/uploads/2014/01/1-22-14-AIFMD-Webinar.pdf> (last visited Mar. 28, 2014).

¹¹ See: Reuters columnist Margaret Doyle argued: “London’s hedge fund managers and private equity firms are lobbying hard against the proposals, which they see as another attack on Britain’s prized financial services industry.” Margaret Doyle, *EU Funds Regulation Hits the Wrong Target*, Reuters, May, 5, 2009, available at: <http://blogs.reuters.com/great-debate-uk/2009/05/05/eu-funds-regulation-hits-the-wrong-target/> (last visited Mar. 28, 2014).

Structure of the Thesis

Before getting to the main submissions of this paper, I will first present some background information. Chapter 1 will provide a general overview of European alternative investment industry. First, I will address the notion “alternative investments” and demonstrate that it is not homogenous, rather a very wide and all-encompassing term. This is one of the reasons why regulating alternative investment vehicles has been so problematic. I will further move to shortly describe the essence and activities of hedge funds, allegedly the main addressees of the Directive. I will conclude Chapter 1 with overview of alternative investment industry in the EU, with focus on the UK and France.

Chapter 2 will dig into details of AIFMD. I will review the legislative history from UCITS Directive to AIFMD, will reflect on the different levels of regulation, based on Lamfalussy process and briefly describe the role of new European Securities and Markets Authority (ESMA). Later I will follow with the content of the Directive and will discuss some of its main novelties: authorization and operating conditions for alternative investment fund managers, asset custody and valuation rules, transparency requirements and, finally, the newly emerging pan-European AIFM passport.

Chapter 3 will address the impact of AIFMD. I will start from briefly describing the standing of different EU jurisdictions in terms of transposition of the Directive into national laws and will focus on implementation process in the UK and France. Later I will assess the impact of AIFMD. I will list its most important positive novelties, as well as the major failures of the Directive. I will show the reasons how AIFMD may harm the hedge fund industry as well as investors. I will also demonstrate, that AIFMD will be more detrimental for the UK, which may risk to lose its reputation of the main financial hub, than for France, which is expected to benefit from the new Directive. I will end the paper with the concluding remarks.

Chapter 1 - Overview of the European Alternative Investment Industry

“When it comes to alternatives, much more is believed than is known”¹²

1.1. Alternative Investment Industry – A Divisible Whole

Alternative investment represents a relatively new phenomenon which aims to deviate from existing risk/return profiles, enhance investors’ portfolios and create new types of investing opportunities. While diversity of alternatives is unquestioned - “the universe of alternative investments is just that – the universe”¹³ – there is no clear definition for this new category. Neither law, nor finance has a readily available solution. As for the law, AIFMD applies to managers of the whole specter of alternative investment funds, but does not give a definition of “alternative investment” itself. From finance perspective, two ways to understand the essence of alternative investment are exclusion and inclusion theories.¹⁴

According to the exclusion theory, alternative investment can be defined as everything falling outside the traditional investment. Bookstaber defines “traditional” asset class as “stocks and bonds of developed countries”.¹⁵ Unlike “traditional” investors, alternative investors seek uncorrelated returns inter alia by using high leverage in combination with other risky strategies. Alternative investments are restricted to professional clients (institutional investors and high net worth individuals). AIFMD follows the exclusion theory since it covers all AIF managers and self-managed AIFs, falling outside the scope of the

¹² Klaas P. Baks, Chris Rider, *A Research Agenda For Alternative Investments: A Limited Partner’s Perspective*, 2009 Emory Center for Alternative Investments, 1, 4, available at: http://goizueta.emory.edu/faculty/cai/documents/ECAI_research_agenda.pdf (last visited: Mar. 28, 2014).

¹³ Richard Bookstaber, *Hedge Fund Existential*, 59 (5) FIN. ANAL. J., 19, 20.

¹⁴ MARK J. P. ANSON *et al.* CAIA LEVEL I: AN INTRODUCTION TO CORE TOPICS IN ALTERNATIVE INVESTMENTS 6 (Wiley Finance, 2nd ed. 2012).

¹⁵ Bookstaber, *supra* note 13.

UCITS Directive.¹⁶In this sense, AIFMD is considered to have a “basket function” since it catches all the left-over types of investment, not covered by already existing EU financial regulation.¹⁷

Conversely, the inclusion approach attempts to define alternative investment by explicitly naming its most notable types. Non-exhaustive list of alternative asset classes includes hedge funds, real estate and other real assets, private equity, commodities’ and currency futures and other financial derivatives, as well as illiquid assets, like wine, antique or art. For better illustration, I will list couple of alternative asset classes.

Commodities are “homogenous goods, available in large quantities”.¹⁸ These mainly include energy sector (natural gas, oil), metals (precious metals, aluminum), agriculture products (corn, rice), etc.¹⁹ Commodities are generally traded in an organized manner, using commodity futures contracts. The latter represents bilateral obligation in which the seller (the “short”) agrees to deliver to the purchaser (the “long”) pre-determined amount of specified commodity at a pre-agreed future date and receives the negotiated price.²⁰ Commodity futures are one of the oldest types of derivative financial instruments, which have standardized form today.

Private equity investments are made in privately held rather than in public companies. Private equity is a distinctive asset class that trades between investors rather than in organized markets.²¹ Private equity investments may be made via different vehicles (e.g. venture capital funds) and using different strategies (e.g. leveraged buy-out). Also, private equity firms may

¹⁶ Article 4 (1) (a) of AIFMD.

¹⁷ See: DIRK A. ZETZSCHE ed., *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE* 11 (Kluwer Law International, 2012).

¹⁸ ANSON et al. *Supra* note 14.

¹⁹ See also: For example, Thomson Reuters Equal Weight Continuous Commodity Index (CCI) lists standardized commodity futures, including energy, agricultural assets, etc. at their online platform, available at: <http://www.reuters.com/finance/commodities> (last visited: Mar. 28, 2014).

²⁰ JERRY W. MARKHAM, THOMAS LEE HAZEN, *CORPORATE FINANCE* 653, (Thomson West 2004)

²¹ Andrew Ang, Morten Sorensen, *Investing in Private Equity* 2013 ALT. INVES. ANAL. REV. 20-30.

invest not only in pure equity but also different types of debt obligations, for example, mezzanine debt. With EUR 72 billion the UK is the number one private equity investment destination in Europe, followed by France (EUR 45 billion).²²

It is possible to devote the whole thesis to only listing and discussing different types of alternative investment. However, for the purposes of this paper, I will conclude this part here. As this overview demonstrates, alternative investment cannot be regarded as an indivisible whole. Rather, the opposite is true. The term encompasses wide range of investment opportunities. Since it is so hard to even define alternative investments, their regulation is also a difficult task.

Perhaps due to its complicated nature and also, the lucrative sums involved, there are a lot of myths surrounding this industry. They reach out every alternative vehicle, however, hedge funds are the most demonized of all alternatives. In the next section I will review the main features and inherent risks related to hedge funds – the notorious alternatives.

1.2. Hedge Funds – the Riskiest of all Alternatives

Hedge funds are probably the most controversial investment vehicles of all times. On one hand, some argue that they contribute to price discovery process and stabilize market prices during market shocks, therefore, they are important for “completeness” of markets.²³ On the other hand, highly leveraged hedge funds are seen as a substantial threat to market stability.²⁴ Popular media often uses the term to describe greed and selfishness. Main criticism comes because of extreme risk-taking. Many believe that the main goal of European

²² Frontier Economics, *Exploring the impact of private equity on economic growth in Europe* 11, May 2013.

²³ Andrew Crockett, *The evolution and regulation of hedge funds*, 10 FIN. STAB. REV. (Special issue on hedge funds, 2007), 19, 22.

²⁴ GORDON DE BROUWE, HEDGE FUNDS IN EMERGING MARKETS 48-52, (Cambridge University Press, 2011).

Commission while enacting AIFMD was to regulate hedge funds. Therefore, it is important to understand the most salient features of these risky vehicles. Before getting into the details, however, it is important to note that “hedge fund” is not an established legal term. It describes diverse investment policies which will be described below.

The first functional equivalent of the hedge fund was established by a New York based *Forbes* author²⁵ Alfred Winslow Jones in 1949, while the name to describe his activity was coined as late as in 1966. Carol Loomis in the “Fortune” article “The Jones Nobody Keeps Up With” created a label for this fast-growing industry. As for today, hedge fund industry is one of the most dynamic parts of the financial market.²⁶

Lately, hedge funds have turned into a widespread asset class which is closely correlated to multiple third parties: fund managers, prime brokers, broker-dealers, fund administrators, custodians, etc. Most of hedge funds pursue risky strategies²⁷ and are usually highly leveraged²⁸. Perhaps, this is why they are deemed to pose significant counterparty risk²⁹ for the related parties, especially banks. Fast growth of the industry fosters such fears even more.

²⁵ Rene M. Stulz, *Hedge Funds: Past, Present and Future*, 21 (2) J. OF ECON. PERSP. 175, 176.

²⁶ DOUGLAS CUMMING, NA DAI, SOFIA A. JOHAN, *HEDGE FUND STRUCTURE, REGULATION, AND PERFORMANCE AROUND THE WORLD* 265 (Oxford University Press, 2013). [hereinafter CUMMING et al.]

²⁷ The UK’s Financial Services Authority in its Discussion Paper on hedge funds mentions three main non-traditional strategies:

1. Event driven, where funds investing in securities try to take advantage of price movements generated by corporate events. (E.g. merger arbitrage funds and distressed asset funds.)
2. Global macro, according to which funds follow economic trends to take long and short positions in major financial markets.
3. Market neutral, where fund managers aim to minimize market risk (E.g. long/short equity funds, convertible bond arbitrage funds, fixed income arbitrage). The Financial Services Authority, *Discussion Paper No. 16, Hedge Funds and the FSA*, Nov. 2002. [hereinafter FSA DP 2002].

²⁸ The Financial Stability Forum found that most hedge funds use leverage with an average ratio of 2:1, however, some of them (‘Market neutral’ funds) tend to demonstrate highest on-balance-sheet leverage ratio of approximately 4:1. Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, Apr. 5, 2000, available at: https://www.financialstabilityboard.org/publications/r_0004a.pdf (last visited: Mar. 28, 2014).

²⁹ Counterparty credit risk is defined by the Basel Committee on Banking Supervision, as “the risk that the counterparty to a transaction could default before the final settlement of the transaction’s cash flows. An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a

According to Reuters, global hedge fund industry, which counted only 600 funds in 1990, now exceeds 10,000 hedge funds.³⁰ In terms of assets under management, the United States is a global leader. International research and consultancy firm Preqin's Special Report on the US Hedge Fund Industry (2013) reveals that absolute majority of 73% of total hedge fund industry assets under management are held by American funds.³¹ For the same year, European-located funds accounted for 22.3% of capital inflow, while the share of Asian-located funds was 5.8%.³² According to Hedge Fund Research Inc. capital invested in hedge funds reached its record of USD 2.63 trillion by the end of last year³³. This represents 17% increase in the industry compared to the previous year. The recent Deutsche Bank survey also revealed that institutional investors demonstrate growing appetite for hedge funds and their non-traditional strategies.³⁴

These results are often brought up to predict further growth of the industry and its ability to influence the systemic risk. Such data are also used as a justification for more detailed and/or restrictive regulation.³⁵ While guesstimating the numbers, what is often forgotten

positive economic value at the time of default." Bank for International Settlements, Jul. 2005 *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, 1, 19.

³⁰ Katya Wachtel, *Why hedge funds still manage to seduce*, Reuters, Nov. 22, 2013, available at: <http://www.reuters.com/article/2013/11/22/us-reuters-summit-hedgefundinvestors-ana-idUSBRE9AL14020131122> (last visited: Mar. 28, 2014).

³¹ Preqin Special Report: US Hedge Fund Industry The Leading Player in Hedge Funds, Sep. 2013, available at: https://www.preqin.com/docs/reports/Preqin_Special_Report_US_Hedge_Fund_Industry_Sep_13.pdf (last visited: Mar. 28, 2014).

³² Hedge Fund Research, *Hedge Fund Assets Surge to New Record To Begin 2014*, Jan. 21, 2014, available at: https://www.hedgefundresearch.com/pdf/pr_20140121.pdf (last visited: Mar. 28, 2014).

³³ *Id.*

³⁴ Viola Caon, *Hedge funds: From alternatives to mainstream - Deutsche Bank*, Investment Europe, Dec. 2, 2013, available at: <http://www.investmenteurope.net/investment-europe/research/2316343/hedge-funds-from-alternatives-to-mainstream-deutsche-bank> (last visited: Mar. 28, 2014).

³⁵ Even though hedge funds were not found as main cause of the crisis, Cumming, Dai and Jonah argue that otherwise, due to their secretive nature and affiliation to the "shadow-banking system" (falling outside the regulation), it would be impossible to collect necessary data about hedge funds. This would therefore, make it impossible to determine their contribution to the systemic risk, which would lead to inability to control and manage such risk. See: CUMMING et al. *supra* note 26 at 266-268.

though, is that the assets under management of the whole global hedge fund industry are almost the same size as the consolidated annual assets of one universal bank only³⁶.

Although their popularity rises fast, there is still no universal definition of hedge funds. Article 4 of AIFMD defines alternative investment funds (AIFs) as collective investment undertakings, which “raise capital from investors with a view of investing according to defined investment policy for the benefit of those investors.”³⁷ Hedge funds fall under this general definition. In this sense, they resemble traditional mutual funds. However, Ineichen in his famous book “Absolute Returns: The Risk and Opportunities of Hedge Fund Investing” makes a clear distinction between hedge funds and their false cognates. Mutual fund aims to achieve relative positive returns while “hedge fund constitutes an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities while protecting principal from potential financial loss”.³⁸

It is important to note that hedge funds differ from mutual funds also in the types of risks they take. Based in the relative returns dichotomy, the main task of mutual funds in terms of risk is not to underperform a pre-determined benchmark. In other words, mutual funds merely try to replicate or beat specified market indices or other objective targets. To the contrary, in hedge funds’ absolute returns environment, fund managers face total risk of capital depreciation or loss. They do not target any particular benchmark. Rather, hedge funds try to deliver absolute returns while being able to stay alive.³⁹

Even though one of the most criticized aspects of hedge funds is alleged excessive risk taking, it is in fact embodied in their very nature. Such inherent risk is one of the reasons why

³⁶ The assets of Deutsche Bank for 2012 was USD 2, 012, 329 million. See: *Deutsche Bank Annual Report 2012, Consolidated Balance Sheet* as of Dec. 31, 2011, available at: <https://annualreport.deutsche-bank.com/2012/ar/financialstatements/consolidatedbalancesheet.html> (last visited: Mar. 28, 2014).

³⁷ Article 4 (1) a (i) of AIFMD.

³⁸ ALEXANDER M. INEICHEN, *ABSOLUTE RETURNS: THE RISK AND OPPORTUNITIES OF HEDGE FUND INVESTING* 34 (Wiley, 2002).

³⁹ ROBERT JAEGER, *ALL ABOUT HEDGE FUNDS: THE EASY WAY TO GET STARTED* 282-285 (McGraw-Hill, 2002).

hedge funds are managed by professional investment managers and are marketed solely to professional clients. Even more so, ability to redefine risks and provide novel solutions is perhaps one of the most important motivating factors of hedge funds' clientele. It is also argued, that risk management is the "area hedge funds have excelled".⁴⁰

Another particularity of hedge funds is constant innovation. To keep up with the overwhelming competition, hedge funds are under pressure to discover and test novelties. To continue innovating, however, hedge funds seek maximum freedom. This is probably why hedge fund structures tend to be formed mostly in offshore zones with far less stringent regulatory oversight and tax burden.⁴¹ On the other hand, hedge fund managers are obliged to take into account investment trust and rely on different service providers. Even though hedge fund investors are chasing the alpha, they also care about foreseeability and quality of the service. Therefore, unlike hedge funds, their managers tend to have their principal place of business in leading financial centers and comply with their supervising authorities.

This is where AIFMD comes into play. Even though it does not directly regulate the funds, the Directive brings them under supervision by imposing strict rules on the AIF managers. It is argued, that unlike indirect regulation of hedge funds in the US (where Dodd Frank Act introduced limitations for the prime brokers to lend money to hedge funds and its Volcker rule prevented banks from managing hedge funds) "European regulators imposed

⁴⁰ Richard Baker, *Education and Advocacy in a Post-Crisis World*, The 2013 Preqin Global Hedge Fund Report, 1,6.

⁴¹ According to the European Commission, it is typical for EU-based managers to manage funds domiciled in Cayman Islands. European 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*, Dec. 19, 2012.

direct regulation on hedge funds under the guise of and using the terminology of indirect regulation”.⁴² Whether this was a correct choice, remains arguable.

Whereas there is no universal consensus, as to how (much) hedge funds have to be regulated, it is recognized that proper oversight can contribute to better performance and benefit the investors. However, such regulation, if improper, “can facilitate consistently poor performance”⁴³ on investors’ detriment. As will be demonstrated below, some elements of AIFMD are principally perceived as beneficial for the development of the industry. On the other hand, some portions of the Directive largely fall under the latter, “improper” category.

1.3. Hedge Fund Industry in the UK

Trading with financial instruments counts centuries in the UK. This métier was already widespread in London when its first regulation was introduced in 1697⁴⁴. London stock exchange was founded in 1801.⁴⁵ Today, British capital is Europe's leading center for hedge fund managers. The recent report of the City UK Research Centre describes several key advantages of London, as the second largest global center for hedge funds management.⁴⁶ According to the report, funds based in the UK manage around 85% of European-based hedge fund assets which means that 18% of global hedge funds’ assets are managed from

⁴² See: Hossein Nabilou, *Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 1, 30, Sep. 10, 2013, working paper, available at: SSRN: <http://ssrn.com/abstract=2323377> (last visited: Mar. 28, 2014). See also: Giorgio Tosetti Dardanelli, *Direct or Indirect Regulation of Hedge Funds: A European Dilemma*, 4 EUR. J. RISK REG, 463-480.

⁴³ CUMMING et al. supra note 26 at 230.

⁴⁴ IAIN G. MACNEIL, *AN INTRODUCTION TO THE LAW ON FINANCIAL INVESTMENT* 39, (Hart Publishing, 2nd ed. 2012).

⁴⁵ Official website of the London Stock Exchange: *Company Overview*, available at: <http://www.londonstockexchange.com/about-the-exchange/company-overview/company-overview.htm> (last visited Mar. 28, 2014).

⁴⁶ Marko Maslakovic: *Hedge Funds*, 2012 Financial Markets Series, 1, 1, available at <http://www.kellogg.northwestern.edu/faculty/bandyopadhyay/courses/Investments/TheCityUK.Report.Hedge-Funds.May-2013.pdf> (last visited Mar. 28, 2014).

London.⁴⁷ The UK is also a leader in fund-related services, such as prime brokerage, fund administration and custody. Such overall trend makes it a very attractive destination. This is probably why in 2011 out of total 1,200 European hedge-funds around two-thirds were based in London.⁴⁸

As for the regulation, MacNeil illustrates that prior to 1986 Financial Services Act, the UK heavily relied on industry self-regulation. Later on, next to the self-regulatory organizations, a single regulator the Securities and Investment Board was introduced. In subsequent years though, such co-existence proved to be ill-functioning. Collapse of Barings Bank in 1995 proved that different regulators for the banking sphere and securities trading complicated monitoring of risks. Therefore, in 1997 a single regulator, Financial Services Authority was established. Its powers were further strengthened by the Financial Services and Markets Act (FCMA) of 2000.⁴⁹

Unlike other rules-based jurisdictions (e.g. the US), the UK regime has historically been principle-based, meaning that the statutes contain only the main principles, while the regulatory authorities are granted large discretion. This was true for the FSA too: “The FSA has clearly not promulgated, and has chosen not to promulgate, a detailed all-embracing comprehensive code of regulations to be interpreted as covering all possible circumstances. The industry had not wanted such a code either.”⁵⁰

Concerning the fund managers, the UK regulated them as early as 2000. Section 19 of the FCMA formulates the general prohibition not to conduct the regulated activity without authorization. Section 22 defines a broad spectrum of regulated activities:

⁴⁷ Maslakovic, *supra* note 46 at 3.

⁴⁸ *Id.*

⁴⁹ MACNEIL, *supra* note 44 at 39-47.

⁵⁰ British Bankers Association v. The Financial Services Authority and The Financial Ombudsman Service, Case No: CO/10619/2010, High Court of Justice, Queen's Bench Division, Administrative Court, Apr. 20, 2011.

Section 22. The classes of activity and categories of investment:

(1) An activity is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and—

(a) relates to an investment of a specified kind; or

(b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.

Managing investments falls under this general article because it is (1) an activity of specific kind, (2) are carried on by way of business and (3) related to an investment of a specific kind. Provision of regulated activities without specific authorization is a criminal offence.⁵¹ Therefore, a decade before AIFMD, fund managers were already subject to authorization requirements. Besides, investment managers already had to comply with threshold requirements and business conduct rules (e.g. procedures in place to demonstrate compliance). These provisions were detailed in FSA Handbook, which also incorporated EU-level regulations, such as MiFID⁵².

Important aspect of hedge funds managers' regulation was risk-based approach of the regulator and understanding that such firms have only "low impact on both retail consumers and UK financial markets".⁵³ Therefore, apart from the authorization and business conduct rules, FSA had chosen to use its discretion and to only minimally interfere in hedge fund managers' activities: "Mindful of our statutory requirement to be economic and efficient in the use of our resources, we therefore do not apply our scarce supervisory resources to maintaining a close supervisory relationship with such firms."⁵⁴

⁵¹ Section 19 of FCMA.

⁵² Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [Official Journal L145 of 30.4.2004].

⁵³ FSA DP 2002, *supra* note 27, at 17.

⁵⁴ *Id.*

In the post-crisis period, however, the UK also witnessed a call for tighter regulation. Already in 2009 FSA warned that hedge funds must not become “shadow banks”.⁵⁵ The 2011 communication of Her Majesty’s Treasury envisaged strengthening financial supervision by substituting the FSA with a new, more empowered regulator: the Financial Conduct Authority (FCA). The new regulator would, inter alia, serve “protecting and enhancing the confidence of all consumers of financial services – from retail customers choosing a current account to a hedge fund engaging in multi-million pound derivatives trades.”⁵⁶ The Financial Services Act of 2012 confirmed the creation of FCA which, interestingly, functions as a private company limited by guarantee and is fully funded by the financial service providers that it regulates.

The principle-based, risk-centered regulation with a more flexible and friendly authority clearly distinguished the UK from other EU jurisdictions, including France, which regulated both hedge fund managers and the funds themselves. It was this industry-friendly reputation of the UK that AIFMD project got at stake. This is perhaps why “The British government and most of the AIFM sector were opposed to the draft directive and then led efforts to dilute its most constraining elements”.⁵⁷ Final text of AIFMD can be considered as some sort of a compromise. Nevertheless, its benefits to the UK industry are less clear while the post-AIFMD confusion and problems are more obvious.

⁵⁵ Nicholas Pettifer, *UK FSA increases hedge fund scrutiny*, 28 (4) Int. Fin. Law Rev., p. 16, 16.

⁵⁶ HM Treasury, *A new approach to financial regulation: building a stronger system*, February 2011, 1, 60.

⁵⁷ James Buckley, David Howarth, *Internal Market: Regulating the So-Called ‘Vultures of Capitalism’*, 49 J. COM. MAR. ST., 123, 130.

1.4. Hedge Fund Industry in France

Out of 19,095 non-UCITS funds in Europe in 2012⁵⁸, France had the most 4,300 alternative investment vehicles.⁵⁹ France is also the second most popular location of the EU fund managers. However, compared to London, it accommodates considerably smaller number of AIFMs. In 2005, only 15% of the European hedge fund managers were domiciled in Paris.⁶⁰ Nevertheless, according to Paris Fund Industry, as of 2013, managers from France had 19.1% of the EU assets under management and maintained slightly better positions than their German and British counterparts.⁶¹

France has long history of investment management. The very first open-ended collective investment scheme SICAV was launched there in 1963. Later, Paris became famous with its independent asset management companies, also known as “French boutiques”. As of today, Paris alternative investment funds hold EUR 996 billion and number of asset management companies are growing every year.⁶² Based on total net assets, French leader Amundi Asset Management was classified as Europe’s largest asset manager in 2013.⁶³ France also boasts with strong overall industry: custodians, auditors, as well as high-level technical education. Interestingly, French alternative funds are fully tax-transparent and their registration is possible on average 21 days.⁶⁴

⁵⁸ EFAMA, (52) *Quarterly Statistical Release*, Mar. 2013.

⁵⁹ Carine Delfrayssi, Assessing the potential impact of the AIFMD on the UCITS industry, 6 (2) J. SEC. OPER. & CUST., 113, 114.

⁶⁰ Tomas Garbaravicius, Frank Dierick, *Hedge Funds And Their Implications For Financial Stability*, European Central Bank, Occasional Paper No. 34, Aug. 2005.

⁶¹ French Asset Management Association (AFG) 2013 *Paris Fund Industry – The Smart Choice*, 1, 5 [hereinafter AFG 2013].

⁶² *Id.*

⁶³ Amundi Asset Management, *Alternative Investments by Amundi*, Sep. 2013, 1, 4, available at: [file:///C:/Users/Administrator/Downloads/Amundi%20AI%20-%20Corporate%20Presentation%20\(GP\)%20-%20March%202014.pdf](file:///C:/Users/Administrator/Downloads/Amundi%20AI%20-%20Corporate%20Presentation%20(GP)%20-%20March%202014.pdf) (Last visited: Mar. 28, 2014).

⁶⁴ AFG 2013, *supra* note 61.

In terms of regulation, French securities law is a relatively new phenomenon. As a separate body of law, it emerged as late as 1967 when Ordonnance No. 67-833 was passed and Commission des Opérations de Bourse (COB) was created to control stock exchange activities.⁶⁵ Later on, market participants were exposed to oversight under the Commercial Code and the Monetary and Financial Code. Even before AIFMD, France regulated both hedge funds (locally known as “fonds d’investissements spéculatifs” or “fonds commun d’arbitrage”⁶⁶) and their managers.

After passage of the Financial Security Act⁶⁷ of 2003, France counts three major legal forms of investment funds under which hedge funds are able to operate: Fonds Communs d’Intervention sur les Marchés à Terme (FCIMT - futures and options fund), Organisme de Placement Collectif en Valeurs Mobilières Agréés à Règles d’Investissement Allégés (OPCVM ARIA - undertaking for collective investment in transferable securities with simplified investment rules) and OPCVM contractuels (contractual undertaking for collective investment in transferable securities)⁶⁸. All of these funds are registered and supervised by French regulator Autorité des marchés financiers (AMF), which was created in 2003 to oversee the industry.

Financial Security Act of 2003 also introduced the status of Financial Investment Advisor (FIA). Investment advice got defined broadly as “providing personalized recommendations to third parties, either at their request or at the initiative of the company providing the advice, concerning one or several transactions in financial instruments”.⁶⁹ Thus, even before AIFMD, hedge fund managers were already caught by this definition. They were

⁶⁵ See: FRANK B. CROSS, ROBERT A. PRENTICE, EDWARD ELGAR PUB, LAW AND CORPORATE FINANCE 137-138 (Edward Elgar, 2007).

⁶⁶ OCDE: GLOSSAIRE DE L’ÉCONOMIE DE L’OCDE 227 (OCDE Publishing, 2006).

⁶⁷ Financial Security Act (Loi de sécurité financière), No. 2003-706, August 1, 2003.

⁶⁸ Anne C. Riviere, The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy, and Germany, (10) RICH. J. GL. LAW & BUS. 263, 284.

⁶⁹ Article D. 321-1 of the Monetary and Financial Code.

subject to different obligations under the supervision of the AMF. For example, Book III of General Regulation of AFM set the rules of conduct for investment service providers and requires, *inter alia*, to install internal “procedures and adequate measures”⁷⁰ to monitor conflict of interests, to separate and protect clients’ assets, to react to their complaints, etc. Fund managers had also been prohibited to engage in general solicitation of the units or shares of their funds (except from solicitation to qualified investors).⁷¹

Despite heavy oversight, hedge funds in France have often come under harsh criticism. Nicolas Sarkozy, campaigning for presidency in 2007, promised not to tolerate these “speculators”, allegedly the main representatives of the “capitalism without ethics or morals”.⁷² Attacks on hedge fund industry turned into a popular tool to accumulate political capital. On the other hand, however, there was an economic reality, notably, growing role of hedge funds and other alternative vehicles. French authorities were forced to take into account the challenges of global competitiveness. If in 1970-80s France was mainly state-driven economy, lately French corporate economy fell “under the control of powerful managerial elite.”⁷³ This turned the focus towards the commercial needs. At the same time, there has been a shift in investors’ mentality. They have become “both increasingly institutional and internationally minded”⁷⁴. Therefore, policy-makers became obliged to

⁷⁰ General Regulation of AMF (Règlement général d’AMF), Section 1.

⁷¹ Riviere, *supra* note 68.

⁷² Ambrose Evans-Pritchard, *Sarkozy turns on ‘predator’ hedge funds*, The Telegraph, May 2007, available at: <http://www.telegraph.co.uk/finance/economics/2808197/Sarkozy-turns-on-predator-hedge-funds.html> (last visited at Mar. 28, 2014). Not much later, the same epithets were used on the other side of the Atlantic too: in 2009, President Obama called hedge funds “speculators” who wanted “to hold out for the prospect of an unjustified taxpayer-funded bailout.” Steven Mufson, Tomoe Murakami Tse, *In Chrysler Saga, Hedge Funds Cast As Prime Villain*, The Washington Post, available at: <http://www.washingtonpost.com/wp-dyn/content/article/2009/04/30/AR2009043004141.html> (Last visited at Mar. 28, 2014).

⁷³ Mary O’Sullivan, *Acting out institutional change: understanding the recent transformation of the French financial system*, (2007) Socioecon. Rev. 389, 433.

⁷⁴ Wayne H. Smith, *The French view of Cross-Border Securities Offerings (Aspects of the Modernization of French Capital Markets)*, in FIDELIS ODITAH ED. THE FUTURE FOR THE GLOBAL SECURITIES MARKET: LEGAL AND REGULATORY ASPECTS 199 (Clarendon Press, Oxford, 1996).

consider the signals of these players and take necessary measures to increase the competitiveness of French alternative investment industry internationally.

Perhaps, this explains why France has so actively pushed for the Directive since the very beginning.⁷⁵ EU-level strict regulation, while burdensome for the British industry, could open new opportunities for its French counterpart. New rules were capable of conferring significant competitive advantage to the French funds. Due to extensive lobbying, French position indeed managed to influence the outcome. Many of the AIFMD provisions are almost the adoption of French rules.

Despite the declared goals of investor protection, monitoring systemic risk and strengthening the single market, perhaps, the whole recent regulatory intervention (and resistance thereof) in financial industry was also driven by competitiveness considerations. The UK resisted to EU-level regulations to perpetuate London's position as a global financial center. Similarly, French and German insistence on a change can be seen as attempts to challenge London's role and advance the position of Paris and Frankfurt.⁷⁶

Such had been development at the outset of AIFMD. On one hand, the alternative investment industry was (and still remains) dominated by Anglo-Saxon players and on the other hand, other major EU powers were willing to redefine the status quo. Ultimately, despite the British opposition, the AIFMD still came into existence.

⁷⁵See also: Jean-Pierre Jouyet, *Intervention de Jean-Pierre Jouyet, Président De L'AMF*, Conference On Hedge Funds, Brussels, Feb. 26, 2009.

⁷⁶ See: Buckley, Howarth, *supra* note 57 at 119–141.

Chapter 2 – Alternative Investment Fund Managers Directive: a Single Market Tool

*AIFMD - “the significant shake-up for European alternative investment industry”*⁷⁷

2.1. Regulatory History: from UCITS Directive to AIFMD

EU-level regulation of financial sector counts approximately 30 years. In terms of investment funds, the most important legislative act before AIFMD was the UCITS Directive. First enacted in 1985 and then upgraded four times, UCITS is a product-based directive which created single market for traditional mutual funds via UCITS passport. Thus, before AIFMD there had been some level of harmonization in terms of investment funds activities. Not so long ago, EU’s approach to the financial services industry was praised for “an admirable balancing” between “guaranteeing the minimum internationally acceptable level of regulation while respecting the quite remarkable diversity of its member states.”⁷⁸ This was especially true about alternative investments industry, where the Member States’ laws differed considerably.

In terms of hedge funds, there was not only “remarkable diversity” but also substantial contradiction between different jurisdictions. In many leading EU jurisdictions “hedge funds were anathema for policy-makers”.⁷⁹ Their reputation had been heavily damaged by both: policy-makers (German Vice-Chancellor Franz Müntefering called them “plague of locusts”⁸⁰) and investors (anonymous institutional investor complained that “it is completely

⁷⁷ Peter Bibby, Helen Marshall, Christopher Leonard, *EU Proposes directive on alternative investment fund managers*, 10 (3) J. Inv. Com, 54, 56.

⁷⁸ ANJALI KUMAR, ED. THE REGULATION OF NON-BANK FINANCIAL INSTITUTIONS: THE UNITED STATES, THE EUROPEAN UNION AND OTHER COUNTRIES 72 (The World Bank, Washington DC, 1997).

⁷⁹ Nick Evans, *Amidst all the angst, the industry is edging towards the mainstream* (2013), available at: <http://www.hedgefundintelligence.com/Article/3235752/Amidst-all-the-angst-the-industry-is-edging-towards-the-mainstream.html> (Last visited at Mar. 28, 2014).

⁸⁰ Sebastian Mallaby, *Hands Off Hedge Funds*, The Foreign Affairs, Jan.-Feb. 2007.

obvious that hedge funds don't work"⁸¹). Some considered poorly regulated funds as speculators and contributors to the systemic risk⁸², while their self-regulation was claimed to be insufficient.⁸³ On the other hand, hedge funds were perceived as necessary players, providing liquidity⁸⁴ to the capital markets and tackling and correcting its inefficiencies.⁸⁵

These contrasting core beliefs were only one reason of unorthodox attitudes towards stricter regulation at the EU level. Competition between the Member States was another key factor. With London accounting for 80% of the EU assets under management,⁸⁶ the UK was principally confident about the existing regulation that warranted its domination. On the other hand, France alongside with Germany sought further EU-level intervention⁸⁷ hoping to use it to advance their own best interests.

Despite such differences, the crisis accelerated the action of the European Commission. In 2009 European bureaucrats drafted the legislative proposal at the expedient speed – in two weeks⁸⁸. Amid the lack of publicity (most of six week consultation period coincided with the Christmas and New Year holidays)⁸⁹, the Draft Directive caused a lot of controversy because

⁸¹ ALEXANDER INEICHEN, ROADMAP TO HEDGE FUNDS 52 (AIMA, 2012).

⁸² "AIFM have grown to become very significant actors in the European financial system, managing a large quantity of assets on behalf of pension funds and other investors; accounting for a significant proportion of trading activity in financial markets; and constituting an important source of counterparty risk for other market participants. AIFM have also contributed to the build-up of leverage in the financial system, the consequences of which for the stability of financial markets became apparent when leverage in the hedge fund sector was rapidly unwound during the crisis. In this context, it is essential that the risks that AIFM pose to their investors, the financial markets and the companies in which they invest are rigorously monitored and controlled." European Commission, *Memo/10/572 (2010) Directive on Alternative Investment Fund Managers ('AIFMD')*.

⁸³ "The moment for self-regulation has passed, if it has ever been there in the real world". Poul Nyrup Rasmussen, *Direct EU regulation for Private Equity and Hedge funds - The real economy comes first*, Commission conference on private equity and hedge funds, Feb.26, 2009.

⁸⁴ Houman B. Shadab, *The Challenge of Hedge Fund Regulation*. 30 (1) REGUL. 36-41.

⁸⁵ Stulz, *supra* note 25 at 180.

⁸⁶ Peter Astleford, Dick Frase, *Hedge Funds and the Law*, 2010 Thomson Reuters, 28-31.

⁸⁷ EILIS FERRAN, NIAMH MOLONEY, JENIFFER G. HILL, JOHN C. COFFEE, JR., *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 23 (Cambridge University Press 2012).

⁸⁸ Janin *supra* note 10.

⁸⁹ Mats Persson, *The EU's AIFM Directive: Likely impact and best way forward*, (Open Europe, 2009), 1, 32.

of its overbroad nature and rigorous rules. Nevertheless, despite the fact that hedge funds “did not play a major role in the emergence of the crisis”,⁹⁰ the draft was soon adopted by the European Parliament and Council.

Unlike UCITSD, the AIFMD does not regulate product (investment funds) but the corporations (investment fund managers). In this sense, AIFMD resembles the US Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act known as the Private Fund Investment Advisers Registration Act of 2010 (the PFIA Act). The latter also restricted rules applicable to investment advisers under the Investment Advisers Act of 1940 and introduced mandatory registration of investment advisers at the SEC. Although similar in many aspects, the Directive goes further than its American cognate.

Despite being only partially aligned with global regulation, in some jurisdictions AIFMD was seen as a tool to finally control the hedge funds, and it was “greeted triumphantly”⁹¹. It was also argued that the comprehensive EU-level regulation could serve as an incentive for previously reluctant investors to allocate resources in European alternative investment industry.⁹² On the other hand, the Directive became a subject to immediate scrutiny, because, arguably, regulators hit the wrong target.⁹³ Some went as far as to state that “every time the EU tries to solve one problem three more crop up”.⁹⁴

Although I disagree with the radical assessment that AIFMD is a completely unnecessary measure, I still take a critical stance. The reasons lie in the very goals of the Directive. In terms of systemic risk, the Commission’s economic impact assessment could not provide enough justification, as to how new measures could increase prevention of hedge fund related

⁹⁰ Jacques de Larosière, High-Level Group on Financial Supervision in the EU, Report, Feb. 25, 2009, 1, 24.

⁹¹ The Economist, *the Alternative Investment Fund Managers Directive, The wrong targets*, May 22, 2010.

⁹² Max Rijkenberg, *Unintended Consequences of AIFMD*, Investment Europe, Dec. 2013.

⁹³ Doyle, *supra* note 11.

⁹⁴ Amy Bensted, head of Hedge Funds Products at Preqin, in John Kenchington, *Hedge fund rules absent in 16 EU states*, Financial Times, Aug. 25, 2013.

risks. Considering that none of the major crashes were caused by the hedge funds in the EU, it is legitimate to argue that the market was anyways able to absorb such risks. In terms of investor protection, it is highly questionable that the sophisticated investors of hedge funds needed new measures⁹⁵. Neither is it proven that AIFMD is going to enhance capital allocation. Therefore, it appears legitimate to argue that AIFMD primarily served the political purpose of financial market integration rather than the economic considerations.

I agree with Stulz's assertion that "regulation should leave alone financial innovators who dream of new strategies and find savvy and well-funded investors to bet on them. Without such financial innovators, capital markets will be less efficient".⁹⁶ AIFMD does the opposite. It imposes very costly and heavy requirements over hedge fund managers while leaving unclear as to how this will lead to better functioning of capital markets.

It is also questionable, whether after AIFMD the acclaimed "balance" between harmonization and national divergences can be kept. While it is true that the Member States will continue to regulate AIFs at national level, AIFMD will undermine the possibility of regulatory arbitrage for AIFMs.⁹⁷ On the positive side, this may bring back onshore a lot of offshore AIFMs who wish to continue marketing their AIFs to the EU investors. On the other hand, this will also undermine the regulatory competition between the Member States which might be ultimately detrimental to the industry.

⁹⁵ ZETZSCHE, *supra* note 17 at 9.

⁹⁶ Stulz, *supra* note 25 at 194.

⁹⁷ Hossein Nabilou, *The Alternative Investment Fund Managers Directive and Hedge Funds' Systemic Risk Regulation in the EU*, Nov. 2013, working paper, 1, 90, available at: SSRN: <http://ssrn.com/abstract=2352373> (Last visited at Mar. 28, 2014).

2.2. Lamfalussy Process and the role of ESMA

Financial law has been the “fastest growing area of EU law” which demonstrated a trend “towards centralization and maximum harmonization.”⁹⁸ Indeed, the AIFMD is only a part of a recent financial regulatory wave. Alongside with MiFID, UCITS and IORPD⁹⁹, the AIFMD creates the framework for “European Asset Management Law”¹⁰⁰. Such new regulations of the EU financial services industry are implemented according to Lamfalussy Process, with the underlying goal of “interlocking national and EU interests”.¹⁰¹

Named after Hungarian-born economist and the chair of the EU advisory committee, Baron Alexandre Lamfalussy (In Hungarian: báró Lámfalussy Sándor), the process was launched in 2001. Its main goal is to “strengthen the European regulatory and financial sector supervision framework”.¹⁰² Lamfalussy Process has four levels. Level 1 corresponds to adoption of the framework legislation by the European Parliament and Council of the European Union. At Level 2 sector-specific (banking, insurance and occupational pensions, and the securities market), detailed measures are issued by committees composed of supervisory bodies from different Member States. At Level 3, national bodies cooperate with other Member States to ensure harmonious implementation. Level 4 describes the transposition of the new legislation into national law.¹⁰³

In order to enhance European oversight of financial industry, initiated by the Lamfalussy Process, in 2010 the EU also developed the common European System of

⁹⁸ Takis Tridimas, *Financial Supervision and Agency Power: Reflections on ESMA* in NIAMH NIC SHUIBHNE AND LAURENCE W. GORMLEY (EDS.) FROM SINGLE MARKET TO ECONOMIC UNION: ESSAYS IN MEMORY OF JOHN A. USHER 55 (Oxford Scholarship, 2012).

⁹⁹ Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision.

¹⁰⁰ ZETZSCHE, *supra* note 17 at 16.

¹⁰¹ Tridimas, *supra* note 98.

¹⁰² European Commission, Review of the Lamfalussy process – Strengthening supervisory convergence, Nov. 20, 2007 [COM (2007) 727 final – Official Journal C 55 of 28.2.2008].

¹⁰³ *Id.*

Financial Supervision and created new European Supervisory Authorities¹⁰⁴, including European Securities and Markets Authority (ESMA)¹⁰⁵. ESMA focuses on stability of European financial market as well as uniform application of community legislation through direct supervision and/or cooperation with national authorities. Its functions are broad and significantly limit those of the national authorities.¹⁰⁶

In terms of AIFMD, the role of ESMA is central. Among other functions, the Directive authorizes the European regulator to “develop and regularly review guidelines for the competent authorities of the Member States”¹⁰⁷ on different tasks they perform in order to provide uniformity. More important, however, is the power of ESMA to request the competent authorities to prohibit marketing in the EU of non-authorized AIFs,¹⁰⁸ impose management-related restrictions non-EU AIFMs in case of “concentration of risk in a specific market”,¹⁰⁹ or when their activities “potentially constitute an important source of counterparty risk”¹¹⁰ to systematically relevant institutions. The broad wording give ESMA substantial discretion. Such development “heralds an era of direct EU presence in supervision and monitoring of compliance.”¹¹¹

Interestingly, the UK has challenged the broad powers of ESMA at the European Court of Justice. Specifically, the United Kingdom addressed the ECJ demanding the “annulment of Article 28 of Regulation (EU) No 236/2012 of the European Parliament and of

¹⁰⁴ European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA).

¹⁰⁵ ESMA was established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing European Supervisory Authority (European Securities and Markets Authority).

¹⁰⁶ Tridimas, *supra* note 98 at 57.

¹⁰⁷ Article 47 (1) AIFMD.

¹⁰⁸ Article 47 (4) (a) of AIFMD.

¹⁰⁹ Article 47 (4) (b) of AIFMD.

¹¹⁰ Article 47 (4) (c) of AIFMD.

¹¹¹ Tridimas, *supra* note 98 at 55.

the Council of 14 March 2012 on short selling and certain aspects of credit default swaps”¹¹²—the Article which enables ESMA to demand the financial institutions to stop short selling in case of any threat of inter alia: “serious financial, monetary or budgetary instability concerning a Member State or the financial system within a Member State when this may seriously threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union.”¹¹³ According to the regulation, “measures adopted by ESMA under this Article shall prevail over any previous measure taken by a competent authority”.¹¹⁴ Despite the UK’s arguments that such power of ESMA did not have a proper basis in the EU Treaties, nor was it consistent with the previous practice of the ECJ, the Court interpreted the conferral powers under Articles 290 and 291 of the TFEU widely to allow the European Commission to delegate its powers to the Union bodies and also confirmed that such bodies (in this case, ESMA) shall be allowed to adopt legally binding measures.¹¹⁵

This case is yet another demonstration of strong political agenda to unify European financial markets. In this process, important powers are given to supranational financial supervisory authorities. Such major turn towards “single-marketism” makes it clear that once decentralized financial services industry now follows French and German “market-shaping” (versus the British “market-making”)¹¹⁶ paradigm. Thus, the flexible and industry-friendly approach of certain regulators (such as the UK FCA) may be challenged. In a long run, this might contribute to diminishing the position of London as the leading global financial center.

¹¹² United Kingdom of Great Britain and Northern Ireland v. European Parliament and Council of the European Union, No. Case C-270/12, ECJ Judgment (Grand Chamber), Jan. 22, 2014.

¹¹³ Commission Delegated Regulation (EU) No 918/2012 of 5 July 2012 supplementing Regulation No. 236/2012, Article 28 (2) a. [hereinafter AIFMD Regulation].

¹¹⁴ Article 28 (11) of AIFMD Regulation.

¹¹⁵ United Kingdom of Great Britain and Northern Ireland v. European Parliament and Council of the European Union, No. Case C 270/12, ECJ Judgment (Grand Chamber), Jan. 22, 2014, paragraphs 77-119.

¹¹⁶ Lucia Quaglia, *The ‘old’ and ‘new’ political economy of hedge funds regulation in the EU*, 34 (4) WEST EUR. POL. 665-682.

2.3. AIFMD: What It Is All About

Even though often addressed as “hedge funds directive”, the scope of AIFMD is much broader. The Directive contains the rules on “authorization, ongoing operation and transparency of the managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the Union”¹¹⁷. AIFMs are legal persons whose regular business¹¹⁸ is managing¹¹⁹ one or more AIFs. The Directive defines an alternative investment funds (AIF) as “collective investment undertakings, raising capital from investors with a view to invest it according to the defined investment policy for the benefit of those investors”.¹²⁰

This definition explicitly excludes the funds, which are authorized undertakings for collective investment in transferable securities pursuant to Article 5 of the UCITS Directive. This definition is “intentionally broad”¹²¹ and disregards the legal structure, close or open ended nature of the fund; therefore, it encompasses every investment scheme, outside the UCITS Directive and other explicitly excluded business structures: holding companies, pension funds, supranational institutions (such as European Central Bank, the European Investment, Bank, etc.), bilateral development banks (the World Bank, the International Monetary Fund), national central banks, national or regional governments, employee saving schemes and special purpose entities.¹²² The Directive also sets the de minimis threshold for the AIFMs managing the AIFs who a) are using leverage but their assets under management

¹¹⁷ Article 1 of AIFMD.

¹¹⁸ AIFMD does not contain the definition of “regular business”, therefore, it will be a subject of further interpretation.

¹¹⁹ Managing for the purposes of AIFMD means “performing at least investment management functions”, (Article 4(1) w of the AIFMD) which is further detailed in Recital 21 as combination of portfolio management and risk management.

¹²⁰ Article 4 (1) a of AIFMD.

¹²¹ Baker & McKenzie, *EU Alternative Investment Fund Managers Directive: Impact on Non-EU Fund Managers*, Mar. 2013, available at: http://www.bakermckenzie.com/files/Publication/cf3acd40-bab8-4c31-9014-7548efb94d19/Presentation/PublicationAttachment/a6813390-9e45-40ed-8983-5aac6ec46152/al_pe_fundmanagersdirective_mar13.pdf (Last visited at Mar. 28, 2014).

¹²² Article 2 (3) of the AIFMD.

in total do not exceed a threshold of EUR 100 million and b) are unleveraged and total assets under management is less than EUR 500 million.¹²³

Such wide scope combined with exceedingly low thresholds have often been understood as an evidence of “political punishment overtones”.¹²⁴ Even if trying to avoid such far-stretching evaluations, it is still clear that thresholds are very low. Managers of such small funds cannot substantially affect the market. Therefore, these thresholds contradict the drafters’ arguments that the regulation was adopted because of the systemic risk and investor protection concerns. This is yet another indication that the most important legislative purpose behind AIFMD was political: bringing all the remaining investment schemes under the EU-level supervision and finalize creation of the EU single market in financial assets.

2.3.1. Authorization

One of the aims of the AIFMD is to provide “common requirements governing the authorization”¹²⁵ of AIFMs in the EU. Therefore, the Directive subjects the AIFMs under its scope to mandatory registration and authorization.¹²⁶ Authorization application shall be submitted to the relevant authorities of the Member States and need to include substantial amount of information: on the persons effectively conducting the business of the AIFM; on the identities of the AIFM's shareholders; organizational structure of the AIFM, including information on how the AIFM intends to comply with its obligations under the Directive; on the AIFs it intends to manage, etc.¹²⁷ Once authorized, the AIFM shall keep up with the conditions for authorization established within the meaning of AIFMD at all times.¹²⁸ The

¹²³ Article 3 (2) of the AIFMD.

¹²⁴ Rodrigo Zepeda, *To EU, or not to EU: that is the AIFMD question*, 29 (2) J.INT. BANK. L. & REG., 82-102.

¹²⁵ Recital 2 of AIFMD.

¹²⁶ Article 6 (1) of AIFMD.

¹²⁷ Article 7 (2) of AIFMD.

¹²⁸ Article 6 (2) of AIFMD.

intention of the legislator to keep UCITS funds and their managers and AIFMs separate, since AIFMs are not entitled to manage UCITS within the meaning of Directive 2009/65/EC on the basis of an AIFMD authorization.¹²⁹

Even though the registration of fund managers and advisors has already been a widespread practice, the new authorization rules go far beyond such pre-existing rules. While its counterpart on the other side of the Atlantic, the Dodd Frank Act, also requires the registration of the investment advisers with SEC¹³⁰, the AIFMD envisages far more comprehensive filing. It is, therefore, argued that with such a regulatory stance, “rather than encourage innovation and entrepreneurialism, the Directive will bury managers under a mountain of paperwork and expose them to increased costs as a result”.¹³¹

Apart from the paperwork, the Directive also requires the minimum capital for the AIFMs (initial capital of at least EUR 300 000 for internally managed AIFs and EUR 125 000 for AIFMs, acting as external managers)¹³². AIFMs are also obliged to increase this initial capital if portfolios under management exceed EUR 250 million.¹³³ Additionally, they will have to obtain a mandatory Professional Indemnity Insurance to cover their Professional liability risks.¹³⁴ All these measures combined are surely going to substantially increase the operating costs of AIFMs.

2.3.2. Operating Principles

The Directive lists general operating principles for fund managers, such as due diligence and care, honesty, effective use of resources and act in the best interests of the AIFs

¹²⁹ Recital 3 of AIFMD.

¹³⁰ Securities and Exchange Commission, *Rules Implementing Amendments To The Investment Advisers Act Of 1940*, Release No. Ia-3221; File No. S7-36-10, 2011.

¹³¹ Matthew Wrigley, *AIFMD – an inconvenient truth*, 292 MONDAQ BUS.BRIEF, 2013.

¹³² Article 9 of AIFMD.

¹³³ *Id.*

¹³⁴ Article 15 of AIFMD Regulation.

they manage, compliance with regulations, fair treatment of investors, etc.¹³⁵ More specifically, AIFMs will have several new obligations.

Firstly, AIFMs have to put in place sound remuneration policies¹³⁶. In the context of hedge funds the typical remuneration structure involves 2% of assets under management as a management fee and 20% of investment profits as an incentive fee. It is argued that such high performance fees are “outrageous”¹³⁷ and contribute to excessive risk taking. AIFMD tries to exclude excessive remuneration practices. It imposes a general requirement of installing such remuneration policies that do not encourage excessive risk taking for those employees of AIFMs whose activities have a “material impact on the risk profiles” of the AIFMs or of the AIFs they manage.¹³⁸

Secondly, they will have to upgrade the standards of managing conflicts of interests in the AIFM. In order to identify and manage the conflict of interest between different parties¹³⁹ the AIFMs have to maintain an effective organizational structure and take all reasonable steps designed to identify and manage and monitor conflicts of interest which could otherwise adversely affect the interests of the investors.¹⁴⁰ With this view, AIFMs shall modify their administrative structure so that to segregate tasks and responsibilities which may lead to such conflict of interests. Therefore, AIFMs will have a new obligation to assess such risks and promptly disclose them to the investors.¹⁴¹ Such division of functions may be an important burden for smaller AIFMs.

¹³⁵ Article 12 of AIFMD.

¹³⁶ Article 13 of AIFMD.

¹³⁷ Steve Denning, *How Hedge Funds Transfer Wealth From Investors To Managers*, Forbes, 2013, available at: <http://www.forbes.com/sites/stevedenning/2013/05/28/how-hedge-funds-transfer-wealth-from-investors-to-managers/> (Last visited at Mar. 28, 2014).

¹³⁸ Article 13 (1) of AIFMD.

¹³⁹ Article 14 lists the examples of such possible parties: the AIFM and the AIF managed by the AIFM or the investors in that AIF; the AIF or the investors in that AIF, and another AIF or the investors in that AIF; the AIF or the investors in that AIF, and another client of the AIFM; the AIF or the investors in that AIF, and a UCITS managed by the AIFM or the investors in that UCITS; or two clients of the AIFM.

¹⁴⁰ Article 14 (1) of AIFMD.

¹⁴¹ Article 14 of AIFMD.

One of the most important requirements is that fund managers will have to “functionally and hierarchically”¹⁴² separate the functions of risk management from the operating functions, such as portfolio management. Since risk management is one of the crucial functions of AIFMs, the Level 2 regulation contains detailed rules. AIFMs shall have adequate risk management policies, including all the necessary procedures,¹⁴³ as well as establish “quantitative or qualitative risk limits”¹⁴⁴ and otherwise monitor risks at all times.¹⁴⁵

In terms of hedge funds, alongside the investor protection concerns, focus on risk management is also explained by the market stability argument. It is contended that the lack of due diligence and deficiencies in risk management of hedge funds contributed to the crisis.¹⁴⁶ Even if the fault of hedge funds in crisis has not been proven to be dramatic, still their activities are perceived as inherently risky. Specifically, highly leveraged¹⁴⁷ nature of hedge funds and their increased correlation with other market participants creates concerns of systemic risk.¹⁴⁸

Cumming, Dai and Johan define systemic risk as “risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions that occur over a short period of time and are typically caused by a single major event.”¹⁴⁹ It is recognized that in Europe such single major adverse event that would lead to a crush of the financial system has never been the default of a hedge fund. Since it is hard to identify exact causes of such massive breakdowns, nobody wants to assume the responsibility either: “systemic risk is a public good, or a “public bad” for which no one is willing to

¹⁴² Article 15 of AIFMD.

¹⁴³ Article 40 of AIFMD Regulation.

¹⁴⁴ Article 44 of AIFMD Regulation.

¹⁴⁵ Article 45 of AIFMD Regulation.

¹⁴⁶ Zepeda, *supra* note 124.

¹⁴⁷ Article 4(1)(v) AIFMD defines leverage as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash securities, or leverage embedded in derivative positions or by any other means”.

¹⁴⁸ See also: Farrell et al, *supra* note 5.

¹⁴⁹ CUMMING et al. *supra* note 26 at 265.

pay”.¹⁵⁰ With this having in mind, the policy choice of the regulator was to make previously unregulated hedge funds (as contributors to such risk) take a share in this systemic risk monitoring costs.¹⁵¹ Now hedge fund managers will have to respect the limits on leverage, employ specific calculation methods prescribed in the Level 2 regulation and report extensively to their home regulators. While hedge funds have not caused any massive market failure in Europe, it is arguable, whether these measures were necessary.

2.3.3. Organizational Requirements

In terms of organizational requirements, in general AIFMD mandates that the AIFMs maintain “adequate and appropriate human and technical resources”¹⁵² for proper functioning. This mainly consists of adequate procedural rules: internal control mechanisms, internal reporting and communication, accounting procedures, etc.¹⁵³

i) *Valuation*

Asset valuation had been one of the heavily debated issues due to risks inherent to it. If the fund manager has right to value the assets it holds, there is always a chance of over or under valuation, depending on the manager’s position. On the other hand, appointing external valuer for each asset can be so costly as to become impossible burden for the industry.

The Directive has resorted to the middle grounds. It imposes requirement on proper and independent valuation of the fund’s assets.¹⁵⁴ Valuation must be conducted at least once a year, and in case of open-ended fund, the shares or units must be valued as frequently as it is appropriate to the specific assets held by the fund. Even though initially the commission

¹⁵⁰ *Id.* at 271.

¹⁵¹ De Larosière, *supra* note 90 at 24.

¹⁵² Article 18 of AIFMD.

¹⁵³ Article 57 of AIFMD Regulation.

¹⁵⁴ Article 19 of AIFMD.

had foreseen the obligation to always appoint external valuer,¹⁵⁵ the final text does not contain such requirement anymore. Thus, valuation may be performed by such external valuer or by the AIFM itself, in which case the valuation function needs to stay functionally independent from portfolio management to avoid the conflict of interests.¹⁵⁶

ii) *Delegation of AIFM Functions*

Prior to AIFMD, delegation of some fund management functions by alternative investment funds or their managers to the third parties had been a common practice. Many of such external investment advisers were not located in Europe and the delegation decision fell under the discretion of AIFM.¹⁵⁷ Now, the Directive sets the rules and limitations on delegating certain functions of AIFM to third parties and requires that the AIFM “to justify its entire delegation structure on objective reasons”.¹⁵⁸ Even though the AIFMD allows the AIFMs to outsource certain functions, they cannot delegate risk management and portfolio management functions so as to stop being able to act in the best interests of investors.¹⁵⁹ Delegation of one of the two key functions is possible. However, before any delegation takes place the AIFM must notify the national authorities about possible delegation and must be able to demonstrate that the delegate is “qualified and capable of undertaking the functions in question”.¹⁶⁰ Despite the fears of the industry of very far-reaching limitations,¹⁶¹ the Directive still allows delegation but prohibits the AIFMs to become mere “letter-box entities”.

Nevertheless, due to the widespread practice of delegation and uncertainty about the “letter-box” provisions, the *Alternative Investment Fund Managers Directive Survey* conducted by Deloitte in 2012¹⁶² demonstrated that 78% of AIFMs were concerned about

¹⁵⁵ Phil Bartram et al., *A guide to the Alternative Investment Fund Managers Directive* 2013 EVCA, 1, 42.

¹⁵⁶ Article 19 (4) of AIFMD.

¹⁵⁷ Mark Browne, *Delegation of investment management under the AIFMD*, 94 AIMA J., 55-60.

¹⁵⁸ Article 20 of AIFMD.

¹⁵⁹ Article 20 of AIFMD.

¹⁶⁰ Article 20 of AIFMD.

¹⁶¹ Mirzha de Manuel Aramendía, *Prepare for profound AIFMD changes*, Financial Times, Jan. 6, 2013.

¹⁶² Deloitte, *supra* note 6, at 4.

delegation rules. The same year, 20 large managers (including Allianz and BlackRock Inc.) issued joint statement stating that delegation rules “undermine the single market” and will result in higher ultimate costs for investors.¹⁶³ I do not share the fear of such devastating results. One of the reasons is that fund domiciles will compete to have the most industry-friendly stance on delegation.¹⁶⁴ For example, the UK has taken relatively liberal stance: an UK-authorized AIFM will not need the prior approval from the FCA insofar as the third-party delegate is “authorised or registered for the purpose of asset management; and subject to supervision in relation to that asset management function.”¹⁶⁵ Insofar as the Member States maintain such discretion, delegation provisions will not be that burdensome. However, they clearly add quite a lot of work (and costs) to already loaded task-list of AIFMs.

2.3.4. Depositary

One of the principal novelties for the industry is the AIFMD rules on depositary. Before AIFMD, a main function of depositary was to ensure asset custody. The Directive confers to the depositary the obligations to monitor AIF’s cash flows, to ensure the payments made by investors in accordance with their units or shares are properly booked in AIFs cash accounts and to safe-keep AIF’s assets.¹⁶⁶ However, the Directive goes much farther than the established industry practice and introduces the strict liability of depositaries in case of loss of assets under its custody.¹⁶⁷ This has been “the most controversial single aspect of the proposed reforms”.¹⁶⁸ According to Deloitte survey, by 2012 56% of respondent

¹⁶³ Brooke Masters, Alex Barker, *EU warned on new fund rules*, Financial times, Jul. 11, 2012.

¹⁶⁴ Aramendía, *supra* note 161.

¹⁶⁵ The Alternative Investment Fund Managers Regulations 2013, Section 26.

¹⁶⁶ Article 21 of AIFMD.

¹⁶⁷ Article 21 of AIFMD.

¹⁶⁸ Ernst & Young, *AIFMD: get ready for European depositary reform*, 1, 1, Mar. 2012, available at: [http://www.ey.com/Publication/vwLUAssets/AIFMD -
prepare_for_European_depositary_reform/\\$FILE/AIFMD_20March2012.pdf](http://www.ey.com/Publication/vwLUAssets/AIFMD_-_prepare_for_European_depositary_reform/$FILE/AIFMD_20March2012.pdf) (Last visited at Mar. 28, 2014).

AIFMs did not have appointed single independent depositary for AIF under their management.¹⁶⁹ It is argued that depositary provisions will have important adverse effect on hedge funds in particular, because of the need to separate prime brokers and depositaries, thus “adding a further level of complexity to custody service charges and requiring new tri-party contracts to be drawn up”.¹⁷⁰

Furthermore, it may have adverse effects on custodian industry. Due to strict liability standards, it is considered that many custodians will merely stop performing the depositary functions and those who will stay in the game, will increase the prices substantially.¹⁷¹ Indeed, a 2013 survey conducted by Multifonds with respondents with managing over USD 13 trillion, demonstrated that 64% of them considered depositary liability as the most challenging part of the Directive,¹⁷² while Deloitte survey revealed that 84% of the respondents were concerned about depositary costs.¹⁷³

According to the new rules, custodians face the reversed burden of proof in case of loss of any assets under their safekeeping. This is way too high standard, and combined with the strict liability rule, it indeed constitutes a reason to worry. Some have even argued that regulation has simply gone too far and is becoming “impossible to manage”.¹⁷⁴ Even if it may be manageable, depositary liability is clearly a very costly measure and its effectiveness remains debatable. On one hand, new rules can contribute to increased investor welfare by higher standards of asset safekeeping, but on the other hand its ultimate costs may be passed to the same investors.

¹⁶⁹ Deloitte, *supra* note 6, at 4.

¹⁷⁰ Ernst & Young, *supra* note 168.

¹⁷¹ Clifford Chance LLP Client briefing, *What will the AIFM Directive mean?* Mar. 2010, available at http://www.cliffordchance.com/briefings/2010/05/what_will_the_aifmdirectivemean.html (last visited Mar. 28, 2014).

¹⁷² Multifonds: *Part 2: The impact of AIFMD and convergence survey*, 2013.

¹⁷³ Deloitte, *supra* note 6, at 4.

¹⁷⁴ Peter Richards-Carpenter, *Regulatory intrusion: Is regulation becoming impossible to manage?* 3 (4) J. SEC. OPER. & CUST. Feb. 1, 2011, 333-353.

As of today, such approach to depositary liability remains a European one. Even though other G20 states do not follow such strict rules, it is anticipated that “in the longer term, depositary changes could spread beyond the alternatives arena and affect the wider asset management industry in Europe and beyond”.¹⁷⁵ However, before that anticipated time comes, new challenges of renegotiating the deals with depositaries as well as new costs associated to custody will definitely affect competitiveness of the EU hedge funds industry.

2.3.5. Transparency Requirements

Importance of transparency in financial markets has long been recognized. As early as 1914 Justice Brandies asserted: “Sunlight is said to be the best of disinfectants”.¹⁷⁶ In modern times too, its positive impact on proper market functioning has been put forward: “the more transparency is provided to the market, the more efficient are the prices it produces and the more effectively will the market allocate capital and other limited resources.”¹⁷⁷ This fundamental notion was revisited in the aftermath of the crisis when investors’ trust to the industry was shaken. Indeed, there was a call for increased transparency¹⁷⁸ and this call was properly addressed by the Directive.

AIFMD provides obligation for AIFMs to submit annual reports to Member State authorities¹⁷⁹ and to disclose to investors information about investment strategy and objectives, types of assets AIFM is going to invest, usage of leverage and other important information.¹⁸⁰ This will not be an easy task. It is estimated that the AIFMs will need to

¹⁷⁵ Ernst & Young, *supra* note 168.

¹⁷⁶ LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92, (F.A. Stokes, 1914).

¹⁷⁷ CUMMING et al. *supra* note 26 at 275.

¹⁷⁸ Max Hilton, *Countdown to AIFMD: Challenges in risk management*, 95 AIMA J., 48-52.

¹⁷⁹ Article 22 of AIFMD.

¹⁸⁰ Article 23 of AIFMD.

provide 300 different data to the relevant authorities as part of their reporting obligations.¹⁸¹ Except from very large companies, this new obligations are hardly manageable for AIFMs without external assistance. This is why 77 percent of AIFMs from different parts of Europe have considered outsourcing their reporting function.¹⁸² Effects of these new rules are also debated.

On a positive side, as a result of AIFMD measures, the lack of transparency shall not be a concern anymore. On the other hand, the new rules may also be detrimental. It is argued that since the profits of hedge fund are mostly derived from its (unique) investment strategies, it is “unreasonable to force them to give up confidentiality of this key information.”¹⁸³ In order to avoid such adverse effects, the disclosure of investment strategies shall be limited to very general descriptions. Also, the investors, who are interested in AIFMs’ performance, do not necessarily wish to be “swamped with unnecessary information.”¹⁸⁴ Amid disclosing too many details, AIFMs may even pass through some of their due diligence obligations to the decision makers at their respective institutional investors. However, this does not seem to be a problematic issue.

I agree that reporting is burdensome, but I still think that AIFMD disclosure provisions are one of the most positive aspects of the Directive. Even though some question whether increased transparency really stems from AIFMD, arguing that extensive investor disclosure was already an industry trend with the same effects,¹⁸⁵ I think these rules were necessary. There is nothing wrong with codification of the best practices of the industry to reassure their effective operation.

¹⁸¹ Marina Daras, *Fund Managers Gear Up for AIFMD Costs, Compliance*, WatersTechnology, 2014, 47, 48.

¹⁸² Mario Mantrisi, *How should managers approach AIFMD?* 96 AIMA J., 57-59.

¹⁸³ CUMMING et al. *supra* note 26 at 278.

¹⁸⁴ AIMA, *Beyond 60/40: The evolving role of hedge funds in institutional investor portfolios*, AIMA Investor Steering Committee publication, May 2013, 1, 4.

¹⁸⁵ Clifford Chance, *supra* note 171.

2.3.6. Marketing

One of the principal (and allegedly positive) novelties of AIFMD is possibility of the EU-wide marketing of funds via AIFMD passport. Marketing is defined as “direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or investors domiciled or with registered office in the Union”¹⁸⁶. AIFMs mostly market their products to sophisticated investors which are defined as “professional clients” under MiFID.¹⁸⁷ It is not prohibited to market the AIFs to the retail investors as well, but it is outside the scope of passport and depends on each Member State’s discretion.¹⁸⁸

Initially there was uncertainty over the notion of “marketing”, notably, about whether “pre-marketing” type of promotional activities would fall under the definition.¹⁸⁹ As for today, it is understood that “marketing” is something which happens late in a fund-raising process.”¹⁹⁰ However current status of marketing still remains one of the most challenging areas of AIFMD compliance, especially for managers from the UK. A recent survey reported in the Hedge Fund Journal demonstrated that the most important concern for London-based hedge fund managers on AIFMD were possible problems related to marketing non-EU funds to European professional investors.¹⁹¹

It is important to take into account that from 2013 (transposition deadline) until 2015 passport opportunities are open only for the EU AIFMs managing the EU AIFs¹⁹². In case of the EU AIFM marketing non-EU AIF, obtaining a passport is possible in limited

¹⁸⁶ Article 4 of AIFMD.

¹⁸⁷ Annex II.I of MiFID.

¹⁸⁸ Article 43 of AIFMD.

¹⁸⁹ Baker & McKenzie, *supra* note 121.

¹⁹⁰ Bartram, *supra* note at 9.

¹⁹¹ Bill Prew, *Marketing in the Post-AIFMD Era: Further ‘institutionalisation’ of the industry?* The Hedge Fund Journal, Mar. 9, 2013.

¹⁹² Articles 31-33 of AIFMD.

circumstances¹⁹³, however, they can market without a passport if the Member States so allow.¹⁹⁴ Non-EU AIFM willing to market EU AIFs have to rely on national private placement regimes, if available, at least until 2015. As for non-EU AIFM marketing non-EU AIF, they also may be allowed to market based on national placement regimes¹⁹⁵, however, the Member States may impose on them stricter rules on marketing.¹⁹⁶ For example, if the requirements of the UK for non-domestic AIFMs were simple (only the minimum requirements laid down in AIFMD while relying on private placement in the UK), France imposed heavy additional requirements for non-French AIFMs, therefore, making it extremely hard for them to make use of French national placement regime at all.¹⁹⁷ Even though for this last category EU-wide passport might become available after 2015, it will depend on the opinion issued by ESMA. Again, based on ESMA's decision, national placement regimes might be abolished in 2018.

Although some have considered the EU passport as a major benefit to balance the bitter effects of AIFMD¹⁹⁸, the novelty also caused skepticism. While optimists believe that the AIFMD passport has a potential to become “a well-recognized global standard for the regulation of non-retail funds”,¹⁹⁹ the opposing views contend that the AIFMD passport has no such potential.²⁰⁰ Seems like many of the fund managers share this view. According to the Deutsche Bank 2013 survey, 61% of 44 European and American hedge fund managers (USD

¹⁹³ Article 35 of AIFMD sets out following requirements: cooperation agreement between MS authorities and authorities of AIF, country of AIF does not have to be a non-cooperative country, etc.

¹⁹⁴ Article 36 of AIFMD.

¹⁹⁵ Article 42 of AIFMD.

¹⁹⁶ Article 42 (2) of AIFMD.

¹⁹⁷ AIMA press-release: Some key EU markets 'gold-plating' AIFMD - AIMA EY survey, available at: <http://www.aima.org/en/media/press-releases.cfm/id/EBA50564-74B7-48CF-80893ACF56625320> (Last visited Mar. 28, 2014).

¹⁹⁸ See: “EU regulators, aware of the fact that the only imposition of responsibilities and duties on hedge funds, will result in the hedge fund relocation from Europe to more accommodative jurisdictions, offer benefits for the funds authorized in the EU. The introduction of the European Passport system is one of those advantages trying to make such a balance”. Nabilou, *supra* note 97 at 90.

¹⁹⁹ The comment of Kieran Fox, the director of the Irish Funds Industry Association, in Marina Daras, *Fund Managers Gear Up for AIFMD Costs*, Compliance, WatersTechnology, 2014, 47, 48.

²⁰⁰ Wrigley, *supra* note 131.

325 billion in assets under management) did not believe that the AIFMD passport could attract new investment from institutional investors.²⁰¹

I understand the doubts of fund managers concerning AIFMD passport vis-à-vis all the obligations that the Directive imposes on the industry but I am still of the opinion that this is the most appealing novelty of the legislation. Even though initially applied in an unfair manner (giving advantage to the EU AIFMs managing EU AIFs), based on the UCITS passport experience, I believe that in a long run, AIFMD passport also has a potential to become a well-recognized global brand and strengthen European alternative investments industry. Its success, however, will very much depend on the way the industry will make use of this new opportunity.

Chapter 3 - Impact of AIFMD

“EU Regulators 1-0 Hedge Funds”²⁰²

The final text of AIFMD was approved by the European Parliament and Council in November 2010. Transposition of the Directive into national laws of Member States was due by 22 July, 2013.²⁰³ Even though “AIFMD is taking root far quicker than other regulations have in the past”²⁰⁴ some Member States are still pending its implementation. Recent report from KPMG found that Belgium, Finland, Greece, Hungary, Poland- in total 11 EU/EEA

²⁰¹ Deutsche Bank Global Prime Finance Survey, 2013 in Hedge Fund COOs Rise to New Regulatory Hurdles, The Hedge Fund Journal, Dec. 2013, *available at* <http://www.thehedgefundjournal.com/node/9036> (Last visited: Mar. 28, 2014) [hereinafter DB Survey].

²⁰² Zepeda, *supra* note 124 at 82-91.

²⁰³ Article 66 of AIFMD.

²⁰⁴ AIMA press-release: Some key EU markets 'gold-plating' AIFMD - AIMA EY survey, *available at*: <http://www.aima.org/en/media/press-releases.cfm/id/EBA50564-74B7-48CF-80893ACF56625320> (Last visited Mar. 28, 2014).

countries²⁰⁵ - have delayed implementation. One of the reasons of the delay can be the extensive requirements of the Directive which require a lot of changes not only in national laws but also in structures of national authorities. Many Member States, apparently, have not been ready to undertake all these reforms.

Such delays strengthen the argument that AIFMD was rushed in and lacked proper assessment. Indeed, “no regulatory system would be effective in providing investor protection without a strong and efficient system of discipline and enforcement”.²⁰⁶ Taking into consideration that 11 states did not manage to meet the implementation deadline of the Directive, it is arguable, how well the EU regulators had evaluated the complexity of new measures and the burden of its transposition and effective enforcement before adoption of AIFMD.

3.1. Transposition in the UK

As discussed above, before the crisis the UK did not see any necessity of EU-level regulation of alternative investment industry. In the aftermath of the crisis, when adoption of supranational measures became inevitable, amid the efforts of the British government as well as industry lobbying, many “non-workable” provisions were scrapped from the initial draft. Their exclusion from the Directive is even considered as a “British government victory in the

²⁰⁵ Charles Muller et al., *AIFMD Transposition - State Of Play across EU Member States & EEA Countries Investment Management Regulation*, KPMG, European Centre of Excellence, Jan. 6, 2014, available at: <http://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Documents/AIFMD-Transposition-overview-3-02-2014.pdf> (Last visited Mar. 28, 2014).

²⁰⁶ Michael J. Perry, *Approaches to Market Regulation – the United Kingdom*. Article reproduced in *The Future for the Global Securities Market: Legal and Regulatory Aspects*, in FIDELIS ODITAH ED. *THE FUTURE FOR THE GLOBAL SECURITIES MARKET: LEGAL AND REGULATORY ASPECTS* 180 (Clarendon Press, Oxford, 1996).

Council”.²⁰⁷ Yet another British success was retaining the distribution of AIFMD passports at the level of national authorities, despite French efforts that ESMA could do this.²⁰⁸

The UK has met the transposition July 2013 deadline. AIFMD the rules governing AIFMs’ activities are detailed in the Alternative Investment Fund Managers Regulations of 2013²⁰⁹ of the FCA. The most important compliance tool for the AIFMs – the FCA handbook was amended.²¹⁰ The broad scope of AIFMD covers the UK investment trusts, unauthorized unit trusts, charity funds, Non-UCITS Retail schemes and other alternative vehicles.²¹¹

As it was expected, the UK used its discretion to favor as permissive and business-friendly implementation of the Directive as possible. First of all, unlike France, the UK did not impose any additional limitations or obligations for non-domestic funds or their managers, except from minimum requirements of the Directive. In terms of marketing, non-EU AIFMs can market funds in the UK after notifying FCA. Notification has to disclose the details about the AIFM (its legal personality, capital and transparency rules, etc.). Also, it is crucial that the FCA has the cooperation agreement with the third-country regulator. In order to simplify marketing of the offshore funds, the UK hurried to sign such cooperation agreements (the Memorandums of Understanding) with the popular fund domiciles: Guernsey, Jersey, Channel Islands, Cayman Islands, etc.

The UK has issued multiple policy statements, consultation papers and other documents to provide detailed answers to the pressing questions and simplify the compliance

²⁰⁷ See: Buckley, Howarth, *supra* note 57 at 139.

²⁰⁸ Christian Bartholin, Secretary General of HDF Finance; Interview at “Les Décideurs de la finance”, Dec. 17, 2010, available at: <http://www.decideurstv.com/video/christian-bartholin-hdf-finance-une-nouvelle-directive-pour-les-marches-financiers-15947/> (Last visited Mar. 28, 2014).

²⁰⁹ HM Government, Alternative Investment Fund Managers Regulations 2013, No. 1773, Jul. 16, 2013.

²¹⁰ Financial Conduct Authority, Handbook, electronic version *available at*: <http://fshandbook.info/FS/html/FCA/>, (Last visited Mar. 28, 2014).

²¹¹ BlackRock, *Directive (“AIFMD”): An Overview and Analysis*, May 2011, *available at*: <http://www.blackrock.com/corporate/en-fr/literature/whitepaper/alternative-investment-fund-managers-directive-aifmd-may-2011.pdf> (last visited Mar. 28, 2014).

process.²¹² The regulator also granted one year transitional period after the transposition (July 2013) deadline for already existing AIFMs. Interestingly, such grace period was granted to not only the EU AIFMs but also to the third-country managers. Such business-centered decisions strengthened FCA's reputation in the eyes of the industry and contributed to the belief that it is an "open regulator which advances the climate of mutual credibility and respect and whose pragmatic approach mitigated the negative impact of the new regulatory wave on the industry."²¹³

Despite this, the future for the UK industry remains unclear. The firms which will not be authorized after the end of the transitional period (July 22, 2014) will not be able to continue working. In order to ensure timely authorization, the AIFMs have to submit the application to the FCA no later than April 22.²¹⁴ Even though only in January the FCA received 103 full-scope and 95 small authorization applications,²¹⁵ general progress of UK AIFMs authorization is hard to assess. This uncertainty causes doubts in investors and hinders the work of the UK (especially small and medium) AIFMs. The picture will be clear only after the end of the transitional period.

3.2. Transposition in France

In the beginning of 2013, out of 12,000 funds managed from France, 9000 were alternative investment vehicles.²¹⁶ Unlike the Anglo-Saxon tradition, France has historically

²¹² For example, Financial Conduct Authority: *Implementation of the Alternative Investment Fund Managers Directive*, Policy Statement PS13/5, Jun. 2013.

²¹³ Tamara Cizeika, *What does it take to make "good" financial laws?* Investment Week, Jun. 2013.

²¹⁴ Financial Services Authority, *AIFMD latest news*, available at: <http://www.fca.org.uk/firms/markets/international-markets/aifmd/latest-news> (Last visited Mar. 28, 2014).

²¹⁵ *Id.*

²¹⁶ Paul-Henri De La Porte Du Theil, Pierre Bollon (Eds.) *Annual Report (Rapport d'activité) 2012-2013*, French Asset Management Association (AFG), 2013, 1, 4.

taken stricter stance on their regulation. Therefore, because of mostly comparable rules, transposition of the AIFMD was expected to be “smooth”.²¹⁷ Even though France has to modify 13 different codes and governing statute of the AFM (Règlement Général AMF)²¹⁸, indeed the Directive has come more as a positive surprise than a burden on French alternative investments industry. Principally, this is because of pre-existing French regime. If AIFMD came as a huge burden for the UK managers, French legal framework, especially the organizational requirements (valuation, depositary, etc.), had already been largely similar to AIFMD requirements.²¹⁹

This is why both, the industry and the regulator (AMF) expected improvement of competitiveness of France after the transposition of the Directive: “the challenge for France was not in the implementation of the AIFM Directive from a purely legal standpoint but rather in the positioning and the competitiveness of the French alternative investment industry.”²²⁰ Indeed, the Directive did not create a lot of new compliance challenges. The French AIFMs clearly had competitive advantage over other jurisdictions²²¹. Even now, due to the certainty, they are in a position to attract the uncertain clientele of the UK AIFMs.

²¹⁷ Les Echos, *Les équipes de gestion françaises sont bien positionnées pour tirer parti de la directive AIFM*, Jul. 2013, available at: <http://www.lesechos.fr/entreprises-secteurs/finance-marches/dossier/0202858271024/0202858271162-les-equipes-de-gestion-francaises-sont-bien-positionnees-pour-tirer-parti-de-la-directive-aifm-581288.php> (Last visited Mar. 28, 2014).

²¹⁸ Societe Generale Securities Services, 2013, *une année décisive pour la directive AIFM*, available at: <http://www.securities-services.societegenerale.com/fr/veille-reglementaire/aifm/2013-une-annee-decisive-pour-directive-aifm/> (Last visited Mar. 28, 2014) [hereinafter SGSS 2013].

²¹⁹ Stéphane Puel, Arnaud Pince, *L’impact d’AIFM sur les fonds français*, 297 Banque & Stratégie, 20-21.

²²⁰ Olivier Dumas, *The regulation of managers and funds in France following the implementation of the AIFM Directive*, Dechert LLP, Apr. 8 2013, available at: <http://sites.edechert.com/27/1075/landing-pages/french-developments.asp?intEmailHistoryId=1899566&intEmailListId=35&intEmailId=63375&intExternalSystemId=1##page=1> (Last visited Mar. 28, 2014).

²²¹ See: Etienne Deniau, *Tout ce qu’il vous faut savoir sur la Directive AIFM*, Societe Generale Securities Services, May, 2013, available at: <http://www.securities-services.societegenerale.com/fr/veille-reglementaire/aifm/livre-blanc-aifmd/> (Last visited Mar. 28, 2014).

Additionally, AMF announced that it would simplify the outstanding tasks for French funds in order to promote Paris as a favorable destination for foreign AIFMs and investors.²²² The industry too, seems to be accepting AIFMD and new opportunities associated with it. The asset management industry organization EVCA announced that “AIFMD is manageable for the industry, it has even become benchmark”.²²³ Yet another industry representative body, French Asset Management Association (AFG) created a new platform Paris Fund Industry and has engaged in substantial promotional work to get maximum benefit of the post-AIFMD competitive advantage. It is also interesting, that while promoting France as an attractive place for future domiciliation of non-EU AIFMs, AFG also focuses on the fact that France has no intention of leaving the EU, while there are uncertainties about UK’s future membership.²²⁴

As the transposition process in France demonstrates, Paris is not satisfied by “Number 2” status and both the industry and the regulator have been actively engaged in promotion of France as the AIFM domicile. The references of the French industry to the possible British exit from the EU is yet another demonstration of competition between the Member States, using every possible means. This is a positive trend though. The fact that despite unification of the EU financial market, competition between the Member States rises, will surely contribute to the investor welfare.

²²² SGSS 2013 *supra* note 218.

²²³ See : Dörte Höppner, President of the European Private Equity and Venture Capital Association (EVCA) in *Les équipes de gestion françaises sont bien positionnées pour tirer parti de la directive AIFM*, Jul. 2013, available at: <http://www.lesechos.fr/entreprises-secteurs/finance-marches/dossier/0202858271024/0202858271162-les-equipes-de-gestion-francaises-sont-bien-positionnees-pour-tirer-parti-de-la-directive-aifm-581288.php> (Last visited Mar. 28, 2014)

²²⁴ Janin, *supra* note 10.

3.3. Benefits for the Industry

AIFMD is controversial piece of legislation, so are its outcomes. The Directive brings both: opportunities and challenges to the European hedge fund industry. The Directive had three main policy goals: strengthening the supervision of systemic risk, enhancing investor protection and creating uniform and harmonious regulation of alternative investment vehicles in the EU.²²⁵ We can conclude that the last objective is mostly achieved. By following Lamfalussy process and empowering ESMA to monitor the national regulators, the EU legislators finalized the foundation of common European framework for AIFMs. Uniform interpretation of financial laws will substantially alter the climate: European financial industry, and specifically alternative investments sector is on the way to become more foreseeable. Increased legal certainty will be one of the positive outcomes of AIFMD.

Also, the Directive increases transparency of once secretive, closed industry. If employed correctly, AIFM data may contribute to better monitoring of systemic risk and prevent large-scale market failures. Specifically, centralized control from ESMA and information sharing between the national authorities can stimulate this process.

Interestingly, despite its focus on uniformity, AIFMD still enhances competition between the Member States. With minimized possibility of regulatory arbitrage, the countries will be obliged to compete in other factors. As the overview of the UK and French industries in post-AIFMD period demonstrated, the Member States are forced to take different incentives to promote themselves as attractive venues for AIFMs. Therefore, indeed, the new regime carries potential for an energetic restart.

AIFMD passport is another important positive novelty. By registering with only one state regulator the AIFMs will have a possibility to reach out a significant investors' base.

²²⁵ See ZETZSCHE, *supra* note 17 at 9-11.

Such eased trans-border distribution allows “geographic optimization of business models”²²⁶ while the use of economies of scale might result in reduced costs.

AIFMD also has potential to contribute to development of alternative investment industry in other, previously inactive Member States. As it was demonstrated above, for the moment most of the assets under management were held by the British, French and German managers. Now there is an ample chance that with AIFMD passport, managers from other Member States will also enter this elite club. Even though some governments are late in their transposition of the Directive into national laws, ESMA has confirmed that the managers from those Member States may still rely on the provisions of AIFMD passport notwithstanding the implementation delays.²²⁷

It is also contended that talks about 30% increase in overall AIFM costs based on AIFMD compliance, is exaggerated.²²⁸ Supporters of AIFMD believe that even though in a short-run the Directive does indeed cause the cost increase, in a long run it will open new opportunities which will outweigh them.

3.4. Negative Impact on the Industry

The opponents of AIFMD contend that “the final AIFMD text remains very burdensome for the industry”.²²⁹ Indeed, Deloitte survey demonstrated that 72% of surveyed managers view AIFMD as a business threat²³⁰. First of all, opponents of the Directive challenge underlying policy reasoning. It is argued that AIFMD was a disproportionate response to hedge funds activities which were not main culprits of the crisis. Further, it is

²²⁶ SGSS 2013 *supra* note 218.

²²⁷ European Securities and Markets Authority, *Practical arrangements for the late transposition of the AIFMD*, ESMA/2013/1072, Aug. 1, 2013.

²²⁸ Hester Plumridge, *Hedge Funds Win Big in Brussels*, The Wall Street Journal, Oct. 20, 2010.

²²⁹ Andrew Baker, *Looking back over the AIFMD process*, 96 AIMA J., 1, 2.

²³⁰ Deloitte, *supra* note 6, at 6.

believed that the Directive failed to provide solutions to main concerns: investor trust and control of systemic risks. AIFMD came with a lot of new costs²³¹ and heavy compliance burden²³². Even considering that their sophisticated investors needed extra protection, instead of benefiting, the Directive might ultimately harm them. Firstly, increased costs will ultimately be passed on them, and secondly, AIFMD will lead to limited investment choices in terms of products as well as geographic dimension.

AIFMD-associated costs may lead the third-country managers to withdraw or at least, reduce operations in Europe.²³³ This brings about the “Fortress Europe” with protective market for EU investors but with less and less foreign players and decreased competitiveness on the global level. Such development leads to limiting investors’ choices to managers from specific geographic area. In addition, AIFMD stringent rules and minimal thresholds may pose substantial hardships for smaller boutiques²³⁴ while ultimately strengthening the large banks or other large players.²³⁵ Finally, AIFMD related uncertainty may push the managers to

²³¹ Increased liability for depositaries is likely to make custody services more expensive. Also, according to Deutsche Bank Global Prime Finance Survey, during last two years more than 40% of respondents expanded their teams with full-time officers to manage the compliance with the new regulations, while 25% costs increase has been estimated by the majority of respondents. See: DB Survey, *supra* note 201.

²³² See also: “Hedge fund chief compliance officers are dedicating up to 50% more time to legal compliance and regulatory matters”, FINalternatives, *Hedge Funds Focus More Time, Personnel On Compliance*, Oct. 28, 2013, available at: <http://www.finalternatives.com/node/25144> (Last visited: Mar. 28, 2014).

²³³ See e.g. “Half of managers have decided to respond only to incoming investor requests for information regarding their funds until they have further clarity on marketing into Europe under AIFMD”. FINalternatives, *supra* note 232. See also: 68% of respondents believe that after AIFMD, fewer non-EU managers will operate in Europe. Deloitte, *supra* note 6, at 4.

²³⁴ BNY Mellon and FTI Consulting Survey demonstrated that 5% of respondent AIFs are expected to be closed, merged or sold, thus contributing to limit the investors’ choice. See: BNY Mellon, New Releases, Jan. 21, 2014, available at: <http://news.bnymellon.com/2014-01-21-Over-80-of-fund-managers-have-yet-to-see-AIFMD-authorisation-as-July-compliance-deadline-looms-according-to-new-BNY-Mellon-survey>, (Last visited: Mar. 28, 2014).

²³⁵ Christophe Girondel, *Regulation is changing the distribution landscape*, 13 PERFORMANCE, DIGEST INV. MANAG. PROF., Deloitte, Jan. 2014, 14-22.

eliminate alternative strategies and resort to established brand of UCITS funds²³⁶ or other parallel structures and diminishing investors' choice in terms of product types too.

It is also highly questionable whether AIFMD measures will anyhow minimize the systemic risk.²³⁷ In order to be able to predict and control such risk, only disclosed information might not be enough. Very strong enforcement authorities are necessary.²³⁸ With the current standing, it is hard to say whether the existing regulators are in a position to analyze this waste amount of data and prevent systemic shocks.

Finally, it is also important to note, that despite being a part of G20 agenda, other global players did not go as far as the EU legislator. Therefore, AIFMD contributed to the global regulatory misbalance to which "other G20 members show little inclination to follow."²³⁹ For these reason, the opponents consider AIFMD as a failed global response to hedge fund activities which puts Europe in a disadvantaged position. Therefore, arguably, the Directive will have adverse effects on the flow of foreign direct investment in Europe, hinder the future growth²⁴⁰ and risk jobs in European asset management industry.²⁴¹

²³⁶ Lyons, William T. O., *Are Newcits the Future of Hedge Funds or Does the AIFM Directive Provide a More Attractive Framework for Hedge Fund Managers and Investors?* Working paper, Mar. 2, 2012, available at: SSRN: <http://ssrn.com/abstract=2014882> (Last visited Mar. 28, 2014).

²³⁷ See also: "Because the regulator is rarely able to prevent all risks through systematic control of industry practices, it seems that a structure whereby control is mutually organized throughout the industry itself is highly desirable". Noël Amenc, Jean-René Giraud, *European Commission Conference On Private Equity And Hedge Funds*, Feb. 27, 2009.

²³⁸ See e.g. Goodheart's reasoning that the lack of information was not a major issue during the crisis. Even if the state regulators had access to more information, it is doubtful, that they could do much with it. GOODHEART, *supra* note 2 at 30.

²³⁹ Ernst & Young, *supra* note 168 at 5.

²⁴⁰ Anneken Tappe, *AIFMD Controversy: BVCA: AIFMD "still damaging"*, 454 Unquote, Dec. 5, 2011, 1, 9.

²⁴¹ New Direction – The Foundation for European Reform provides an estimate of the jobs at risk by member states in case after AIFMD the EU loses its global competitive advantage. The estimates include direct, indirect and induced employment and are based on assets under management, while the number of jobs are derived from per unit of assets under management in each member state. Table 2 demonstrates that the UK has 35,000 and France 18,000 jobs at risk, while total number of jobs at risk in Europe is 107,000. New Direction – The Foundation for European Reform, *The Real Economic Impact of the EU's Alternative Investment Fund Managers Directive*, Oct. 2010, 1, 9.

On the industry level, after more than two years of entry into force, the uncertainty still taints the fund managers (especially in the UK). Besides the lack of clarity over the Directive requirements, AIFMs also doubt, whether the new measures will anyhow strengthen investors trust and allocation of capital.²⁴² Finally, it is questionable, whether the passport option will be a valuable “carrot” alongside with all these “sticks”, especially, when majority of the managers also do not believe that the AIFMD passport has a potential “create a global standard for regulated hedge funds”.²⁴³

Based on all these observations, it is possible to conclude that the AIFMD has mixed results. If we consider that the political and single market goals outweigh immediate economic impact, then AIFMD is a successful piece of regulation. Its objective to create the final “basket regulation” and include the whole asset management spectrum under the EU-level oversight is achieved. Empowered ESMA and diminished role of national regulators will further strengthen the single market in financial assets. In this process, interests of the industry were largely neglected.²⁴⁴ Nevertheless, such impact on hedge fund industries differed in the Member States.

On one hand, there is the UK with the largest and the most developed hedge funds industry in Europe. Before AIFMD it was successfully functioning around the unique, principle and risk based regulation. Therefore, the UK has never favored more supranational harmonization of the asset management industry, neither was specifically getting ready for it. The new measures of AIFMD created a lot of uncertainty and important challenges for the British industry. On the other hand, AIFMD rules were well-known for the French managers. French industry had been supporting and even lobbying for similar regulation. Therefore, the

²⁴² See: DB Survey, *supra* note 201.

²⁴³ Deloitte, *supra* note 6, at 11.

²⁴⁴ ZETZSCHE, *supra* note 17 at 6.

transition was very easy and much less uncertainty was involved. Amid such development, the French industry is demonstrating an active recapitulation. Whether Paris will be able to challenge London's position as the global financial hub, at least in terms of alternative investments, still remains to be seen.

Conclusion

“A messy compromise that will not drive the industry out of business or out of Europe, but will do little to improve financial stability either.”²⁴⁵

This thesis examined various aspects surrounding the controversial piece of the European Union financial legislation: the Alternative Investment Fund Managers Directive. Firstly, I outlined different approaches to definition of “alternative investment” and demonstrated the inherent problems related to regulation of this wide and unorthodox category. Further, I focused on hedge funds - the most widely discussed type of alternative investment, considered as initial target of AIFMD²⁴⁶. In order to provide comprehensive picture and evaluate the impact of AIFMD on the European hedge funds industry, I studied the effects of the Directive on two levels. Notably, I analyzed the EU dimension of AIFMD and its impact on the individual Member States. For these ends, I selected two leading jurisdictions: the United Kingdom and France.

Alongside with the background factual information about the hedge fund industry in the EU and in two selected jurisdictions, the thesis also described the underlying policy goals of the European legislator. After the overview of the pre-AIFMD differences in the regulatory

²⁴⁵ The Economist, *supra* note 91.

²⁴⁶ Despite the fact that the Directive only regulates the managers of alternative investment funds, it effectively reaches out to hedge funds in significant ways. For discussion about indirect regulation of hedge funds, see p. 11 of the thesis.

approaches, it became apparent that the political and economic objectives of the Directive were not equally acceptable in the UK and France.

In terms of strengthening the single market in the financial assets, the UK had resisted the consolidation of power in the hands of the EU authorities, amid the fears of undermining its global leadership (alongside with the US). Contrarily, France, with Germany, had long favored such development based on the political agenda as well as competitiveness considerations. As for the economic goals of AIFMD, systemic risk and investor protection concerns had already been addressed by both British and French authorities. However, by introducing the common European financial supervision, including Lamfalussy process and ESMA, the role of national authorities diminished. This is going to have more implications on the UK industry, where the FCA had historically employed distinctive, principles and risk based approach, and had acquired the reputation of the industry-friendly authority.

After addressing the political and economic context of the AIFMD, I moved to its content and analyzed the most important novelties of the Directive. First, I demonstrated the wide scope of AIFMD, which ultimately makes it a “basket” regulation, sheltering all the previously unregulated investment vehicles. Later I moved to describe provisions on the AIFM authorization, organizational requirements, operational principles, rules concerning depositary, new transparency provisions and marketing of AIFs in the EU.

The thesis made clear that AIFMD is going to have a mixed impact on the hedge fund industry. Some of its rules (such as very low thresholds, restrictions on delegation of functions, limits on amount and calculation of leverage, strict liability for depositaries, etc.) are heavily burdensome, while others (enhanced transparency requirements, cross border marketing via AIFMD passport), if employed correctly, have potential to strengthen investors’ trust, increase allocation of investment and contribute to developing a global brand

for alternative assets. Nevertheless, careful examination of the provisions and the expressed concerns of the industry, led me to the conclusion that AIFMD remains more of a challenge than an opportunity. Eleven Member States have delayed its transposition, and even where it is duly in force, uncertainty is high.

At the EU level, the Directive proves to be more of a political tool, rather than an economic need-based regulation which will ultimately minimize systemic risk. Rather, it may deteriorate the global position of the EU hedge fund industry, reduce the availability of foreign funds in the Union and result in more limited product choice. At the individual Member States' level, France is expected to take advantage of the changed reality and direct its efforts to promote Paris as the leading place for hedge fund management in the EU. On the other hand, the attitude to AIFMD is negative in the UK, where the situation will remain uncertain until the end of the transitional regime in July, 2014.

Despite some of these conclusions being far-sighted, it is also important to recognize that the real impact of AIFMD is a matter of decades and subject to various political and economic factors. Considering the experience of the UCITS Directive, it is no surprise that unleashing the potential of such complex regulation takes a lot of time and money. Looking at AIFMD, at the moment we only see the top of the iceberg, evidencing that the immense changes are yet to come.

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