
by

Miguel Hernandez

A thesis submitted in conformity with the requirements for the degree of Master of Laws
Graduate Department of the Faculty of Law
University of Toronto

© Copyright by Miguel Hernandez 2012
THE DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS: COMPARATIVE ANALYSIS OF CERTAIN ASPECTS OF REGULATORY REGIMES IN EUROPE, CANADA AND THE UNITED STATES OF AMERICA

ABSTRACT


This thesis discusses potential financial risks for the AIFs industry arising from the European regulatory reform, which started before the current financial crisis, and compares relevant European, Canadian and US rules governing AIFs. This comparative analysis is based on four main criteria: i) registration and authorization requirements, ii) general financial transparency requirements, iii) capital requirements, and iv) remuneration restrictions.

The analysis of AIFs regulatory reform in Europe leads to three main conclusions. First, the AIFMD requirements are much stricter than analogue regimes in Canada and the United States. Second, as a consequence of this regulation, European AIFs may be in disadvantage.
Third, the complexity of the present European institutional framework is not able to fully implement the European regulatory reform.
## TABLE OF CONTENTS

1. Introduction


   - 3.1 National Regulations
   - 3.2 Self-regulation of the Alternative Investment Fund Industry

4. The regulatory reform of the Alternative Investment Fund Industry as a consequence of the financial crisis: the International initiatives

5. The Alternative Investment Fund Manager Directive ("AIFMD")
   - 5.1 The EU Regulatory Process
   - 5.2 The AIFM Directive: Overview of key requirements for Alternative Investment Fund Managers.

   - 6.1 The Canadian Regulatory Regime
     - 6.1.1 Introduction
     - 6.1.2 Authorization Requirements
     - 6.1.3 Capital Requirements
     - 6.1.4 Financial Disclosure Requirements
     - 6.1.5 Management Remuneration restrictions
   - 6.2 The United States Regulation
     - 6.2.1 Introduction
     - 6.2.2 Authorization Requirements
     - 6.2.3 Capital Requirements
     - 6.2.4 Financial Disclosure Requirements
     - 6.2.5 Management Remuneration restrictions
7. Preliminary Assessment: Is the AIFMD in the right direction or can it fall in certain regulatory excesses?

8. Conclusions
1. Introduction.

The financial crisis creates a suitable scenario to develop a regulatory backlash. The regulators use such a circumstance to impose reforms that have a limited connection to the crisis itself. The enactment of the Alternative Investment Fund Managers Directive\(^1\) (AIFMD) by the European Parliament and European Council supports this claim. The alternative investment fund (AIF) industry, of which private equity and hedge funds are important components, was not the primary cause of the financial crisis started in 2008. However, the adoption of the AIFMD by the EU has established very detailed and strict new pan-European regulatory regime.

In order to help a better understanding of the present study, it is helpful to clarify the conceptual meaning of private equity funds and hedge funds in the AIF industry context:

**Private Equity** - In general terms, private equity funds are pools of capital created from the founders of the fund, but mostly from experienced and sophisticated investors. They are committed to making their capital available for the life of the fund without redemption rights, and their investments are thus highly illiquid. This type of funds are usually structured so as to fall outside the standard collective investment investor protection regulatory framework. Private equity funds usually invest in a portfolio of companies that are not quoted on public markets, including “taking private” companies that were previously quoted.\(^2\) These portfolio investments are usually financed through a combination of equity and debt, with the debt component typically provided by banks and often distributed to other entities.

Although private equity leverage is usually focused on the portfolio companies level rather than on the fund level,\(^3\) private equity funds have been strongly associated with the use of leverage in their ordinary operations.\(^4\) These funds operate leverage buyouts deals whereby the funds try to increase the value of each portfolio company over the original purchase price by improving their management performance. The revenues that private

---


\(^2\) IOSCO Technical Committee, *Private equity Conflicts of Interest* (FR11/10), November 2010) provides an overview of the private equity funds.

\(^3\) UK, Financial Service Authority, *Private Equity: A discussion of Risk and Regulatory Engagement* (DP06/06) 37-8

\(^4\) IOSCO Technical Committee, Private Equity (May 2008), 11
equity funds generate are important not only for servicing their debts, but also for providing returns to funds’ managers and external investors.\(^5\)

**Hedge funds** - Hedge fund is a term that is not susceptible to an exhaustive definition due to heterogeneous type of investment strategies that these funds usually use, assets that they trade, and markets they operate on. However, there are some common characteristics in all of them, such as broad investment mandates, focus on delivery of absolute returns, high trading volumes/turnover, high and systematic use of different types of leverage, and investor base mostly confined to institutional and other sophisticated investors.\(^6\) The IOSCO Technical Committee has also identified a number of other characteristics associated with hedge funds. Among them are significant performance fees (often in the form of certain percentage of profits) paid to the manager in addition to annual management fee; often significant ‘own’ funds invested in the fund by the manager; the extensive use of derivatives, often for speculative purposes; the ability to short sell securities; and the right of investors to redeem periodically (quarterly, semi-annually or annually) their interest.\(^7\)

Most often, hedge funds are established as private investment partnerships that are open to a limited number of investors and require significant initial minimum investment. Moreover, investments in hedge funds are also illiquid as they often require investors to keep their cash in the fund for at least one year.

Additionally, it is important to highlight that although hedge funds and private equity funds represent different industry segments, they have some features in common. Hedge funds’ investments in private equity-related debt instruments and in companies that subsequently become leveraged buyout acquisition targets create overlap between both industries.\(^8\)

---


\(^6\) UK, Financial Service Authority, *Hedge Funds: A Discussion of Risk and Regulatory Engagement* (DP 05/04) 10.

\(^7\) IOSCO Technical Committee, *Hedge Funds Oversight* (June 2009) para 5.


After reviewing the conceptual definitions of hedge funds and private equity funds, it is relevant to discuss the potential risks and benefits that their financial activities may collaterally produce. This work will help to put in context my study of AIF regulatory reform in EU.

2.1 Hedge Funds Costs.

As previously mentioned, hedge funds use many different forms of leverage. This particular *modus operandi* involves three main costs: (i) systematic risk costs, (ii) costs related to adverse selection for lack of disclosure, and (iii) ownership agency costs.

On the grounds of their strong financial role in different markets, the hedge funds’ peculiarities, *i.e.*: high leverage and selling short, exacerbate systemic risk and create a negative externality, which are primarily caused by two aspects of hedge funds. First, hedge funds are not required to meet the same capital adequacy standards that mutual funds and other institutional investors are required to meet and, therefore, a loss might have a more critical impact on hedge funds' survival. Second, hedge funds may choose to sell short, not just to hedge long positions, but to leverage the bet in one direction, thus increasing the size of the potential loss. The occurrence of high losses, which can be verified even in a short timeframe, demonstrates the highly volatile and risky nature of the industry.\(^9\)

Based on the aforementioned aspects, the Financial Service Authority has defined two channels through which hedge funds may cause systemic risk\(^10\). The first one is the "credit channel", which is concerned with the counterparties' credit exposure and the possibility that hedge funds’ failures may lead to losses in the banking sector. The second is the "market channel", which is concerned with hedge funds' aggressive, high-volume and often highly-correlated trading strategies. In this second case, the danger represents the main motivation. As hedge funds follow similar strategies to crystallize their investments, there is a risk that they may collectively enter to or exit the market, and in doing so they disturb the supply and demand liquidity and normal operation.


The costs related to adverse selection for lack of disclosure are a consequence of the opaque nature of the hedge funds sector and their *de facto* exemption from mandatory disclosure provisions. The regulatory framework applicable to these financial vehicles creates an area where hedge funds have minimum disclosure requirements. The capital markets are notoriously characterized by informational asymmetries between issuers and public investors and, interestingly, also between intermediaries and public investors. In addition, given the absence of any regulation in this regard, capital markets are characterized by an undersupply of information from intermediaries to public investors. Thus, without disclosure obligations, hedge funds present informational deficiencies, which may give rise to adverse selection problems: hedge funds that had poor performance records might be selected to the detriment of “better” hedge funds. However, it is important to note that adverse selection costs in this sector are lower in this sector than in other industries. The problem is diminished due to the profile of its investors, who are sophisticated players, often institutional investors who perform lengthy due-diligence processes to implement their investments.

The third cost is an “ownership agency cost” (private benefits of control). By ownership agency cost, I mean the costs involved in the change of the company ownership structure caused by the hedge funds operation. In the recent years, hedge funds have been increasingly acquiring influential stakes in portfolio companies. Accordingly, the ownership structure of this type of companies turns from dispersed ownership to concentrated ownership, and one of the major consequences of this structural change is the tradeoff of different agency costs involved in those two structures. Both concentrated ownership and dispersed ownership structures face different agency costs, but concentrated ownership companies are potentially tainted by higher agency costs than are dispersed ownership companies. Therefore, the hedge funds’ governance activity could be interpreted as increasing the overall agency costs of companies in which it takes a controlling stake.\(^\text{11}\) This conclusion is however arguable for a number of reasons. First, dispersed ownership companies also present severe agency costs, some even more acute than concentrated ownership companies in view of the collective behavior problems suffered by dispersed shareholders. Second, these agency costs are not likely to emerge immediately after the

hedge fund intervention, but in the long term: some governance actions need to be carried out by the hedge fund before the agency costs arise.\textsuperscript{12}

In this context, it is relevant to study “empty voting” and “short selling”, which are examples of costs generated by hedge fund activity, in order to determine whether or not the AIF regulation makes sense from a social point of view.

\subsection{2.1.1 Empty voting}

The evolution of equity swaps and other privately negotiated equity derivatives have made that decoupling a share’s economic ownership from its voting rights has become easier and simple. Hedge funds are taking advantage of this opportunity. Sometimes, these AIFs hold more votes than shares - a phenomenon known as "empty voting' because the votes have been emptied of economic interest. In extreme situations, an investor can be “long the vote” while holding a "net short" economic position, which gives the investor an incentive to vote in ways that reduce the company value.\textsuperscript{13}

The “empty voting” is defined by the legal doctrine as "the new vote buying" or simply as "decoupling".\textsuperscript{14} In the past several years, “decoupling” has affected takeover battles\textsuperscript{15} and the control of public companies in (at least) the U.S., the U.K., Germany, France, Spain, Japan, Australia, and New Zealand.

There are a number of ways to decouple votes from economic ownership. The most common approach relies on the stock lending market, which permits one investor to “borrow” shares from another one. By using standard share loan agreements, the borrower acquires voting rights but no economic ownership, while the lender keeps the economic ownership without voting rights. Another approach involves holding shares but hedging the economic risk on the shares by holding a short equity swap position. In this case, the person with the long equity side (the “equity leg”) acquires the economic return on shares (but not voting rights) from the short side (the "interest leg"). Gains or losses are cash settled at the

\begin{flushleft}
\textsuperscript{14} The “new decoupling strategies” is a new example of the challenges that derivatives and financial innovation pose to corporate government principles.
\end{flushleft}
swap maturity date. The combined position (long shares, short equity swaps) conveys voting rights without net economic ownership. Conversely, a long equity swap position conveys economic ownership without voting rights.\textsuperscript{16}

Although the theoretical possibility of decoupling votes from economic ownership is not new, hedge funds are starting to use this investment strategy on a large scale. There are two main causes to justify this new scenario: first, the light regulation of AIFs brings on that hedge funds could be free from conflicts of interest that may stop other institutional investors from aggressive use of decoupling strategies, and second, the lower transaction costs that new financial innovations let hedge funds to obtain.

From a corporate governance perspective, the new vote buying strategies can create undesired market distortions and reduce the company’s value. In order to correct these negative outcomes, it seems plausible that enhanced disclosure (crafted with sensitivity to disclosure costs) is desirable. This measure may permit that both, regulators and market participants, determine how much new vote buying occurs and how often it affects shareholder vote outcomes.

\textbf{2.1.2 Short Selling}

Another controversial outcome of hedge funds operation is the so-called “short selling”, which is the practice of selling securities that have been borrowed from a third party with the intention of buying identical securities back at a later time in order to return them to that third party. The short seller makes profits from a decline in the securities’ price between the sale and the repurchase. Hedge funds usually use a financial derivative or other contract under which the investor similarly profits from a fall in the value of the securities. The “short selling operation” works as \textit{Figure I} shows.

\begin{footnote}
\textsuperscript{16} There are slight differences among these strategies. The long side of an equity swap typically receives full return on shares, including price changes as well as dividends or other distributions. In contrast, the returns on a single stock future, call option, or short put option position normally depends solely on share price changes.
\end{footnote}
As mentioned above, short selling is a key component of most hedge fund strategies. As happens with “empty voting”, although “short-selling” investments existed in the past, the different use of this strategy by hedge funds is linked with the huge amount of money that they use in order to achieve their investments. This abundance of resources is a result of hedge funds’ trading advantages over traditional funds such as unlimited leverage and use of derivatives, unrestricted choice of strategies and clients, and the use of tax havens. In fact, during the current economic crisis “short selling” has been appointed as one of the circumstances that are causing undesired market disruptions.

Additionally, part of the legal literature\textsuperscript{17} states that hedge funds exploited the dotcom bubble cashing in extensive holdings just before the crash. Although these AIFs were aware of the bubble, hedge funds decided that the best strategy was to make profits with it, rather than correct prices. Also, some financial institutions indicated that in the recent 2007-09 crisis, the CDO (collaterised debt obligation) machine drove the housing bubble, with leveraged hedge funds purchasers of higher risk tranches. When the bubble burst, the run on hedge funds became a torrent. Similarly, part of the legal doctrine\textsuperscript{18} finds a correlation between the “short selling” strategies of the hedge funds during the crisis, with disorderly exits from crowded trades linked to the critical evaporation of the market liquidity. Finally, during the current crisis of sovereign debt, some governments are accusing the AIFs to be

\textsuperscript{17} M Brunnermeier & S. Nagel, “Hedge Funds and the technology bubble” (2004)

\textsuperscript{18} M. Pericoli & M. Sbracia, “Crowded trades among Hedge Funds” (2010)
behind the speculation of international sovereign bond market, scenario that is blocking their access to international credit markets. It is relevant to notice that some EU Members like Germany, Italy, France, Belgium and Spain have imposed strict temporary short selling ban on financial stocks (still in force) in order to mitigate their economic troubles.

It seems plausible that also in this case enhanced disclosure should be desirable in order to correct the negative outcomes that “short selling” can cause.

2.2 Private Equity Industry Costs

Regarding private equity funds, the potential systemic concerns are specifically focused on the high volume of leverage that characterizes private equity backed buyouts.\(^\text{19}\) Usually, this scenario increases the debt of its portfolio companies and may make them more vulnerable to financial distress, which may have adverse consequences for the lenders and/or the secondary market where that debt has been sold.

These potential problems are exacerbated by non-transparent ultimate economic exposure resulting from secondary market trading of leveraged buyout debt and derivative products, since the lack of transparency complicates corporate restructuring and default workouts. In contrast, private equity funds’ investment strategies are not driven by high-intensity investor redemption pressures and do not involve aggressive trading so intrinsic to hedge funds. Therefore, as opposed to the hedge fund industry, there are fewer reasons to consider the private equity industry as the one posing indirect systemic threats by causing the market disruptions.

Additionally, the IOSCO Technical Committee has pointed out some corporate governance concerns relevant to the private equity industry.\(^\text{20}\) Unlike hedge funds, private equity funds acquire controlling interests in portfolio companies which they intend to hold for a reasonable period of time in order to make management and other structural changes. This peculiarity usually involves use of portfolio companies’ assets for repaying financing of leveraged buyout. This gives rise to concerns about distortion of incentives because being under pressure to pay off the debt corporate managers may take wealth-extraction decisions


\(^{20}\) IOSCO Technical Committee, Private Equity (May 2008), 11
without proper regard to the long term impact of their actions on employees and other stakeholders.

2.3 Benefits of AIF industry.

Notwithstanding its negative aspects, the AIF industry can be highly beneficial for the markets where it operates. Its activity involves three main types of benefits: i) liquidity benefits, ii) market efficiency benefits, and iii) financing benefits.

AIFs can significantly enhance market liquidity, particularly in the case of hedge funds. Trade statistics shows that AIFs’ impact on capital markets has mounted to a staggering 40 to 50% of the daily trading activity in major equity markets and to “over 70% of daily trading activity in the convertibles market, the U.S. distressed debt market and the U.S. exchange-traded fund market”.²¹

Their dynamic and innovative trading strategies can also contribute to market efficiency. AIFs perform basically two beneficial activities on the markets.²² First, AIFs make returns on investments anticipating market moves, basically performing an arbitrage activity. This activity generates a reduction in the spread between the actual price and the perfect price on the market, thus improving market efficiency. A second positive feature is related to the discrimination function of AIFs’ investment decisions. Here, the decision by an AIF to invest in a particular company may be interpreted in different ways, namely as a positive or negative signal to fellow investors. On one hand, the AIF may invest in a particular company either because that company has had a good economic performance or because that same company is simply undervalued; on the other hand, the AIF may disinvest because the company has performed poorly or because it can cash out a nice profit. In any case, the AIF’s investment decisions have a strong discrimination power and help the markets’ informational efficiency; in particular, empirical evidence seems to suggest that AIFs, unlike previous block holder activists, tend to target companies with good performance and high cash flow.

²¹ UK, Financial Service Authority, Hedge Funds, n 2, 14 (reporting that hedge funds were estimated to account for between a third and half of daily activity on the New York Stock Exchanges and London Stock Exchange)
Lastly, financing benefits are incontestable. AIFs expand the sources of financing available to the corporate sector and, according to the IOSCO, can “form an important part of the development lifecycle of a firm”\textsuperscript{23}. For investors, the AIFs diversify investment options that can improve traditional investment products.

Given the above, it appears that many positive results can be achieved if the regulators and financial institutions cooperate in order to design and develop a regulatory reform of the AIF industry aimed at mitigating the potential risks inherent to AIFs. At the same time, the reform should create conditions that would allow AIFs to fully benefit the markets.

\textsuperscript{23} IOSCO Technical Committee, Private Equity (May 2008), 11

This section reviews two main types of European regulatory initiatives: AIF industry’s self-regulation initiatives and the EU institutions’ initiatives.

Although often described as an “unregulated” segment of the market, in fact the European AIF industry has been subject to various regulatory requirements and forms of supervision. Unfortunately, these initiatives adopted a national approach and limited supervisory oversight rather than a comprehensive EU approach specifically dedicated to AIFs.

3.1 Initiatives of the EU Institutions.

During the period from 2003 to 2008 three main EU institutions - the European Commission, the European Parliament, and the European Central Bank – launched a few initiatives in order to regulate the AIF industry, including the following:

The European Commission (EC)

The EC is the institution that has the right to propose new EU legislation. During the pre-crisis period the Commission created a number of task forces and expert panels in order to study the industry and suggest possible measures to improve the efficiency of the EU investment fund market. The personal preferences of Charlie McCreevy, then the Internal Market Commissioner, influenced the rhetoric of these initiatives in a pro-market direction.

The conclusions of these task forces and expert panels were reflected in the European Commission Green paper. This document recognized that the AIF industry was developing in a way that was likely to create a “growing need for a coherent and enlightened European approach” in this sector. The EC focused mostly on potential for the regulatory intervention to foster the development of private equity funds and hedge funds activity in Europe.

The European Central Bank (ECB)

---

In its approach to the industry, the European Central Bank recognized many benefits that hedge funds’ activities had brought to the financial markets. However, the ECB also noted that making comprehensive assessments with respect to systemic matters was difficult at that time because of the opacity of the industry. This comment highlighted an important problem of hedge funds from a systemic perspective, which existed before the financial crisis. Specifically, lack of transparency was the main concern. Hedge funds were seen as a part of the “shadow banking” system. Accordingly, full information on aggregate investment exposures and leverage in the sector was not available. Regarding private equity funds industry, the European Central Bank concluded that the potential systemic risk that this sector of the AIF industry could cause to financial markets was significant participation of the European banks in LBO (Leveraged Buy-out) transactions. However, in its report the ECB stressed “the likelihood that the LBO activities cause systemic risks for the banking sector appears to be remote on the EU level.”

**The European Parliament (EP)**

Unlike the EC and the ECB, the European Parliament (“EP”) presented critics to the investment fund industry during the regulatory debate carried out in the years leading up to the financial crisis. As an evidence of its position, EP passed a number of resolutions calling upon the EC to look more closely at the industry and adopt more critical stance. Another notable contribution to the debate was a lengthy report on the need for more robust regulation of hedge funds and private equity, which was published by the Parliamentary Socialist Group. This Report identified a number of concerns about the industry operation that required a regulatory intervention. Among such concerns were the lack of transparency, short-termism, distorted remuneration incentives, and the threat, especially from hedge funds, to financial stability. The Report was also very critical to the private equity industry

---


and its use of leveraged buyouts in ways that often had serious negative consequences for the target companies.

In addition to this institutional debate within the EU, it has to be noted that in the pre-crisis period the AIF sector started some self-regulatory initiatives that will be reviewed in detail in the next section. In this scenario, various hedge fund associations published their own best business practices standards. The private equity industry also published industry guidance on a range of matters including transparency, valuation, and ethics. These self-regulating initiatives were encouraged by the national and international regulators which considered that a reasonable balance between the national regulation and self-regulation could be a correct policy to avoid potential systemic risks. However, as the situation on financial markets got worse, the international regulators recognized the need for more stringent official controls.

3.2 Self-Regulation Initiatives of the Alternative Investment Industry.

The European self-regulatory initiatives of the AIF industry during the pre-crisis period are diverse and extensive, both at national and supranational level. Nevertheless, it is important to note that despite these diverse regulatory approaches, all of them show common characteristics regarding capital aspects of the AIF industry. For instance, the recommendations to promote integrity and improve reputation of this financial sector as well as to ensure a high level of investor protection are common for all the initiatives previously discussed.

These common requirements can be explained by the fact that since 1985, the European framework for collective investment schemes, so-called “the UCITS regime”, is in place. This regimen allows the UCITS to operate freely throughout the EU on the basis of a

---


34 The Undertakings for Collective Investment in Transferable Securities (or "UCITS") are a set of Union Directives that aim to allow collective investment schemes to operate freely throughout the EU on the basis of a single authorisation from one member state. In practice many EU member nations have imposed...
single authorization of one member state. The UCITS Directive has been amended significantly in 2001 as UCITS III\textsuperscript{35} and in 2009/2010 as UCITS IV\textsuperscript{36}. Consequently, the UCITS regime has helped to harmonize the European AIF industry self-regulatory initiatives at supranational and national level.

In order to illustrate this circumstance, I review the two most important pan-European self-regulatory initiatives developed by the European AIF industry; the 2006 EFAMA Code of Conduct that focuses on the hedge fund sector, and the European Private Equity and Venture Capital Association Code of Conduct establishing rules in the private equity funds.

**The EFAMA Code of Conduct**

The European Fund Asset Management Association Code and Best Practice Recommendations represented a significant initiative developed by the European investment management industry in 2006.

The EFAMA Code built up a self regulatory regime in order to promote; i) the integrity of the European marketplace for investment management and its worldwide reputation; ii) the confidence of investors in investment management services and the level of investor protection; and iii) the integration of the European investment management industry and the single market for financial services.

The EFAMA Code of Conduct covers the investment fund business by taking into account that in Europe it is not only regulated by the UCITS regime but also it is impacted by the MIFID Directive\textsuperscript{37}. It is important to note that EFAMA Code of Conduct reflected the implementation of both regimes - the UCITS and the MIFID - at the European level for first time.

From a material point of view, the principles of the EFAMA Code of Conduct cover the following points: the fiduciary duty and the governance on AIFs; conflict of interest on AIFs; organization and procedures on AIFs; compliance with the law, regulation and rules; additional regulatory requirements that have impeded free operation with the effect of protecting local asset managers.


appropriate risk management regarding the investment decisions; fair value of the portfolio assets on AIFs; the mandatory segregation of portfolio assets from those of the AIFs; the obligation of custody of portfolio assets in the interest of the investors by a depositary; the prohibition of trading practices that could harm interests of long-term investors; the obligation to use shareholder and creditor rights attached to portfolio holdings in the best interest of investors; the obligation to provide true, fair and not misleading information to investors regarding to objectives, policy, potential returns and risks; and the obligation to obtain information about the customer and ensure the suitability of the advice and the appropriateness of the products for that particular investor.

**The EVCA Code of Conduct.**

The most important self-regulatory initiative regarding private equity industry within the EU was the ECVA Code of Conduct promulgated in 2007 and subsequently amended in 2009 and 2010. The Code represents a range of professional conduct standards for private equity and venture capital fund managers, both in respect of the management of their activities and their relationships with investors and portfolio companies.

From material point of view the EVCA Code of Conduct includes:

- The principles of professional conduct in the private equity and venture capital investment industry, including confidentiality requirements and requirements to respect interests of all stakeholders in a business;
- The principles of professional conduct for private equity and venture capital managers as shareholders in portfolio companies, including the requirement to consider potential conflicts of interests and the need to ensure that portfolio companies have right tools in place for appropriate decision making;
- The principles of professional conduct as a board member of the portfolio company, including the importance for all board members to identify and assess the areas of risk for the business;
- The principles of professional conduct for the management of portfolio companies, including the requirement to ensure that relevant information
is produced accurately and timely and that appropriate measures for governance monitoring are in place.

In conclusion, both self regulatory initiatives represent the efforts of the AIF industry to develop a useful tool to promote integrity and improve its reputation as well as to ensure a high level of investor protection in multi-jurisdictional approach. However, the biggest weakness of the EFAMA and the EVCA Codes of Conduct and other self-regulatory initiatives mentioned above is the lack of enforcement mechanisms, since no sanctions are stipulated for deviating from the rules of conduct. As the EFAMA Code of Conduct provides “the national associations must have the competence of this enforcement task in order to ensure the compliance of alternative investment funds”. Unfortunately, the recent financial crisis has demonstrated that the self-regulatory initiatives in general, and the codes of best practices in particular, have doubtful efficiency. As a result of the financial crisis, the international institutions and financial regulators realized that the regulatory reform of the AIF industry was necessary.
4. The regulatory reform of the Alternative Investment Fund Industry as a consequence of the financial crisis: the International initiatives

After analysis of the pre-crisis regulatory initiatives in the EU, this section discusses the regulatory measures adopted on the international level during the period from 2008, when the current financial crisis started, to 2011. It is important to put the European regulation of AIFs’ activities as it was before the crisis and the current regulation into the context of the regulatory initiatives developed by international institutions because the two are closely related. During the last 5 years, the international policy response to the financial meltdown has influenced and was influenced by the European regulative approach to the AIF industry.

4.1 International Initiatives

Since the beginning of the financial crisis started in first quarter of 2008, AIFs have not been directly involved in any systemic collapses that affected the international financial markets during the last three years. Nevertheless, despite the fact that the AIF industry was not the main cause of the problem, it attracted close attention of the reformers during the current crisis. There is a widespread opinion, though not universally accepted, that hedge funds and private equity industry have aggravated the consequences of the financial crisis by employing aggressive trading strategies, relying extensively on leverage, and quick unwinding their positions in order to meet investor redemption demands. Moreover, the involvement of hedge funds in “short selling” as I mentioned above, has generated a global consensus on the need to adopt stricter regulations for this sector.

As an example of these new global concerns, in early 2010 the cross-sectoral Joint Forum formed by representatives of the Basel Committee, IOSCO38 and the International Association of Insurance Supervisors concluded that there was a "general consensus that hedge funds, given their role in the economy, may have a systemic impact"39. It was more skeptical to link private equity funds (which, as noted earlier, tend to be relatively long-term illiquid investments) to the systemic problems in the markets exposed by the crisis. However, these entities operated using business models similar to those employed by hedge funds. Therefore, they were included in the same regulatory net. A general argument for extending

38 The International Organization of Securities Commissions.
the perimeter of regulation was that this measure was necessary in order to eliminate opportunistic shifting of business to unregulated segments and continuing highly risky practices that due to competitive pressures could seep back into and contaminate the regulated parts of the industry.\textsuperscript{40}

At this point, it is useful for the study of the regulatory reform review and analyze the key developments in the evolution of regulatory policy with respect to the AIF industry from 2008 to 2011 that have been adopted by three main international and financial forums: IOSCO, G20 Summits and Joint Forum.

\section*{The IOSCO}

The International Organization of Securities Commission ("IOSCO") is an umbrella institution that cooperates with national regulators in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks. The IOSCO has elaborated during the recent years some initiatives and prepared reports regarding the Alternative Investment Fund industry. The most prominent of them are the following:

1. On November 2009, the IOSCO published “The Private Equity Final Report”\textsuperscript{41} that established the principles for mitigating potential conflicts of interest between managers and third-party investors.

2. On June 2009, this institution published “The Hedge Funds Oversight Report”\textsuperscript{42} that has been used by the financial regulators as a route map of AIFs legislative reform; the document detailed six high level principles on the regulation of hedge funds based on best market practices: i. Mandatory registration of hedge funds/ hedge fund managers/advisers; ii. Registered hedge fund managers/advisers must be subject to

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{40}] In its Hedge Funds Oversight Report (June 2009), IOSCO’s Technical Committee Task Force indicated that it had focused on hedge funds rather than dealing with other potentially “unregulated” entities such as private equity funds because of the G20’s particular interest in hedge funds. However, it noted that many of its observations and conclusions could be applicable to other market participant entities holding or controlling large pools of capital. See also Joint Forum, Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations (January 2010), 19 (recommendations with a "functional tenor" intended to apply to all pools of capital and to managers/advisers who engaged in activities posing risks substantially similar to hedge funds).
\item[\textsuperscript{41}] IOSCO, Private Equity Final Report (November 2009)
\item[\textsuperscript{42}] IOSCO, Hedge Funds Oversight Report (June 2009).
\end{itemize}
\end{footnotesize}
ongoing regulatory requirements (organizational and operational standards, conflicts of interest and other conduct of business rules, disclosure to investors, and prudential regulation); iii. Prime brokers and banks providing funding to hedge funds must be subject to mandatory registration/regulation and supervision. iv. Hedge fund managers/advisers and prime brokers must provide required information for systemic risk purposes; v. The regulators must encourage/take account of industry good practices, where appropriate; and vi. The regulators shall have the authority to cooperate and share information to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks internationally.


4. In February 2010, the IOSCO issued “The Template for gathering of hedge fund systemic risk data on a global basis”\(^{44}\) which purpose was to assist the regulators in collecting comparable and consistent data from hedge fund managers and advisors in relation to, *inter alia*, their trading activities, the markets where they operate, and counterparty information.

5. In June 2010, the IOSCO prepared “The Objectives and Principles of Securities Regulation”\(^{45}\), a document that includes the requirement to conduct appropriate regulation to ensure that hedge funds and hedge funds managers/advisers are subject to appropriate oversight.

6. In November 2010, the IOSCO published “Private Equity Conflicts of Interest Report”\(^{46}\), an enhanced report initially published in 2009 about conflict of interests relevant to private equity funds.

7. Finally, on March 2011, the IOSCO issued “The Principles on Suspensions of Redemptions in Collective Investment Schemes”\(^{47}\) that defined the guidelines to regulating the potential suspensions of redemptions in AIFs.

\(^{43}\) IOSCO, Element of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices (September 2009).

\(^{44}\) IOSCO, Template for gathering of hedge fund systemic risk data on a global basis (February 2010).

\(^{45}\) IOSCO, Objectives and Principles of Securities Regulation (June 2010).

\(^{46}\) IOSCO, Private Equity Conflict of Interest Report (November 2010).
All the IOSCO reports mentioned above have played important role in regulation of the AIF industry. Some EU Members, specifically those countries with strong pro reform views (e.g. France and Germany), have used these documents to advocate more stringent regime for AIF sector.

**G20 Summits**

The so-called G-20 is the meeting of heads of governments in a series of on-going discussions about financial markets and the world economy. This new international forum has grown in stature since the Washington Summit on 2008. The G-20 has become the premier forum for discussing, planning and monitoring the international economic cooperation and has replaced the G8 as the main economic council of wealthy nations. Its Recommendations and Conclusions regarding the AIF industry have also played a key role in the AIF regulatory reform. Below are important decisions took by the G 20:

1. In November 2008, Washington Summit Declaration\(^48\) called for the extension of regulation to all sectors of the financial industry, and suggested introducing unified best practices for the AIF industry.
2. In April 2009, London Summit Declaration\(^49\) provided that all systemically important financial institutions, markets, and instruments should be subject to appropriate degree of regulation and oversight. Specifically, the Declaration of the Summit introduced mandatory registration of AIF/managers as well as the regular disclosure requirements. Also, a strict oversight over their activities was suggested in order to ensure adequate risk management. This included special mechanisms to monitor funds’ leverage and setting limits for single counterparty exposures;
3. In September 2009, Pittsburgh Summit Declaration\(^50\) confirmed support for global regulation of financial services, including activities of AIF.

---

\(^{47}\) IOSCO, Principles on Suspensions of Redemptions in Collective Investments Schemes (March 2011)

\(^{48}\) The Group of 20, Washington Summit Declaration (November 2008) 5

\(^{49}\) The Group of 20, London Summit Declaration (April 2009) 4

\(^{50}\) The Group of 20, Pittsburgh Summit Declaration (September 2009) 6
4. In June 2010, Toronto Summit Declaration\textsuperscript{51} agreed to strengthen the financial market infrastructure by accelerating the implementation of strong measures aimed at improving transparency and regulatory supervision of the AIF industry.

5. In November 2010, Seoul Summit Declaration\textsuperscript{52} reaffirmed the commitment to work in internationally consistent and non-discriminatory manner in order to strengthen the regulation and supervision of AIFs.

The upcoming G20 Summit in Cannes scheduled for November 2011 shall considering strengthening and monitoring the on-going regulation of AIFs.

\textbf{Joint Forum}

As discussed above, the Joint Forum is a cross-sector forum for the Basel Committee, the IOSCO and the International Association of Insurance Supervisors. It is important to highlight that this institution issued an important document in January 2010 called “The Review of the Differentiated Nature and Scope of Financial Regulation Key Issues and Recommendations”\textsuperscript{53} where the Joint Forum identified the lack of consistent prudential regime for monitoring and assessing hedge funds’ activities as a critical gap in the regulatory framework. The Joint Forum confirmed the principles that the IOSCO declared in its “Hedge Funds Oversight Report”\textsuperscript{54} and added three more: i. the need for financial supervisors to introduce and/or strengthen appropriate and proportionate minimum risk management regulatory standards for hedge fund operators; ii. the need for supervisors to impose reporting requirements on hedge fund operators in order to identify current or potential cause of systemic risks and to enable cross-sector monitoring of important hedge funds; and iii. in view of the operational risks posed and in order to allow for orderly winding down of a fund operator in the event of bankruptcy, the need for supervisors to impose minimum initial and ongoing capital requirements on important hedge funds.

Also, the Joint Forum issued other important recommendations for AIFs, such as, financial cuts and margin requirements, closed-end form/redemption gates, risk-independent...
leverage requirements, risk-based capital or leverage requirements, and risk management procedures for timely delivery of financial instruments.

In conclusion, from the analysis of the IOSCO, G20 and the Joint Forum initiatives summarized in this section it can be inferred that there is a general expectation at the international level that AIFs and AIFs’ managers have to be registered with a supervisory authority and comply with clear mandatory requirements, especially with respect to disclosure and conduct of business. There is also a growing consensus that more stringent prudentially oriented requirements should be applied to those AIFs that are systemically important. Nevertheless, there is no default assumption that all hedge funds or other types of alternative investment funds are “per se” systemically relevant. Nor do corporate governance concerns about the activities of AIFs occupy the foreground of the international policy debate.
5. The AIFMD: An Overview of the EU regulatory reform and key requirements for Alternative Investment Fund Managers

5.1 The European Union regulatory reform.

Although the G20 Declarations created an international agenda for the strengthened regulation of AIFs’ business, there was no clear consensus about how to drive forward these regulatory reforms. In Europe, there were two main groups with different opinions about it. On one side, a group of the EU Members led by the United Kingdom and Luxembourg was of opinion that the AIF regulation was a global issue that required a global response. On the other side, a second group of EU Members led by Germany, France, Italy and Spain stated that Europe may seize the opportunity to lead the way and play an instrumental role in shaping a new global regulation of the AIF industry. This last group supported decisions of the G20 to introduce stricter regulation of the AIF industry.

Additionally, as I stated in section 3.1, the pre-crisis European debate about the regulatory reform of the AIF industry was especially wide-ranging and clear distinctions were not always seen between different regulatory concerns posed by the AIF sector. The initiative ranged from improving the safety and soundness of the industry through strengthening investor protection and preventing fraud and to corporate governance issues caused by hedge fund investments in companies, particularly those associated with private equity-backed leveraged buyouts.

As a consequence of this confusing backdrop about regulation of the AIF industry within the EU, when the financial meltdown hit the global markets, some EU members (particularly France and Germany) used the opportunity to pursue a strict regulatory reform of the AIF industry according to their national interests that were in conflict with interests of other EU Members (particularly UK). The best example illustrating this confusing scenario is the confrontation between two opposing views on the regulation of the AIF industry, specifically the dispute among the EU Institutions (the EP, the EC and the Council) where both groups of EU Members tried to advance their views on the regulatory reform. Below is

---

55 HM Treasury & FSA, European Commission Consultation on Hedge Funds: Response (January 2009) 6
56 eg, M Barnier, Conference Keynote Speech: Delivering on the EU’s G20 Commitments (Berlin, May 2010)
a brief summary of this institutional tension within the EU institutions during the beginning period of the current financial crisis:

During 2008 and early 2009, the European Parliament used the procedural mechanism provided by the European law to ask the EU Commission to suggest “necessary proposals” for more stringent regulation and supervision of the AIF industry. Also, the Parliament passed two key reports about this issue in 2008.

The first of them was the so-called “Lehne Report” that demanded for directive(s) guaranteeing a common standard of transparency and tackling the issues of hedge funds activities (especially voting policies) and private equity funds (especially asset stripping, leverage and employee rights). Also, the document asked the Commission to encourage improvements in transparency by supporting and monitoring the evolution of the industry self-regulation. The second document was the so-called “Rasmussen Report” on hedge funds and private equity. This document advanced the need for regulatory reform of these financial institutions. The reasoning of both Reports was used by the European Parliament to issue a Resolution requesting the Commission to bring forward legislative proposal(s) covering all relevant actors and financial market participants, including hedge funds and private equity.

It is important to stress that among the specific recommendations of this Resolution, the Parliament outlined very clear instructions, including; i. the need to close the lacunae in existing legislation as regards the regulation of hedge funds and private equity; ii. the need to extend mandatory capital requirements to all financial institutions, iii. the need to increase transparency requirements for providers of prime brokerage services; iv. the development of a harmonized EU-wide framework for venture capital and private equity and a new legislative private placement regime; v. the need to establish more stringent disclosure requirements; vi. the need to increase protection of employees’ interests under the EU law whenever control over a company is changed, including when private equity and hedge funds are involved; vii. the need to implement better information to employees or staff.

representatives in respect of holdings in hedge funds and private equity; viii. the need to introduce mandatory restrictions on private equity leverage; ix. the need to fix new controlling mechanisms to prevent unreasonable asset stripping in target companies; and x. the need to enact new conflict of interest measures to ensure the effective separation of services that investment firms provide for their clients.

Despite the efforts of the Parliament, the European Commission took a more skeptical approach to the AIF industry regulation. By this time, Commissioner McCreevy who defended the UK and Luxembourg ideas about the reform issued a pre-legislative consultation that did not even cover private equity funds. Even in early 2009, the Commission was still battling against overreaction in any regulatory response. In a prominent speech in February 2009, Commissioner McCreevy emphasized the need for policy intervention to be proportionate and targeted on clearly identified market failures.

Nevertheless, the pressure for an ambitious reform of the AIF industry was also increasing from the Council. In the first months of 2009, the Council (ECOFIN) published the Key Issues Paper in which it declared that the scope of regulation should be extended to actors that are significant for the financial stability and had not been sufficiently regulated so far, in particular hedge funds and other alternative investment vehicles. In addition, in March 2009 the European Council’s conclusions included proposals for an “appropriate regulation and oversight over all financial markets, products and participants that may present a systemic risk, without exception and regardless of their country of origin, especially private pools of capital, including hedge funds, private equity and alternative investment vehicles.”

In this convulse scenario where the EU Members were using the EU institutions to lobby their national interests, it was inevitable that the passing a regulation reforming the AIF sector would be difficult and controversial. The first version of the Directive, published by the Commission in April 2009, was a disputable proposal that showed many signs of

---

61 EC, Commission, Commissioner McCreevy Speech, EC Conference on Private Equity & Hedge Funds (Brussels: EC, February 2009)
62 EC, Council (ECOFIN), Key Issues Paper (Brussels: EC, March 2009), 3
63 The European Council’s conclusions is the official document that defines the measures adopted by the Heads of Governments of EU Members after every European Council’s meeting.
64 EC. European Council, Presidency Conclusions. (Brussels: EC, March 2009). 7880/1/09/09 REV 1
having been produced under the intense political pressure. It was poorly aligned with existing EU laws on asset management and contradicted the earlier positions of the Commission, it failed to differentiate adequately among different industry segments and to take into account the international nature of the industry. This was the starting point of the 18-months European debate under the so-called triilogue process where the Commission, the Parliament, and the Council finally promulgated the final Directive in November 2010.\footnote{Formal adoption by the Council followed by the publication in the Official Journal still pending.}

There were three key concerns that persisted throughout this legislative process. First, the EU was the adopting of a "one size fits all" approach that failed to differentiate the relative risks posed by different types and sizes of AIF managers and different types of AIFs. Second, the EU was acting in a disproportionate manner by assuming too readily the systemic significance of the AIF industry and its various component parts. Third, the EU’s actions were inspired by protectionist preferences, especially on the part of certain Member States (France and Germany).

During these eighteen months, the negotiations between the European institutions, the EU members, and the industry representatives were complex and intense. The role of lobbies was crucial in moderating the Parliament’s expectations. Although the European legislative maintained its demands for new controls over acquisitions of stakes in companies by the AIF industry and pressed for certain restrictions that there were included in the preliminary Commission’s version, mostly the Parliament’s approach to demonstrated a relatively conciliatory attitude towards the industry concerns about too strict regulation.

Finally, after strong efforts were undertook by successively elected Presidencies of the Council (representing Sweden, July–December 2009, Spain, January–June 2010, and Belgium, July–December 2010), the political disagreements among the EU Members, especially between France and the UK, were solved and a compromise version of the Directive supported by the Council was agreed upon by the parties.

### 5.2 The AIFMD: key requirements for AIF Manager.

The final version of the Alternative Investment Fund Managers Directive ("AIFMD" or "Directive") regulates the activities of alternative investment fund managers ("AIFM" or “fund managers”). The Directive defines an AIF as a collective investment scheme not
covered by the UCITS  regime, which includes hedge funds and private equity funds. However, there are certain exemptions. One of them covers fund managers who manage funds with total assets of less than €100 million or less than €500 million that are not leveraged and with no redemption rights for the first 5 years. Member States must still impose registration and simplified disclosure obligations on these smaller funds.

The AIF industry has stated that these thresholds are too low to be regarded as a credible attempt to limit the Directive’s application only to systemically relevant funds. A limited number of the requirements are relaxed in certain cases and some systemically-oriented rules apply only to leveraged funds. There is some scope for further proportional and differential treatment regimen to be developed within the regulatory framework. Also, effective supervisory guidance must be elaborated in order to make the regime operational. The European Parliament was a prominent advocate of differentiated approached to the industry regulation based of the type of a fund rather than on a uniform approach. On the other hand, however, the Parliament stated that the Directive should cover small funds.

The Directive covers all the EU-based fund managers managing the EU and non-EU AIFs, non-EU fund managers of the EU AIFs, and non-EU fund managers marketing the EU or non-EU- based funds operating in the EU.

Fund managers must be authorized under the Directive by their home Member State supervisor. The conditions for the authorization and other operating conditions include:

1. **Capital Requirements**. Managers must satisfy minimum capital and own funds requirements of €125,000 plus 0.02% of the amount of assets managed in excess of €250 million up to a maximum of €10 million. AIFs are also subject to a further requirement that the amount of own funds must not be less than one-quarter of the preceding year’s fixed limits. Importantly, there is additional requirement related to potential professional liability. The Directive requires AIFMs maintain additional own funds "appropriate to cover potential

---

66 Undertaking for Collective Investment in Transferable Securities
68 See epigraph 10 of this section about the new authorization and passport system process.
liability risks arising from professional negligence" or hold appropriate professional indemnity insurance.

2. Independent Valuation\textsuperscript{70}. The Directive requires that assets of each AIF must be valued by a sufficiently qualified external appraiser or by a unit of the AIFM that is functionally independent from the portfolio management unit and remuneration policy. Where an AIFM acts as appraiser, special measures must be in place to ensure that there are not conflicts of interest or ill influence on the staff responsible for appraisal are avoided. Also, a Member State competent authority may require that AIFMs’ valuation procedures are verified independently by an external appraiser or an auditor.

It’s important to stress that AIFMs are responsible for the proper appraisal of their AIFs’ assets, the calculation of their AIFs’ net asset value and publishing that information. Therefore, in no case an AIFM’s liability towards the managed AIF and its investors is affected by the fact that the AIFM has appointed an external appraiser.

Regarding the private equity funds’ asset appraisal, there was a point of view in the European Parliament supporting exemption of private equity funds from the periodic appraisal requirements on the grounds that this was not relevant to their business model and the expectations of their investors. Since this position did not find enough support, the final version of the Directive allows appraisals to be performed internally. This eases the compliance burden for AIFMs.

3. Depository Duties and Liabilities\textsuperscript{71}. The AIFMD provides that AIFMs must ensure that a single depositary is appointed for each fund under management. The depositary is responsible for the safekeeping of the fund’s assets and for monitoring cash flows. The EU credit institutions and certain investment firms that are subject to strict requirements are eligible to act as depositaries. The same rules apply to the non-EU credit institutions and other entities of the same nature that are eligible EU financial institutions, if they are subject to effectively enforced “equivalent” regulation and supervision. There are also requirements with respect to third countries in which depositaries can be located, including the requirement that a country where a depositor is incorporated must not be listed as a non-


cooperative country or territory by the Financial Action Task Force (FATF) on anti money laundering and terrorist financing.

Although the relaxation of liability provisions regarding depositors was intensively lobbied during the legislative process, they remain quite strict in the final text of the Directory. Article 21 of the AIFM Directive, for instance, provides that a depositary is liable for loss to an AIF unless "it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary". In a concession that is aimed primarily at private equity funds, where full depositary arrangements would generate unnecessary expenses given that investments in portfolio companies are illiquid and held on a long-term basis, in certain circumstances and subject to specific conditions the depositary can be a professional depositary entity rather than a credit or similar institution. There was support in the European Parliament to completely exempt private equity funds from the depositary requirements mentioned above.

4. Asset Stripping Restrictions\(^{22}\). One particularly interventional feature of the Directive as it affects private equity funds is that a manager of a fund that acquired control over a non-listed company or an issuer is not allowed for a period of 24 months from the acquisition of control to facilitate; i. support or instruct any distribution; ii. capital reduction; and iii. share redemption or acquisition of own shares by the company. Nor, insofar as it is authorized to vote on behalf of the fund, may it vote in favour of any of these corporate actions. Furthermore, AIFMs must apply best efforts to prevent these corporate actions taking place. This “asset-stripping” restriction is subject to a few qualifications. The most significant is that only those distributions are ruled out that would cause net assets falling below the subscribed capital or which would exceed available net profits. In broad terms, the effect of the asset-stripping restriction implemented by AIFM Directive extends to AIFs the restrictions that apply already to European public companies by virtue of the Second Company Law Directive\(^{73}\). However, the restriction is tighter in relation to reductions of capital and share buybacks and its effect. Therefore, it narrows the range of options that may


be used to return the value to shareholders in a tax efficient way. The asset stripping restriction does not appear to extend the Second Company Law’s controls on the giving of financial assistance by public companies. Accordingly, it should remain possible for acquirers to make use of more relaxed regimes governing financial assistance by private companies, provided no capital reduction is involved.

5. Transparency Commitments. The Directive fixes extensive transparency and disclosure requirements:

Annual Report – AIFMs must arrange for each AIF to produce an audited annual financial report for six months of each financial year end. Such report must be provided to the competent Member State authority where AIFM is incorporated and to each AIF and investor upon request. While annual report is related to AIF, the AIFM Directive requires disclosure of remuneration the AIFM staff, including break down of fixed and variable remuneration, as well as more specific details on remuneration paid to the senior management and key staff who have a material impact on the risk profile of the AIF. (See subsection 5 of this section).

Investor Disclosure (Initial) – The Directive requires that AIFMs must make specific disclosure to investors prior to accepting investments. The AIFM Directive is not specific on

---


75 The AIFM must make available to potential investors, in the manner provided for in the AIF’s constitution: a) a description of the investment strategy and objectives of the AIF, to include information on: (if the AIF is a fund of fund) where the master AIF and the underlying funds are established; the types of assets in which the AIF may invest in; the techniques it may employ; all associated risks; any applicable investment restrictions; the circumstances in which the AIF may use leverage; the types and sources of leverage permitted and the associated risks; any restrictions to the use of leverage, collateral and asset re-use arrangements; and information on the maximum amount of leverage which the AIFM may employ on behalf of the AIF; b) a description of the procedures by which the AIF may change its investment strategy or investment policy, or both; c) a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, applicable law and on the existence, or not, of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established; d) the identity of the AIFM, the AIF’s depositary, auditor and any other service providers and a description of their duties and the investors' rights; e) a description of any delegated management function and of any safekeeping function delegated by the depositary, the identification of these delegates and any conflicts of interest that may arise from such delegations; f) a description of the AIF's valuation procedures and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets; g) a description of the AIF’s liquidity risk management program, including as a result of the operation of redemption rights both in normal and exceptional circumstances; h) a description of all fees, charges and expenses and of the maximum amounts which are directly or indirectly to be borne by investors; i) how the AIFM ensures a fair treatment of investors and, whenever an investor obtains a preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment as well as, where relevant, their legal or economic links with the AIF or AIFM (i.e.,
the format of information to be provided. Such information can be incorporated into the AIF’s offering document and some (but not all) of the required information is usually provided in a standard fund offering document. However, some of the information, such as historical performance data and latest net asset value or market price of AIFs’ shares will need to be provided.

**Investor Disclosure** (Ongoing) – The AIFMs have to make specific disclosures to investors periodically regarding liquidity, risk management procedure and the level of leverage employed by AIFs. The details and periodicity of such disclosures will be established by the Commission.

**Regulator Disclosure** – The AIFMs must disclose information about their operations and the AIFs they manage to the competent authority of their home Member State.6

### 6. Leveraged Additional Disclosure

The Directive imposes a number of special obligations on AIFMs who manage funds that acquire control of non-listed companies or listed issuers. These obligations are primarily aimed at excessive private equity-backed leveraged buyouts and also cover hedge fund investments over specific thresholds. However, investments in small and medium enterprises are excluded (effectively, this puts most of venture capital activities outside the scope of the Directive) and so are real estate financing special purpose vehicles. AIFMs must make specific disclosures to supervisor authorities when the proportion of voting rights in a non-listed company held by a managing fund reaches or passes through the thresholds of 10, 20, 30, 50 and 75 percent. Regarding listed issuers, there are already notification obligations under the Transparency Obligations Directive. Once 50 percent control of a non-listed company is achieved (or 30 per cent in the case of a listed issuer), the fund manager must notify the company/issuer, its shareholders, and the manager’s supervisory authority about this circumstance, and also supply additional descriptions of side letters and similar arrangements; j) the latest annual report for the AIF; k) the procedure and conditions of issue and sale of units or shares; l) the latest net asset value of the AIF or the latest market price of the unit or share of the AIF; and m) where available, the historical performance of the AIF.

6 These reports must include details of: a) the percentage of the AIF’s assets which are subject to special arrangements arising from their illiquid nature; b) any new arrangements for managing the liquidity of the AIF; c) the actual risk profile of the AIF and the risk management tools employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk; d) the main categories of assets in which the AIF is invested; and e) the results of the stress tests performed in accordance with the Directive.

information, including the policy for preventing and managing conflicts of interest, especially among the fund manager, the fund and the company, and the policy for external and internal communication relating to the company, in particular regarding employees.

When control of a non-listed company is acquired, the AIF or the AIFM, acting on its behalf, must also disclose its intentions regarding future business of the company and possible impact on employees to the company and its shareholders. The AIFM must ensure that the disclosed information is available to the employees’ representatives or directly to the employees. The information on financing of the acquisition of control over a non-listed company must also be provided to the fund manager’s supervisor and to the fund’s investors.

7. Regulator Leverage Limits. The topic of leverage caps was one of the most controversial issues of the Directive. Initially, the European Parliament proposed to give ESMA a significant role in this process and allowed it to set leverage caps on individual firms. However, after eleven-hour negotiations in the European Council between delegations of France and the UK, the final text of the Directive requires that each AIFM must set its own limits on the leverage it uses.

Nevertheless, the Parliament’s and the Commission’s strict position on this issue imposed certain limits. First, the total amount of leverage employed by AIFs and any changes in the maximum permitted level of leverage must be included in the information disclosed to investors. Second, AIFMs that employ leverage on a substantial basis must, as part of regular reporting obligations, make available further information about the overall level of leverage to the supervising authority.

Also, the supervisory authority can require additional information if this is necessary for the effective monitoring of systemic risks. In exceptional circumstances, the ESMA may request the supervisory authority to impose additional reporting requirements. Supervisors use this information to monitor the threats of systemic risk and can share it with other Member State supervisors, the ESMA and the European Systemic Risk Board. Moreover, supervisors have authority to impose limits on the level of leverage that AIFMs can employ or other restrictions in order to prevent harm to the financial system from AIFMs activities.

---

79 European Securities and Markets Authority.
8. Remuneration Restrictions. Remuneration of AIFMs’ staff including senior management, risk-takers, and staff who have material impact on the risk profile of AIFMs or AIFs they manage is subject to risk-adjustment principles. The remuneration provisions are designed to achieve alignment with the European Commission Recommendations on remuneration that apply to public companies, banks, developers and investment firms starting from 1 January 2011 and are expected to be supplemented by the ESMA guidelines. AIFMs have to comply with the requirements on the proportionality principle (taking into account the size, internal organization, and the nature, scope and complexity of the activities of the AIFM). Some key requirements provide that at least 40% and, in some cases, 60% of variable remuneration must be deferred over at least three years. There is also a requirement that at least 50% of variable remuneration has to be paid in units or shares in the relevant AIF. This should also be subject to appropriate retention policy. Moreover, the scope of the provisions also extends to carried interest and includes provisions on claw-back arrangements. All these instruments will also be subject to a retention policy designed to align incentives with the interests of AIFMs and AIFs under the management and AIF’s investors.

9. Delegation of duties. The Directive provides that the Manager that intends to delegate one or more of its functions to a third party must notify its home Member State regulator beforehand. The AIFM must be able substantiate the delegation, and the entity to whom the duties are delegated must have sufficient resources and be managed by persons of sufficient reputation and experience. The delegation must not impede effective supervision over the AIFM’s ability to act in the best interests of investors. The AIFM must have selected the entity to delegate the duties with due care and retain an ability to monitor its activities. Where the delegation concerns portfolio or risk management, the entity to whom the duties are delegated must be authorized or registered for the asset management purposes.

and be supervised by respective authority. Otherwise, the delegation must be approved by the competent authorities of the AIFM home Member State. The delegation of portfolio or risk management to a non-EU entity is permitted only if there is appropriate enough cooperation between the AIFM’s home Member State and the third country. In addition, the AIFM remains strictly liable for all functions it has delegated or the entity to which the duties are delegated delegates them further.

10. Authorization and Passport system. A core requirement of the Directive is that no AIFM to which the Directive applies may manage or promote one or more AIFs unless it has been authorized by the competent authorities of the Member State in which the relevant AIFM has its registered office. This authorization can only be provided if the competent authorities are assured that the AIFM can comply with the Directive. The authorization procedure requires the applying AIFM to provide certain information about itself, its compliance systems and controls, and AIFs under its management to the authorities. Additionally, according to the Directive, the authorization can be suspended if certain circumstances occur.

The basic passport provisions in the Directive allow EU-based AIFMs to manage EU-based AIFs in the European Union (on a cross-border basis or via a local branch), and to market EU AIFs to professional investors in other Member States.

Regarding rules in respect non-AIFM and non-AIF, the Directive in chapter VII extends its scope to third countries and imposes specific rules on AIFMs and AIFs established in non-EU countries that intend to do business in the EU. Throughout a

---


85 The AIFM must disclose: a) the identities of the persons in charge of the AIFM, as well as of the AIFM’s shareholders; b) a program of activity setting out the organizational structure of the AIFM; and c) the remuneration policies and practices and arrangements made for the delegations and sub delegations to third parties.

86 The AIFM must make disclosures related to each AIF that it wishes to manage. This includes in particular: a) information about investments strategies; b) information on where the master AIF is established; c) the AIF’s rules or instrument of incorporation (its constitutional documents); and d) information on the arrangements made for the appointment of the depositary.

87 These are where the AIFM: a) does not make use of the authorization within 12 months of being granted, expressly renounces the authorization or has ceased the activity covered by the Directive for the preceding six months; b) has obtained authorization through false statements; c) no longer fulfills the conditions under which authorization was granted; d) no longer complies with the requirements of the Capital Requirements Directive; and e) has seriously or systemically infringed the provisions of the Directive.
transitional period that will be fixed by European Commission’s final rules, there will be retained the possibility for EU-based AIFMs to market non-EU AIFs and for non-EU AIFMs to market to investors under the private placement rules of individual EU Member States. Additionally, the Directive introduced the passport system for the benefit of non-EU AIFMs and non-EU AIFs. Another noteworthy feature of the Directive is that it excludes reverse solicitation from its scope, enabling any AIFM (including non-EU AIFM) to accept subscriptions from professional investors in respect of any AIF (including non-EU AIF) without being required to comply with any requirements of the Directive, so long as the investors invest at their own initiative.

The third-country passport will not take effect at the same time as the general Directive regime\textsuperscript{88}. In 2015, the ESMA will issue its opinion on the functioning of the basic EU management and marketing passport, and advise the Commission on the applicability of the passport system to marketing non-EU AIFs by EU-based AIFMs in the European Union, on the management and/or marketing of AIFs by non-EU AIFMs in the European Union, and on the functioning of national private placement regimes. If the ESMA decides that the passport system is favorable, the Commission will adopt measures to bring the passport into effect at the date then to be determined (likely in 2015).

In 2018, three years following the likely entry into effect of the third-country passport, the ESMA will issue further advice on the functioning of this passport and of private placement regimes, and if the advice is favourable to discontinuing private placement regimes, the Commission will adopt measures to bring those regimes to an end at a date then to be determined (but likely to be in 2018). The process is therefore designed to facilitate replacement of private placement regimes by the passport system. The outcome, however, is not still clear and will depend on further developments in the industry and the effectiveness of the suggested regulatory framework.

Also, it is important to highlight that under the third-country passport provisions, an authorized EU AIFM can market third-country AIFs (and feeder AIF whose master AIF is not EU-based), if these managers obey the following rules: i) the AIFM must comply with all requirements of the Directive; ii) there must be arrangements for the exchange of supervisory information between the home Member State of the AIFM, the third country where the AIF

\textsuperscript{88} The Directive must be implemented within the EU from January 2013
is established, and the other Member States where the AIF is marketed; iii) there must be OECD-compliant tax information-exchange arrangements between the home Member State of the AIFM, the third country where the AIF is established, and each other Member State where the AIF is marketed.; and iv) the third country must not be on the blacklist of the Financial Action Task Force (“FATF”) on anti-money laundering and terrorist financing.

Finally, regarding the management of non-EU AIFs marketed outside the European Union, the Directive establishes that a EU AIFM that wishes to manage a non-EU AIF marketed outside the EU must comply with all new requirements (with the exception of the depositary and annual reporting requirements), and there must be arrangements for the exchange of supervisory information between the home Member State of the AIFM and the third country where the AIF is established.

Table I: AIFM Level of Application.
## AIFM Directive Implications

<table>
<thead>
<tr>
<th>Note</th>
<th>Scenario</th>
<th>AIFM Directive implications</th>
</tr>
</thead>
</table>
| 1 | EU AIFM managing EU AIF | • Full AIFM Directive authorization required by AIFM.  
• AIF can be marketed to professional investors in the EU. |
| 2 | EU AIFM managing non-EU AIF which are not marketed | • The AIFM Directive applies to the AIFM with the exception of Articles 21 and 22 relating to appointment of a depositary and production of annual report by each AIF  
• Co-operation arrangements must be in place between AIFM's home Member State competent authority and supervisory authority in third country where the AIF is established to ensure the efficient exchange of information allowing the AIFM's home Member State competent authority to carry out its duties under the AIFM Directive |
| 3 | Starting from 2015: EU AIFM marketing non-EU AIF within the EU under a passport | • AIFMs have to comply with AIFM Directive in full  
• Co-operation arrangement must be in place between the regulators (see Note 2 above)  
• AIF must not be from a country from the FATF blacklist  
• OECD compliant tax transparency agreement must be in place between AIFMs’ home EU Member State and AIF’s home country |
| 4 | EU AIFM marketing non-EU AIF within the EU without a passport (up to 2018) | Private placement to professional investors may be permitted by the Member States provided the minimum conditions in Article 36 are met (but the Member States may apply stricter rules):  
• AIFM must comply with AIFM Directive in full (but less strict depositary provisions apply)  
• Co-operation arrangement must be in place between the regulators (limited to monitoring of system risk oversight)  
• AIF must not be from a country from the FATF blacklist |
<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>
| 5 | Starting from 2015: Non-EU AIFM managing or marketing EU AIF | - Non-EU AIFM must be authorized under the AIFM Directive.  
- Filing and notification procedure required in order to enable a non-EU AIFM to market an EU AIF within the EU  |
| 6 | Starting from 2015: Non-EU AIFM marketing non-EU AIF within the EU under passport | - Non-EU AIFM must be authorized under the AIFM Directive  
- Co-operation arrangement must be in place between the regulators (limited to monitoring of system risk oversight)  
- AIF must not be from a country from the FATF blacklist  
- OECD compliant tax transparency agreement must be in place between the EU Member State of reference and AIF’s home country.  |
| 7 | Non-EU AIFM marketing non-EU AIF to professional investors within the EU without a passport | Private placement to professionals may be permitted by the Member States provided the minimum conditions of Article 40 are met (the Member States may apply stricter rules):  
- AIFM must comply with the requirements regarding annual accounts (Article 22), initial and ongoing investor disclosure (Article 23) and regulator disclosure (Article 24)  
- Co-operation arrangement must be in place between regulators (limited to monitoring of system risk oversight)  
- AIF’s domicile must not be on FATF blacklist  |
| 8 | Non-EU AIFM managing non-EU AIF not marketed within the EU | The AIFM Directive does not apply  |
| 9 | EU and non-EU AIFM marketing EU or non-EU AIF to retail investors | Each Member State may permit an AIF managed according to the AIFM Directive to be marketed to retail investors on their territory and may impose stricter rules. Any such rules must be applied consistently to all AIF proposing to market on a retail basis  |
6. The AIFMD comparative law perspective.

In order to assess the regulatory efficiency of the AIFM Directive, in this section I provide a short overview of the Canadian and US regulatory regimen for the AIF industry. More specifically, this overview is focused on the four following criteria: 1. registration and authorization requirements; 2. general financial transparency requirements; 3. capital requirements; and 4. restrictions on management remuneration. These criteria are the most significant for the purposes of this paper because they determine AIFMs’ decisions on choosing a jurisdiction to establish and register hedge funds and private equity funds.

The regulatory regimes of Canada and the US were chosen as comparison models because these countries together with Europe represent three important global markets for the AIF industry. Hence, a comparative study of these three regulatory frameworks can give an understanding of the strictness and efficiency of the new European AIFM Directive.

6.1 Canadian Regulation.

6.1.1 Introduction

In Canada, the regulation of AIFs falls under the provincial jurisdiction, therefore, there is no a national regulatory framework. There are 10 provinces and three territories in Canada, each of them having own regulator. The largest authority dealing with AIFs is the Ontario Securities Commission. Collectively, the provincial and territorial regulators are referred to as the Canadian Securities Administrators.

Although the legislation varies from province to province, a national policy has been established and applies to almost all Canadian provincial regimes. Usually, offering, promotion and sale of privately offered shares/units in an AIF are less regulated than, for example, business of retail mutual funds. Shares/units in retail mutual funds are offered to the public in a prospectus, subject to prior approval of securities authorities across the country. In Canada, the term “mutual fund” has a specific meaning for the regulatory

---

purposes. It is defined as “an investment pool whose securities are redeemable on demand at their net asset value”\(^\text{90}\) (“NAV”).

Retail mutual funds\(^\text{91}\) are subject to numerous rules and restrictions set out by the Canadian securities regulators. The main requirements are defined in the National Instrument 81-102\(^\text{92}\) “Mutual Funds”, the National Instrument 81-104\(^\text{93}\) “Commodity Pools”, and the National Instrument 81-105\(^\text{94}\) “Mutual Fund Sales Practices”.

However, the majority of AIFs’ shares/units are sold to accredited investors on a private placement basis and are not subject to the requirements of NI 81-102 and NI 81-105. This means that securities issuers rely on certain exemptions\(^\text{95}\) under the securities law from the prospectus requirement.

There are no requirements for AIFMs to provide investors with an offering memorandum. If an offering memorandum is provided anyways, there are no specific regulatory requirements as to its contents. However, depending on the jurisdiction, there are certain disclosure requirements aimed at guaranteeing the statutory investor protection rights. If an offering memorandum offers the sale of shares/units in an AIF, it must meet the securities regulation requirements.

The regulatory analysis below focuses on the four criteria specified above.

\textit{6.1.2 Authorization Requirements}

\(^{90}\) Ontario Securities Commission. Investment Funds.

\(^{91}\) Investment funds are subject to a number of regulatory requirements that affect their day-to-day operations. The requirements vary based on the type of investment fund. The OSC distinguishes types of investment funds based on whether an investor can redeem their investment in the fund for a portion of the fund’s net asset value and whether the fund is a specialized fund. The different types of investment funds are: conventional mutual funds, non-conventional investment funds or AIF, and specialized funds including scholarship plans, labour sponsored investment funds, and commodity pools.

\(^{92}\) Canada National Instrument 81-102, Mutual Funds CRC.

\(^{93}\) Canada National Instrument 81-104, Commodity Pools CRC.

\(^{94}\) Canadian National instrument 81-105, Mutual Fund Practices CRC.

\(^{95}\) There are three main exceptions: i) \textit{Accredited Investor} Exemption. Be categorized as “accredited investors” or “sophisticated purchasers,” require that the investor could be assimilated as an institutional investor, such as a financial institution or pension plan, or be able to reach minimum income or asset thresholds. There is no minimum prescribed amount for an investment by accredited investors. Note that these tests are not necessarily equivalent across each province and territory. ii) \textit{Minimum Investment Exemption}. Investors who are able to invest a prescribed minimum amount (which varies by province or territory) are eligible to invest in private offerings subject to certain restrictions. iii) \textit{Offering Memorandum Exemption}. There is an exemption from delivering a prospectus if investors are given an offering memorandum in prescribed form and within a certain time frame. (Not available in Ontario)
The registration of AIFs in Canada is regulated by the National Instrument 31-103\textsuperscript{96} “Registration Requirements and Exemptions”, a set of new rules introduced in most of the Provinces and Territories on 28 September 2009. This Instrument establishes new registration categories as well as additional capital, professional standards, insurance, and other key requirements. The aim of the registration rules reform was to harmonize and streamline nationally the registration regimes across the country according to the commitments of Canada to G20.

The NI 31-103 has established four main categories required to be registered under the current regime: investments fund managers, portfolio managers, permitted individuals, and exempt market dealers.

**Registration of Investment Fund Managers**\textsuperscript{97}. The new category “investment fund manager” applies to Canadian managers of all AIFs and their chief compliance officers.

Securities law defines “investment fund manager” as “a person or company that directs the business, operations or affairs of an investment fund”\textsuperscript{98}. This category covers managing partners of hedge funds organized as limited partnerships unless they delegate management duties to a registered investment fund manager. Nevertheless, private equity fund managers, whose mandate is to exercise control over or to participate in management of investee companies, do not fall under this registration requirement.

An AIFM must be registered in the province or territory where its head office is located. Investment fund managers that do not have a head office in Canada are not required to be registered under National Instrument 31-103, although, they are required to pay market participation fees in Ontario, Quebec and other provinces.

**Registration of Portfolio Managers**\textsuperscript{99}. The National Instrument 31-103 also requires all advisers to be registered in each province and territory where they render services either as portfolio manager or restricted portfolio manager. In this context, “advisers” are defined as

\textsuperscript{96} Canada National Instrument 31-103, Registration Requirements and Exemptions CRC.
\textsuperscript{97} Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, division 2.1 Individual Categories.
\textsuperscript{98} Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, Division 1.1 Definitions.
\textsuperscript{99} Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, division 2.1 Individual Categories.
persons who engage in, or hold themselves out as engaging in, the business of advising others as to the investing in or buying or selling of securities. Some provinces, such as Québec and Ontario, continue to maintain the parallel regulatory regime for advising and trading in exchange-traded commodities and futures, and separate registration is required for those activities. As the name suggests, restricted portfolio managers are subject to conditions of registration that limit their advising activities. For example, they are limited in advising in respect of specific type of securities or of securities of issuers within a specific industry. Officers and employees of a registered adviser that carry out the advising activities, as well as the chief compliance officer and ultimate designated person of the firm, must be registered.

Registration of Exempt Market Dealers. Additionally, National Instrument 31-103 introduced a new registration category of “exempt market dealer” that replaces the “limited market dealer” (LMD) category in Ontario and Newfoundland and Labrador. An AIFM has to register as exempt market dealer in every province and territory where it markets and sells a fund’s shares/units, unless the AIDM engages a dealer registered in that province or territory. Every officer and employee of a registered exempt market dealer involved in trading activities, its chief compliance officer, and ultimate designated person must also be registered.

Permitted Individuals. Although there is no registration requirement, directors and senior officers of a registered fund manager that do not themselves conduct any activities that are subject to special regulation must nonetheless provide information to the regulators since they fall under the category of “permitted individuals”.

To summarize, new NI 31-103 rules require advisors and AIF managers to register as portfolio managers, dealers are typically required to register as exempt market dealers (EMD), and fund manager must be registered as investment fund managers. In addition, as

---

100 Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, Division 1.1 Definitions
101 Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 5, 5.1, 5.2.
102 Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, division 2.1 Individual Categories
103 Canada National Instrument 31-103, Registration Requirements and Exemptions CRC, Part 1, division 2.1 Individual Categories
discussed further in this section, each of the above types of activities is subject to insurance and capital requirements.

It is important to note that once registered an AIF manager must comply with general securities law requirements regarding insider trading, conflicts of interest, proxy voting, etc., and must also follow the federal and/or provincial information privacy, anti-terrorist and anti-money laundering rules. A registrant must also have in place written policies and procedures ensuring the compliance with all applicable regulatory requirements.

The registration procedure requires an AIF manager to go through the process of preliminary registration with the local securities regulator in the jurisdiction where it wishes to be registered. This process will vary from jurisdiction to jurisdiction and depends on the registration category, but typically requires a proof of meeting the professional standards. Insurance, audited financial statements and payment of registration fees are also among the requirements.

6.1.3 Capital Requirements

The National Instrument 31-103 requires AIFMs to meet specific capital and insurance requirements. The minimum own capital requirements are $100,000 for investment fund managers, $50,000 for dealers, and $25,000 for portfolio managers. The minimum working capital has to be adjusted upward to reflect deductibles under required insurance policies, guarantees provided by the manager, unresolved differences, such as disputed settlements for purchase or sales of securities, and margin rates on securities owned by the manager and accounted as current assets. For the manager registered in more than one category, these minimums are not cumulative.

Also, insurance requirements vary for the managers depending on their own assets or assets under management starting from $50,000 to $25,000,000. The National Instrument 31-103 specifies the types and level of insurance or bonding required.

6.1.4 Rules regarding general financial disclosures

The National Instruments 81-106 and 31-103 regulate the continuous disclosure requirements for AIFs in most Canadian jurisdictions. These requirements include the following:
1. Audited annual financial statements and special forms must be provided to the securities regulators and investors during 90 days following the year-end.

2. Semi-annual audited financial statements must be provided to the regulators and investors during 60 days following the period-end (although exemptions from filing with the regulators are available).

3. The requirement as to immediate reporting of any fall in capital below the minimum regulatory capital. The Canadian Securities Administrators requires all registrants to keep their financial records in accordance with the International Financial Reporting Standard.

4. The National Instrument 81-106 imposes additional disclosure requirements, such as preparing a Statement of Investment Portfolio.

6.1.5 Rules regarding management remuneration restrictions

In Canada, unlike in the EU, there are no specific rules limiting AIFMs’ remunerations. Nevertheless, this gap has been filled in by self-regulatory national initiatives of the Canadian AIF industry.

Although these self-regulatory rules do not fix any specific limits for AIF managers’ remuneration, the rules, however, are very definite as to disclosures of their fees and expenses. The most important Canadian self-regulation initiative was brought by the Alternative Investment Management Association (AIMA)104, this guide provides that all the information regarding management remuneration and costs has to be disclosed in a clear and concise manner in one dedicated section in the offering document. The Code of Conduct provides the list of fees that apply to all forms of AIFs. It includes management fees, performance fees, dealer/sales commissions and trailer fees, placement or referral fees, administration fees, marketing expenses (typically part of the management fees), financing and leverage costs, legal fees, audit and offering expenses and custodian and trustee fees.

The AIMA stresses that these fund expenses have to be disclosed properly in order to provide understanding of total cost of investing to potential and current investors.

---

6.2 The United States Regulation.

6.2.1 Introduction

The US is considered to be the most important AIF market. The AIF industry was relatively unregulated sector prior to 2006. There are four key pieces of legislation that regulated AIFs’ activities during the last decades: the Securities Act 1933, the Securities Exchange Act 1934, the Investment Company Act 1940, and the Investment Advisers Act 1940. These Acts had overlapping requirements, primarily covering the number of investors, the “type” of investors, and the way investors could be solicited. As a consequence, AIFs were not subject to these federal laws because of various exceptions. Particularly important was the “private adviser” exemption under the Adviser Act which was available to advisers having fourteen or fewer “clients”. The former US laws considered clients of each fund as separate clients. Consequently, during many years AIF managers could be advisers of hundreds of clients and use this exemption in order to avoid a more stringent regulation.

In 2004, the SEC revised the rules based on the Investment Advisers Act of 1940. This effectively brought all hedge fund managers except for venture capital and private equity managers) into the scope of applications of the Act. Soon afterwards however, the rule was struck down by the U.S. Court of Appeals for the District of Columbia, as an invalid exertion of administrative power. The regulatory approach that the SEC took was generally unpopular, and represented the SEC’s desire to impose heavier regulation on the AIF industry.

Finally, in 2009 the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) impacted AIF advisers and managers in multiple ways. The most important

---


106 The origin of this revision was the SEC Report (Staff Report to the Securities and Exchange Commission, Implications of the Growth of Hedge Funds (2003) where the Commission identified four primary reasons for its concerns: i) that the SEC staff was unable to detect fraud and other misconduct by hedge funds at an early stage. Typically, hedge fund fraud was identified only after the SEC had been contacted by third parties suspecting fraudulent activity. ii) the broad discretions that AIF managers had on the valuation of fund assets and the “inherent” conflict of interest that this scenario provokes, because the adviser and manager’s performance fee are based on its valuation of the fund assets. iii) that the number and size of the AIF were rapidly growing and this growth could have consequences for the securities markets, and fourth, that less advanced investors were beginning to be affected by the industry

107 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)
modification was the elimination of the “private investment adviser” registration exemption. Since then, AIF managers and advisers, including hedge funds and private equity funds, are required to register with the SEC in order to comply with the Advisers Act 1940, unless they qualify for one of the exemptions provided therein.

Additionally, AIFMs must comply with other requirements, such as provide disclosure to advisory clients of all material conflicts of interest, comply with trading rules, ensure that advertising and performance reporting complies with the regulatory rules, implement codes of ethics governing trading by firm principals, appoint a chief compliance officer, and implement an effective compliance program. In addition, once registered, advisers become subject to the SEC supervision.

More recently, in June 2011, the Securities and Exchange Commission adopted new rules that modify the Investment Advisers Act provisions, and implement various provisions of the Dodd–Frank Act. These rules introduced new exemptions from the SEC registration requirement and some reporting requirements for certain advisers, changed the definition of venture capital fund, and divided the responsibility for regulation of advisers between the SEC and states.

The analysis below is focused on the four criteria: authorization and registration requirements, financial disclosure requirements, capital requirements, and management remuneration restrictions.

6.2.2 Authorization Requirements

The SEC rules and amendments under the Investment Advisers Act 1940 and the implemented provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act establish three main registration categories: AIF managers and advisers with mandatory registration with the SEC, mid-sized AIF advisers and managers with mandatory registration with the states regulators, and exempt AIF managers and advisors. The purpose of the new registration reform rules was to harmonize and streamline registration regimes across the States, and perform the US AIF regulation commitments to G20.

Mid-sized AIF advisers and managers. In the US, the regulatory responsibility for investment advisers and managers has been divided between the SEC and the states
regulators, depending on the amount of money that AIFMs manage. As mentioned above, under the former laws advisers were not subject to registration with the SEC unless they managed at least $25 million for their clients. Nevertheless, the Dodd-Frank Act raised the threshold for the SEC registration requirement up to $100 million by creating a new category of advisers called "mid-sized advisers". The managers or advisers who manage funds between $25 and $100 million are currently subject to the state registration with the regulator of the state where the head office and place of business are located, and are also subject to the general anti-fraud provisions of the Advisers Act.

**AIF Manager or Advisor.** This registration category cover US managers and advisers of all AIFs, including hedge funds and private equity funds that are not classified as a mid-sized AIF manager or exempt reporting advisor. Under the new SEC rules that implement Section IV of the Dodd-Frank Act, AIFMs must register with the SEC.

In order to be registered with the SEC, an AIFM must fill out the amended ADV form providing the following information about its financial activity: i) basic organizational and operational information about each fund they manage, such as the type of private fund (e.g., hedge fund, private equity fund, or liquidity fund), general information about the size and ownership of the fund, general fund data, and the adviser's services to the fund; and ii) identify the five “gatekeepers” that perform critical roles for the adviser and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators and marketers).

Additionally, the SEC is implementing other amendments regarding the registration process. Soon, the rules will require all registered advisers to provide more information about their advisory business, including information about: i) the types of clients they advise, their employees, and their advisory activities; ii) their business practices that may cause significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals); and iii) additional information about non-advisory activities and financial industry affiliations.

**Exempt reporting advisor or manager.** The latest rules introduced by the SEC in June 2011 have created a third registration category providing new exemptions for certain private equity managers. Although, as a general rule the Dodd-Frank Act established a compulsory
registration for private equity funds managers and advisors, some of those advisers do not need to be registered if meet criteria for the new exemptions:

- Advise (manage) only venture capital funds\(^{108}\);
- Advise (manage) only private funds with less than $150 million in assets under the management in the U.S.;
- Certain foreign advisers\(^{109}\) without a place of business in the U.S.

Nevertheless, under the new rules exempt reporting advisers are required to file and periodically update reports with the SEC using the same registration form as registered advisers. Rather than completing all of the items on the form, exempt reporting advisers have to fill out a limited set of items, including: i) basic identifying information for the adviser and the identity of its owners and affiliates; ii) information about the private funds the adviser manages and about other business activities that the adviser and its affiliates are engaged in that may present conflicts of interest; and iii) the disciplinary history (if any) of the adviser’s or managers and its employees that may reflect on the integrity of the firm. Additionally, under the new SEC rules, exempt reporting advisers must file reports electronically to the Commission’s investment adviser electronic filing system (IARD), and these reports are publicly available on the Commission’s website.

The following table summarizes new registration rules for AIFMs.

\(^{108}\) The SEC states that a venture capital fund is a private fund that: i) invests primarily in “qualifying investments” (generally, private, operating companies that do not distribute proceeds from debt financings in exchange for the fund’s investment in the company); ii) may invest in a “basket” of non-qualifying investments of up to 20 percent of its committed capital; iii) may hold certain short-term investments. iv) is not leveraged except for a minimal amount on a short-term basis; v) does not offer redemption rights to its investors. vi) and represents itself to investors as pursuing a venture capital strategy

\(^{109}\) These foreign advisers or managers who do not have a place of business in the United States have to have less than $25 million in aggregate assets under management from U.S. clients and private fund investors, and fewer than 15 U.S. clients and private fund investors.
<table>
<thead>
<tr>
<th>NO</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture Capital Fund Advisers</td>
<td>Private equity funds managers/advisers (unless eligible for an exemption)</td>
</tr>
<tr>
<td>Advisers/Managers to separate accounts with &lt;$100 million AUM</td>
<td>Advisers to separate accounts with &gt;$100 million AUM</td>
</tr>
<tr>
<td>Advisers/Managers of AIF with &lt;$150 million AUM</td>
<td>Advisers/Managers of AIF with &gt;$150 million AUM</td>
</tr>
<tr>
<td>Non-US advisers/managers with no place of business in the US, and &lt;15 clients or investors, and &lt;$25 million AUM for US clients or investors, and do not hold out as an adviser in US (advisers to BDC or a registered investment company are not entitled to this exemption)</td>
<td>Non-US advisers with a place of business in the US, or &gt;14 US clients or investors, or &gt;$25 million AUM for US clients or investors, or that hold out as an adviser in US</td>
</tr>
<tr>
<td>Family offices</td>
<td>CFTC-registered commodity trading advisers/managers</td>
</tr>
<tr>
<td>CFTC-registered commodity trading advisers/managers</td>
<td>CFTC-registered commodity trading advisers if business becomes predominately securities-related</td>
</tr>
</tbody>
</table>

Finally, it is important to note that the new SEC rules that require registration with the SEC or a state’s regulator must to be complied with by March 30, 2012, unless an AIFM qualifies for one of three exemptions.

### 6.2.3 Rules regarding Capital Requirements

With respect to capital requirements, there are no specific minimal limits in the US legislation for AIF fund managers/advisers. However, it is a common practice for the general partners of AIF to maintain a minimum capital account. This practice is typically disclosed in the offering memorandum of AIF.

In rare instances where AIF managers and advisers register with a state instead of the SEC, there are nominal capital requirements.

### 6.2.4 Rules regarding general Financial Disclosures
Although the SEC has not yet implemented the Dodd-Frank provisions regarding financial disclosures for AIF advisers and managers, the Dodd--Frank Wall Street Reform and Consumer Protection Act empowers the SEC to require registered AIFM to update specific information regarding the advised and managed AIFs. This information will be subject to examination by the SEC. Among other things, advisers will be required to maintain records describing: i) the amount and types of assets under management; ii) detailed information on leverage at both fund and investment levels (including the sources, amount and providers of leverage, details of assets used as collateral, anticipated levels of leverage and a substantiated example of the impact of leverage on investment returns); iii) counterparty credit risk exposure; iv) trading and investment positions; v) valuation policies and practices; vi) side arrangements or letters; and vii) trading practices.

In addition, the SEC, subject to consultations with the Financial Stability Oversight Council, may require a manager (advisor) furnish additional information if it determines it is necessary and appropriate in the public interest for the protection of investors or for the assessment of systemic risk. The Act introduced reporting requirements for different of AIFMs based on their type and size. Also, the Act provides that the SEC has to adopt rules that would require institutional investors to submit monthly public reports on short sales (by name and issuer of the security, the aggregate number of shares, and any other information the SEC determines).

Regarding AIFM of mid-sized funds, the SEC is empowered monitor systemic risks that may be caused, taking into account the size, type of management, and investment strategy of AIFMs.

Also, when they registering with the SEC first time, AIF managers and advisers need to disclose the following; i) information on the liquidity of its fund's portfolio; ii) its fund's downstream investment structure (including details of holding structures, the jurisdictions where it operates, details of due diligence target companies, and the identity of services providers and intermediaries); iii) a fund's investment holdings (including information on the size of the fund and past investment returns, details of target and actual asset class allocations, actual liquidity profile information); and iv) details of the terms on which
investors can withdraw their money from the AIF (including full disclosure of the limitations applying to withdrawals such as gating restrictions).

6.2.5 Management Remuneration restrictions.

With respect management remuneration restrictions, the Dodd-Frank Act imposes certain limits to AIFM’s remuneration schemes and requires some disclosures. More specifically, section 956 of the Dodd-Frank Act states that the “Agencies”\(^{110}\) have to put in place rules that preclude financial institutions\(^{111}\) (AIF are included) from offering any type of incentive-based compensation that represent excessive compensation or expose the institution to inappropriate risks that can lead to material financial losses.

In order to meet this requirement, on March 30, 2011 these Agencies issued a joint draft regulation which was published in the Federal Register on April 14. This first proposal is now under discussion, but should it be adopted, the final rules would become effective six months after being published in the Federal Register.

This proposed regulation will introduce new rules that will affect AIFM’s remuneration policies in the US. Specifically, among other innovations are: i) the prohibition from establishing or maintaining any incentive-based compensation arrangements\(^{112}\) for management that encourage inappropriate risks for the managed and that can lead to material financial losses, ii) the additional requirements related to the deferral of incentive-based compensation for the management. This rule will require at least 50 percent of management incentive-based compensation be deferred on a pro rata basis over a period of at least three years, and to be adjusted accordingly to reflect actual losses or other aspects of performance.

\(^{110}\) Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Depository Insurance Corporation (FDIC), the Treasury Department’s Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA).

\(^{111}\) The proposed rule would apply to “covered financial institutions” that have total consolidated assets of $1 billion or more, including: Broker-dealers and Investment advisers; National banks and federal branches and agencies of foreign banks; State member banks, bank holding companies, state-licensed uninsured branches or agencies of foreign banks, and the US operations of any foreign bank with more than $1 billion of US assets that is treated as a bank holding company; State non-member banks and insured US branches of foreign banks; Savings associations and savings and loan holding companies; Credit unions; Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Federal Home Loan, Banks system’s Office of Finance; and

\(^{112}\) The Agencies propose to adopt standards for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking. These standards would be consistent with the key principles established for incentive compensation in the interagency Guidance on Sound Incentive Compensation Policies (“Banking Agency Guidance”) adopted by the federal banking agencies.
that are realized or become better known during the deferral period; and finally iii) the requirement to maintain appropriate policies and procedures according to their size, complexity, and use of incentive-based compensation to help ensure compliance with the above requirements and prohibitions.

Finally, according the proposed rule, AIFMs must submit annual report\textsuperscript{113} to their federal regulators disclosing the structure of their incentive-based compensation arrangements. This report must be of sufficient detail in order to allow the regulators to determine whether the incentive-based compensation structure provides persons with excessive compensation, fees, or benefits, or can lead to material financial losses.

\textsuperscript{113} The report must contain: i) clear narrative description of the components of AIF incentive-based compensation arrangements applicable to covered persons, and an enumeration of the types of covered persons to which these arrangements apply; ii) a succinct description of the AIF policies and procedures governing its incentive-based compensation arrangements for covered persons; iii) a description of any material changes in incentive-based compensation arrangements and policies and procedures made since the covered AIF’s last report was submitted; iv) and a statement specifying why the AIF believes the structure of its incentive-based compensation does not provide persons with excessive compensation or incentive-based compensation that could encourage those persons to take inappropriate risks and thereby lead to material financial loss at the covered financial institution.
7. Preliminary Assessment: Is the AIFMD in the right direction or can it fall in certain regulatory excesses?

As a result of the global financial crisis, regulation of AIFs became a political topic that can be easily sold to the public. Leaving political and ideological considerations aside, in this section I will analyze the convenience of the AIFs’ regulatory reform. In order to achieve this goal, first, I will review the motives for AIFs regulation that have been identified from broader perspective, and second, I will detail the cost and benefit analysis of the new European regulation.

### 7.1 Motives for AIF Industry Regulation

Regulation in the sense of government intervention is considered to be necessary in case of market failure because general economics assumes that, since the market is not able to cope with certain problems on its own, the state has to intervene\(^\text{114}\). Market failure is typically a situation in which markets do not efficiently organize production or allocate goods and services to consumers. Accordingly, we can state that the recent financial meltdown could be considered an example of inefficient markets’ operation.

Against the background of market failures and its accompanied impacts on financial markets, four motives for AIFs regulation can be identified: systemic risks, enhancement of efficient allocation of funds and risks, and general interest and consumer protection.

#### Systemic Risk

The main intention of financial regulation is to ensure that no systemic risks can potentially harm the financial system\(^\text{115}\). The harmful effects of systemic risks could be witnessed, for example, with the chain of bank’s failures that happened between 2008 and 2009 with the peak point of the crisis on Lehman Brothers collapse.

Systemic risks exist when a series of events undermines the confidence in the banking system, a condition that may cause the collapse of the payment system and of the money

---

\(^{114}\) It is commonly understood that the four main sources of market failure form law and economics point of view are (i) monopoly and market power, (ii) externalities, (iii) public goods and (iv) severe informational asymmetries.

supply and which potentially ends with a recession or depression. In this regard and from a financial market perspective, settlement systems and the markets’ liquidity are major concerns. These two aspects in particular require government supervision and interventionism in order to avoid serious financial problems.

**Efficient Allocation**

Based on the general dogma of efficiency\(^{116}\), economic theory implies that the market structure is most efficient when agents can compete freely without any government intervention. Nevertheless, there are some problems in free markets which have a special relevance for securities markets: asymmetric information, public goods, externalities, and market power.

Asymmetric information is directly relevant to financial markets because in case of any trading in markets, it is possible that one counterpart can be better informed than the other. There is always a loss in trades with asymmetric information, since informed traders will only buy when the asset is undervalued and sell when the asset is overvalued. Therefore, adverse selection takes place, which leads to lower welfare of all traders and transaction costs. If the asymmetric information is large enough, the market may collapse completely.

In addition to asymmetric information, externalities have to be mentioned. If more traders have access to specific trading system, the benefits for every active participant of the system will rise. Externalities, therefore, have an impact on market liquidity. It also has to be stressed that externalities often cause a consolidation of trading to a limited number of trading markets. Such concentration tendencies are likely to limit competition and thus, financial markets and natural monopolies can have many features in common.

**General Interest and Consumer Protection**

Another motive to improve AIFs regulation is the need for a proper protection of markets and public interest of shareholders and investors. In this regard, the aim is to ensure that the

\(^{116}\) The dogma of economic efficiency consists of maximization of aggregate consumer and producer surplus.
price formation process is efficient and transparent as well as that there is enough and equal competition between market participants.

The more efficient the market is, the better protected the investors and traders are, which means that ensuring efficient markets is the highest priority for securities regulators. However, as I previously mentioned, financial markets are not perfectly efficient, mostly due to the fact that information is not equally spread between investors. Normally, small investors have less access to information. Therefore, securities’ regulation is mostly intended to reduce asymmetric information among market actors and diminish the potential danger of asymmetric information.

However, when regulators implement rules to achieve participants’ protection and public good, they do not have to protect investors against losses, risks or mistakes because these factors are intrinsic to the market.\footnote{D.T Llewellyn. “The Economic Rational for Financial Regulation”, (2009) Financial Services Authority, Occasional Paper Series, http://www.fsa.gov.uk/pubs/policy/p14.pdf}

7.2 Cost and Benefit Analysis.

Once the motives for AIFs regulation have been identified from a broad perspective, I will now present a cost and benefit analysis of the new Alternative Investment Fund Manager Directive (AIFMD). This analysis will help to identify the positive and negative effects of the new regulation on the AIF industry and its suitability from a general interest perspective.

Benefits of the AIFM Directive

- Increasing transparency for investors and regulators. Although AIFs did not cause the financial crisis, better regulation is needed in this sector, just as in any other area of the financial services industry. Many of the principles behind the Directive such as the basic transparency and disclosure requirements in the Directive have to be welcomed by both the industry and the investors. They will assist to correct bad practices of the AIF industry such a “empty voting” and “short selling”,

Better Supervision. Since AIFs’ activities can impact not only on domestic markets but also markets across borders, and on financial actors around them, it seems appropriate that regulators can monitor alternative investment funds in a similar manner to how they monitor other financial institutions.

Allowing for marketing of funds across the EU. The possibility for an AIFMs to market their funds throughout the EU – the so-called passporting provision – has potential to enhance the Single Market and has to be welcomed.

Cost of AIFM Directive.

On the other hand, AIFM Directive will impose costs to the economy, investors and the AIF industry.

Cost to the economy:

- Tax revenues and costs: In a plausible scenario, a significant number of jobs and an important amount of money in tax revenues could disappear. Because of restrictions in the Directive, AIFMs may decide to stop marketing their funds to EU investors altogether, as doing so would be prohibitively costly. In this scenario, there would be little incentive for fund managers to remain in the EU at all. Restraining the AIF sector could also lead to less investment in European firms and make Europe a less attractive place for investors and talent from around the world, thereby reducing the EU’s overall competitiveness.

Costs to investors.

- Loss of choice. Although better protection for investors is one of the main objectives behind the Directive, under the Directive, investors would no longer be able to choose freely from among the best performing funds and managers around the world, because in a worst scenario case, they will be restricted to managers and funds established in the EU only. The AIF industry states that more than 84 percent of all hedge funds managed by EU-based managers are domiciled outside the EU. At the

---

118 Alternative Investment Manager Association (AIMA), and EVCA European Venture Capital and Private Equity Association (EVCA) statistics.
same time around 8 out of 10 hedge fund managers are based in non-EU countries. Unless a series of international agreements will be adopted, these funds and managers may be cut off from European investors, meaning that the loss of choice for investors would be radical, with a corresponding negative impact on the value investors can get for their money.

- **Increased Compliance Costs.** The increased compliance costs for all players along the AIF value chain – managers, custodians, administrators – are also likely to be passed on to investors through lower returns and higher fees and charges.

- **Lower level of returns.** AIF industry maintains that AIF manager’s ability to deliver returns for investors could be reduced significantly. Consequently, the AIFM Directive could make European investors billions of Euros poorer.

**Cost for the industry**

- **Compliance Cost.** There will be new and significant compliance costs for the industry, KPMG launched a report\(^{119}\) about this issue estimating a €1,2/€1,9 billion one-off adaptation costs and an ongoing compliance costs of €311 million that could have resulted from the Commission’s original version. Although, the compliance costs with the final version of the Directive will not be so significant, probably as soon as these operational costs were applied to investors, returns will be reduced.

- **Opportunity costs.** The new regulation will also bring associated significant opportunity costs, for instance foregone benefits that could have been reaped in the absence of the measures that the new Directive introduces. This will primarily come through raising barriers to entering the industry, through the capital requirements cost for instance; and the increased cost of launching new funds, for instance through the independent valuation requirement. This, in turn, could hamper industry growth with implications for investor’s choice, liquidity of markets and tax revenues. Indeed, there is also evidence that the new Directive is already hampering the growth of the industry. An AIF industry surveys shows that 8 percent of hedge fund manager respondents said they had delayed a launch of a fund as a consequence of AIFMD.

• **Distortion of Competition.** The extra disclosure requirements for European AIFs threatens to distort competition in global markets. This is because non-EU AIFs, with which EU AIFs compete, are not subject to the same requirements. Therefore, the new European regulation creates a competitive disadvantage for EU AIFs to compete for potential investors and investment goals in international markets.

In conclusion, it seems plausible that the new Directive will bring associated and increasing transparency for investors and regulators that has to be welcomed. Transparency leads to trust and can have several positive side-effects: it can prevent market abuse, improve the battered reputation of the industry and contribute to better understanding of alternative investment among politicians, media and the general public. At the same time, it will assist to correct bad practices of the AIF industry such a “empty voting” and “short selling”, and it will also help investors discriminating unscrupulous managers. Moreover, the so-called passporting provisions are consistent with single market principles. All of this has the potential to benefit both investors and managers.

But on the other hand, there are also risks. There will be new and significant compliance costs for the industry, as soon as these operational costs were applied to investors, returns will be reduced. Some AIFs and AIFMs may stop to operate in Europe at all. Withdrawal would reduce European investors’ opportunities, and consequently, European markets would lost a significant amount of financial resources.
8. Conclusions

In summary, a detailed analysis of the AIF regulatory reform in Europe allows us to reflect and understand three important aspects related to the new regulation.

First, how strict are the AIFM Directive requirements under a comparative law perspective. Second, the potential impact of the AIFM Directive on the European AIF industry. Third, the existence of certain deficiencies related to the European institutional framework internal operation.

AIFM Directive under an international perspective.

The study of the AIF regulatory reform in the main AIF markets - Europe, Canada and the US - allows us to determine how strict are the new requirements imposed by AIFM Directive from a comparative perspective. All different criteria that have been analyzed for the purposes of this study leads to an identical result: the AIFMD requirements are more demanding than the equivalent requirements that are currently in force in the Canadian and the US legislation. It is important to point out, however, that this is a preliminary analysis, which is subject to possible changes, since the regulatory reforms in Canada and the US have not being concluded yet. While the EU is leading the way to accomplish a new global regulation of the AIF industry, North-American markets are developing their respective reforms with a slower pace and with a certain pro market approach. Nevertheless, most likely in the near future North-American markets will implement more restrictive rules regarding the AIF industry in order to comply with their G20 commitments.

By focusing the comparative analysis on each of the analyzed requirements, we can conclude the following:

Authorization requirements. We could observe that, although Canada and the US legislation have created registration categories that are similar to those created by the European Directive for Alternative Investment Fund Managers and Portfolio Managers, the “exempt manager” registration categories in North-American markets allow to avoid regulatory reporting and authorization requirements to a significant number of AIF

\[120\] Authorization Requirements, Financial disclosure Requirements, Capital Requirements, and management remuneration restrictions.
managers, particularly to AIF managers who are not based in Canada or the US, and some categories of private equity managers.

**Capital requirements.** The comparison showed that while the Canadian regulation requires $100,000 for AIF managers and $25,000 for portfolio managers, European AIF managers have to deal with higher fund requirements, €125,000 plus 0.02% of amount of assets managed in excess of €250 million up to a maximum of €10 million, also subject to a further requirement because the amount of own funds in the AIF must never be less than one-quarter of the preceding year’s fixed overheads. Contrary to these minimum fund requirements, the US legislation does not have any fund requirements for AIF managers.

**Management remuneration restrictions.** The study showed relevant differences on how North-American and Canadian regulations deal with this issue. While the new European Directive adopts a more interventionist approach, ruling not only on how to properly disclose management remuneration in terms of corporate governance, but also in terms of proportionality of these remunerations, taking into account the size, internal organization, scope and complexity of the activities of the AIF manager, and including demanding provisions about variable remuneration and claw-back arrangements. The US and Canadian legislation focus their attention on how to provide to potential and current investors the investment’s total cost, including a clear disclosure of managements, administration and performance fees. Despite this fact, most likely the SEC’s future plans may change this approach, if US Agencies promulgate final rules in order to implement section 956 of Dodd-Frank Act.

**Financial disclosure requirements.** We could observe that in terms of transparency commitments (annual report, initial and ongoing investors disclosure and regulators disclosures), Canadian, US and European regulations presented similar requisites. Nevertheless, one of the most controversial AIFM Directive’s provisions: leveraged additional disclosure to regulators and investors, again, makes European requirements stricter, particularly for private equity funds that must make specific disclosures in terms of voting rights held by the fund in a listed and non-listed companies, corporate policy for preventing managing conflicts of interest, and the manager’s future business intentions of the company and the likely repercussions on employment.
In summary, subject to further regulatory developments in the US and Canada, which can result in similar or even more restrictive requirements than those dictated by the new European regulation, the conclusion from this preliminary comparative analysis is clear: the AIFM Directive imposes more restrictive requisites to the AIF industry than equivalent regulations in Canada and the US.

AIFM Directive impact on European AIF industry.

After this conclusion, the second determination that this study can provide is the analysis on how this circumstance can impact on European AIF industry.

In reference to this point, with debt financing for new deals no longer readily available and forced write-downs on past acquisitions that had been made at peak prices, it is an evidence that this recent crisis has hit the AIF industry. Financial media have suggested that around 60 per cent of all hedge funds and 40 per cent of private equity fund could close\textsuperscript{121}. This fact shows that make the AIF industry a regulatory policy priority could have been a mistake.

Although, likely the AIF industry could have amplified the effects of the current financial meltdown, there is not an incontrovertible proof that the AIF industry could have caused “\textit{per se}” the crisis. So, the key question is; could a suspicion of potential systemic risk be enough to place the AIF industry in the regulatory firing line? In my view, the answer is NO. Maybe it was necessary reform and improve the regulation in order to increase transparency for investors and regulators, but the new European Directive includes a number of issues that can impact on investor’s access to the AIF industry. Perhaps curbing the excesses of the industry was yesterday’s problem, but the implementation of the new Directive can provoke an irreparable harm that could make the scenario for EU economy even worst.

As discussed above, the AIF industry can be highly beneficial for the markets in which it operates. Hedge funds can significantly enhance market liquidity, their dynamic and innovative trading strategies can also enhance market efficiency. Moreover, private equity funds can expand the sources of finance available to the corporate sector and can form an

\textsuperscript{121} \textit{Financial Times}, 12 January 2009, 13
important part of the development lifecycle of a firm. Consequently, damage AIF industry could mean create problems for European economies too.

In my view, new regulations has to try to prevent next crisis, not simply cleaning up the mess from the previous one. AIF industry is too small and/or is leveraged at too low level, at least relative to average bank sector leverage, to be a likely source of future systemic harm.

The analysis of the situational context of the regulatory reform shows that the opacity issue, which has for a long time hampered supervisors’ efforts to understand the AIF industry’s significance, has been one of the main reasons that have increased the political pressure within regulators to restrict the activity of the industry. In these circumstances, requiring the industry to submit at least to disclosure and transparency obligations that help regulators and central banks do a better job of identifying systemic risk concentrations in the system is a reasonable step forward. Resistance to the imposition of obligations of this sort would merely serve to suggest that there is something to hide.

However, the Directive goes a lot further than simply impose transparency obligations in order to allow authorities to patrol for the build up of systemic risk. This suggests that the EU Institutions could have committed a regulatory excess. The legislation is certainly formidable, both in its length and its technical complexity. Given that it is to apply only to a relatively small part of financial market activity.

The first draft of the Directive launched by the Commission in 2009 could have caused serious harm to AIF industry in Europe, the interest of investors, the corporate sector and the wider European economy. Nevertheless, the lobbying efforts helped to modify some of the more unpalatable features of early proposals. The constructive reaction of the industry showed the intention of AIFs to adapt the former regulation to the new reality.

The Directive will not become operative until 2013 and there is an additional regulation that has to be passed by European institutions. So, full assessment of its impact must await those developments but some tentative comments are possible. On the one hand, many of the fundamental ideas to which the Directive gives effect – such as proper disclosure to investors, regular reporting of investment performance, independent valuation of assets, segregation of assets, and robust risk management and fund governance arrangements – are not far away from self-regulation initiatives that we reviewed on epigraph two. However, AIFM Directive is much more prescriptive than self- regulatory standards.
The European legislative defends the Directive arguing that it is conceivable that new rules could boost AIF sector by bolstering investor confidence as to safety and soundness of the industry. AIF and AIFM that are presently based outside the EU could re-locate inwards, bringing with them associated tax revenues and other benefits for the wider European economy. In addition, it is fair to point out that the new regulation will assist to correct misfeasance of the AIF industry such a “empty voting” and short selling”, it will help investors discriminating unscrupulous managers, and it will also reinforce the single market principle within the EU.

But on the other hand, there are also risks. There will be new and significant compliance costs for the industry, as soon as these operational costs were applied to investors, returns will be reduced. Some AIF and AIFM may stop to operate their AIF in Europe. Withdrawal would reduce European investors’ opportunities, and consequently, European markets will lost a significant amount of financial resources.

Full evaluation of the Directive’s significance must also be postponed until it is possible to compare its effects to those resulting from the ongoing regulatory reforms on global AIF markets, particularly in North-American and Asian markets. However, the initial analysis of the regulatory reforms in Canada and US show that north-american regulators are adopting lighter regulatory reforms that EU institutions. Consequently, this scenario puts European AIF on a critical situation to compete for potential investors and investment goals in international markets.

EU Institutions and their inefficient operation.

The third conclusion of the process by which the Directive was passed is the current relative strengths and weakness of the EU Institutions in shaping EU regulatory policy and law for the financial markets.

After analyze the full process of the regulatory reform, we can conclude that the role of the European Commission in AIFMD was not one of its best interventions. The Commission had to develop a difficult task launching the first draft of the Directive under severe political pressure and facing movements of its key figures due to the change of legislature. Both

---

122 The President of the European Commission, Jose Manuel Barroso, appointed the new Commissioners for the period (2010-2011) in the first trimester of 2010.
circumstances affected to its leadership. As consequence of these internal changes, the Commissions approach is no longer characterized by the strong association with pro-market deregulatory preferences, as when Mr. Charlie McGreevy was the Internal Market Commissioner.

Currently, the most important concern about this change of scenario is that the Commission could go too far in the opposite direction. Key regulations for European financial markets like the new European Supervisory Authorities are showing that the Commission is taking a dangerous path, adopting a risky and interventionist role.

Unlike the Commission, the European Parliament played its part in the development of the Directive very cleverly. It changed itself from its pre-crisis reputation as an indiscriminate scourge of AIFs. Although the Parliament imposed more restrictions in certain areas respect Commission’s first draft. Its approach to the regulation of private equity funds provides a good example of its balanced strategy. Whilst it would have been content to exempt private equity funds from some obligations under the Directive, the Parliament defended the need for new controls in respect of portfolio companies. These controls constitute the most opportunistic part of the Directive in the sense that they are the sections furthest away from systemic risk concerns, thanks to the Parliament, in their final form they are more onerous than the Commission’s initial version. Additionally to this circumstance, the Parliament took the initiative in pressing for management remuneration restrictions, which was characterized by the adoption of different requirements for each type of AIF, and maintaining third country access to EU markets. Finally, its support for self-imposed leverage caps was much less heavy-handed than the Commission’s original idea.

Finally, with respect to the Council of Ministers and European Council position in the regulatory reform process, as I stated above, both institutions played a relevant role characterized by constructivist criticism that let correct the original version that was launched initially by European Commission. The Council’s intervention showed a constructive disagreement between certain key Member States which have different domestic preferences such a UK, France, Germany, Italy and Spain. They still have a relevant influence on the development of EU law and especially in issues related to financial market regulation. Although the regulatory philosophies and preferences of these Member States were not close in a pre-crisis period, the EU finally could reach a political consensus about AIFMD in order
to reinforce the intensification of market integration in the “more Europe” direction. The implications of this new political reality within the Council could have significant consequences, in the future legislative reform of European financial regulators, particularly the role and powers of ESMA and its sister authorities for banking and insurance, we will check if this new “more Europe” orientation is definitive or occasional.

This convulse and complex feedback among EU institutions allows us to infer one more reflection, the so-called trialogue among the Commission, the Parliament and the Council is not the most appropriate and efficient legislative process to promulgate significant regulations within the EU, particularly when different EU Members held opposite views about the regulatory reform. Simplify and make more dynamic the European legislative process should be part of European agenda if EU Members want to advance integrating their financial markets.

In summary, we can affirm that the AIFM Directive is a regulatory development of major significance for fund managers based in the EU or raising capital in the EU. This landmark piece of EU legislation will enter into force in 2013, during the “vacatio legis period” the Commission have to promulgate a significant number of final rules that should help to implement the provisions of the Directive and, hopefully, mitigate some of the most controversial requirements related thereto. Only time will tell us how the AIFM Directive will affect the AIF industry competitiveness.