REGULATION OF HEDGE FUNDS IN THE US, THE UK AND THE EU

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Thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy

Supervised by Professor Rosa Maria Lastra

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DECLARATION

I declare that no part of this thesis has been accepted or is currently being submitted for any degree or diploma or certificate or any other qualification in this University or elsewhere. This thesis is the result of my own work unless otherwise stated.
ABSTRACT

Two major trends have emerged in the hedge fund industry over the last ten years. On the one hand, this industry became one of the most creative and innovative fields in international finance. Due to its fast growth and its constant development, regulators found it difficult to mitigate the potential risks induced to both investors and the financial system. On the other hand, the crisis emerging in 2007-2009 concurrently caused many recalls within the hedge fund industry. This shut down many funds. Similarly, hedge fund managers received arbitration and litigation charges in recent years, all at investors’ expense. These cases were extremely rare during the previous years. These trends raised two major questions: Should tighter regulation or lighter regulation be applied to the hedge fund industry? Which one favours the investors better and assures their increased protection?

This thesis pursues the answer to these questions, by examining the regulation of hedge funds focusing mainly on investor protection firstly in the US, including the impact of the Dodd-Frank Act and secondly in the EU and the selected single European jurisdictions (the UK, Italy, France, Ireland, Luxembourg, Malta and Switzerland), and the impact of the AIFM Directive on the local jurisdictions, with the final purpose to establish the framework for a global hedge funds regulation, especially in terms of investors’ interests protection. In addition, this thesis provides practical recommendations for their regulatory future.

The present research confirms that the lack of global regulation in this industry before the crisis simply indicated the preferences of the two prevailing financial world leaders: the US and the UK. However, hedge funds regulation should not be performed in absurdum. Risks mitigation alone is not enough reason for eliminating the advantages of hedge funds.

Real progress in providing protection to investors is necessary for the coordination of the hedge fund regulation in the European countries with those in the US, while simplifying the financial regulatory system, as investor protection and prudential regulation are the main financial stability instruments in the hands of law-makers.
ACKNOWLEDGEMENTS

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Furthermore, I would like to express my special gratitude to all the professors in this University, and especially to Professor Graham Roberts, Professor George Walker and Professor Lukas Mistelis, whose competence and guidance were of great help during my specialisation in such a present field of interest. Special thanks to Professor Dalvinder Singh from the University of Warwick for his valuable support provided in the early stages of my PhD study. Thank you for the constructive ideas based on your vast experience in banking and financial regulation research, not only from a theoretical but also from a practical perspective.

My thanks go to the former as well as the current PhD students who have assisted me in various ways, especially in challenging me with alternative views during various stages of my research. I feel very much indebted to them. Last but not least, I wish to wholeheartedly acknowledge the moral and material support of my family throughout the course of my studies. I dedicate this work to them.
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<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>AIFM</td>
<td>Alternative Investment Fund Managers Directive</td>
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<td>AIMA</td>
<td>Alternative Investment Management Association</td>
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<tr>
<td>AUM</td>
<td>Assets Under Management</td>
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<tr>
<td>BSC</td>
<td>Banking Supervision Committee</td>
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<tr>
<td>CDO</td>
<td>Collateralised Debt Obligation</td>
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<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
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<td>CEBS</td>
<td>Committee of European Banking Supervisors</td>
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<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
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<tr>
<td>CIS</td>
<td>Collective Investment Scheme</td>
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<td>CRD</td>
<td>Capital Requirements Directive</td>
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<tr>
<td>CRMPG</td>
<td>Counterparty Risk Management Policy Group</td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>ECOFIN</td>
<td>European Union Council of Finance Ministers</td>
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<td>EFAMA</td>
<td>European Fund and Asset Management Association</td>
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<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
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<tr>
<td>FoHF</td>
<td>Fund of Hedge Fund</td>
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<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
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<td>FSAP</td>
<td>Financial Services Action Plan</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
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<td>FSR</td>
<td>Financial Stability Review</td>
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<td>HFI</td>
<td>Hedge Fund Index</td>
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<tr>
<td>HFWG</td>
<td>Hedge Fund Working Group</td>
</tr>
<tr>
<td>HLI</td>
<td>Highly Leveraged Institutions</td>
</tr>
<tr>
<td>HNWI</td>
<td>High Net Worth Individual</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
</tr>
<tr>
<td>ISD</td>
<td>Investment Services Directive</td>
</tr>
<tr>
<td>LOLR</td>
<td>Lender of Last Resort</td>
</tr>
<tr>
<td>MAD</td>
<td>Market Abuse Directive</td>
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<tr>
<td>MFA</td>
<td>Managed Funds Association</td>
</tr>
<tr>
<td>MIFID</td>
<td>Markets in Financial Instruments Directive</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>NAV</td>
<td>Net Asset Value</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>PWG</td>
<td>President’s Working Group on Financial Markets</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities Exchange Commission</td>
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<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investments in Transferable Securities</td>
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INTRODUCTION

Background
During the last two decades, hedge funds gained the status of one of the most powerful players in the financial and banking sector although they were part of the financial markets since the 1940s. This thesis comprehensively analyses all legal investor protection-based regulations, approaching the possible shift in the hedge funds regulation paradigms, from an interdisciplinary point of view, with an emphasis on the implications of regulatory systems. The core of the thesis is represented by the potential changes of investors’ rights stemming from the financial crisis, addressing their limits also.

While severe criticism attacked hedge funds during the 2007-2009 financial crisis, risk mitigation and the increased level of investors’ interests protection was paid much attention globally not only by investors but also by the entire financial system. Their poor transparency and light regulation made hedge fund activities more and more interesting even to regulators, lately. The great potential of hedge funds is greatly revealed by literature, while in the meantime investor protection is a crucial subject of hedge funds regulatory systems. Nevertheless, researches are rather fragmented, addressing extensively theoretical debates and a few case studies.

Nowadays, hedge funds are greatly appreciated not only by the investors, but also by the regulators and the media. One major aspect of the debate has been whether hedge funds should be allowed to keep their status of lightly regulated entities, and whether increased regulation is required in order to mitigate the risks induced by hedge funds. Another aspect emerges from the recent financial crisis that had stricken hedge funds markets investors, together with misconduct of issuers and financial intermediaries. These failures resulted in losses to investors, and simultaneously negatively affected the market confidence. Under these circumstances, the investor protection concept and the struggle to restore market confidence became essential in the hedge fund debate.
This thesis depicts an overview of the financial regulatory systems before the 2007-2009 crisis and a view of the recent regulatory frameworks in various jurisdictions, namely, the US, the UK and the EU and single jurisdictions. With the increase in complexity and innovation of financial products, the creative and proactive nature of financial regulation and insurance of investors’ rights protection needs to be the highest. In this context, the key pieces of legislation adopted in the aftermath of the financial crisis (the Dodd-Frank Act in the US and the AIFM Directive in the EU) are compared and analysed in a critical manner. The regulation and legal structure are critically examined, checked and evaluated. This research pursues also to contribute to a better understanding of the hedge funds development during volatile times, focusing on investor protection and to provide a global framework for the most frequent available alternative investment tools.

The thesis has a twofold aim: to find out similarities and differences, choosing between different regulatory models, and to evaluate the supreme regulatory version of hedge funds management in order to provide the best answer to a global financial area. The ultimate goal is an international hedge funds regulation focused on providing investor protection and mitigating the risk. The thesis analyses the US and the EU hedge funds regulatory frameworks and also focuses on several local jurisdictions such as UK, Italy, France, Ireland, Luxembourg, Malta and Switzerland to measure the consequences of local rules on hedge fund investor protection-based regulation and their effect on the spreading of hedge funds in this area.

The figure below illustrates the interconnection of the American, British and European financial regulatory systems: common core elements, similarities and differences.
Pursuant to the financial crisis, the investors’ interests emergence on the agenda of legal debates besides stronger supervisory regulations is unsurprising, questioning the sufficiency of traditional means and instruments in avoiding such problems in the future. The thesis points out the similarities and particularities of the analysed financial regulatory frameworks emphasising investor protection, before and after the financial crisis of 2007-2009, by different methodological and contrastive approaches, analytical and comparative studies.

The common principles of American, English and European methods of post-crisis financial regulation, as well as the future ones shall meet the requirements of a globalised society where free capital movement ignores national or regional boundaries: a new architecture of financial regulation, an internationally coordinated process of financial regulation, an international cooperation for a sustainable financial stability, the prudential regulation to limit the abuse of finance, the mitigation of the risk at global, regional and national level, accountability and transparency in the financial system, the protection of investors and market integrity.

*Problem discussion*

The significance of investors’ interests protection on the global financial stage is highlighted in this research, together with the role of the lessons learnt from several countries’ past and present regulatory experiences. The construction of a comparative
approach in such a complex field of interest requires the thorough study and examination of hedge fund regulatory systems in the US, the UK, the EU and single jurisdictions (Italy, France, Ireland, Luxembourg, Malta and Switzerland). In Europe, new laws or directives are on the agenda to protect investors and customers, such as the recent Alternative Investment Funds Managers Directive (AIFMD), the Markets in Financial Instruments Directive (MiFID) or the revised Prospectus Directive. However, the overregulation of markets by defending the investors’ rights could result in an uneconomical underproduction of new financial products. The perfect balance between these two poles seems to be difficult to find by legislators. Therefore, normative guidelines in investors protection are most of the times considered and used by legislators worldwide, especially in Europe and in America.

In choosing this topic one presumed that hedge funds legal characteristics could be defined by studying their regulatory forms, features and strategies in the American and European systems, aiming to understand how they may lead to similar regulatory frameworks (and in the end to one single global regulation), enabling risk mitigation, greater transparency and investors’ protection in the US and the European countries.

Hedge funds regulatory field is continuously changing because of its internal and external interacting processes. In this context, the thesis researches various shifting regulations in the US, the EU and national jurisdictions in Europe in terms of financial law, following the reform of their legal statutes in the aftermath of the crisis. The thesis aims to empirically determine the guidelines and techniques used by hedge fund regulators worldwide in the context of the rapidly changing regulatory field, particularly addressing investor protection. Various types of hedge fund regulatory codes applicable in the analysed countries are identified by the author of the thesis, who also addresses the regulatory factors that could motivate or inhibit the development of the hedge fund industry.

Objectives of the research
Therefore, the main objective of this research is to explore new hedge funds’ regulatory elements of the national, the EU and the US frameworks, and the legal system of financial policy collaboration, characterised by discrepancies and unsolved interrogations, presented within an ample, interconnected methodological approach and
focused on investor protection issues with grouping of the different sets of regulation applicable to hedge funds worldwide (in certain countries).

*The actuality of the theme*

It is undeniable that the research is of great interest nowadays. The current international depression, hedge funds supervision, and the evaluation of their regulatory bodies surface and surpass the national regulators and reveal themselves at the international level. The same reform process occurs not only within the EU through the “*Alternative Investment Fund Managers Directive*” (AIFM Directive), but also in the US, through the “*Dodd-Frank Act Wall Street Reform and Consumer Protection Act*” (Dodd-Frank Act) This makes the author of this thesis consider and promote internationally the subject of regulation and supervision of hedge funds, with major focus on investors protection. The reform of hedge funds regulation which aimed to mitigate the risk and increase the level of investors’ interests protection within the EU and the US governance, is not over yet. However, inherently, the different regulatory approach of the selected countries analysed in the thesis implies a clear grouping of the sets of hedge funds regulation. These countries are all trying to reform their legal systems through cooperation and closer supervision of financial policy within the EU, revolving around investor protection and risk mitigation. In addition, the overall approach of EU and American regulation regarding investors’ rights protection is progressively attacked on grounds of behavioural economics that consider irrational behaviour.

The thorough examination of the unique phenomenon of the hedge funds reform in the EU and the US required the detailed research of the regulatory framework and the study of the EU and US financial policy on hedge funds and their results achieved so far regarding mainly the protection of investors’ rights. In addition, the author reveals the features and the possible deficiencies, and the lack of consistency characterising the hedge fund regulations.

The author looks at the fundamental coordination of European and US hedge fund policy, highlighting common issues of the European and the American regulatory systems. Many hedge fund regulation inadequacies were revealed by the present financial crisis. Meanwhile, major problems were identified by the same financial crisis with regard to the traditional approach in finance and securities markets regulation,
challenging the paradigm of rationale behaviour and well-informed investors. Considering the significance and niche nature of the research, the author analyses the distinctive features of the “European hedge funds regulatory integration”, focusing mainly on regulatory statutes, regulations and other financial tools of hedge fund policy systems and their changes until 1 December 2012.

The research methodology

This research uses several distinct methods: deductive method, analytical study, interpretation of statutory tools, teleological method, historical research and comparative study. Due to a consolidated and complex empirical approach of hedge fund regulations, the author examines hedge fund regulatory features, paying particular attention to investor protection in the EU and US systems through several complex methods. The method used is both factual and doctrinal, including illustrative, but also expository issues.

The EU has built up special international relationships and forms of integration with other countries. Hedge fund law features of the above-mentioned relations may be established by analysing the hedge fund regulatory policies in some European countries. Therefore, the author outlines the hedge fund law in selected single jurisdictions, including the impact of the AIFM Directive, in a case study approach. These are based on subjective selection with the main intention to add value to this thesis. The selected case studies also included some statistical data.

Further complexity is provided to the thesis by the advantages and disadvantages of the distinct methodological approaches, analysing different rules and mechanisms developed under the investor protection concept whose first goal is both to better inform investors and to protect them by limiting exposure to financial loss. In addition, the author studies the hedge fund legal order of the selected European countries from the “regulatory integration models” point of view, rejecting the solely classical positive method and the purely descriptive approach, and focusing mainly on the contrastive approach.

In the process of using the analytical methods, the researcher also uses an interpretation technique of statutory tools. This method is applied when closely analysing relevant
national, EU and US legal instruments regarding hedge funds, focusing mainly on investors’ rights protection. Within this overview, the examination of hedge fund regulation in the selected countries implies the use of the historical method and comparative analysis, as well as the case studies approach.

The historical method and teleological analysis are used when studying legal history related to the hedge funds regulation. In addition, in attempting to analyse the development and the shifting of regulatory bodies, the researcher intends to establish the particular changes, reasons, scopes, and features of the examined legal institutions within a critical approach, considering the financial crisis circumstances and provision of investors’ interests protection.

Research question
In this dynamic regulatory field, which are the practices and tendencies related to hedge fund regulation, mainly investor protection-based regulation that can provide guidelines for a successful global hedge funds regulatory system? Therefore, the thesis clearly groups the different sets of hedge funds regulation aiming to: mitigate the risk, increase investors’ interests protection, market integrity and financial system stability.

The thesis outline
The six chapters of this thesis attempt to provide an answer to this question. The first chapter includes an overview of hedge funds, their definition, history, structure, advantages, investment strategies and the description of the parties involved. It also explains their light regulation before the 2007-2009 financial crisis. The hedge fund overview presented in this chapter is necessary for the clear understanding of all aspects of the regulation further discussed in this thesis. The purpose of the first chapter is to give an overview of the present framework regarding hedge funds, “the nature of hedge funds, their characteristics, and their use in investment portfolios.” The author considered that the detailed explanation of the hedge fund framework is necessary in order to better comprehend why the hedge fund managers are controlled by regulation instead of the fund itself. Therefore, the first goal of this thesis is to present “a review of definitions and descriptions of hedge funds found in literature, and an outline of the complex investment strategies they employ” in order to understand the hedge fund and the complexity of its operation. The author considers that registration rules and
reporting requirements must be developed by regulators in prompting investor-centric regulation and in enhancing protection for investors, by diminishing some of the higher risk behaviour of hedge funds. Moreover, logical concerns have been expressed on the impact of the hedge funds industry increase on (1) the overall financial markets, particularly during the high insecurity period doubled by disruption, and on (2) the many potential conflicts of interest and risk factors uniquely applicable to hedge funds and affecting mainly the investors.

The second chapter analyses the rationales of hedge fund regulation, namely, investor protection, market integrity and financial stability. One idea needs to be apprehended: the hedge fund involvement in market manipulation and insider dealing is clearly unsupported. Hedge funds were not the cause, as they spread systemic risk, but they did not create it. To increase the level of investors’ rights protection, one need to understand the rationale of hedge fund regulation centred on prudential regulation and investors’ interests protection, together with the re-thinking of the entire hedge funds’ regulation and disclosure policy. The chapter explains why hedge fund regulation in general and investor protection-based regulation in particular is both necessary and desirable, stating that with the prevalence of moderation and good sense, there are no reasons to believe that its implementation would not be feasible. As Professor Rosa Lastra stated: “We should also beware of the excesses of regulation and the dangers of over-regulating a given sector or type of institutions, creating incentives for businesses to move outside the regulatory framework. Any regulatory perimeter brings its own shadows and loopholes.”\footnote{Lastra, Rosa Maria, “The Quest for International Financial Regulation”, Inaugural Lecture, Queen Mary University of London, Charterhouse Square, 23 March 2011.} Debates on whether tighter or lighter regulation should prevail still continue.

The EU legislation on hedge funds is examined in chapter three, particularly the “Undertakings for Collective Investments in Transferable Securities” (UCITS) and “The Markets in Financial Instruments Directive” (MiFID) frameworks, and the new AIFM Directive. This chapter aims to provide first an overview of the EU regulation on hedge funds and then a discussion on the AIFM Directive. The author analyses the repercussions of recent EU regulatory developments in the financial services field on the hedge fund regulatory dispute (with an emphasis on the UCITS reform and the MiFID application). The author also argues that, although the revised UCITS
framework does not include EU hedge funds, it might provide a basis and a possible model for their future EU-wide law. Another observation is that the impact of MiFID on the prospective regulation of the EU hedge fund industry is expected to be significant, even though it is too early to establish this with any degree of certainty. In addition, the investigation of the AIFM Directive approved in the aftermath of this unfolding financial depression is imperative to understand the new rules regarding hedge funds in the EU financial industry. The consequences of the AIFM Directive on the hedge fund sector led to the author’s decision to make an overview of the critical assessment of the AIFM Directive. This review involves also a more critical analysis that goes further than the simple description of the regulatory process integration. Due to the ongoing financial crisis, this will probably govern the next round of regulatory integration. In this context, the author acknowledges the cross-border nature of the hedge funds sector and the need to create a harmonised international hedge funds regulation regime.

Chapter four conducts an examination of UK hedge fund regulation, examining the international regulatory intervention. It also analyses the hedge funds regulation in various European jurisdictions: Italy, France, Ireland, Luxembourg, Malta and Switzerland. These have become popular jurisdictions for hedge funds registration. The chapter also addresses the impact of the AIFM Directive on these local jurisdictions. The importance of this chapter lies in the fact that it explains not only the hedge funds regulation in the selected jurisdictions in their current version, but that it also debates the impact of the AIFM Directive on each of the examined jurisdictions. The comparative analysis performed in this chapter concludes that uncoordinated national solutions have led to cross-jurisdictional disparities in handling the hedge funds, which will later support, the author’s opinion that a global regulation approach for hedge funds is urgently needed. The common features of national hedge fund regimes encompassing their emphasis on product regulation and investor security do not lead to a de facto convergence towards a general model capable of removing the need for harmonised hedge fund regulation. Expanding over such a vast-range problem, cross-jurisdictional regulatory differences are unlikely to disappear by the operation of simple market forces alone and by absent legislative arbitration. Several topics are debated for each of the jurisdictions mentioned above, particularly: a comparative presentation of the legal regimes relevant to hedge funds; the regulatory developments concerning hedge funds; the scope and intention of the hedge funds-oriented regulation and the benefits and disadvantages of the regulation. A better-regulated industry at European level may or
may not lead to a development of this sector. The impact of the AIFM Directive on the local regulation in each jurisdiction represents a very significant issue. One may notice that regulators can provide a lighter touch and can clearly articulate their best practices, instead of assuming the over-regulation risk.

Chapter five debates the hedge funds regulation in the US, particularly in the context of the economic reform introduced by the Dodd-Frank Act in 2010. This chapter begins with an overview of the laws addressing hedge funds regulation in the US and it continues with the analysis of the revolutionary financial reform introduced by the Dodd-Frank Act and its impact on hedge fund regulation. This is read and discussed in the context of the financial crisis that affects the financial world. In the aftermath of the crisis, governments were asked to introduce forceful financial reforms to avoid a future Lehman Brothers scenario. The author of this thesis would like to indicate that the financial reform introduced by the Dodd-Frank Act will have a severe impact on the hedge fund industry. It will certainly be a challenge to study how the sector will cope with such massive changes, particularly if hedge funds decide to stay and comply with all the reporting requirements or relocate to other more lightly-regulated jurisdictions. One observable issue in this over-regulation debate is to clearly define the limit between too much and too little regulation by considering the tolerable and the intolerable risks. Dodd–Frank acknowledges the problem of investor protection. However, its solutions, while useful, seem too small to stop or even delay the growth of such an important problem. The author’s opinion is that more efforts should be done, such as changing the relationship between financial service providers and their clients from wary antagonism to trusted, well-trained protectors and guardians.

The sixth chapter of this thesis discusses several cases concerning hedge funds litigation and arbitration. The litigation and arbitration cases illustrated in this chapter are only the latest of the regulatory enforcement failures during the last ten years. Unlike Madoff’s alleged Ponzi scheme, which apparently was a single huge fraud, many of the other cases involved very frequent abuses in the hedge fund industry. Considering the above-mentioned aspects, it becomes clear that authorities regulate under uncertain circumstances, especially due to the complex strategies of funds. Since 2000, regulators have failed to take timely and effective action to prevent hedge funds-related abuses, which led the author to the conclusion that regulatory enforcement is more than necessary. In addition, investors’ protection is another aspect that should be carefully
explored. This chapter provides a well-structured perspective of lawsuits types faced by financial institutions upon the collapse of a regulatory enforcement. Recent litigation and arbitration cases show that affected investors tend to become highly innovative, pursuing mainly financial organisations that might have been involved. It is possible that these trends become patterns, not only due to the stagnant economic situation but also to the increasing social outrage regarding poor or no supervision of financial-markets. Hence, this chapter addressed the conflicts of interest that hedge fund managers face and the regulatory measures necessary to better protect hedge fund investors.

This thesis was written using standard legal research methodology. The main sources used were reference books and scientific articles, primary and secondary Community legal acts and non-binding measures, national regulations and instruments, as well as studies and technical reports relevant to the subject matter of this particular research. Given the technical dimension of precise aspects of this research topic, the author also used papers written by economists and experts in risk management and investment.

The subject of the thesis is interdisciplinary, as it addresses not only financial law matters, but also different branches of law (for instance, international law, European primary and secondary legislation, US law, UK national law) and second disciplines (for instance, economics). Therefore, interdisciplinary approach is necessary in the research of hedge fund regulatory systems in the American, British, European and single jurisdictions from a financial law standpoint.

It is essential to perform an in-depth assessment. Therefore, by using the normative method regarding financial law, the scope, function and discrepancies between some legal authorities cannot be comprehended in the absence of political and economic processes. Hence, the analysis of hedge fund regulation must only be performed by referring to both political and economic background.

The law is stated as of 1 December 2012, and all forthcoming changes are mentioned, where important. Website citations are applicable to the same date.
CHAPTER ONE

OVERVIEW OF HEDGE FUNDS

1.1 Introduction

Hedge funds represent lightly regulated active investment vehicles with large trading flexibility, with main purpose to execute highly sophisticated investment strategies so that they can deliver absolute returns to their investors regardless of the conditions and fluctuations of the financial markets.

The hereby chapter offers a broad image of the evolution and growth of hedge funds, and describes the history of this alternative investment vehicle together with the characteristic features. Its purpose is to lay down the foundation for the analytical part of the thesis by introducing the relevant theoretical knowledge for the parts to come. In addition, this chapter is designed to offer less critical comments but rather to place this subject into a larger conceptual framework, in order to illuminate wider and longstanding concerns about hedge funds universe and characteristics as to grasp a general view which will further allow us to asses investor protection, market integrity and financial stability.

1.2 The shape and profile of the global fund industry

Over the last twenty years, the hedge fund industry experienced tremendous expansion and success. The number of funds and assets under management in this industry grew rapidly from 610 funds in 1990 to more than 8,923 in the second quarter of 2009\(^2\), according to Hedge Fund Research, Inc. Moreover, the development of the hedge fund industry was extremely rapid in these last 15 years. The most recent estimates illustrated the total assets under management to be about “USD2.19 trillion as of the end of

Also, the frauds related to hedge funds have become more common and more concerns were expressed regarding the reality of reported returns. According to recent research, hedge funds misreport their returns and due to these misreports, the wealth transfer ranged from USD1 to 2 billion between 1994 and 2005. In a recent speech, a Commissioner from the “Securities and Exchange Commission” (SEC) stated that there has been a clear progress of this industry, from around USD38 billion in 1990, to USD625 billion after twelve years, reaching about USD1.9 trillion in 2007. In addition, the industry estimates reached the climax in mid-2008, stating that the hedge fund market has grown above USD2.5 trillion in assets. Six months later, researches from IOSCO and OECD estimated that the hedge fund industry had reached USD1.4 trillion in assets under management (AUM). Hence, almost a third of the assets under management crashed due to negative investment returns, associated investor withdrawals, and fund closures. In terms of market impact, hedge funds were responsible for 18–22% of the total exchanging amount on the “New York Stock Exchange” (NYSE).

During the last months of the year 2010, the professionals of the so-called global macro and relative value gained the most from client inflows, reflecting the investors’ concerns over economic uncertainty. The strategy remained popular despite the fact that many managers of hedge funds, whose purpose is mainly to take advantage of international economical changes through currencies and bond investments failed to generate rapid returns. “Hedge Fund Research” states that during the third quarter of 2010, the global macro funds acquired net subscriptions totalling USD6.9 billion.

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7 International Organisation of Securities Commissions.
8 Organisation for Economic Co-operation and Development.
Hedge funds came to dominate the investment fund market. These are private, limited membership collective investment tools and will be further approached by the author of the thesis. The expected high returns generated by these funds made them increasingly attractive. The hedge funds provide a high enough investment return and create many other economic advantages, among which an optimised portfolio risk management and diversification, reduced market distortion and volatility, improved liquidity and information supply, as well as a higher general market profitability, efficiency and stability.\(^{13}\)

Problems occurred due to regulatory neglect and/or eluding, forceful selling, over-leveraging, subsequent consolidation and market misrepresentation, market herding and settlement issues, and due to possible conflicts of interest and market abuse. Fund closure and winding up create further problems and consequently market contagion, crisis and lack of any effective market support. Wanted or unwanted publicity also contributed to hedge funds reputation. “Long Term Capital Management” (LTCM) from 1998, Amaranth from 2006, and more recent outrages such as Philippe Jabre in the UK, in 2009 are among the most famous publicity topics.

Like other acknowledged alternative investments (real estate, commodities, venture capital, private equity), hedge funds give access to returns, which do not correlate with traditional investments, and superior risk-adjusted returns.\(^{14}\)

In the author’s opinion, hedge funds are specifically established, structured and operated to take maximum advantage of the available legal and regulatory exemptions and concessions. Funds are not unregulated although they make maximum use of regulatory concession to operate under maximum regulatory advantage conditions. A number of complex issues arise in understanding the present regulatory treatment of hedge funds. This is also subject to ongoing review in the context of the identified concerns. It should nevertheless be possible to enable alternative investment practices and hedge funds, in particular, to continue playing an essential financial and social role while working in a fair, harmonious regulatory scene.

\(^{13}\) Lhabitant, Francois-Serge (2002), “Hedge Funds – Myths and Limits” (John Wiley & Sons, Chichester), first chapter, p. 52.

Risk management

Systemic instability may arise if hedge funds and their counterparties do not implement an adequate management, creating a domino effect affecting the entire system. If the institution collapses and an associate needs to turn assets into cash through the massive closing-out of positions and realisation of collateral by counterparties, this will cause market prices alterations and volatility.\textsuperscript{15}

Hedging is a technique which involves “buying and holding assets that have good long-term prospects while simultaneously selling assets that have doubtful prospects.”\textsuperscript{16}

Hedge funds are liquidity providers offering great flexibility. Risks occur even if they have positive effects.\textsuperscript{17} Both the investment strategies and funds classification influence the hazards. One must consider costs and benefits to achieve successful regulation.\textsuperscript{18}

Overall costs and impacts of regulation but also of non-regulation should be apprehended to make a decision whether to regulate or not. Therefore, the proper assessment of risks associated to this industry is very important.\textsuperscript{19}

Financial stability risk-systemic risk

The simultaneous collapse of hedge funds strategies represents a possible threat to financial security. This is of lesser concern for the investors and more important for the manner it affects associates and the bankers usually supporting these funds. The major failure might alter the price data, liquidity and market confidence. Financial stability is threatened by market confidence failure, as all the investors escape. Consequently, regulation is necessary when social costs are very high and when the financial system as a whole experiences a heavy burden due to this situation\textsuperscript{20}, according to Goodhart.

“Long Term Capital Management (LTCM)” failure

Due mainly to market instability, LTCM fund nearly collapsed in 1998, and this eroded confidence. The failure was globally debated. Leaving leverage aside, LTCM had also a liquidity problem. Amaranth is another example of a large hedge fund failure.

*Risks of defective assets appraisal*

Many essential operational risks within the hedge funds assets appraisal affect investors’ ability to control performance and make informed decisions regarding their investments, influencing price information, markets and market quality.

For a correct asset valuation, the fund manager analysed further in this chapter needs to depend on: valuation models frequently used by the manager, associates shares and estimations from the manager. Undoubtedly, this requires the answer to the question whether these appraisals tend to be right and entirely free, since conflicts of interests may occur.

*Other risks related to market trust* refer either to the fact that regulators have insufficient data to make informed decisions about risk, or that certain managers do not have the necessary skills. The hedge fund managers’ background is that of traders rather than fund managers. The chapter further examines and discusses this.

*Risk to market cleanliness*

*Trading on non-public information*

Some concerns have been raised that particular hedge funds are pushing at the limits of admissible practice in terms of trading based on non-public information.

*Market manipulation*

The hedge fund regulators can also test the limits of admissible practice as far as market manipulation is regarded. Major hedge funds seems tempted to use their size, or begin market rumours, to deliberately move the market and take advantage of profitable prices.

*Financial crime risk. Fraud*
Investors were deprived of important amounts of capital lately, mainly because of frauds. On this matter, fifty-one fraud cases were pursued by the SEC against US hedge fund managers in 2005 alone, while in 2010, the amount of money reached USD1.1 billion. There are two important fraud methods, namely: misreporting, when incomes are inflated, and Ponzi schemes, which will be analysed in chapter six.

Money laundering

It is always possible to use a fund for money laundering purposes. Nowadays, hedge funds in Europe are regulated by “the Anti Money Laundering Directive.”

As closing remarks on risks, the author would like to emphasize that the national regulators around the globe are concerned about all the above-mentioned issues, focusing on investor security, but also on industry security.

1.2 Features of hedge funds

Hedge funds are characterised in terms of their light regulation, in comparison with mutual funds in the US or UCITS in the EU.

Funds take advantage of legal exclusions in the US, failing to register themselves or their managers. Hedge funds are unregulated in the UK, because they are generally located offshore in order to achieve tax and regulatory exemptions. This is a feature explored by the author throughout this thesis. This chapter further presents, examines and discusses regulation of hedge fund managers in the subsection dealing with the parties involved in a hedge fund structure.

In terms of performance fees and absolute return, the hedge funds manager acquires performance fee based on funds performance. This is not valid for traditional investments funds. “Absolute return investing occurs when portfolio managers seek

positive holding period returns without any benchmark except for, possibly, the return on the risk-free asset.”

Consequently, in order to improve performance even under unfavourable market conditions, hedge funds develop their strategies with the purpose of achieving a return, which does not correlate to the market performance or to a particular market benchmark. In case of a major failure, both price data and liquidities lead to significant losses in terms of confidence, which might spread all over the economic system. According to Goodhart, when social costs are colossal, and when there are burdens to the overall financial system, regulations must be tightened.

The structures of classical funds include: (a) a fund, which is the capital pool usually located offshore; (b) a manager, who makes all the investment decisions, who is established in most cases in an important financial centre; (c) a prime broker, usually an investment bank that supply credit and financial services to the fund (stock lending and direct financing, and asset valuation and custody); (d) investing individuals. They can be either institutional investors or persons with important net-value; (e) administrators who manage funds from their offshore centres namely, from those particular locations where they were made. At the same time, the investment strategy can reinvest some of the hedge funds in other different hedge funds. This complex configuration of hedge funds will be analysed in detail in the section dealing with hedge fund parties.

1.3 Characteristics of hedge funds

Hedge funds have some common characteristics. In enumerating these common features of hedge funds, the author calls attention to Dale Gabbert’s book on “Hedge Funds.”

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26 See also Sections 1.5.on Hedge funds structures and Section 1.6. on Investment strategies of hedge funds of this thesis.
27 See Section 1.7. Hedge fund parties of this thesis.
One main feature of the hedge funds is the capacity of their assets to invest in financial instruments. Examples of such instruments are securities traded on exchanges or “over-the-counter” (OTC), related financial instruments (known as “derivatives” because their value derives from another asset) or debt obligations of companies undergoing insolvency (“distressed” debt). The significance lies in the fact that the fundamental portfolio has some amount of liquidity, which ranges substantially between the hedge funds and the strategies (example: distressed debt may be mainly illiquid). The former started to invest capital in supplementary classes of assets (private equity but also property) in trying to reduce the portfolio liquidity and mask some of the gaps between hedge funds and secondary industry members.

The second characteristic is the unregulated nature of funds. These are not subjected to regulation by “onshore” regulators such as the FSA28 and SEC, because they are usually set up in offshore jurisdictions29, where they are not taxed directly. In case of laws conflict, countries usually avoid regulation of activities that occur outside their own borders, unless those entities have some connections with their country. This connection can be management, trading or sale of hedge funds in onshore jurisdictions.

The third feature of hedge funds consists in their tendency to have broad investment parameters. Most onshore jurisdictions have certain restrictions controlling the scope of permissible investments and investment techniques in funds sold to the public. In UK, there are rigorous limits on “authorised funds” (funds that can be marketed freely), like “Unit Trusts” and “Open Ended Investment Companies” (OEICs). The European law has issued a set of conditions30 for funds in one EU state to be marketed in another, which encourages normal principles on diversity, leverage and investment methods. The range of investment techniques used by hedge funds is much wider than that available to traditional authorised funds, for a simple reason – the better the freedom of a fund in its investment policy, the better its opportunity to make positive returns (and conversely, losses).31

The fourth characteristic is their purchase unavailability directly to the society. This does not mean that the general public is not exposed to them. There are some

28 Financial Services Authority.
29 Like Jersey, Guernsey, the Cayman Islands, the British Virgin Islands or, less usually, Bermuda.
30 The United Collective Investment Schemes for Transferable Securities Directives.
jurisdictions (Germany for example) that enable funds sale to invest in hedge funds portfolio. Additionally, there are several hedge funds which use other routes to achieve investor concurrence and regulation. \(^{32}\)

The fifth characteristic is their capacity to use leverage or borrowing to increase the performance of the fund. The borrowing level alternates a lot and can be determined “by the rules of the exchange on which the shares of the fund are listed.”\(^{33}\) Managers of fund of hedge funds can have problems due to the proposed restraint on leverage to 10%, since managers may want to have a greater leverage cushion to meet redemption requirements.

The sixth characteristic is that they would have to double charge investors: first for yearly management (1.5% to 2% tax); second for accomplishments, one-fifth of its returns.

None of the above characteristics is unique to hedge funds. Still, a fund featuring all these characteristics can legitimately be described as a hedge fund.

1.4 Definition of hedge funds

Hedge funds represent a legitimate investment vehicle for individuals with excess funds. This placement offers investment capital, increases liquidity and improves market efficiency. The use of arbitrage techniques can correct instabilities within markets, while volatility is generally ameliorated and stability optimised. The development of advanced techniques improves financial engineering and innovation, which assists longer-term market growth and efficiency. Nevertheless, ongoing concerns arise despite these benefits.

These concerns deal mainly with leverage, complexity, concentration and lack of transparency, as well as with possible market distortion problems (intentional or unintentional), market abuse and possible insider trading. Herding, settlement, closure and winding down of outstanding positions may also generate some issues. The potential

\(^{33}\) For example, The London Stock Exchange.
exposures created by particular strategies that arbitrage position across separate sectors or markets also create additional levels of interdependence and possible contagion. All this may increase the occurrence possibility or financial instability level, and possible crisis and collapse.

According to the above-mentioned risks with hedge funds (see section 1.1.) and the ones mentioned also below, a rigid and comprehensive grouping of risks is arising from hedge fund operation:

**Figure 2. Grouping of risks from hedge fund operation**

The national and international bodies throughout the world are treating these issues. The next chapters will describe the national and international regulations and efforts that are made to mitigate the risks associated with hedge funds from the view of investor protection and stability in the financial markets since these are the main risks.

Several definitions of a hedge fund are used for legal or regulatory purposes. Different bodies use various expressions to separate papers with various degrees of accuracy.\(^{34}\) In practice, it is simpler to distinguish funds by their main characteristics.

Usually, the hedge fund term illustrates “any fund that is not a conventional investment fund – that is, any fund using a strategy or set of strategies other than investing long in bonds, equities (mutual funds), and money markets (money market funds).”\(^{35}\)

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\(^{34}\) The UK FSA used the following five determining characteristics in its 2002 discussion paper. FSA, “Hedge Funds and the FSA” (August 2002).

At the same time, an alternative strategy includes: hedging by selling short – selling shares without being the owner of these shares, intending to purchase them back cheaper, hoping that their prices will fall; using arbitrage – trying to analyse inabilities emerging from price determination through connected securities; exchanging options – agreements with values settled based on the efficiency of every essential financial asset; making use of leverage – leveraging to increase the profits. Another strategy is investing in underestimated securities\textsuperscript{36} or trying to benefit from the discrepancy between the present market prices and the buying prices, under the circumstances caused by hostile mergers/takeovers by the target company management.\textsuperscript{37}

Hedge funds are considered investment vehicles providing risk and return possibilities hardly attained by classical long-only stock or by bond investment vehicles. These opportunities could be reached mainly by taking part in many financial products and international markets generally unavailable to classical investors, and by their abilities to hold not only long- but also short-security positions.\textsuperscript{38} Hedge funds provide benefits for returns under different financial circumstances. Their structure is mostly that of privately pooled investment vehicles employing different leverage rates and charging a performance tax.\textsuperscript{39}

This analysis of the hedge fund activities provides a common ground for the understanding of such a definition. Hedge funds “are eclectic investment pools, typically organised as private partnerships and often located offshore for tax and regulatory reasons.”\textsuperscript{40}

Several national and international \textit{fora} and bodies dealing with hedge funds have defined them according to certain criteria. According to the “Report of the Asset Managers Committee of US President’s Working Group on Financial Markets”\textsuperscript{41}, hedge funds fail to be strictly regulated, “private investment pools of capital available only to

\textsuperscript{36} Debt or equity.
\textsuperscript{38} Mallaby, Sebastian, “\textit{Hands off Hedge Funds}”, \textit{Foreign Affairs}, Volume 86, n° 1, 2007, p. 91.
\textsuperscript{39} Ibid.
\textsuperscript{40} See Eichengreen Barry et al., “\textit{Hedge Funds: What Do We Really Know?}”, IMF, September 1999, p.5.
\textsuperscript{41} Now, it has become the Financial Stability Oversight Council.
in institutional or wealthy investors which due to the performance tax⁴² seen as a payment offered to managers, in exchange for performing an vast range of exchanging strategies in order to get not relative, but absolute return.

The Asset Managers Committee identifies several criteria that characterise a hedge fund. These criteria tend to be connected with:

- the private character of the hedge funds offer, respectively, they cannot be publicly sold;
- the restricted nature of investors in a hedge fund, usually including the high net worth persons and organisations;
- the different manner to record the fund, not similar to that of an investment entity according to the active laws (for example, the Investment Company Act of 1940 in the US);
- the management of these fund assets by an expert investment management company partly compensated by the vehicle’s investment performance;
- the aim of hedge fund major investment is to place money and other investment assets within a liquid securities portfolio;
- the regular, but rather restrained or limited redemption rights of hedge fund.⁴³

“Hedge fund” illustrated a type of financing fund requesting an amount of money from investors as a tax, using two techniques: first, over-leveraging for amplifying income, second, short selling for market risk limitation. Even nowadays, parts of the features presented above can be true, but not for all funds.

The term “hedge fund” implies a “fund or collective investment scheme which allows several investors to participate in a common pool of assets that hedges i.e. utilises the investment technique known as hedging, which pursues to offset the risk inherent in one investment by purchasing another investment considered likely to move in the opposite direction.”⁴⁴

⁴³ Ibid.
There is no legal or regulatory clear separation of a “hedge fund” in the UK. Similarly, there is a large series of funds called as such. Hedge funds do not all use leverage, nor do they all get involved in short selling. Very few are currently used and operated for retail investors.\textsuperscript{45}

To conclude, funds apparently are more difficult to label than to perceive. Nevertheless, it seems that the elephant test fits them comprehensively: one definitely recognizes a fund when sees it despite not being able to describe it.

The ability to differentiate the funds and funds’ managers is very important. The latter must normally observe regulations and ethic codes. Contrary to classical, long-only asset managers, fund managers apparently have supplementary instruments, and this explains the high returns.

These tools include:

- Generation of returns and/or hedge market vulnerability by losing stock. This means taking stocks on loan, and gaining from the decrease of the security worth after trading it;
- Increase of returns by the use of leverage. Leverage is to be understood here as buying securities with borrowed money;
- Generation of returns and/or risk reduction by employing derivatives. These might represent a productive manner to increase exposure and possible profit/loss, and hedge vulnerability thus mitigating risks;
- More active exchange as compared to traditional managers.\textsuperscript{46}

Nevertheless, funds cannot be completely defined by a single feature mentioned above, because sometimes funds may have some common features and sometimes they are completely different from one another.

The tax form might be the common feature of most if not all hedge funds. Generally, “hedge funds will charge investors a management fee of 1.5-2.0% and a performance

\textsuperscript{45} Gabbert, Dale, Op. Cit., p. 3.
fee of 20%. This means managers are heavily incentivised to generate good performance for investors.\textsuperscript{47}

\subsection*{1.5 History of hedge funds}

Various forms of investment resembling several aspects of the modern hedge fund have always been available throughout history. These include early forms of cooperative trade venture dating back from pre-Roman times.\textsuperscript{48} More specialized individual investment management services have also been available for as long as individuals and governments have held assets in need of management. Organised forms of collective investment in the US and UK began with the origins of the mutual fund and unit trust industries.

The modern history of hedge funds began in the late 40’s, more precisely “in 1949 when Winston Jones established the first hedge fund.”\textsuperscript{49} He is considered to be the father of modern hedge fund and he was a Harvard graduated financial journalist who was once a US diplomat in the German capital during the ‘30s. Winston Jones was later hired by Fortune, a US business periodic publication. There, he grew an interest in investments establishing also an investment association. The fund he managed was composed of a limited partnership allowed to have maximum 99 investors. He did this to escape requests from the US regulation of the Investment Company Act of 1940, but also so that the general associate/fund manager could receive $1/5$ of the profits as payment for the services provided. Aiming to increase exposure but also returns while using the short selling of stock, and to eliminate market risks, his investment approach seemed to have the main objective of using leverage.\textsuperscript{50} According to Jones, his purpose resided in hedging out industry risk by transforming the fund into a neutral one. The other way around, returns would depend rather on choosing the right stocks, than on the fluctuations of the stock market.\textsuperscript{51}

\textsuperscript{47} Ibid.
\textsuperscript{49} Jones, A.W., “Fashion in Forecasting”, Fortune (March 1949) 186.
In 1966, an article presenting Jones’s ideas was written in the Fortune magazine. Its outcome was remarkable: a large number of persons adopted his rationale.

At the beginning, the funds market was not large probably due to the small amount of advertising. However, “the number of hedge funds, and the total assets under management began to increase significantly during the 1990s and the rate of growth has accelerated enormously in the last years.”

Several reasons accounted for the boost. The first was the agreeability of the hedge fund payment organisation, which occurred as a good motivation for endowed merchants but also investors to allow investment credit institutions and large capital managers start their own funds. The second reason was the intellectual and regulatory freedom achieved from operating their own hedge funds without having to be bound by the institutionalised, benchmark-driven approach preferred by many of classical capital managers. This freedom attracted many endowed investors in this universe of hedge funds. The third reason dealt with the technological advances, which enabled the endowed investors from this market to start their own investment businesses, outsourcing back office activities to relevant providers.

The relationship between hedge funds and financial crisis emerges as ampler and less causal than it is described most of the times. Nevertheless, there is consensus that measures need to be taken, but there is not a general consensus on what these measures should be. Some scholars support the idea that hedge funds are to blame for extensive and damaging industry shifts in the exposed economies. Still, many exhaustive studies consider that hedge funds were not actively involved in speeding up the financial market crisis during the last few years, as hedge funds were unidentifiable “as the culprits for the financial crisis”.

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56 Andrew W. Lo, Regulatory Reform in the Wake of the Financial Crisis of 2007-2008, J. FIN. ECON. POL’Y 4, 16 (2009) (“While the shadow banking system has no doubt contributed to systemic risk in the financial industry, hedge funds have played only a minor role in the current financial crisis, as evidenced by the lack of attention they have received in the government’s recent bailout efforts.”); Roberta Romano,
assertion that hedge funds are not responsible for the current financial crisis is that, on a large scale, they were negatively impacted,\textsuperscript{57} because, as Billio et al. put it, the ongoing crisis has considerably diminished “returns to all hedge fund strategies, leaving no safe place for investors.”\textsuperscript{58} Also, hedge funds by themselves are not large enough to be capable of affecting prices on liquid markets, because their capital is not significant in connection to that of other investors, among which one can mention banks and insurance companies. Other studies\textsuperscript{59} blamed banks and credit-rating corporations, considering they hold far bigger responsibility for generating the crisis than did hedge funds.

Current researches focus on the liquidity risk as far as hedge funds are concerned. Liquidity risk affects hedge fund performance to a high degree and correct foreseeing of liquidity leads to avoidance of losses.

Current researches considering hedge fund performance concluded that hedge funds, in comparison with investment benchmarks involve higher profits, but also higher risks.\textsuperscript{60}

1.6 Advantages of hedge funds

Hedge funds provide a number of market benefits or advantages, by delivering a number of important market functions and corrections. As the industry continues to grow, these advantages and functions will improve accordingly.

They are valuable in terms of flexibility, absorption, profit, correction and liquidity,\textsuperscript{61} and they have a key role in the re-appropriation of assets but also risk among market


participants\textsuperscript{62}, promoting at the same time a diverse and innovative character\textsuperscript{63}. This allows other investors to adjust their position “in times of stress”\textsuperscript{64} and assist “stabilised markets in times of distress.”\textsuperscript{65}

The main point of attraction regarding hedge funds is “the potential high-level of return generated”\textsuperscript{66}, through innovative strategies, which should allow the fund to gain profit and to be hedged. Modern hedge funds no longer follow complete hedging practices.\textsuperscript{67} Nevertheless, funds can also lose money. Despite “the risks, investors poured money into hedge funds in recent years, until market losses in 2008 prompted a wave of redemption requests.”\textsuperscript{68} Many funds have closed and George Soros estimated “that the value of capital under management may shrink with 75%.”\textsuperscript{69}

The increased investment portfolio diversity is possible by the active investment management of hedge funds\textsuperscript{70}, also available through investment in “funds of funds.” By this, fund managers can trade or arbitrage across different asset classes and markets, causing increased linkage, markets dependence, risk propagation, and arguably increase of market stability.

The development of risk management techniques by investment strategies enables improvements in industry risk management. The author considers that anticipated results on hedge funds and their connected risks do not depend only on the \textit{ex ante} assessment of their portfolios strategies \textit{per se}, but they also depend on the managers’

\textsuperscript{61} Alan Greenspan, “\textit{Testimony before Board of Governors of the Federal Reserve System before a Hearing of the Committee on Banking}”, US Senate, 108\textsuperscript{th} Congress, 20 July 2004.


\textsuperscript{63} Gieve, John, Speech at “\textit{Hedge 2006 Conference}”, 17 October 2006.

\textsuperscript{64} Ibid.


\textsuperscript{66} Funds such as Tiger Fund have generated annual returns of 43% or more. Alfred Winslow Jones outperformed the 5-year mutual fund market by 44% and the 10-year market by 87%.

\textsuperscript{67} Jones’s first fund was perfectly hedged.


\textsuperscript{70} International Financial Services, “\textit{Annual Report on Hedge Funds}”, City Business Series (April 2007).
abilities to efficiently handle the funding and redemption opportunities. Correspondingly, risk management is at the forefront of present financial engineering and innovation. Many investment banks provide partial assistance in this matter, while help is given also by the competition between managers in the hedge fund sector.

Hedge funds play a significant role in the efficient re-appropriation of assets and risks, by locating and placing capital where it can be used efficiently and by transferring risk where it can be handled effectively. This applies “to financial risks generally, in higher risk areas like higher risk structured finance”, “derivatives markets” or in “distressed markets”. In doing so, funds “can provide liquidity in all markets.” Basel III new capital rules will inevitably involve the increased use of credit derivatives by banks and other collateral and credit risk mitigation techniques with hedge funds becoming major investors. In response to the EU Solvency II and associated IFRS adjustments, funds are expected to take over more risks from insurance companies.

Funds identify price distortion and instabilities they profit from. In doing so, prices change to the correct form, become true prices, favouring the competitive pressure and efficiency of financial markets.

Correcting price distortions and providing liquidity in all markets increases the amount and quality of information within markets, improves market efficiency, optimises risk management, diversifies investments, corrects imbalances, and reduces market volatility. All these contribute to improved stability.

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75 Hedge funds have increasingly produced credit derivative which transfers default risk from the banks. G.P Mustier and A. Dubois, (2007), “Risks and Return of Banking Activities Related to Hedge Funds”, Financial Stability Review – Special Issue on Hedge Funds, nº10, p. 86.
78 International Financial Reporting Standards.
The design, development application, revision and correction of investment strategies improve risk management, supporting financial engineering. Hedge funds commonly invest in “Contracts for Differences” (CFDs), “Credit Default Swaps” (CDSs), “Collateralised Debt Obligations” (CDOs), “Collateralised Loan Obligations” (CLOs), other “Asset Backed Securities” (ABSs) and “Payments in Kind Loans” (PIKs).”

These concepts are approached in more details below.

CFDs or contracts for difference are derivative products providing the investors with unprecedented trading opportunities, allowing them “to trade on the price movements of securities and indices without owning the underlying asset, and offering a leveraged, flexible, cost-effective alternative to traditional trading methods.”

CDS embodies one agreement through which a certain firm/country provides assurance in case of a credit risk, also called credit event. If a credit event occurs, the insurance purchaser is allowed to sell a specific bond that the entity issues for its face value. When the above-mentioned event happens, the purchaser receives a compensation for his loss (by hypothesis) resulting from that particular credit event.

The CDO can be created by founding either a SPE or a SIV, able to purchase assets and to issue bonds guaranteed by the cash flows of the assets. These relations can be divided into several sections with various requirements on the principal but also interest brought into being by the CDO’s assets. Hence, the person who issues them needs to repackage (corporate or sovereign) debt securities or capital taken as a loan under the form of reference portfolios generally known as “collaterals”. Their proceeds will further on be part of a sale dedicated to the investors as debt securities with various degrees of senior requirements on the above-mentioned “collaterals.”

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84 Ibid.
87 Special purpose entity.
88 Structured investment vehicle.
As far as the ABS transactions are concerned, they represent particular financial goods originally developed based on uniform reference portfolios, helping issuing persons to increase the profits they make by off-balance-sheet financing and also longer-term securities. It is securitised for driving balance sheet liquidity, which attracts funding sources for many financial organisations and firms.

All the above-mentioned hedge funds practices create market return or profitability, generating significant benefits for their investors, managers and service providers (including prime brokers) and generally improving the quality and performance of markets.

Accordingly, hedge funds can perform several useful functions and services with regard to market operation, growth and development, making markets more liquid and stable in time while continuous re-engineering and innovation can improve product selection, quality and efficiency in general. Thus, hedge funds carry out relevant functions and do have value, if all corresponding exposures and sources of instability are entirely identified and addressed.

1.7 Hedge fund structures

Funds can be established under various forms. The most commonly used vehicles are “limited partnerships or limited liability companies in the US” and offshore investment companies elsewhere. Nevertheless, the funds are only a vehicle for attracting external investment and participation. The raw returns evidence for the hedge funds indicate that this is an attractive investment instrument for many types of investors. “All funds’ operations will be carried out externally with all essential services being outsourced.” This function outsourcing itself is considered to improve efficiency, service quality and returns. Today, funds are generally regarded as investment vehicles assumed to generate an absolute return measure regardless of the

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market conditions. By their loose regulations and flexible investment strategies, hedge funds may use many investment strategies like short positions, leveraging and derivatives. This enables them to profit of all the market conditions and to generate favourable returns, to promote and induce confidence in investor. Fund managers usually hold a strong position in their fund.97 The understanding of structures of hedge funds from a lawful angle is important in order to further comprehend how law applies to them.

Hedge funds operate within extended management and legal structures. The fund itself will include investors (also known as limited partners), sponsors (also known as general partners) and a board of directors, as well as a registrar and a transfer agent. A separate team will set up and implement the particular investment strategy to be adopted. This team will be composed of investment advisors, managers, prime brokers and clearing brokers.98 Another team of legal advisors, accountants and auditors, custodians and administrators will be formed. Many of these parties will also operate in separate jurisdictions and in compliance with various laws. The fund will only work effectively where the activities of all of these parties can be operated together within a single effective business operation or model.

Various sub-organisational structures can also be used for portfolio management purposes. Managers can be responsible for up to 14 separate funds under US restrictions.99 Thus, in the 1990s, a hedge fund in the US was allowed to have up to 499 investors. Each of these investors was required to have more than USD5 million in assets, otherwise it would be subjected to the Investment Company Act 1940.”100 Separate funds or sub-funds could then be held under different management structures.

98 Walker, George, “Investment Finance and Hedge Funds”, unpublished, 15, cited with the permission of the Author.
1.8 Investment strategies of hedge funds

The various organisations collections comprising hedge funds involved in exchange activities are best classified by employment issues “of mark-to-market discipline, leverage, and active trading.”\textsuperscript{101}

From a regulatory perspective, it is relevant to understand the strategies used by hedge funds in order to invest the money and determine whether their strategies are consistent and low-risk. As seen before, hedge funds are acknowledged more and more as significant factors in the financial markets field. Even if the hedge funds regulatory regime is considered to be light, these funds are however forced to comply with the regulations governing the decision-making process of the companies, and related financial activities in the market. Hedge funds use certain legal strategies to limit the restrictive nature of these norms. These legal strategies prove to be a very profitable manipulation generator in terms of rules.\textsuperscript{102} Hedge funds’ legal strategies and regulation cannot, however, be viewed in isolation. On the contrary, the author of this thesis thinks that they should be considered in the context of a more developed programme as to integrate global financial services markets, particularly because the recent instability of global financial markets urges legislators and regulators, to call for global regulation of hedge funds in the author’s point of view. As a consequence, the author firmly believes that the research lens should be pushed forward to perceive hedge fund regulation in the context of a wider, international policy regulatory regime in financial services.

1.9 Hedge fund parties

As stated above, “hedge funds are legal creations”. The fund vehicles themselves do not have any staff, except for their non-executive directors. Consequently, another individual executes all the activities performed by a hedge fund. Funds rely not only on their daily existence but also on their long-run achievements, and on the professional expertise of the service providers assisting them. If the above-mentioned providers did


\textsuperscript{102} Ibid.
not exist, funds would not exist either. In fact, the service providers make the fund possible.\textsuperscript{103}

Therefore, the high significance of hedge funds composition to their connection with different third parties should not be surprising. The fund will be asked to employ a certain number of specialist service providers, so that it may take advantage from the supporting taxation and regulatory treatment of the fund, in order to ease its smooth organisation and transaction, and to maximise returns.

This section explains the significance of each major service supplier, his or her contribution to fund activities, and their terms of employment. The main service suppliers for a hedge fund are the following: “(a) the investment manager; (b) the administrator and; (c) the prime broker.”\textsuperscript{104}

One should remember that funds have a board of directors. While the hedge funds management is generally assigned to the funds’ investment manager, the daily operation of funds is assigned to the funds’ administrator. At the same time, the board of directors responds for the appointment and supervision of the service providers retained by the fund and for the provision of oversight and corporate governance. This board is usually the only personnel engaged directly by the fund.\textsuperscript{105}

The daily role of the fund’s board of managers is minimal, but they still have a significant function. The directors can make decisions and therefore end the contracts of the service providers, including that of the investment manager. This circumstance might sound a bit radical if one takes into consideration that the investment manager typically established the fund. Instead, this is a function of the funds structure, splitting the vehicle holding the assets (the fund) from the staff managing then (the principals and employees of the investment manager).\textsuperscript{106}

The aim of this section was to identify and describe the roles played by the key service providers who “make the fund happen” and work together to make sure that the fund runs smoothly and successfully and to depict their role from a regulatory and

supervisory perspective. In addition to the aspects analysed above, the fund may also use, *inter alia*, other providers such as: placement agents/distributors to solicit subscriptions; listing sponsors (if any of the interests in the fund are to be listed), auditors and lawyers (often in a number of jurisdictions).\textsuperscript{107}

1.10 Concluding remarks

This first chapter aims at providing a critical examination on the modern framework of hedge funds. To achieve this, first the definition of hedge funds and then an overview of their history are provided. The structure of hedge funds and the parties involved together in the investment strategies are analysed in order to offer a common ground for understanding hedge funds. The author considered that the detailed explanation of the hedge fund framework was necessary to achieve a better comprehension of the reasons leading to the situation of non-regulation of the fund himself but the regulation of the manager, and as a consequence, the investor protection concept emerged.

From the author’s perspective, in agreement with the remarks of this chapter, until now, no widely accepted definition of the “hedge fund” concept was provided. This lack of a general definition might be interpreted as an indication of the insuperable difficulties inherent in delineating the hedge fund collecting area in a comprehensive manner. In this respect, another question arises: if struggling to regulate (one might even use the term: “re-regulate”), do hedge funds represent a realistic objective? Meanwhile, such argument seems right *prima facie*. Yet, this line of argument may, after careful consideration, unnecessarily focus on reaching a definition of hedge funds before submitting them to a fundamental regulatory structure, simultaneously overstating the imminent challenges in designing a practicable definition thereof.

In fact, the author’s debate in this chapter concerning the definition of the term “hedge fund” advocates the fact that the achievement of this type of definition is not at all impossible. In addition, as it is going to be apparent from the debate that is going to be carried on later in this thesis, in the fourth chapter, addressing the Member States hedge fund regulatory frameworks, there are many examples of this type of frameworks in the EU. Therefore, a global definition of hedge funds is urgently needed. The strengths and

weaknesses of these regimes come neither from the distinguishing quality nor from the comprehensiveness of their definition of “hedge funds” (definition which is, most of the times, absent).

Last but not least, the authenticity of this rationale stating that hedge fund regulation definitely relies on a previous definition of its topic matter critically arouses the de facto aim and the scope of an individual’s regulatory perspective. For example, those pleading in favour of the indirect regulation (performed by its managers/brokers) might want to challenge the real necessity of an extremely exact definition of “hedge funds”, considering this a *sine qua non* precondition for the endorsement of their recommendations.108

Apart from the definition issue regarding hedge funds, this chapter argues that there are increasing empirical proofs in favour of the increasing challenge that the complexity of financial markets poses to regulators, managers and investors. Overall changes occurring within the regulatory framework centred on prudential regulation and investor and consumer protection make it even more difficult for all the above-mentioned parties. The re-thinking of the entire hedge funds’ regulation and disclosure policy is therefore considered necessary in order to increase the protection of investors’ interests.

The hedge fund market development so far implies the fact that hedge funds will continue to play a significant role within the overall market, even with the ability to grow despite the emergence of the financial crisis, the major condition for this being re-assurance of investor confidence through their increased protection. There are few factors certifying the constant asset influx within this industry in the future. Among these factors, one can mention: larger profits ensured by hedge funds managers; increased availability within pension funds together with various organisational investors to make investments within the funds, and the gradual expansion of the industry, to retail investors.

Speaking from the client’s profile perspective, which became more and more diversified in time, several scholars even depicted hedge funds as the prospective/next “active

108 Indeed, a much too persistent quest for a conclusive definition might, especially if successful, prove counterproductive if it leads to a situation where different types of hedge funds would be homogeneously regulated, irrespective of their individual characteristics and, more notably, of their risks and benefits.
management" or, to a lower extent, as the future major issue occurring in the investment management. Starting from this active management, the author of the thesis considers that regulators must develop their registration rules and reporting requirements, by obtaining from all of these advisers/managers a substantial collection of data that needs to help investors and assist the regulatory and examination efforts of both the United States Securities and Exchange Commission (“SEC”) and the European Parliament, in prompting investor-centric regulation and in enhancing the investors’ rights protection, by diminishing some of the higher risk behaviour of hedge funds. Similarly, the hedge funds industry lost part of the distinguishing details classically counting for its light regulation because of the crawling “retailisation” tendency together with the industry’s step-by-step institutionalisation. This occurred due to the junction between the investment strategies of hedge funds and those of mutual or private equity funds. In addition, logical concerns have been expressed about the impact of the hedge funds industry increase firstly the overall financial markets, particularly in a period affected by high insecurity doubled by disruption, and secondly the many potential conflicts of interest and risk factors that are uniquely applicable to hedge funds and that affect especially investors.

After reviewing major features of the hedge fund industry, the author of the thesis also identified major problems and circumstances that make this field a real threat to financial stability, it should be mentioned that although hedge funds contributed to the development of the crisis, they cannot be held responsible for it.

As one can notice in this chapter while analysing the hard work associated to risks mitigation by means of regulation, the facts gravitate mainly around jurisdiction. At the same time, there are duplicated concerns regarding hedge funds: small charges connected to zero advertisement. On the one hand, funds are able to select the best area of authority so that managers may relocate without problems if a state changes its laws, charges or disclosure requests. On the other hand, since the hedge fund market represents a source of return for countries, it becomes obvious that no country wants the market to shift its jurisdiction, as this actually decreases the regulators’ impact on risks mitigation and therefore, investors’ interests protection.

This chapter has also reviewed a major dissimilitude between hedge funds and various financial institutions, namely the degree of hedge fund failure, which tends to be constantly higher. Despite the deficiencies emerging from the lack of accurate data regarding the percentage of hedge funds failure, the author argues that these successive failures of hedge funds were not those leading to the development of the financial crisis.

Indeed, over the past ten years, the emergence of globalisation, financial innovation, and that of deregulation tended to increase the systemic risk potential. Uprising financial globalisation offered assistance for financial institutions together with investors in trading assets without being conditioned by time zones or national boundaries. All these factors should enable risk sharing while increasing market liquidity. Still, the rapidity and the horizon that the problems within this market have spread globally emphasise the extent to which globalisation, financial innovation, together with deregulation have lately increased the systemic risk potential.

However, the author has to acknowledge that the knowledge on hedge funds is still very limited. Even if this overview of hedge funds has been revealing, conclusions are however relatively delicate to draw because hedge fund managers continue to work in a confusing environment, where they are not asked to make their return performance systematically available to the public, while being able to potentially manipulate their returns for some periods and thus communicate low risk doubled by consistent performance. This is one of the reasons why, further on, this thesis will thoroughly review each of these rationales and will argue that, from a legislative perspective, the protection against systemic risk and the concern for investor protection should be the primary goals of any regulatory policy regarding hedge funds.

All in all, direct regulation of hedge funds appears as an unsuitable, inappropriate solution, possibly ineffective due to two main reasons: on the one hand, the constant delays emerging from reporting and processing the data and, on the other hand, the opportunity of hedge funds to move offshore if their purpose is to avoid regulation. In this regard, position reporting to withdraw from crowded exchanges could lead to the encouragement of moral hazards. Meanwhile, increased transparency regarding positions might unintentionally lead to a liquidity decrease, making markets
increasingly volatile and at the same time expanding financial insecurity during stress periods.
 CHAPTER TWO

THE RATIONALES OF HEDGE FUND REGULATION

2.1 Rationales of financial regulation applicable to hedge funds

The vast literature on the issue suggests that there are three objectives that provide the rationale for financial regulation in general and for hedge fund regulation in particular. These objectives are: (a) protection of investors, (b) promotion of market integrity, but also (c) preservation of financial stability.

As remarked by various observers, such as Sander Van Berkel, Peter Cartwright, Niamh Moloney, Phoebus Athanassiou, the above-mentioned aims are connected and overlap, in certain aspects. For instance, the provision and insurance of fair, efficient and transparent markets need some requirements, which are also used for investor protection and mitigation of systemic risk. Similarly, some of the systemic risk mitigation measures afford investor protection. All the above-mentioned principles are being addressed in the current chapter, in relation to the apparent validity of their application to hedge funds, not only within European borders but also outside Europe. The chapter makes a clear organisation of the different sets of regulation applicable to hedge funds aiming to protect investors, market integrity and financial system stability.

2.1.1 Investor protection as rationale of hedge fund regulation

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111 Among the new literature on this issues see Phoebus Athanassiou, “Hedge Fund Regulation in the EU: Current Trends and Future Prospects”, Walters Kluwert, 2009.
113 IOSCO, “Objectives and Principles of Securities Regulation”, May 2003, p. 5. These are by no means the only regulatory rationales: the case for regulating financial markets also rests on a number of additional grounds including particularly, the need to ensure correct competitiveness for the financial intermediation industry.
Investor protection concerns the strand of regulatory attention directed towards making sure that investors’ interests are conducted against market failure or unfavourable behaviour within institutions possessing investors’ funds. Non-compliance to “investor rights” may have so far-reaching results that the investor protection-based law has consistently featured amongst the main components of most capital market regulatory schemes, with national arrangements differing from one another only in terms of pointing out the specific investments that best suit them, based on the information that product providers are mandated to disclose by law\textsuperscript{114}. There are some factors that turned the protection of investors into one of the most visible objectives pursued by financial market supervisors and lawmakers worldwide\textsuperscript{115}. Among these, one needs to mention: the non-economic\textsuperscript{116}, paternal\textsuperscript{117} basis of many of the current financial market regulatory frameworks, the public desire for outer (governmental) regulation, together with the supervision of private self-regulation (mainly in crucial times of crisis), the prejudicial economic results emerging from the “loss of investor confidence in the aftermath of market failures”\textsuperscript{118}, but also from the high amount of empirical proof or researches stating that there is a causal connection between tighter investor protection regulation and financial market increase\textsuperscript{119}. This is even more relevant in the context of

\textsuperscript{114} Edwards differentiates between “top down” and “bottom up” investor protection regimes, of which the former is based on the exhaustive authorisation of the available investment products, while the latter is disclosure based, relying on rules requiring product vendors to explain the features of their products, their risks and returns, allowing investors the freedom to determine whether these are suitable for them (Franklin Edwards, 2006, “Hedge Fund and Investor Protection Regulation”, 91(4) Federal Reserve Bank of Atlanta Economic Review, 38.

\textsuperscript{115} The importance of investor protection as a ground for financial regulation is reflected both in the statutory objectives of several of the EU Member States’ financial market supervisory authorities, including the FSA (FSMA 2000, sections 2(2)(c) and 5), and in the score of investor protection-oriented Community legislative measures adopted in recent years. See Gillian Garcia and Henriette Prast, “Depositor and Investor Protection in the EU and the Netherlands: A Brief History”, Netherlands Central Bank Research Series Supervision (discontinued) 54, 2003.

\textsuperscript{116} Academics often distinguish between the economic and social rationales for external regulation. The conceptual difficulty of differentiating between the two may serve little practical purpose: measures justified on social grounds (e.g. consumer protection) may also improve the functioning of markets and vice versa (cf. Ramsay, I. (1995) “Consumer Credit Law, Distributive Justice and the Welfare State”, 15 (2) Oxford Journal of Legal Studies, 177.


“institutional investment vehicles”, where, as Franklin Edwards emphasized, investor protection represents the top-priority goal of public policy underlying regulation.120

Many aspects need to be considered regarding the meaning of hedge fund-specific legal transparency requirements for the investor protection-related data. This is because there is a lack of a realistic comprehension by (several) investors (mainly less-experienced ones) of hedge fund investment strategies and imminent conflict of interests that emerge between managers of the fund and individuals investing capital in it. This is to be performed even in the EU Member States where hedge fund-specific legal transparency requirements are applied.

One must consider the case of single-manager hedge funds regulation based on investor protection rights claiming that this premise is highly unrealistic and that the existence of relevant barriers might go a long path to approaching whatever legitimate investors risks a realistic regulator might have wanted to keep against in this area.121 Following the example of the US hedge fund situation, despite the huge dimension and the absolute relevance of its onshore industry (which surpasses by far the European industry), the compulsory transparency actions aiming to protect the investor were not considered necessary. This impressive “exempted status” that the American hedge funds take advantage relies on the general apprehension that the so-called “accredited” (also known under the name of qualified) investors, who owned most of the hedge funds industry established somewhere on the Atlantic shore, tend to be highly sophisticated and therefore they afford to make professional investment options and bear their costs. This makes the protection through regulations pointless. Meanwhile, retail investors are protected by the very fact that they denied the access to hedge funds.122

122 Paredes, T. A., (2006) “On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style and Mission”, University of Illinois Law Review, 975, 991. “It is nevertheless interesting to note that the SEC’s rationale for adopting Rule 203 (b)(3)-2, requiring the registration, by 1 February 2006, as investment advisers (within the meaning of the Investment Advisors Act of 1940) of most hedge fund managers was inter alia motivated by the need to protect investors in hedge funds and to enhance the Commission’s ability to protect our nation’s securities markets” in the face of the industry’s “retailisation” and of the growing incidence of fraud amongst hedge fund managers” (SEC, “Registration Under the Advisers Act of Certain Hedge Fund Advisers”, 17 CFR Parts 275 and 279, Release No. 1A-2333, File No S7-3-04”).
However, in some cases, qualified investors may need protective guaranty as well, where there is an objective leverage deficiency in setting up their investing conditions and in assessing their risk outline.\cite{123} The promoters of transparency regulations inspired by investor protection still have to prove that real investor transparency safeguards can be implemented. They have to identify the costs and benefits and their practical purpose, taking into consideration the complex framework of hedge fund strategies and the flexibility of their investments capable of making sound antique even the most comprehensive, mandatory investor transparency data in a de facto short period.\cite{124} In addition, good incentives are offered to hedge fund investors to gather the necessary information for their self-protection. If they assess the information to be inadequate, they have all the rights and power to withdraw their assets and redeem their investments (with the exception, maybe, of an extremely long “lock-up” time).\cite{125}

Public concerns have been expressed as additional grounds for investor protection-based regulation, regarding the major increase of capital allocations of institutional investors in alternative investment products. All the above represent legitimate concerns attributed inter alia to the indirect retail investor exposure produced by the organisational investor allotments. However, the fact that hedge fund regulation is justified or not by these concerns is a different matter.\cite{126}

Despite the numerical increase of organisational investors who assign parts of their own liquid assets to hedge funds (they can do this either directly or indirectly, by means of the FoHF\cite{127}), increasing pension funds into an international hedge fund industry major financial suppliers, institutional investor allocations to hedge funds continued to be limited and did not change lately.


\cite{125} Spangler, Timothy, Scholer, Kate, 2010, Op. Cit., p. 27.

\cite{126} Spangler, Timothy, Scholer, Kate, 2010, Op. Cit., p. 27.

\cite{127} Funds of Hedge Funds.
Without damaging the quantitative dimension of recent institutional investor interest in hedge fund investments, at first glance, it seems that however useful the inclusion in the regulatory arsenal of basic conflict of interest prevention safeguards might be, a feasible solution for the investor protection connected concerns brought about by institutional investor allotments to hedge funds stands in their own hands. There is a very relevant conflict of interests between pension fund managers, who are ready to take risks in order to increase their funds’ returns (and their own compensation, too) and their beneficiaries, who have an interest in funds, adopting more conservative investment policies. This is an effective institutional oversight and governance mechanism to rectify the noticed conflict of interest arising between the managers of a fund and its beneficiaries.\textsuperscript{128}

This contrast is more an issue for pension fund regulation (or, more properly, for the enforcement of existing pension fund-related corporate governance rules) than it is for hedge fund regulation. As Franklin Edwards has competently observed “…hedge funds are not the source of this conflict, only its latest manifestation.”\textsuperscript{129} If the problem is more relevant to the relationship between pension fund managers (as agents) and beneficiaries (as principals), then the appropriate answer is in terms of tighter institutional investor governance, so that fund beneficiaries may control fund managers more efficiently.

\subsection*{2.1.2 Market integrity and hedge fund fraud as rationales for hedge fund regulation}

The protection of market integrity represents the second aspect of regulatory interest in the field of financial investments. This occurs as one major determinant concerning each investor’s capability to transact the business he/she manages in a transparent, fair background, and in the absence of discrimination, manipulative market conduct, secret agreements and different abusive conducts.\textsuperscript{130}

One cannot underestimate the ramifications of market integrity infringements. Factors like the misuse of insider information, “the misevaluation of complex instruments” or the predilection manifested by brokers towards specific funds may reduce the investors’ confidence but may also lead to the deterring of the business, since either “bona fide investors” are deprived of their money or their costs are increased. This can have a knock-on effect on market activity.\(^{131}\)

As the economic relevance of these results might be significant and wide-ranging, financial market regulators have issued and enforced scores that are inspired from market integrity norms, which focus on the interdiction of insider exchanging together with market manipulation, on management of business problems, as well as on the governance together with fiduciary assignments of financial intermediaries. Resources and initiatives of regulated markets also contribute to maintain market integrity.\(^{132}\)

The need to make sure that hedge funds cannot control or manipulate markets is, undoubtedly, pertinent. The suggestion that market integrity breaches are widespread to the hedge fund industry is nevertheless, misleading. Some of the real issues across markets are insider information, wrongful appraisals regarding either profit or loss (or both), and the incomplete exchange records. These tend to be mainly concentrated in the hedge fund industry and consequently, need to be removed from other, tighter regulated industries.\(^{133}\)

Hedge funds have undoubtedly highlighted some shortcomings in the existing market integrity protective framework and their operation has added to the urgency of revising monitoring mechanisms. However, recent literature states that the occurrence of “insider trading and market manipulation” within hedge fund managers tends to be extravagantly prominent lately if we consider recent US cases which have resulted in convictions and have shown a clear involvement in market manipulation and insider dealing of hedge funds.\(^{134}\)


\(^{134}\) Gupra v. SEC (2012) and SEC v. Rajaratnam, 622 F.3d 159 (2nd Cir. 2010).
Also, it seems less probable that hedge funds could include the market integrity threat that some appear to believe that they do, if only because, despite the higher incidence, amongst hedge funds of more concentrated portfolios, a large part of them are not that powerful so that to manipulate prices.

The large hedge funds managers’ tendency for manipulative behaviour towards the markets cannot be assumed to be stronger than that of other financial market professionals to do so. This is both because the generous financial rewards received by the hedge fund administrators capable of generating abusive behaviour represent no monopoly of this industry, but also because hedge fund managers cannot simply and spontaneously be expected to appreciate their prestige to a lesser extent than their counterparts from other financial organisations.135

Also, it is worth remembering that laws like those governing insider trading, notifiable holdings and share registers are already implemented to all market participants, especially to hedge funds and their managers. This means that hedge fund-specific market integrity issues can be solved using common tools such as those applied to fraud or collusion in the banking or securities field, despite the relative difficulty of providing, in the case of hedge funds, evidence to substantiate unlawful conduct, due to the insufficient transparency or regulation within the sector and the complexity of its trading strategies.136

Regarding specifically hedge funds, dealings in tools accepted to enlist in regulated markets in the EU, these would fall under the MAD137, regardless of the inexistence of homogenous hedge fund regulation framework in other respects, they would be subjected squarely to the Community law security guarantee together with their managers and would be conditioned by very much alike conformity responsibilities just like the other industry participants, inter alia regarding market manipulation.138

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137 Market Abuse Directive.
The solution of market integrity problems raised by hedge fund market activities should be searched in: (a) the effective implementation of the existing rules rather than in the introduction of new ones, devised with hedge funds and their operations in mind and (b) the investors’ accomplishment of the regular due diligence checklist suggested by sound investing procedures and constant precaution.\footnote{FSA, (2005), “Hedge Funds: A Discussion of Risk and Regulatory Engagement”, Discussion Paper 05/4”, 54; and Mc Vea, Harry, (2007) “Hedge Funds and the New Regulatory Agenda” 27 (4) Legal Studies, 709, 728-729.}

Due to the financial crisis, systemic risk and its importance for stability and economy has been re-viewed. Nevertheless, neither systemic risk, nor the intentions to mitigate are new. This is the main reason why quite a lot of the reform recommendations underline this need for macro-prudential orientation of classical micro-prudential regimes. Otherwise said, such new regulatory regimes would not only focus on the solvency and other elements (in banking CAMEL) of commercial banks and other individual financial institutions (micro-prudential), but would also take into consideration the impact of financial institutions’ activities on the financial system and real economy (macro-prudential).\footnote{Mc Vea, Harry, 2007, Op. Cit., pp.725-727.}

In addition, one should take into consideration that at least some of the abuses associated with “hedge funds” imply leaks of internal information attributable to investment banks, making the receiving hedge fund managers “accomplices rather than the chief offenders.”\footnote{Mallaby, Sebastian, (2007), Op. Cit., p. 95.} After the financial crisis, all financial newspapers pointed fingers towards hedge funds, although the crisis must not be attributed to the hedge funds sector. They may have contributed to spread the chaos on the financial market, but they are not the ones to blame. In the aftermath of the financial crisis, all international organisations called for more regulation towards the shadow banking sector. Only if hedge funds continue to rely on investment banks for data related to market conditions and for the purpose of placing their trades, the “front running”\footnote{“Front running” – i.e. “the practice of trading ahead of a large buy or sell order placed by an institution or a mutual fund – is something that hedge fund managers can only do if they receive inside information form executing brokers who are probably more to blame than the hedge funds themselves for front-running.”} threat to market integrity often associated to these funds is still unapproachable, except
through the wider use of electronic trading which becomes accessible only in the context of assets, when trade depends on exchanges.\(^\text{143}\)

2.1.3 **Financial stability as rationale for hedge fund regulation**

The protection of the financial system stability\(^\text{144}\), by means of ongoing systemic risk mitigation represents the third major motivation concerning financial market regulation and its primary objective, as some commentators, such as Phoebus Athanassiou, would say.\(^\text{145}\)

Generally, active industry participants like hedge funds offer advantages for securities industries through liquidity promotion, but also through performance. In addition, they can be relevant for financial new products and for the reshuffle of fiscal risk. Nevertheless, there are several funds, which just like various highly leveraged organisations can throw into confusion or even worse, rupture every financial markets operation. Hedge funds were indeed considered causative of excessive but also, at certain times, turbulent industry processes emerging within vulnerable financial systems.\(^\text{146}\) Many academic researchers considered that hedge funds did not have a major significance for the propagation of the financial market crises during the last several years.\(^\text{147}\)

“Systemic risk” is an ambiguous concept of particular major importance to the financial stability rationale. This term has been clearly defined as the occurrence ability of one crucial *systemic event* leading to several connected failures within financial entities,

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\(^\text{144}\) Athanassiou, Phoebus, (2009), Op. Cit., p. 64.


\(^\text{147}\) Ibid.
capable to adversely affect most operations of financial markets as systems (and not at the level of each of their participants). This capacity may also lead to the deterioration of the real economy by, inter alia, the abrupton of payments, the collapse of financial markets, the insufficiency of credit supply (market liquidity) and, ultimately, the occurrence of conditions favourable to deflation and recession.149

A recent report to the G 20 by the IMF, BIS, and FSB, describes the systemic risk concept in terms of “the disruption to the flow of financial services as (a) generated by a distortion of all parts of the financial system; and (b) capable of causing serious negative consequences for the real economy.”

The following definition of “systemic events” was provided: situations in which “...shocks to one part of the financial system lead to shocks elsewhere, impinging in turn upon the stability of the real economy.”154 Emphasizing the role of a loss for the real economy as a key feature of the economic crisis concept, the CRMPG identified a financial event, which differed from a “systemic event” according to whether or not its consequences entail significant damages which hit not only financial systems but also real economies. They defined the term as a drop occurring within productive investments, subsequent to the decrease in credit provisions, and the loss of balance as far as the financial, but also economic activities are concerned.157

Some aspects were considered very important in terms of financial stability: recurring financial crises during the last two decades, in association with the progressive liberalisation (“deregulation”) and increasing integration and interdependence of global capital markets. These have progressively shifted the focus of the contemporary

150 International Monetary Fund.
151 Bank for International Settlements.
152 Financial Stability Board.
regulatory policy debate from micro-prudential (investor-related) to macro-prudential (systemic stability-related) issues.

One of most important lessons to be learnt from the economic depression consists of the fact that previous financial regulation took exaggerated measures to preserve the integrity of private corporations, while it reduced the interdependence between financial organisations, not focusing at all on what this interdependence really symbolised in terms of systematic security. Essential causes creating systematic insecurity imply: “counterparty risk, the risk of default on the part of counterparties to OTC transactions, and fire-sale risk.”\textsuperscript{158}

It was Brunnermeier et al. who have asserted the measurement of systemic risks with a variable named \textit{Co VaR}. This is composed of \textit{“the value at risk”} (\textit{VaR}) of financial entities depending on other entities which are at risk. A growth of \textit{Co VaR} relative to \textit{VaR} reveals the growth in systemic risks.\textsuperscript{159} Another group\textsuperscript{160} proposes that credit institutions receive the authority to oversee systemic security. This delegation completes the already enforced responsibilities regarding inflation constancy and (for instance, if one refers to “the US Federal Reserve”) unemployment mitigation. Several issues must be considered in terms of supervising: the analysis of data and information collection regarding the asset positions but also risk vulnerability in a standardised form enabling the contrast between entities; the public issue of information, subjected to periodic intervals which provide a balance between disclosure and transparency goals, but also rightful concerns regarding financial innovative techniques, and proprietary business models protection; and last but not least, the elaboration of a yearly report on systemic security and risk.\textsuperscript{161}

Issues involving systemic stability produced a major regulatory impact to date\textsuperscript{162} and are likely to provide an ongoing focus of regulatory attention with the increase of financial risks within the banking sector.\textsuperscript{163}

\begin{flushleft}


\textsuperscript{160} “Squam Lake Working Group on Financial Regulation”.


\textsuperscript{162} “Market transparency, deposit insurance, capital adequacy and bank failure resolution regulatory measures, to name a few, are premised (at least to an extent) on financial stability considerations as a justification for financial market regulation.”
\end{flushleft}
Hedge fund operations and entities also need to have financial stability, as this is the main reason for their coming under the spotlight in much the same way as the other financial market participants because of the fact that their operations might have undermining effects. The other way around, comparing a hedge fund with an investment credit institution, the first one is probably by far the most changing of comparable leverage because it may fight the whole financial market by means of its strong advantages. Moreover, some funds with an incontestable record of actual performance comprising 30% up to 40% returns yearly, most of the time use their managers’ honour but also charisma in planning copycat and crowd behaviour.164

When addressing the systemic stability risk usually generated by hedge funds, the main scenario considered by policy-makers is failure. Instead of the downfall of an individual large fund, the collapse of several funds might be more credible and pertinent; regardless of their form or features, breaking down during the same period, disseminating confusion and alarm throughout the economy, and involving systemic risk. The former situation described is called “contagion”. The issues directly related to the latter consist of “liquidity risk” (the request of cutting loose investments after some important deficit), “risk to counterparties”, and “herding” (possibly unsuccessful various funds investing in similar areas). Concerns regarding the fact that market might fail from contagion are mainly hypothetical. Only few academic studies on hedge funds address systemic risk directly, and neither of them concludes the gravity of the threat, nor even provides a definitive measure or assessment.165

The previously mentioned so-called “direct” channel which can result in systemic contagion has also an “indirect” channel. This channel represents another way for hedge funds to affect financial stability, characterised by: “…a forced hedge fund liquidation [that] exacerbates market volatility and reduces liquidity in key markets (especially where the hedge fund under threat was the prime provider of liquidity).” Systemic

163 Recent research “suggests that systemic risk within the banking sector has been on the increase, both in Europe and across the Atlantic” (see, for instance, Hartmann, Philipp and others, “Banking Stability: A Cross-Atlantic Perspective” in Carey M. et al “The Risks of Financial Institutions” (University of Chicago Press, Chicago 2006), 133).

The transmission mechanisms of systemic risk are one of the issues debated in a recent article by Professor Rosa Lastra\footnote{See Lastra, Rosa Maria, (2011), \"Systemic Risk, SIFIs and Financial Stability\", in \textit{Capital Markets Law Journal}, Vol. 6, No 2, pp. 197-213.} describing how \textquote[Lastra, Rosa M., 2011, Op. Cit., pp. 197-213.]{the channels of contagion or transmission mechanisms can be classified into at least four categories [...]: a) the inter-bank, inter-institution, inter-instrument channel; b) the payment systems channel; c) the information channel; and d) the psychological channel.}\footnote{Lastra, Rosa M., 2011, Op. Cit. pp. 197-213.} These transmission channels contribute to disseminate the systemic risk across the financial markets globally. As Professor Lastra explains, \textquote[Lastra, Rosa M., 2011, Op. Cit. pp. 197-213.]{what makes a crisis of a systemic nature is not so much the trigger event (\textit{causa proxima}) but these transmission mechanisms, domestically and internationally. If the linkages are strong, the potential for systemic instability increases. If the connections are weak, there is less of a threat of systemic risk.}\footnote{These are by no means the only ones. A paper highlights the following reasons for concerns over the external effects of hedge funds: the risk that hedge funds might be a source of market vulnerability because of their use of high-risk strategies or the deterioration of the quality of investment managers following an increase in transactions and a reduction in profit opportunities; the risk that hedge funds might trigger steep price fluctuations, especially in low liquidity markets, and that prime brokers’ counterparty-risk-management standards for hedge funds are lowered as the prime brokerage business becomes more competitive; and the concern that the emergence of risks will go undetected because of the constraints imposed by quantitative data and secondary related information of hedge funds and the limitations of available analytical methods (Bank of Japan, \textit{Recent Developments in Hedge Funds", Report, 13 June 2006, 48).}

The systemic implications of the industry’s operation and its potential to generate, precipitate or propagate systemically relevant shocks include three main reasons which have recently stepped forward. These are: (a) the public prominence hedge fund failure experiences starting with 1998 and the possibility that they reoccur within the next future, (b) the ongoing increase of the hedge funds’ segments of the asset management industry, together with the insufficiency of accessible data for the public reported in their balance sheets, but also the quite recent decrease of the industry profits in conjunction with (c) the function and impact of hedge funds within the credit risk transfer markets.\footnote{These are by no means the only ones. A paper highlights the following reasons for concerns over the external effects of hedge funds: the risk that hedge funds might be a source of market vulnerability because of their use of high-risk strategies or the deterioration of the quality of investment managers following an increase in transactions and a reduction in profit opportunities; the risk that hedge funds might trigger steep price fluctuations, especially in low liquidity markets, and that prime brokers’ counterparty-risk-management standards for hedge funds are lowered as the prime brokerage business becomes more competitive; and the concern that the emergence of risks will go undetected because of the constraints imposed by quantitative data and secondary related information of hedge funds and the limitations of available analytical methods (Bank of Japan, \textit{Recent Developments in Hedge Funds", Report, 13 June 2006, 48).}

This does not consider these guaranteed concerns and the relevance of hedge fund late developments for the determination of the applicability of the systemic stability rationale of financial regulation to hedge funds.
The recent financial crisis of 2007-2009 has led to an increase of regulation regarding hedge funds. All international organisations pointed the fingers towards the shadow-banking sector as being the one to blame for the recent financial crisis. For the reasons illustrated above, hedge funds were not to blame, as they spread systemic risk, but they did not create it. Thus, two major arguments support this affirmation. On the one hand, they were not involved in the forming of the toxic securities at the centre of the crisis since they had nothing to do with nonconforming mortgages, as their repackage into securities, the bundle of these securities along with other securities as collateral for yet other securities, have provided a rating to the structured credit securities or have distributed the above-mentioned securities. On the other hand, there were many others that bought the high yield bearing subprime-backed securities and among these one can find: pension and mutual funds, insurance corporations, as well as European and Asian banks, all having been similarly convinced into buying them. It is the view of the author of this thesis that an increase of regulation towards the hedge fund sector will not be the right answer of the shadow-banking problem. Hedge funds should be more regulated, but according to certain criteria, more transparency and disclosure should be asked to hedge fund managers bearing in mind that the risk of over-regulation is high. Private investors will find alternative ways to invest their money. A recent example of this statement belongs to the renowned George Soros, who has decided to gradually diminish his hedge fund on claims that in the aftermath of “the Dodd-Frank Act” there is too much regulation affecting the hedge fund sector in the US. What Soros did was to give back money to his investors and establish a family office. According to the new “provisions of the Dodd-Frank Act” in the US, a family office will not incur the risk of being supervised by the Federal Reserve as the large hedge funds currently may incur this risk in the event of being considered a systemically important financial institution.

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173 See chapter five of this thesis on Regulation of hedge funds in US.
2.2 Regulatory response at international level

A number of official papers have been published in this area. Many of these are nevertheless selective or only issue-specific. Not a single comprehensive statement of effective regulatory response has yet been produced, as it is still difficult to form any overall opinion on the value of the recommendations made to date.

In 1999, in the US, immediately after the 1998 LTCM collapse, “the President’s Working Group on Financial Markets” (which has become the Financial Stability Oversight Council) released an initial study.\textsuperscript{174} The Working Group issued subsequent premises, but also guidance on private pools of capital starting with 2007.\textsuperscript{175} “The Basel Committee” had released its first study on credit institution and “Highly Leveraged Institutions” (HLIs) in 1999 with a support paper on sound practices and a follow-up paper in January 2000.\textsuperscript{176} IOSCO issued an initial paper in November 1999, comparing work of the Basel Committee with a joint Basel/IOSCO report in 2001.\textsuperscript{177} IOSCO issued subsequent surveys in 2006 and 2007 on hedge funds.\textsuperscript{178} In 2005, the “Banking Supervision Committee” (BSC)\textsuperscript{179} issued a separate paper on the vulnerability of EU credit institutions “to hedge funds.”\textsuperscript{180}

Similarly, the “Financial Stability Board” (FSB) issued an important document on HLIs in 2000, which was updated seven years later. The 2000 report was mainly concerned with systemic risk and leverage following the collapse of LTCM in 1998.\textsuperscript{181} The FSB recommended mainly a market discipline rather than a direct regulation based approach.


\textsuperscript{178} Several articles and reports need to be consulted: IOSCO, “The Regulatory Environment for Hedge Funds: A Survey and Comparison”, 2006; and IOSCO, “Survey on Funds of Hedge Funds”, 2007.

\textsuperscript{179} Of the European System of Central Banks (ESCB).

\textsuperscript{180} Banking Supervision Committee, “Report on Large EU Banks’ Exposures to Hedge Funds”, 2005.

Specific recommendations were made on risk management, oversight, disclosure and surveillance.\(^{182}\)

While the 2007 report accepted that substantial improvements had been made in prudential supervision and risk management capacity, a number of changes had arisen within the hedge fund system a short time ago, while further specific factors increased the threat of systemic exposure.

The year 2008 represents a run out period in terms of several strategies involving investing, generally strategies which have been exposed to “liquidity risk, high yield or equity risk.”\(^{183}\) In terms of regulations, there are two major events: in 2006 the “Statement of Financial Accounting Standards” (SFAS) 157 (Fair Value Measurements) was disclosed, enacted one year later in November although it had been entirely implemented only another year later (2008). SFAS 157 governs two major standards. The first is the fair valuation and norms on the corresponding marking to market of illiquid assets. This offers a definition of the fair value, but also of the future management regarding fair valuation performances. These require extended disclosure regarding fair valuation quantifications.\(^{184}\)

The implementation of SFAS 157 was postponed mainly due to the 2008 depression. The secondary cause of this situation was the decrease of house values, sales decrease, Bear Stearns’ incapacity to pay the debts and the wreck of Lehman Brothers at the end of 2008. During the last days of September, SEC and the “Financial Accounting Standards Board” (FASB) made one collective declaration elucidating “the implementation of fair value accounting”, when the securities industries tend to be either passive or disorganised. At the same time, they explained that \textit{forced liquidations} do not reflect fair values or an orderly transaction. In addition, in April 2009, the FASB

\(^{182}\) Ten specific recommendations were made concerning; a) stronger counter party risk management; b) “stronger risk management by hedge funds; c)enhanced regulatory oversight of credit providers;” d) greater risk sensitivity in credit institution capital adequacy regulations; e) sustaining industry progress f)building a firmer infrastructure; i) enhanced national supervision of financial market activities; and j) good practice recommendations for foreign exchange trading.


published a certified SFAS 157 update to facilitate mark-to-market norms in cases when markets become unreliable or passive.\textsuperscript{185}

After the 2008 depression, the discoveries related to Madoff Ponzi scheme and the discoveries regarding plenty of declared frauds brought to trial by SEC, it is not difficult at all to comprehend the active, increasing the attention of regulators, legislators and investors. While the industry press and academic literature have well covered some specific features of the Madoff saga, it is of no use to observe that those alleged operational risks and their evaluation have been and continue to be a major item within the hedge funds sector. At the same time, it will continue to receive scholars’ and other stakeholders’ attention.\textsuperscript{186}

Regulation of hedge funds apart from straighter reinforcement for existing laws will progress in either one or two directions. Primary, legislators and regulators need to continue to directly address hedge fund regulations. “The Dodd-Frank Act” for the US and the AIFM Directive for Europe are recently adopted more uptight regulations on hedge fund industry.

Other national and industry initiatives have also been continued. The FSA in the UK has published several studies regarding hedge funds, prime brokers, retail sales, engagement and managers.\textsuperscript{187} A number of speeches have also been given by senior FSA staff on hedge funds and hedge funds risks.\textsuperscript{188} The FSA has identified 11 key exposures.\textsuperscript{189} The FSA chose not to respond to all exposures as they were not material. An adequate

\textsuperscript{189} FSA refers to: (a) serious market disruption and erosion of confidence; (b)liquidity disruption leading to disorderly markets; (c) insufficient information to inform regulatory action;(d) internal systems and controls as well as capacity and incentive issues; (e)operational risk; (f)risk management; (g) valuation weaknesses; (h) market abuse; (i)fraud; (j)money laundering; and (l) conflict of interest. FSA, Discussion Paper 05/4.
industry response may be available and a further regulatory review was required. The FSA would rely on its current risk mitigation response with further immediate action to be taken. Over time, further risk mitigation action would be considered.

In the wake of the still ongoing depression, the IMF argued that a new and broader perimeter for prudential regulation was needed in order to better capture systemic risks and supervision necessary to be extended to previously unregulated financial institutions. The IMF also noted that the elements of the “shadow banking system” would be captured as variables used to proxy systematic risk in global financial markets.

Considerable work has been undertaken in order to address financial system stability. The “IMF/Bank for International Settlements/Financial Stability Board” Report released in October 2009 provides guidelines for the assessment and approach of systemic relevance within financial entities, markets but also tools, and moral hazards induced.

The interconnectedness issue amongst financial system players is to be addressed mainly through broader macro-prudential coverage, and reinforcement of the capital and liquidity requirements for the global banking industry. As the financial crisis was caused not by the lack of capital, but rather by a liquidity crisis induced by concerns about asset quality and transparency, the “Basel Committee on Banking Supervision” (BCBS) is developing enhanced risk-weighted capital adequacy standards (the “Basel III” framework). To strengthen the resilience of banks to loan losses, hybrid “Tier 1” capital is to be phased out for more conventional forms of permanent equity capital (that is, common shares and retained earnings). More capital will be needed for contingent calls on capital arising from derivative instruments. Additionally, the capital adequacy framework will incorporate a non-risk weighted (or “simple”) leverage ratio intended to identify leverage build-up from any gaming of the capital adequacy rules.

190 Global Financial Stability Review.
191 e.g. “Hedge funds and special purpose vehicles”.
193 “Systemic importance – the potential for an institution to have a large negative impact on the financial system and the real economy – is partly endogenous as it is dependent upon the structural characteristics of financial systems and economies which vary across jurisdictions. For a detailed discussion of the criteria and methodologies used to assess systemic risk.” see the Financial Stability Board Report of 2009.
and minimum liquidity standards (both short and long-term coverage ratios). Considerable attention was paid to pro-cyclicality in bank lending and provisioning practices. There are proposals to introduce counter-cyclical capital buffers (building up capital requirements under favourable circumstances and dynamic provisioning (relying on expectations of losses, rather than on already incurred losses).  

Executive remuneration practices which have been blamed for reckless lending and excessive risk-taking within financial institutions which precipitated the financial crisis have received considerable scrutiny. The FSB Thematic Review on Compensation published on 30 March 2010 reviewed the compensation practices (for example, in November 2008, UBS (a Swiss bank) introduced a “malus policy” providing for the claw-back of bonuses).  

Even before the crisis, the operational complexity and potential for fraudulent dealing within the burgeoning hedge fund segment had led to increased regulation.  

At the inaugural 2008 summit of the “Group of Twenty”, leaders called for the development of best practices to enhance transparency, both at market and counterparty levels, for hedge funds and other systemically significant financial institutions. The G-20’s subsequent declaration of the 2nd of April 2009 also favoured increased regulatory oversight for hedge funds, and for other private capital pools to improve investor protection but also systemic risks management.  

IOSCO’s Technical Committee was established in November 2008 and released its final report outlining six principles for regulation of hedge funds in June 2009. Generally, hedge fund managers must be registered intermediaries and provide regulators with increased disclosure of product leverage, portfolio bets and systemic risk potential. Significantly, prime brokers and credit institutions providing finance to hedge funds are also asked to provide details of credit exposures to the sector, giving regulators early

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194 For further information about developing a framework to address pro-cyclicality within the banking systems see Financial Stability Board 2009 Report.
196 In the US, the SEC issued a rule change requiring companies “managing in excess of USD25 million and over 14 investors” to register with the SEC as of February 2006 under “the US Investment Advisers Act”. For further discussion on US regulation see chapter five of this thesis.
198 For further details see IOSCO Final Report 2009.
warnings of systemic risks build-ups and institutional linkages. The requirement for lenders to disclose their hedge fund exposures should constrain leverage, and this factor (rather than increased transparency of hedge fund bets) is most likely to alter their capacity to move markets. However, recent media reports reveal that regulators are taking a more aggressive attitude in monitoring their activities.\textsuperscript{199}

From an European point of view, the author has to mention that at the end of October (29) 2008, the EC implemented a Communication entitled “\textit{From financial crisis to recovery: A European framework for action}”\textsuperscript{200}. The action plan is structured into three essential elements, notably an innovative financial market construction as far as the EU level is concerned, having to do with the manner in which it affects real economies, an international reply to the ongoing crisis.\textsuperscript{201} The above-mentioned Communication was followed by a second one sent by the EC to the European Council on November 26, 2008, “\textit{A European Economic Recovery Plan}”\textsuperscript{202}. The major aim of this recovery scheme is to rebuild the trust of clients, but also that of business, so that to encourage them to take loans again, increase foreign investments with the help of the EU countries, “create jobs” by hiring the unemployed. The focus of the plan is quite naturally on the macroeconomic situation, but it also sets out action at the EU level in order to increase infrastructure and major industries investments. The entire package equals approximately EUR200 billion, representing 1.5\% of the total GDP\textsuperscript{203} of the EU.\textsuperscript{204}

Regarding more specifically the issue of financial markets and their appropriate supervision, the EC created in October 2008 the “\textit{Group of high level experts}” chaired by Mr. de Larosière. The Group was mandated to consider, \textit{inter alia}, the structure of

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\item[199] According to a \textit{Wall Street Journal} article, the US Justice Department launched an investigation to determine if hedge funds (including Soros Fund Management, SAC, Greenlight and Paulson & Co.) had acted collusively to bet USD8 billion against the EUR during the Greek debt crisis: Pulliman, S. and Kelly, K., “\textit{U.S. Probes Bearysh Euro Bets}”, www.wsj.com, 3 March 2010. In Australia, following the collapse of a fund of hedge funds which affected retail investors, the Australian Securities and Investments Commission (ASIC) has reportedly increased its monitoring and information collection of fund managers, including site visits: Searle, J. and Buhrer, K. “\textit{ASIC Widens Hedge Fund Crackdown}”, \textit{The Australian Financial Review}, 15 March 2010, p. 42.
\item[203] Gross domestic product.
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European financial organisations to guarantee prudential integrity, precise operation of industries, and solid European co-partnership regarding financial stability overlook, instant alert device, but also crisis management, comprising the management of transnational, but also cross-sector risks. The Group presented its Report on February 25th, 2009. The Report includes thirty-one Recommendations on dealing with the causes and effects of the financial crisis at the EU, and at global level. With regard to financial supervision in particular, the Report suggests the establishment of a new body guided by the “European Central Bank” (ECB), which should identify systemic risks and issue binding risk warnings. Regarding the micro-prudential supervision, the Report anticipates a two-stage approach. During the first phase, both the role of the existing Level 3 Committees, and that of national supervisors must be reinforced. During the second phase, the three Level 3 Committees must be changed into the so-called Authorities with highly important goals and far-reaching powers as regards cross-border financial institutions in the EU.

In addition to the actions outlined above, the EC has initiated a general in-depth examination and analysis of the supervising and regulatory set of rules applicable for each important actor and participant in the financial markets, comprising hedge funds and private equity, concentrating mainly on financial requests, risk management, and visibility. The aim of this work is to assess the adequacy of such proposals for the guarantee of financial stability within the EU. The results of these primary reflections were set out in the Communication towards the “Spring European Council”, entitled “Driving European Recovery”, adopted by the EC on March the 4th, 2009. This Communication provides the next investigation to the “European Economic Recovery Plan” of December (2008), addressing a number of measures in the context of the global down-turn of the real economy and the inevitable effects on employment. Under the heading “Restoring and maintaining a stable and reliable financial system”, the Communication refers to main conclusions withdrawn by De Larosière Group and outlines an ambitious time schedule for the adoption by the EC of some legislative proposals within the area of financial services, involving the set up of the necessary legal framework for a new architecture of the EU financial supervisory system.

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It remains to be seen whether future solution will take the form of mere regulatory reforms, such as adaptations to and reinforcement of the current framework while respecting the existing principles, or regulatory revolution, eventually necessary changes to the Treaty. In any case, whatever the legal form and details of the new supervisory approach, all actors involved will have to make one compromise or another, and they have to manifest a willingness to find rapid solutions to the obvious political difficulties that any attempt to move in the direction of more integrated supervision and more shared powers at the Community level can be expected to entail.

2.3 Concluding remarks

In this chapter different sets of regulations applicable to hedge funds aiming the protection of investors, the market integrity and the financial system stability are well-grouped and illustrated.

The relevance of economic activities regulation can only be highlighted if the process takes into account the risks of market failure, which can be limited by regulation without excessively interfering with the associated legitimate advantages. The decision-making process implies whether (and the manner in which) certain given economic activities are supposed to be regulated. During this process, one must also assess not only its risks and advantages, how they correspond to one or more of the financial regulation rationales, but also whether there is any empirical evidence and a wider, lato sensu “philosophical” disagreement regarding the regulation.

Disagreement evidently exists; the question is where does it emerge from? According to analyses performed throughout this chapter, this emerges mainly from the highly ambiguous role of hedge funds in the financial crisis. Following the crash of LTCM in 1998, many dealer-banks requested overall collateralisation of hedge fund undertakings. In agreement with this, hedge funds used to be less levered as compared to credit institutions. Afterwards, the collapse of significant hedge funds, among which one can mention Amaranth in 2006, and the major redemptions by investors during but also after the crisis which did not lead to systemic problems. Furthermore, hedge funds have fewer assets and less leverage as compared to credit institutions. This could diminish
the probability that hedge funds might be a causal agent of any future crisis. In the absence of the systemic risk threat and of an exact delineation of social externalities brought about by hedge funds, the aim of direct hedge fund regulation is not so clear. However, in the light of the above-mentioned events, requests for a tighter regulation start to make sense, as the supervisors started to face four major issues: investors’ protection, transparency, market integrity and risk mitigation.

Regarding the present crisis, the author does not attribute it to the hedge funds. However, the blame belongs to hedge funds in terms of their involvement and responsibility during the crisis, having turned into a whim for the problems that affect many issues regarding financial markets. International regulators examined hedge funds closely and to a great extent, and consequently implemented, alongside other measures, registration requests, limitations on leverage, and increasing disclosure and transparency for protecting investors.

So far, there has been harsh criticism regarding the new regulation in the Dodd-Frank Act due to the fact that it is reactive, but also narrow-minded. Similar criticisms emerged also about the AIFM Directive. As already seen, scholars have suggested a wide range of possible solutions to address the concerns in the debate on hedge funds and hedge fund regulation. Some favour regulatory arbitrage as a measure against systemic failure. Other scholars state that the pre-Dodd-Frank Act approach dealing with allowing advisers to voluntarily register would be the most effective in this respect, proposing an approach based on trust that would let funds having previously earned general trust from the public to develop on the grounds of that trust, with less or no interference of regulation.

The author argues that this debate on the most suitable type of hedge fund regulation appears to be very controversial. The shift of the criteria dealing with hedge funds investments, the appointment of one self-regulatory authority, the application of higher disclosure criteria to counterparties and the increase of leverage limitation as well as of the transparency disclosure are some of the recommendations discussed in this chapter. The author continues her argumentation as regarding the benefit of fees from hedge funds, regulation of hedge fund creditors and the moderation of the mutual funds regulation for the increase of the competitiveness between hedge funds.
Thus, the author of this thesis states that hedge funds regulators worldwide face an increasing dichotomy. The major concern of the regulators is the investors’ protection in conjunction with making sure that the industry is operating properly. With this in mind, regulators try not to tightly regulate the industry while tailoring measures and recommendations for avoiding systemic risks.

One very frequently mentioned argument of individuals against each type of external intervention in the industry processes is that not all types of regulation are compatible with the hedge fund industry basic role and characteristics. This is the main reason to presume that regulation would be bound to affect negatively their development and performance, not in terms of the imminent growth in compliance costs entailed by its introduction.

Other often cited argument opposing to regulation of the industry consists of the fact that normative compulsion might dissuade hedge funds or their managers from locating in the EU, forcing them to leave Europe in order to find locations that are more “favourable”. In the event that this might happen, the argument further develops as follows: regulatory arbitrage\textsuperscript{207} would be reinforced and the sector’s effective supervision diminished. Finally, the argument continues as regulating the industry would not serve a meaningful function, as the purpose of each normative initiative would prove unsuccessful in covering offshore hedge fund jurisdictions, regardless of the “extra-territorial” nature of its consequence.

On the other side, a professor experienced in financial law notes that: “We should also beware of the excesses of regulation and the dangers of over-regulating a given sector or type of institutions, creating incentives for businesses to move outside the regulatory framework. Any regulatory perimeter brings its own shadows and loopholes\textsuperscript{208}.


Considering the arguments stated above in this chapter, hedge fund regulation appears not only as a necessity, but also as a wise issue. From the author’s point of view, moderation and good sense should prevail, and therefore, nothing would come to indicate that this kind of implementation could prove unfeasible. There is one major aspect that should not be overseen: if this emerging chance to eventually implement harmonised norms applicable to on-shore hedge funds had been offered as a consequence of an important European or global financial crisis a priori their operation and if its norms had not been the result of observation but rather, the outcome of extreme hurry, together with urgency in the aftermath of the disorderly unwinding of the positions of one or more hedge funds, it is likely that moderation or sound judgement would not prevail within their structure. Moreover, the regulatory process could become a scapegoat to the caprices of political tensions, together with the vagaries of public perceptions regarding the image of ideal hedge fund regulatory overview.209

Current efforts aiming at regulating hedge funds through their registration with regulators together with requesting disclosure of pertinent data might aid minimizing moral hazard, social externalities, and systemic risk that the hedge fund industry is generating, making all the efforts to improve investor protection. So far, hedge funds’ involvement in the ongoing financial crisis is still not clear. In this respect, dissymmetric hedge fund regulation emerging from the Dodd-Frank Act together with the AIFM Directive becomes in the author’s perspective disadvantageous and even undermining, this requiring a global regulation of hedge funds with major attention on investor protection.

From a global point of view, the AIFM Directive might develop incentives for regulatory arbitrage, might lead to retaliatory action by states from outside the EU and might lead to the achieving of an appropriate level of investor protection. In the long term, this might prove counterproductive for the competitiveness of the EU alternative investment community in conjunction with financial markets in Europe, while keeping an adequate standard of protection of investors’ interests. In this regard, the author of the thesis considers that investors would benefit in terms of protection from the AIFM

Directive mainly because of the disclosure and operational requirements that it stipulates. Thus, this disclosure would not only provide investors with up-to-date material data about their funds, but at the same time would also offer features of the potential conflicts of interests and risk factors the investors could be subjected to.

In the Dodd-Frank Act, the SEC received the authorisation from the Congress to adopt norms in order to interpret the exemptions for hedge funds. The SEC needs to use its discretion to provide the vital-needed guiding. In the author’s opinion, many of the regulatory dilemmas in the AIFM Directive, but also in the Dodd-Frank Act might have been prevented or even entirely avoided if the Basel Committee had introduced a fee for credit institutions’ lending exposure to hedge funds. Basel III capital requests that credit institutions implement a fee for banks’ assets according to their systemic risk contribution. The Basel III measure for hedge fund lending exposure could have been associated with a focus on the exposure of credit institutions to complex financial products. This might prove of great benefit in addressing the connection between market failure in terms of financial instruments, and in augmenting the significance of hedge funds within the market for financial instruments.

Due to these reasons, the author acknowledges the cross-border nature of the hedge funds sector and therefore the need to create a harmonised international hedge funds regulation regime.

As a concluding remark, the governments, central banks, but also every regulating authority need to choose between the effectiveness of a regulation, on the one hand and the price implied in complying with it, on the other hand. As far as the hedge funds sector is concerned, an investment area careful to watchdogs after decades of being unregulated, regulators will have to convince fund managers that a continuous free in/out data flow, together with open communication are of major importance, and that active intervention will occur if market stability and investor protection are at risk.

Therefore, the greatest challenge that regulators will have to face is finding an ideal suitable manner to increase compliance in conjunction with investors’ protection without forcing hedge fund managers to move to unregulated jurisdictions.
In the author’s opinion, the trend towards the new architecture of financial regulation has three similar ways with important different characteristics referring to the US, the UK and the EU financial regulatory frameworks.
CHAPTER THREE

REGULATION OF HEDGE FUNDS IN THE EU

3.1 Introduction

As the primary source of harmonised rules relevant to hedge funds, the current European regulatory framework representing comprises: the “Undertakings for Collective Investment in Transferable Securities” (UCITS) Directives and the “Markets in Financial Instruments Directive” (MiFID) together with the “Alternative Investment Fund Managers” (AIFM Directive). The following sections examine how the contemporary UCITS Directives from the first until its last version UCITS V, and the MiFID and AIFM Directives together with a number of other Community legal acts, could affect first of all, investor protection, then, the marketing and distribution of hedge fund shares and units and the activities of their managers and last, the shaping of the European hedge fund industry’s regulatory future as a result of their evolution and implementation. Hence, the major aim of this chapter is to study the latest evolutions in terms of regulatory integration of the EU economic market analyzing mainly the protection of investors’ rights.

This chapter is organised as follows: first, it explains the dynamics of the financial security structure within the EU in connection to the European regulatory framework, more precisely, an overview of the UCITS Directives, focusing on investor protection. This section also explains the European law evolution from the single market concept, the Single European Act, to the Lamfalussy framework and De Larosière Report.

The next section deals with valuable information learned from the financial crisis, it addresses the main recent regulatory reforming trends and assesses investor’s interests protection, but also the UCITS Directives. The third part presents the UCITS IV Directive and the proposed UCITS V Directive. The fourth section presents a critical overview of “the AIFM Directive”. The fifth and the sixth parts focus generally on the
MiFID Directive components in relation with funds regulation. The analysis of the AIFM Directive approved in the turmoil of the recent financial crisis is valuable in order to comprehend the new rules regarding hedge funds in the European market. The impact of this Directive on the hedge fund sector and particularly on investor protection is the main reason for the author’s decision to provide an overview of the critical evaluation of the Directive. This review includes also several critical analyses, which exceed the mere presentation of the legislative integration operation. After examining other sources of Community legal rules regarding the protection of investing parties within the regulation of hedge funds, the chapter ends with some concluding remarks. Due to the fact that the progressing depression is most likely to govern the future rounds of regulatory integration, several major compulsory challenges will be outlined in the last part.

The chapter points out that the major objective of the reform is in line with that of the thesis theme, namely the creation of uniform market conditions across the EU (although the thesis addresses the making of uniform market conditions at the international level), by increasing investor protection, investor confidence and the safeguard of the UCITS market integrity worldwide.

3.2 The European regulatory framework: an overview of the UCITS Directives

The regulatory integration includes several phases. The first lasts until 2001, and this is the single market phase, followed by the harmonisation process and afterwards by the shift to a collective admission procedure. Still, during the same year, the Lamfalussy process occurred, which represented a significant “institutional innovation within the EU”\(^2\).

Secondly, until the adoption of the Lamfalussy procedure, the EU policy focused on the adoption of directives stipulating regulatory rules, but the supervision necessity appeared with the Lamfalussy procedure. The Lamfalussy committees set up a

regulatory framework and engaged in the supervisory practices process that would ensure the consistent enforcement of EU regulations in all EU Member States.\textsuperscript{211}

Thirdly, the thesis also considered the crisis management. “A High Level Group” presided by Jacques De Larosière was established by the “European Commission” (EC) in October 2008. This group had the power to propose recommendations to improve the EU financial supervision arrangements in the context of the financial crisis.\textsuperscript{212}

This subsection is structured chronologically and follows the phases presented above. For the general overview of each regulatory phase, relevant regulatory policy contexts were summarised and the most important directives approved during the given period were noted. Exclusive consideration was given to the Lamfalussy procedure and to the De Larosière Report.

The author starts her analysis with the single market concept, initiated in 1985, when the EC’s White Paper introduced the single market approach to financial services\textsuperscript{213}. This document included political availability to undertake economic reformation, in the sense of market liberalisation, and additional market integration in the EU.\textsuperscript{214} Later on, the framework for EMU\textsuperscript{215} and the single currency framework were developed by the Maastricht Treaty of 1992. This also involved the establishment of the ECB and the “European System of Central Banks” (ESCB).\textsuperscript{216}

In the summer of 2000, the Lamfalussy Committee issued several assessments regarding the regulatory adoption for securities as “mechanisms for regulating securities markets and practices to ensure: timely adjustments, faster convergence and better cooperation.”\textsuperscript{217}

The Lamfalussy Committee distinguished between the legislation framework and its enforcing rules and the reallocated responsibility for each of them, by a four-level

\textsuperscript{215} European Market Union.
governance mechanism. They include old and new bodies, which would eventually determine the implementation of better communication between the EU and the national bodies dealing with financial regulations. This process was introduced in 2001 in the securities field. Four years later, it expanded to banking and insurance.\textsuperscript{218} Due to “the Lamfalussy” report, a new European regulatory framework regarding the single financial market was set up in 2003. The current organisational framework would represent the basis of this regulatory system and this would not involve any abilities transfer or any Treaty alteration.

The High-Level Group\textsuperscript{219} appointed by the EC, issued a report on the 25\textsuperscript{th} of February 2009\textsuperscript{220}, recommending 31 measures necessary to establish the “European Financial Supervisory Architecture.” Accordingly, EC\textsuperscript{221} (2009) proposed the reform of “the European financial supervisory” framework, with the implementation of two pillars: Pillar I – “European Systemic Risk Council” (ESRC)” and Pillar II – the “European System of Financial Supervisors” (ESFS).

Even nowadays, EU Member States have a decentralised prudential monitoring, based on the home-country supervision key element, combined with prior regulatory harmonisation-related mutual recognition.\textsuperscript{222}

The 4\textsuperscript{th} Framework Directives of the Lamfalussy Process represented one step forward in pledging for an effective and active operation of the EU’s securities sector. Several directives and regulations have been enacted since and further shifts have been proposed by now.

“The UCITS”\textsuperscript{223} represents a group of “European Directives” whose purpose is to let “Collective Investment Schemes” function within the EU without restriction due to one

“authorisation” provided by a Member State. Indeed, several Member States have introduced secondary regulatory requirements limiting the independent process of hedge funds so that to ensure the protection of local asset managers.224

This subsection of the chapter provides an overview of the UCITS Directives framework as the author will first explain its origins and evolution until the UCITS IV version of the directive. UCITS II refers to the UCITS reform from the ‘90s that was never adopted. Several scholars considered “that the management company directive was UCITS II with the product directive as UCITS III225”. A separate subsection is dedicated to the latest version of the directive, the proposed UCITS V Directive now, promoting significant changes to the UCITS framework.

The original UCITS I Directive aimed to integrate the European sector for investment funds, with advantages for investors, and expansive entrepreneurial advantages for asset managers. One main priority was to enable the distribution of a previously authorised fund within an EU country in another country. A “product passport” was implemented.226 The regulation of investment services would be dominated by the regulatory passport in the securities regulation field, using the UCITS I Directive as a model.227

Three main ideas influence the financial governance of the EU: “harmonisation of rules, mutual recognition and national supervision.”228 Home country control and the single passport are the key pillars accompanying harmonisation and mutual recognition.

From an organisational point of view, some academicians pointed out that supervisory authorities’ collaboration represented a normal repercussion after the establishment of similar norms at the EU level. This is mainly due to the existence of a necessity to

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implement EC\textsuperscript{229} norms uniformly, and secondary, to the growing number of transnational exchanges motivations for cross-border mutual actions to prevent undertaking from breaking away of prudential surveillance.\textsuperscript{230}

Theory proved different from practice because of the particular marketing standards from every EU state, leading to impediments for UCITS cross-border marketing. Moreover, the restrictive manner of defining investments enabled UCITS to reduce their overall marketing possibilities. New proposals were released in the 1990s to correct the 1985 Directive in harmonisation of European regulations. Although they lead towards the making of a draft UCITS II Directive, these debates were not continued because they were excessively ambitious at that moment when the Council of Ministers could not reach a common viewpoint.\textsuperscript{231}

In the summer of 1998, more precisely in July, the EC released an innovative recommendation, which included two sections (a product and a service provider recommendation), meant to rectify “the 1985 Directive”, adopted in December 2001 (“UCITS III”). This is composed of:


The first intends to offer “the European passport” to the fund corporations, in order to provide them the ability to freely perform inside the EU, thus expanding previously permitted processes. Similarly, it introduces another concept: that of a “simplified prospectus”, defined as a form made easier for assisting the transnational selling of UCITS all over Europe.\textsuperscript{232}

Both the above-mentioned directives were designed to improve investor protection by regulating the management companies managing UCITS and by enhancing the

\textsuperscript{229} European Commission.
regulation of UCITS, under the form of investment entities designating the same management entity. Based on Article 47(2), its primary purpose, however, was the implementation of management company market access conditions, operating controls and prudential safeguards.233

The core scope of the “Product Directive” consists in removing transnational limitations for the exchange of collective investment funds units by enabling them to invest in a larger system of financial tools.

Currently, products similar to hedge funds have the possibility to acquire pan-European passports. This is available now through the adoption of UCITS III among the EU’s regulations. This simple fact that such passport is available ought to diminish significantly all impediments towards cost-effectiveness retail transnational distribution of these products.234

The UCITS III Directive aims to promote the free movement of collective investment schemes and to make it easier for a CIS235 located in an EU country to trade its units in other EU countries. Article 47(2) EC (former Article 57(2) EC), setting the basis of the Directive is part of the Treaty’s free movement structure and it is designated to facilitate the freedom of establishment.

The Directive stipulates that UCITS can be established in two forms: investment companies or unit trusts236, depending on whether they are in a corporate form. Three entirely individual entities compose a unit trust under the Directive: the capital rose from unit-holders; the management company administering the trust’s assets and marketing the trust; and the depositary with custody of the trust’s assets.

Greater inter-relations of securities markets are fostered by the Directive, by granting a UCITS regulatory passport to act cross-border in the EU (in host Member States),

235 Collective Investment Scheme.
236 “Unit trusts” as regulated by the Directive are not limited to trust structures. The Directive includes contractual arrangements such as common funds or fonds commun de placement under the umbrella of unit trusts. The defining feature of a unit trust in this context is that the common fund or the trust is managed by a management company.
without further regulations except the local marketing rules, if authorised by the Member State of its location (home of the EU Member) according to the Directive. Article 4(1) provides that a UCITS is unable to perform any activities without previous authorisation from the EU country where it is located. Once the authorisation is granted, it is available for all Member States.

3.3 Regulation of hedge funds and the UCITS regime

The main goal established by “the UCITS Directive” resides in providing an universal regulatory context capable of enabling harmonised and open-ended CIS, hence facilitating the “free” pursuance of business within the EU and the marketing of their shares or units. This can be performed based on a single authorisation issued by the competent “home” Member States authorities. This effect of the UCITS “product passport” was undermined through the diverging interpretation and implementation by its addressees with regard to several of its provisions on the one hand, and through the lack of a unified marketing regime, on the other hand, with severe restrictions pertaining the type of assets that UCITS could invest in the diverse Member State and tax regimes for retail funds. As a result, the ensemble of such provisions has led to the obstruction of the establishment of an effective Single Market for designated asset management products.

In the early 1990s, the proposals issued by the EC to help overcome these shortcomings\(^\text{237}\) did not reach their scope until January 2002, when the European Council finally approved two modernising directives: “the Product Directive”\(^\text{238}\) and “the Management Directive”\(^\text{239}\) (jointly, “UCITS III”).

A major effect of the Product Directive has been the extended scale of eligible UCITS investments, and consequently of those UCITS funds marketed on a cross-border basis.


The introduction of the Management Directive, on the other side, has brought about a single “European passport” providing the UCITS management companies the possibility to expand activities in EU countries, others than those of their establishment, subject to conditions similar to those applicable to investment services firms under the Investment Service Directive.\textsuperscript{240}

Notwithstanding the increase in the list of UCITS investments, the combination of individual strategic mechanisms pursued by alternative investment vehicles under the UCITS roof, the theoretical similarities between UCITS and non-harmonised funds, and the gradual convergence of their respective investment strategies\textsuperscript{241}, hedge funds continue to be excluded from the harmonised funds’ framework.

The present version of the UCITS III discipline does not allow genuine short positions\textsuperscript{242}, preventing the establishment of onshore, UCITS - compliant hedge fund-type vehicles. Consequently, the UCITS framework might influence the European hedge funds in light of its evolution impetus and subsequent indirect “institutionalisation” of investments in onshore hedge funds. The main implication of the UCITS funds investment discretion widening is indirect, with the lately regulatory modifications having brought within the reach of UCITS fund managers derivatives trading and, indirectly, leverage, enabling them to offer retail investors partial benefits of sophisticated portfolio diversification (through funds of hedge funds investing) and higher returns promises (through recourse to derivatives)\textsuperscript{243}.

\textsuperscript{240} Council Directive (EEC) 93/22, [1993] OJ L141/27. The ISD, covering some of the same area as the MiFID was repealed on 1 November 2007, the date of the MiFID’s entry into force.
\textsuperscript{241} The trend towards enhanced convergence of mutual and hedge funds has been particularly pronounced in Europe since the adoption of the UCITS III (Alternative Investment Expert Group, “Managing, Servicing and Marketing Hedge Funds in Europe”, Report, 2006).
\textsuperscript{242} Article 19(1)(g) from the revised UCITS Directive allows for the creation of “synthetic” short equity positions, permitting funds to run short derivative positions on equities provide, however, that these are cash-settled. To establish such positions, a UCITS manager could either buy a put option on a particular security and hold cash on cover (instead of holding the specific underlying security) or, alternatively, make use of an equity swap. By simultaneously increasing the fund’s leverage on the long side, a UCITS fund manager could, \textit{de facto}, replicate a long/short strategy (incurring, nevertheless, the relevant transaction costs).
\textsuperscript{243} “The changing composition of eligible UCITS investments is linked to the increasing penetration of hedge fund investment and risk management “techniques” in the traditional asset management industry and to the impact of changing investment trends and investor demands on the regulatory treatment of UCITS funds. A report for the European Commission has found that the effect of hedge funds on the classical asset management market extends beyond the mere demand-side substitution effect and has encouraged traditional asset managers to adapt their business models in accordance with the hedge fund paradigm” (Oxera Consulting, “Current Trends in Asset Mangement”, Report, October 2006, 46).
Recent surveys regarding definition of UCITS “eligible assets”, further to Article 2 of the product Directive, outlined an insertion opportunity of additional hedge fund-related features in the revised UCITS framework. Moreover, they highlighted ways to distribute indirectly non-harmonised products, like hedge funds, on an EU-wide basis, as eligible UCITS assets. One must also specify that the definition of eligible assets was considered one of the most problematic part of UCITS III, this being the main reason for the adoption of a Commission implementing directive to address this weak point of the revised harmonised funds’ framework.

Although the original scope did not relate to hedge funds, the “Committee of European Securities Regulators” CESR) (now substituted by the newly created “European Banking Authority” (EBA) operating as of the 1st of January 2011) – already involved in the Directive implementation process of the EC – examined the issue of the inclusion of credit derivatives in the amended UCITS framework and, more significantly for the purpose of the present research, of hedge fund indices (HFIs). Despite the fact that the Product Directive acknowledged “index tracking” as a legitimate investment management option for UCITS funds, in its last recommendation on the understanding of concepts regarding “eligible assets for UCITS” investments, CESR reserved its viewpoint on the issue of their eligibility as UCITS-compliant “financial indices.” Such instance was subsequently approached in a CESR “issues paper”.

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244 “As a commentator has observed, the possibility of a pan-European distribution of hedge funds has indirectly surfaced with the implementation of UCITS III and, more specifically, during the consultation phase organised by the Committee of European Security Regulators regarding the eligible assets of the UCITS III funds” (L’Habitant, Francois-Serge, “Hedge Fund Indices for Retail Investors : UCITS Eligible or not Eligible?” Swiss Finance Institute Research Paper Series 2006/14, July 2006, 2).


247 The Product Directive provided little guidance on the eligibility of specific derivative instruments. The importance attributed by the Commission to avoiding potential inconsistencies between Member States on the use of derivatives as UCITS eligible assets and to the correct implementation of the Product Directive is clear from a Commission Recommendation (EC) 2004/383 regarding “the use of financial derivative instruments” for UCITS [2004] OJ L144/33, followed by a July 2005 CESR report on its implementation (Ref: CESR/05-302b).

248 The recent Commission implementing directive qualified, in recital 11, the issue of a clarification of the state of play with regard to derivatives on financial indices as “particularly pressing” (Commission Directive (EC) 2007/16, n.237).

249 UCITS Directive, Articles 19(1)(g) and Article 21(3). These provide that harmonised “funds may invest in several instruments, including derivative instruments on financial indices if these indices full fill some minimum criteria.”

250 CESR, “Advice to the European Commission on the Clarification of Definitions Concerning Eligible Assets for Investments in UCITS”, CESR/06-005, January 2006, para. 158 et seq. To include HFIs in the list of UCITS eligible assets means that “any non-approved offshore hedge fund could be distributed
whose publication has led to a consultation addressing the criteria under which HFIs might be subjected to UCITS III definition regarding “financial indices.” However, in its feedback statement, CESR did confirm HFIs as eligible assets in case they fulfil the common criteria specified by Article 9 of the Directive 2007/16/EC\textsuperscript{252}, with several secondary requirements concerning index methodology and information disclosure. The implications of the increase of the HFIs from UCITS funds must be understood by the remainder of the analysis, first for the investing policy of harmonised funds and second, for the larger acceptability of the onshore hedge fund industry.

3.4 The UCITS IV Directive

UCITS IV stands as a major step forward to the achievement of a single market for financial products. This might change the asset management industry in a manner similar to that of MiFID changing the broker-dealers and investment credit institutions.\textsuperscript{253} Since 1985 when they appeared, until their later modifications six years later, UCITS funds have turned into an international brand, as they became well known for their adjustability and reliability.

Today, the organisational structure of the European fund market is sub-optimal. For instance, there were 36,935 UCITS funds in Europe in 2009 (according to EFAMA\textsuperscript{254}). Still, the medium size of the European fund market reached USD183 million, this being very little compared to American mutual funds, which was USD1,269 million according to the Investment Company Institute. Similarly, more than 65\% of the net assets of the European funds/sub-funds reached maximum EUR50 million. This amount represented less than a third of the medium worth held by an American fund.\textsuperscript{255}

\textsuperscript{251} CESR “Can Hedge Fund Indices Be Classified as Financial Indices for the Purposes of UCITS?”, Ref: CESR/05-530, October 2006. The issues paper sought the “views of market participants on questions concerning the ability of hedge fund indices to fall within the definition of financial indices contained in UCITS III.”


\textsuperscript{254} European Funds and Asset Manager Association.

The new measures included in the UCITS IV Directive will enable the freely operation of asset managers within Europe based on a single authorisation received from an EU Member State. Accordingly, the aim of the UCITS IV is the increase of the efficiency/investor protection as well as of the flexibility of the European fund industry, reducing administrative burden at lower total costs. The figure below presents the three objectives and five topics of UCITS IV:

![Figure 3. Objectives and topics of UCITS IV](image)

By its five essential measures, the Directive will favour fund mergers and master-feeder structures on the one hand, and will enable centralised fund management throughout Europe on the other hand. At the same time, this will also shorten the time available for asset managers to inform regulators of new products.

Since 2005, market conditions have significantly changed. Due to the serious ongoing crisis, the worth of equities and of other asset structures greatly decreased. Complicated financial products became clearer, risk was avoided and opportunistic alternative investments were much looked for. Currently, pressure is placed on asset managers who earn less as subscriptions slow down, assets perform inappropriately, while expenses increase. An expenses-cut simulation alone is not enough. Asset managers are forced to

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256 Ibid.
reposition themselves strategically, but they must also restructure their expenditure base.\textsuperscript{257} They have to consider the best practices of using the new legislation.

UCITS IV provides support to asset managers in reshaping their fund strategy. The Directive provides not only the reduction of costs, but also “new business opportunities: in cross-border fund distribution and leveraging the UCITS vehicle for fresh investment strategies.”\textsuperscript{258} Asset managers have to make important decisions regarding the classes of investors they should pay attention to, either within or outside the EU.\textsuperscript{259}

The definition of the new UCITS Directive’s depositary importance does not change from that of UCITS III, as this still remains in the fund’s domicile. Additionally, their role has been emphasized in the light of current considerable credit institution failure and fraudulent activities. Hence, the EC’s AIFM Directive tends to impose that a depositary employment for every particular fund is necessary, not only for UCITS. Those debates can lead to an increase of the degree of the depositaries’ liabilities, which might further result in higher costs. The “AIFM Directive’s depositary returns create at present intense debate in the alternatives industry.”\textsuperscript{260}

As stated above, the forth version of the UCITS Directive represents a courageous move to a single market for financial products from Europe. Every measure gathered in the provisions of the Directive under debate has been meant for the reinforcement of the competitiveness of the hedge funds industry in Europe.\textsuperscript{261} The buy-side is going to change, in a similar manner as the “MiFID” made for the sell-side. The transnational distribution of funds and activities represents the Directive’s key concept. This should enable the transnational distribution of funds\textsuperscript{262}, and it should also ensure higher protection to the investor.

\textsuperscript{257} Mertzanis, Harilaos, “The UCITS IV Directive, The Need for Rationalization, and Master-Feeder Structures”, Workshop on master-feeder funds and key investor information, Ref: 44408, Capital Markets Board of Turkey Ankara, 7 April, 2011
\textsuperscript{259} Ibid.
\textsuperscript{262} Cumming, Douglas, Imad'Eddine, Gael, Schwienbacher, Armin, The European Journal of Finance, Volume 18, Numbers 3-4, 1 April 2012 , pp. 261-292(32), Publisher: Routledge, part of the Taylor & Francis Group.
3.4.1 *The management company passport*

Another important measure to increase efficiency enforced by the UCITS IV Directive refers to the asset management entity Pan-European passport. This passport enables a management company to provide the UCITS funds a wide variety of collective portfolio services, while these funds are registered in a different EU country, without necessarily being entirely set up in another EU country. There are two ways to do this. The first is on a full/remote basis. The second is through setting up a secondary office where the UCITS are domiciled. Regardless of the chosen option, the management company will be forced to move not only the managerial, but also the accounting departments to the UCITS domicile location.

The controlling responsibilities need to split between the home regulator of the management firm and that of the fund, as below:

(i) The regulator in the UCITS fund home location will control all facets related to the authorisation, and operation of the fund;

(ii) The compliance of the management entity to all rules of its EU home country is compulsory;

(iii) The compliance of the management company regarding all facets from the administrative and accounting tasks to the regulations of the fund’s domicile, comprising those related to the net asset valuation is compulsory.263

3.4.2 “Master-feeder fund structures” – pooling

“Master-feeder structures” are meant to bring an increase to the performance of the sector, by reducing the products selling cost made possible by the large size of the business. The performance is also increased by pooling of master as well as feeder fund assets. A secondary advantage resides in fostering cross-border funds trade. The feeder fund is forced to invest minimum 85% of its assets in entities of a single master UCITS fund, while the rest of 15% must be placed in other current assets or derivative

instruments, excepting the case when the derivatives tend to be employed for hedging. In addition, it is compulsory that master funds are UCITS funds, as these do not have permission to be another feeder funds. Similarly, master funds do not have permission to invest in/hold units in feeder funds. Besides, “the investors in the master fund can be feeder funds and/or direct unit holders of the master fund.”

3.4.3 Key investor information

The simplified prospectus needs to be replaced for the improvement of investor protection through better cost disclosures.

The new proposal stipulates that the asset management company has not only to disclose a paper of two pages containing “Key Investor Information” (KII) expressed in a nontechnical manner, in the specific language employed by the distribution state, but this needs to be intelligible so that the investors are enabled to draw comparisons. Therefore, this KII needs to be “clear, understandable and not misleading.”

3.4.4 UCITS supervision

Wishing to eliminate administrative barriers and interruptions, and to make sure that all instruments are applicable, this new Directive brings around complex proposals to increase collaboration between national and overseas authorities. For instance, they are adopting proposals such as instant examinations, but also checks and a process for transferring data between regulators. Therefore, regulators are able to exercise surveillance but also examine powers, in cooperation with other officials, through delegation or via the regulatory system. The author’s firm opinion is that, if nothing were done on harmonising the regulation of hedge funds, investor confidence in the safety of assets invested through a collective investment vehicle would remain shattered.

The UCITS supervision aims to address lessons learned from the financial crisis, relating mainly to the Madoff incident which highlighted several issues dealing with the

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264 Ibidem.
265 Ibidem.
inconsistency of regulation existing between “Member States” in enforcing the provisions of the UCITS Directive.

### 3.4.5 Conclusions

The UCITS IV Directive is meant to lead to the performance development of the asset management industry for the increase of EU competitiveness. Undoubtedly, the Directive will lead to a change of the present situation of asset management firms, as these are structured in vertical set-ups to a structure where the set-ups are rather pan-European, centralised but also horizontal. Currently, asset managers distributing in six EU states, are forced to have six different management firms, administer six different funds and employ six various depositaries. According to UCITS IV, this situation changes as for the same distribution coverage, a single management entity, two funds, two feeder funds or four depositaries may be owned by the same asset manager.\(^{266}\)

Advantages for asset managers will differ from one state to another in terms of asset manager entrepreneurial standard and dimension. Alternatives will flourish coming from different markets influenced by the local community and tax system. Asset managers need to know how to consider their investors’ needs and their own organisations’ features when approaching each country. Each country will continue to have specific accounting rules, tax treatment and regulatory reporting and that is exactly why the regional monitoring of asset-servicing providers is going to be highly pursued.\(^{267}\)

Asset managers need to take advantages from the UCITS IV Directive, and therefore they need to approach it from a strategic point of view. First, if they deal not only with UCITS but also with non-UCITS, they need to focus on resemblances as well as on dissimilarities brought forth by the AIFM Directive and the UCITS Directives, in order to enable regulatory arbitrage. Besides, local knowledge should not be underrated. Most of the time, a global view but also a local expertise is needed in order to choose the

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\(^{266}\) Ibidem.  
adoption of the best strategy, no matter if the asset manager is developing across - or rationalising in – Europe.

Further on, the Legislative framework of UCITS IV will be presented as a timeline:
Figure 4. Legislative framework UCITS IV
Source: ALFI, 2012, author's analysis
The EC newly published consultation document dating from 26 of July 2012, “Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments”, recognises that there were several measures introduced under UCITS IV that do not operate as expected. In this respect, through this consultation paper, the EC emphasizes some specific areas where further enhancement may be appropriate, *inter alia*: (a) recommending more detailed organisational norms for self-managed organisations; (b) some modifications to the dynamics of operating master feeder structures; (c) certain changes to the mechanics of operating fund mergers; and (d) several improvement revisions of the transnational notification procedures.

### 3.5 The proposed UCITS V Directive

Towards the middle of the year 2012, more precisely in July, a recommendation for reviewing the UCITS regime was published by the EC concerning depositary functions, payment principles but also penalties concerning the UCITS (UCITS V).

Overall recommended proposals in addition to the already existing UCITS regime are directed towards the lessons learned from the financial crises, especially connected to the Madoff’s fraud, which revealed several problems concerning lack of consistency between the Member States regarding the application of the UCITS Directive provisions. The main goal related to the reform consists in creating uniform market facilities within the EU, thus generating the increase of the investors’ protection, which leads to the increase of the investors’ reliability but also to the UCITS sector’s integrity protection at international level.

The UCITS V Directive has the purpose to adapt the UCITS to the depositary and the AIFM Directive provisions regarding the remuneration and to contain a harmonised clearance framework. The harmonised UCITS policy overlooked the fundamentals of remuneration and sanctions compatible with other financial services fields.

Thus, there are several main objectives of the UCITS V Directive, respectively: (a) clear understanding of the “UCITS depositary’s functions” and “liability in circumstances where assets are lost in custody, (b) rules governing remuneration policies which
UCITS will be obliged to introduce and (c) the harmonisation of the minimum administrative sanctions regime across the Member States."  \(^{268}\)

The UCITS V legislative timeline is as it follows:

![UCITS V legislative timeline](http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-proposal_en.pdf)

During the summer of 2012, on the 26\(^{th}\) of July, the EC issued a consultation paper under the name of “Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments”. This paper would improve, by means of adjustment, every further amendment to the UCITS regime forming at the same time the basis of “UCITS VI” to build on and revise the newly introduced UCITS IV, as well as the forthcoming UCITS V.

The above-mentioned consultation represents the beginning of a process for UCITS regime shifts whose process of becoming effective would last at least two years (or even more). However, one should take into account that there is a certain disillusion in the industry regarding the forthcoming changes to the UCITS regulation recommended by the EC before the completion of the UCITS V Directive. Nevertheless, a positive part of this initiative consists of the fact that the EC formulated this initial stage of UCITS VI as a consultation, asking questions on ways of enhancing the present model. Still, the industry participants are presumably inclined to judge severely and find faults. On the other hand, the result might indeed produce positive outcomes that favour the industry in conjunction with investors.

3.5.1 Depositaries

Eligibility Criteria

The present UCITS overview does not offer much clarity regarding those entities which are allowed to behave like UCITS depositaries and therefore gives a certain degree of discretion to the Member States in this regard. This has led to divergent approaches across the EU. The UCITS V Directive draft provides that only two types of companies are going to be capable of acting as UCITS depositaries, respectively:

(i) EU certified banks;

(ii) investment entities authorised by MiFID, which provide safekeeping and administration services. The draft contains a two-year grandfathering period during which UCITS will be allowed to use a non-compliant depositary. However, these provisions are not final and the funds industry intends to propose additional eligible depositaries categories to be included as per the AIFM Directive and the Irish Central Bank’s rules for UCITS and non-UCITS.

3.5.2 Delegation of custody

Nowadays, UCITS invest by far in more states using also more elaborated instruments as compared to 1985. This increases the obligation of appointing sub-custodians in various jurisdictions. The EC notes that the current UCITS framework lacks clarity in relation to the conditions that apply to the delegation of custody to sub-custodians. In this context, new due diligence and current controlling requirements are introduced. Consequently, the draft of the Directive stipulates the concepts upon which the assurance obligations of the depositary may be entrusted to a tutor. Moreover, the UCITS depositaries can hand over their safekeeping obligations to third parties under certain conditions and requirements compliant with those applicable to the AIFM Directive.269 Similarly, one needs to mention that, in case of the securities held by a delegate in a state of insolvency of a safekeeping, it will not be available for distribution to their creditors. According to the UCITS V Directive draft, the EC holds the power to

further define the first but also continuous due diligence obligations of the depositary. The above-mentioned duties include also the aspects related to the selection and appointment of a sub-custodian.\(^{270}\)

3.5.3 Liability

The existing loss commitment standard of a monetary tool under custodianship resides in its emergence in cases of failure justification impossibility in performing duties or performances related to unsuitable obligations. These norms have been interpreted differently in various Member States, which has lead to diverging levels of investor protection. The draft UCITS V Directive implements a rigorous liability criterion forcing depositaries to give back financial tools lost in custody, regardless of the fact they were lost due to fault or neglect, except those losses caused by an outsider event beyond the depositary’s rational supervising.\(^{271}\) Depositaries will remain liable for the loss of assets in cases where safekeeping duties have been entrusted to third parties. Accordingly, the draft UCITS V Directive, in contrast to the AIFM Directive, makes the depositary responsible for the return of the financial tool, despite the loss occurred to the sub-custodian, without the possibility to discharge the liability by contract.

3.5.4 Prospectus disclosure

The inclusion of a characterisation of any safekeeping functions that the depositary entrusted in favour of a third party within the UCITS prospectus was proposed. Such disclosure will be required to identify the representative but also additional “conflicts of interest” which might occur due to the delegation. While this provision corresponds to the disclosure requirement included in the AIFM Directive in terms of the required disclosure level, it goes further in requiring that this information be provided in the prospectus of a UCITS, not that it simply be provided to investors, as stated in the


AIFM Directive. This provision will pose both practical and operational challenges and, as such, will be the subject of intense lobbying by industry bodies, such as the IFIA\textsuperscript{272}.

### 3.5.5 Remuneration of UCITS Managers

The EC proposes the introduction of a requirement for UCITS management companies to adopt “remuneration policies consistent with sound risk management”\textsuperscript{273}, which discourages disproportionate exposure to risk. Increased risk exposes investors to greater possible losses, which could be presumed due to the risk profile disclosed to the investors. These policies and practices will apply not only to senior management, but also to those persons who affect the risk profile of the Management Company or UCITS through their services. These provisions of the draft Directive correspond to the relevant provisions of the AIFM Directive. The EC has not confirmed if the requirement to implement the remuneration policies described in the draft Directive will be applicable when a self-managed UCITS or UCITS management entity receives no asset-based tax.

### 3.5.6 Administrative Sanctions

After investigating the national norms regarding penalties for infringements of the UCITS Directive, the EC has concluded that there is a significant divergence between jurisdictions, both regarding the criteria applied to issuing sanctions and the level of sanctions applied to specific breaches. The draft UCITS V Directive requires that Member States of the EU invest their regulatory bodies with power, as well with the diversified inspecting powers but also administrative penalties set out in the draft Directive covering a range of breaches of regulatory provisions. The draft proposes harmonisation of the sanctioning regimes by requiring the national regulators to introduce catalogues of sanctions and other punitive measures, and lists of sanctioning criteria.

\textsuperscript{272} Irish Funds Industry Association.  
\textsuperscript{273} [http://ec.europa.eu/](http://ec.europa.eu/).
### 3.5.7 Implementation

Currently, the draft Directive is presented to the European Parliament, but also to the European Council thus being submitted to the co-decision process. When an agreement is reached on the text, the EU Member States will be obliged to implement all recommendations in their internal regulations within 24 months. Thus, these laws will become effective in 2014.

### 3.6 The Alternative Investment Fund Managers Directive

The AIFM Directive was enacted on the 21st of July 2012 (level I). The AIFM Directive timeline can be seen below, and this will be discussed further on:
Figure 6. The AIFM Directive timeline

Source: author’s analysis
This AIFM Directive implements harmonised requirements for financial intermediaries involved in the management of AIFs\(^\text{274}\) in the EU. The Directive defines an AIF as any collective investment scheme that requires no authorisation in compliance with the UCITS Directive.\(^\text{275}\) This extended definition was meant to include institutional vehicles which previously did not fit the perimeter of the EU financial regulation, among which one can mention “hedge funds/absolute return' funds, private equity funds/collective investment schemes, real estate funds/fixed property funds”\(^\text{276}\) and others. AIFs management and administration experience certain limited exceptions, especially for the EU-domiciled AIFMs\(^\text{277}\) authorised as per the Directive.\(^\text{278}\)

The purpose of the AIFM Directive is to regulate all major risk sources in the alternative investment value chain by guaranteeing that AIFMs are authorised and undergo periodical and continuous governing and that robust regulatory standards govern the key service providers, including depositaries and administrators. The Directive seeks to attain also the improvement of the transparency of AIFMs and their managed funds in front of supervisors, investors and other key stakeholders. In addition, the Directive needs to guarantee that all governed bodies comply with the appropriate governance standards and benefit of robust systems for the risk, liquidity and conflicts of interest management. The Directive also intends to enable AIFMs to market funds to professional investors throughout the EU, subjected to compliance with imperative regulatory standards.

The authorisation received from the responsible authorities in its EU home Member State is compulsory to every AIFM intending to manage or market an AIF, according to the provisions of the Directive.\(^\text{279}\) The Directive contains a \textit{de minimus} exemption for managers who directly or indirectly manage AIF portfolios holding minimum EUR100

\(^\text{274}\) Alternative Investment Funds.

\(^\text{275}\) 2009/65/EC, Article 3 (a).

\(^\text{276}\) “Directive on Alternative Investment Fund Managers (AIFM Directive): Frequently Asked Questions”, Memo/10/572 (November, 2010) (FAQ). The breadth of this definition is curtailed somewhat by a number of exceptions. Specifically, the Directive “does not apply to collective investment schemes regulated under the UCITS Directive, EU credit institutions, pension funds, life assurance or reinsurance companies or sovereign wealth funds”; Article 2, s. 2(c)-(g). The Directive also does not apply to an AIFM EU-located but that does not offer management services to an AIF located or marketed within the EU; Article 2, s. 2(b). That is not to say, however, that these institutions fell outside the perimeter of regulation in their home Member States.

\(^\text{277}\) Alternative Investment Fund Managers.

\(^\text{278}\) Article 18 and 36.

\(^\text{279}\) Article 4, s. 1. An AIFM might become authorised in providing management services in respect of all or only some forms of AIF; Article 4, s. 2.
This threshold is raised to EUR500 million for managers who (a) only manage AIFs without employing any leverage, and (b) do not assure investors the right to redemption for minimum five years from the day of a fund’s inception. One of the preconditions of authorisation is that an AIFM should provide all officials in charge, detailed information observing, *inter alia*, ownerships’ details, features of the AIFs the company intends to trade, all adjustments for the delegation of management functions and the appraisal, as well as safekeeping of portfolio assets. More broadly, the AIFM has to assure the competent authorities that it is able to observe all the basic requests of this Directive. After receiving the authorisation, the AIFM is enabled to provide management activities to AIFs settled in any Member States, but also to market the securities of the AIFs managed to professional investors within the EU. In the short term, this passport will only be accessible to EU-domiciled AIFs and AIFMs. However, it is carefully considered at present that the passport extends to the non-EU-domiciled managers and funds in 2013.

Once an AIFM receives authorisation under the Directive, it must provide full compliance with substantive requirements observing, *inter alia*, (a) conduct of business, governance and risk management, (b) third party appraisal and safekeeping, but also (c) open, periodical and event-driven disclosure to investors, competent official bodies, but also to some third parties stakeholders. The Directive also empowers the EC and, if
absolutely necessary, official representatives from EU Member States, so that they can act for the restriction of the use of leverage by AIFs.

The Directive causes controversy at various levels. The uniform regime that the Directive intends to enforce on a wide range of distinct AIFs is one of the controversial issues. This implies purely national funds without any evident systemic security relevance. Many of these are regulated at national level by now. However, credit institutions or insurance companies are excluded.\footnote{ECB (2009), “Opinion of 16 October 2009 on a Proposal for a Directive on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC,” paragraph 7.}

Another major source of concern is the similarity of the draft directive and other previous European directives. Thus, an example could be “the Prospectus”, “the Transparency”, and “the Market Abuse Directives”. As an alternative, the other way round, MiFID already regulates “open-ended and listed, closed-ended investment funds”. In addition, the assertion of the necessity to require a double license on management firms operating simultaneously UCITS and non-UCITS funds\footnote{Athanassiou, Phoebus, (2010), “The Draft AIFM Directive and the Future of European Alternative Investment Fund Regulation”, CESIFO DICE Report”, vol. 8, nº. 1, p. 10.}, the directive brings forth arguable issues in the regulation of such sectors where clearness is an essential element.

The intent of the AIMF Directive to regulate both authorisation and advertising across the EU, as well as the funds located outside the EU is disturbing and to some point even offensive, from a double perspective. The requirements, according to which the competent Member State official bodies issue this authorisation, and the activation of the foreign funds’ exchanging capability three years after the enactment of the directive, reduce the chances for non-EU AIFM to achieve such authorisation.\footnote{Athanassiou, Phoebus, 2010, Op. Cit., p. 10.} If this approach has the slight chance of being defended \textit{prima facie} due to its possible consideration in compliance with the objective of the “\textit{G-20 Pittsburgh Summit}”, which is to offer “transparency” around overseas areas, the limitations imposed to third state funds and to administrators represent a major issue. The first restriction is upon the investors’ choice. To this, one might add the fact that they tend to contradict the “\textit{G-20 London Summit’s}” demand that both regulators and supervising persons must reduce their aim for regulatory arbitrage while promoting international trade and investment and rejecting
protectionism. The legitimacy of the internal market regulation objective of the “passport-driven opening of the European fund market to offshore funds and their managers”\textsuperscript{292} is questioned.

One major problem revealed by the AIFM Directive resides in its chaotic and confused regulatory framework. The emphasised concept is hardly understood: either “financial stability” (individuals tend to consider this as target point) or investor protection. In this case, investor protection seems to be to some point improper under the AIFs circumstances due to the fact that the aim of the proposal tends to be limited to the funds marketing and AIFM’s services offering only to professional investors. Also, financial stability seems to provide a more compelling basis for regulation in this area. The parallel pursuit of these two mutually exclusive regulatory rationales is capable of reducing the chances of the directive to fulfil any of these rationales\textsuperscript{293}.

On the one hand, if “the Directive” would mainly focus on financial stability, this would be more than enough for the limitation of the scope of the Directive to transnational, very high leveraged funds with significant AUMs, so that systemically relevant funds are accessed\textsuperscript{294}. On the other hand, if its fundamental focus was the protection of investors, then it would definitely need the revision of some investor disclosure rules, which are not tailored to professional investors, but rather to the needs of retail\textsuperscript{295}.

The Directive includes the following requirements on transparency: yearly reporting (Article 22), disclosure to investors (Articles 23 and 43) and reporting to competent authorities (Article 24).

Currently, the final AIFM Directive covers over 100 fields where EC or ESMA were asked to enlarge to “Level 1”. The process began in December 2010 when EC requested the advice of ESMA and would finally end when the EC publishes its implementing regulation. During the first months of 2012, ESMA’s technical advice had been put through the political mangle in the lack of a suitable technical discussion. This was the main reason why everybody impatiently awaits the publication of the implementing regulation. One should also carefully consider ESMA’s Discussion paper regarding the

\textsuperscript{293} Ibid.
\textsuperscript{294} Ibid.
\textsuperscript{295} Ibid.
“Key concepts of the AIFM Directive and types of AIFM”, from 23.02.2012, together with the “Consultation paper on Guidelines on sound remuneration policies under the AIFM Directive” published on 28 of July 2012. All the above-mentioned documents from ESMA will facilitate the shaping of the types of organisations under the purpose of the AIFM Directive, and the extent to which the Level 1 remuneration provisions will be applied.

To conclude, the AIFM Directive is an important piece of legislation and needs to be carefully analysed because of its relevance and especially because of its effects. After the financial crisis, it became clear that rushing regulation not only does not help or serve any public interest, but it might even be more dangerous or damaging than no action at all. Therefore, the author of this thesis considers that further negotiations and debates could be needed when transposing it into national law, in order to achieve the correct equilibrium between the two main parties involved: the international or global nature of this market, on the one hand and the local nature of the investors, on the other hand. The AIFM Directive, will definitely: (a) diminish systemic risks and the leverage use; (b) improve investor protection while increasing the transparency, too; (c) enhance the integrity and the efficiency of the sector; (d) promote the sector for the supervision of corporations.

3.6.1 Conduct of business, governance and risk management requirements

The Directive imposes uniform care and loyalty duties upon authorised AIFMs. Specifically, it mandates AIFMs to: “(i) act honestly, with due skill, care and diligence and fairly in conducting its activities, (ii) act in the best interest of the AIFs it manages, the investors in those AIFs and the integrity of the market, and (iii) ensure that all AIF investors are treated fairly.”

This includes a prohibition against any undisclosed preferential treatment of investors; Article 9, s. 1 (a)-(c).
An AIFM must also take all acceptable actions in order to identify “conflicts of interest” but also, thereafter keep and operate efficient institutional and administrative adjustments to stop these conflicts from negatively affecting the interests of an AIF or its investors. When an AIFM identifies material conflict of interest within its operations – or when it determines that its conflict arrangements do not have enough power to ensure the adversely impact of AIF investors interests in a reasonable and confident manner – it must disclose this fact to AIF investors.

The Directive stipulates that an AIFM should adopt risk management systems designed to measure and supervise overall risks induced to the AIFs it manages by virtue of their investment strategies. This requirement contemplates, inter alia, (a) the implementation of an appropriate, highly informed, but also regularly updated due diligence process for investments, (b) accurately identification, measurement and monitoring of risks by means of appropriate stress testing procedures, (c) the compatibility between the risk profile of each AIF and its size, structure, investment strategies and objectives, and (d) the implementation of risk management procedures to an AIF engaged in short selling. The Directive also requires an AIFM to implement systems designed to manage liquidity risk and to conduct regular “stress tests of these systems under both normal and exceptional market conditions.” It further asks for the separation of portfolio and risk management functions – along with their respective review process – within the operational environment of an AIF. These risk management requirements are augmented by a requirement that an AIFM should

297 This includes conflicts (a) between an AIFM (including its managers, employees and those able to exercise direct or indirect control) and AIF investors, and (b) between different AIF investors; Article 10, s. 1.
298 Article 10, s. 1. This is in fact a purposive interpretation of what, it must be said, is a tortured piece of legislative drafting which contemplates the maintenance of “effective” adjustments “with a view to taking all reasonable steps designed to prevent conflicts of interest”. It remains to be seen how authorities will interpret the interplay between the requirement of effectiveness, the subsequent reasonable qualifier and the notion that the arrangements need only be “designed” for preventing “conflicts of interest.”
299 Article 10, s. 1-2. This is once again, a purposive interpretation of an ambiguously drafted provision. Specifically, the Directive contemplates disclosure where an AIFM’s conflict arrangements are “not sufficient to ensure, with reasonable confidence, that the risks of damage to investors’ interests will be prevented”. However, if one acknowledges that preventing the risk of damage is not the same thing as preventing the damage itself, this language is potentially inconsistent with the “adverse effects” standards articulated in the same Article.
300 Article 11, s. 2.
301 Article 11, s. 3 (a)-(c).
302 Article 11, s. 4. The Directive further provides that EU States shall guarantee that an AIFM has in place “procedures which provide its access to securities/financial instruments on the date” it is required to deliver them pursuant to any short selling arrangement.
303 Article 12, s. 1. As a corollary, an AIFM must ensure that the redemption policy of each AIF it manages is appropriate given the liquidity profile of its portfolio assets; Article 12, s. 2.
304 Article 11, s. 1.
adopt payment policies which tend to be compatible with and to encourage sound risk management.\textsuperscript{305}

Lastly, the AIFM Directive institutes simple incipient and evolving capital requirements. All AIFMs are required to keep their own funds of minimum EUR125,000.\textsuperscript{306} Additionally, when the AIFs’ aggregate portfolio worth exceeds EUR250 million, an AIFM must set aside an extra amount of 0.02\% of the total surpassing the quarter million EUR threshold of the portfolio value.\textsuperscript{307} Accordingly, for an AIF with a EUR1 billion worth portfolio value, an AIFM would be required to put aside capital totalling EUR275,000. The capital requirements mentioned above according to any very important duties comply with Article 21 of the Capital Requirements Directive governing the money ability of investment companies but also of banks.\textsuperscript{308}

Perhaps not surprisingly, given the broad nature of many of these requirements – to say nothing of the wide diversity of investment strategies, business models, conflicts of interest and other risks typically encountered in connection with different types of AIF – the Directive contemplates that the EC will advance to second level adopting clauses, besides specifying the precise substance “of these requirements”\textsuperscript{309} as they are intended to apply to each species of AIF. Accordingly, it is too early to evaluate the precise impact of these requirements in terms of the AIFMs’ daily conduct and practices.

3.6.2 Third party valuation and safekeeping requirements

The Directive requires that “an AIFM appoints an independent third party to value both the portfolio assets of the AIFs it manages and their issued securities.”\textsuperscript{310} This valuation exercise must be undertaken at least once a year and every time the securities of an AIF

\textsuperscript{305} The remuneration requirement does not appear in the most recent draft of the directive made available by the Commission. However, it is described in the more recent FAQ, and more broadly, is consistent with the EU’s emerging position on remuneration within financial institutions; http://ec.europa.eu/

\textsuperscript{306} Article 14.


\textsuperscript{308} 2006/49/EC.

\textsuperscript{309} Article 9, s. 2; Article 10, s. 3; Article 11, s. 5, and Article 12, s. 3.

\textsuperscript{310} Article 16, s. 1. Third party valuators domiciled in jurisdictions outside the EU must be subject to regulatory standards equivalent to those applicable within the EU; Article 37, s. 1 (b).
are traded or redeemed.\textsuperscript{311} An AIFM must also appoint a depositary for the purposes of, \textit{inter alia}, “(i) receiving subscription proceeds from AIF investors and depositing them into a segregated account, and (ii) safekeeping AIF portfolio assets.”\textsuperscript{312} The depositary shall be a credit institution whose registered office must be in the EU\textsuperscript{313} The depositary is obliged to act freely and only in support and on behalf of “AIF investors”. He will be responsible to the AIF investors for any damages inflicted upon them due to its failure to perform its obligations according to the Directive.\textsuperscript{314}

\textbf{3.6.3 Disclosure requirements}

The Directive sets up a series of initial, periodic and event-driven disclosure requirements designed to increase the transparency of AIF activities to investors, competent authorities and certain other stakeholder constituencies. “MiFID requires investment firms to provide”\textsuperscript{315} \textit{inter alia}, a description of the relevant AIF’s (a) investment strategy and objectives\textsuperscript{316}, (b) valuation and redemption policies, (c) custody, valuation, administration and risk management activities, but also (d) investment taxes, charges and costs.\textsuperscript{317} Thereafter, an AIFM will be required to provide the investors a yearly audited report comprising the AIF’s balance sheet, income statement, activity report and auditor’s report.\textsuperscript{318} The AIFM should also submit these annual reports to the empowered officials from its home EU country.\textsuperscript{319}

The Directive contemplates additional periodic disclosure to both investors and competent officials with respect to: (a) the special arrangements percentage of AIF portfolio assets emerging from their illiquid type, (b) every new liquidity management settlements, and (c) the current risk profile of each AIF and the AIFM’s risk management systems.\textsuperscript{320} An AIFM will be required to provide aggregated data for

\textsuperscript{311} Article 16, s.1.
\textsuperscript{312} Article 17, s. 1(a)-(c).
\textsuperscript{313} Article 17, s. 3. An AIFM cannot, however, act as a depositary; Article 17, s. 2.
\textsuperscript{314} Article 17, s. 2 and 5.
\textsuperscript{316} Including descriptions of (1) the permitted assets and techniques and their attendant risks, (2) any investment restrictions, and (3) the circumstances under which the AIF may use leverage and the types and sources of permitted leverage; Article 20, s.1.
\textsuperscript{317} COM/2009/0207, Article 20, s.1.
\textsuperscript{318} Article 19, s. 1-3.
\textsuperscript{319} Article 21, s. 3 (a).
\textsuperscript{320} Article 20, s. 2 and Article 21, s. 2.
empowered officials according to a certain pattern, observing not only main markets and tools of AIFs’ trade, but also their fundamental vulnerabilities, and significant risk concentration.\(^{321}\)

In addition, an AIFM must report to the competent officials the main forms of assets where its AIFs are invested but also, when important, the employment of short selling.\(^ {322}\) The Directive contemplates that the EC is going to adopt implementing measures which ensure the adaptation of the nature and frequency of these periodic disclosures – or at least those targeted at investors – to every AIF species.\(^ {323}\)

Finally, the Directive imposes event-driven and subsequent periodic disclosure obligations on an AIFM related to the acquisition of “a controlling interest in a company domiciled in the EU which employs more than 250 persons, has an annual turnover exceeding EUR50 million”\(^ {324}\), but also a balance sheet surpassing EUR43 million. An AIFM will be thought to have acquired a “controlling interest” if either it or any of the AIFs it manages holds either separately or totally “30% of the voting rights”\(^ {325}\) of the target corporation. In case an AIFM acquires a controlling interest, this shall offer certain prescribed data\(^ {326}\) to the corporation, its shareholders and employees (or their representatives). In addition, the yearly report of an AIFM is going to contain data regarding every entity where it holds a controlling interest. More specifically, the report must include information observing, \textit{inter alia}: (i) its operational and financial affairs, (ii) any financial risks associated with its capital structure, (iii) employee turnover, termination and recruitment, and (iv) any significant divestment of assets.”\(^ {327}\)

### 3.6.4 Leverage requirements

The Directive empowers the EC to establish leverage requirements for AIFs where these are considered imperative for guaranteeing security and “integrity of the financial

\(^{321}\) Article 21, s. 1.
\(^{322}\) Article 21, s. 2(d)-(e).
\(^{323}\) Article 20, s. 3.
\(^{324}\) Articles 26-29. This provision applies to both listed and non-listed companies, and includes the conclusion of an agreement, which would enable an acquisition.
\(^{325}\) Article 26, s. 1 (a)-(b).
\(^{326}\) The nature of the information required will depend on whether the company is listed or non-listed; see Articles 27-28.
\(^{327}\) Article 29.
system.”\textsuperscript{328} It further empowers national officials to prevent the use of leverage for individual AIFMs and AIFs in exceptional circumstances\textsuperscript{329}. The Directive mandates that an AIFM is evaluated once every four months if any of the AIFs it manages uses “high levels of leverage on a systematic basis.”\textsuperscript{330} An AIF is considered to have passed this test if its merged leverage from overall elements exceeds its amount of “equity capital in two out of the past four quarters.”\textsuperscript{331} When an AIF transcends this threshold, its manager must make prescribed disclosures to both AIF investors\textsuperscript{332} and the properly qualified officials in its EU residence countries.\textsuperscript{333}

### 3.7 The MiFID Directive: an overview of the framework

The “Markets in Financial Instruments Directive” (MiFID)\textsuperscript{334} was enforced in 2004, being the earliest in the financial services area, or the so-called “Lamfalussy-formatted”, which cleared the way for several thoroughly implemented Directives or Regulations. MiFID relates to securities that are still under implementation nowadays in the credit institutions and insurance area in particular. The MiFID represents the most exhaustive exemplification of the “Lamfalussy approach” up to now.

The European supervisory architecture has changed in the aftermath of 2007-2009 financial crisis. In terms of financial supervising, a simultaneously accomplishment of single financial market and financial stability is very difficult, maintaining at the same

\textsuperscript{328} According to the Directive, “leverage” represents “any method by which an AIFM increases the exposure of an AIF to a particular investment, whether through borrowing of cash or securities, leverage embedded in derivative positions or any other means; Article 3(1). The Directive contemplates that the Commission will adopt implementing measures setting limits on the leverage an AIFM can employ taking into account, inter alia, the type of AIF, its investment strategy and sources of leverage”; Article 25, s.3.

\textsuperscript{329} Provided that “they are temporary in nature and comply with the Commission’s leverage limits”; Article 25, s. 4.

\textsuperscript{330} Article 22.

\textsuperscript{331} Article 22, s. 4.

\textsuperscript{332} An AIFM managing an AIF with “high levels of leverage on a systematic basis must disclose to investors (1) the maximum level of leverage which the AIFM may employ as well as the right of re-use of collateral or any guarantee granted under the leveraging arrangement; and (2) on a quarterly basis, the total amount of leverage employed in the preceding quarter”; Article 23.

\textsuperscript{333} “An AIFM must regularly provide to competent authorities information respecting the level of leverage and a breakdown between leverage arising from borrowed cash or securities and that embedded in financial derivatives”; Article 24, s. 1. This information must “include the identity of the five largest sources of borrowed cash or securities for each AIF and the amounts of leverage received”; Article 24, s. 2.

time a higher supervision level at the national position. Schoenmaker called these inconsistent goals “trilemma”, as far as the financial monitoring is concerned: the security of the financial system, the harmonised financial sector and the national financial monitoring.

Within the EU, prudential supervising is decentralised in each Member State, due to the home country control principle combined with prior regulatory harmonisation-based mutual recognition. As a consequence of regulatory harmonisation, the EU banking policy presents a rather unified picture. This is one of the reasons why Tommaso Padoa-Schioppa considered that the current approach was based on national supervision European regulation. The Lamfalussy framework set up many committees, while the new supervisory structure was established by the De Larosière Report.

The following framework sets the grounds for the new European Supervisory Authorities: five regulations approved by the European Parliament and the European Council on 22 September 2010, each of them establishing the following new bodies: the “European Systemic Risk Board” (ESRB), assigning tasks to the ECB in relation to the ESRB, establishing EBA and the “European Insurance and Occupational Pensions Authority” (EIOPA), but also, finally setting up the “European Securities and Markets Authority” (ESMA).”

The new objectives of the ESFS are: the adequate implementation of the rules to the financial sector, the maintenance of financial stability and of confidence in the financial system, but also the financial services consumers’ protection. This shall account for to the European Parliament and the European Council (ECOFIN).

The ESRB will perform inter alia the following tasks: (a) define, access and collect the relevant data supporting “the systemic risk” assessment at European level, (b) identify and assess the risks to financial security within the EU, relating to developments within

“the financial system” focusing on its interaction with “the real economy”, (c) prioritise the risks and insurance of risks warning to be considered by public authorities (central banks, supervisors, Ministers of Finance), or made available to the public, (d) issue recommendations (including in the legislative field) or advice on identified risks to stability, (e) “supervising of follow-ups to warnings as well as suggestions” (“comply or explain”), (f) connection with international bodies (“IMF, FSB”) and third country counterparties.

The EBA was founded on the 1st of January 2011. It was entrusted overall tasks and duties of the CEBS. EBA’s role is to guard and preserve the financial system stability, the markets and financial products transparency and the depositor and investor protection, acting as a hub and spoke network of the EU and national bodies.

Also, among its core abilities, the author mentions: prevention of regulatory arbitrage, promise of a level playing sector, reinforcement of global surveillance coordination, promotion of surveillance convergence and provision of advice to the EU authorities in the credit institutions, remuneration and e-money legal fields, but also on matters concerning corporation governance, control and “financial reporting.”

3.7.1 The Lamfalussy approach

At the beginning of 2000, Al. Lamfalussy presided several “Wise Men” under the EC’s protection and started working on the best procedural approach for the European institutions to reach the most appropriate financial services action strategy. Actually, the Group was trying to find a solution for the compliance guarantee of two different goals. The first goal was that of increasing the harmonisation between Member States when European directives were transposed. The second goal was to speed up the implementation of – and to subsequently amend – such European directives (or regulations).
The analysis of these four levels concludes that the major principle is the difference between the main policies from Level 1 but also the technical adopting issues from Level 2. Baron Lamfalussy asserts that governance change by means of the bottom-up approach might apply to different fields of European integration.345

In 2001, “the Group work” issued some conclusions examined within the recommended organisational approach. The “Wise Men” decided upon “a four-level approach to European institutions and Member States”346, influenced by the existing and currently named committology activities, adapted to financial sectors:

*The first scale* consists of “European framework directives or regulations”, which means that similar law documents must be confined by important standards. Level 1 refers to EU framework legislation. The Stockholm Resolution invites EC to use regulations instead of directives, when “legally possible”. The integration of financial markets has often obstructed different national transposition processes. That is why the new approach needs to be reconciled with the status quo in banking and insurance, where the directives set the norm. The directives seem to be preferred due to their consistent use with the minimum harmonisation and mutual recognition principles, which have always been the driving force of the EU’s strategy. Unlike the directives, regulations are consistent with the full or detailed harmonisation principle and leave no freedom to Member States in terms of their national transposition.347

*Level 2 consists “of directives or regulations implementing the technical details of the essential principles set up by the Level 1 directives or regulations”348*, implemented by “the European Commission” following several modifications made under the close observation of “a special Committee.” The EC would propose the “implementing measures” of the Second Level as recommendations, after sending a prior “technical

advice” which would be supposedly presented to the EC through the CESR, made up of overall national securities regulatory bodies. \(^{349}\)

*The third Level* consists of guidelines that will be promoted through “CESR” according to First and Second Level directives or regulations. “Level 1 and 2” represent the fundament for the first Level. The objective of the third Level management reside in assuring that authorities implement the established measures without any differences to achieve an upper integration level in the EU.

*The fourth level* represents the enactment level, which must be performed by “the EC”. A major objective resides in becoming aware of whether EU Member States manifest delays while enacting, or even worse, abandon the implementation of first and second Level measures. Then, “the EC” may act before going to the ECJ\(^ {350}\).

All the above-mentioned Levels are presented in the scheme below:


\(^{350}\) European Court of Justice.
In 2001, “the ECOFIN Council” has authorised the four-step “Lamfalussy approach”. This has later resulted in a settlement with the European Parliament.\textsuperscript{351} MiFID is among the primary European directives emerging after the \textit{Lamfalussy approach}. Apart from this, the MiFID represents essentially the most all-embracing Directive of Lamfalussy approach up to now.\textsuperscript{352}

The major “impact of the MiFID is that targeted though significant provisions of the MiFID will apply to management companies managing UCITS funds.”\textsuperscript{353}

At first sight, only some articles of MiFID refer to the management firms regulated by the UCITS. These rules cannot apply to “the management of collective portfolios”. Instead, they apply only to “the investment services” empowered “to be provided by UCITS management companies according to Article 5(3) of the UCITS Directive, i.e. individual portfolio management and non-core services (investment advice and safekeeping/administration of funds’ units).”\textsuperscript{354}

The quantifiable constraint implemented via MiFID available for “UCITS management firms” could be considered very narrow. Nevertheless, many details were provided to the important amendments of the Level 1 MiFID, almost “40 articles of the Level 2 MiFID”\textsuperscript{355} (for instance Articles 5-43, 45, 47-49).

The UCITS Directive cannot be applied to the management companies dealing only with non-UCITS funds. On the contrary, the entire MiFID can be potentially applied, except for their non-UCITS funds management activity, as this is tackled neither by the UCITS Directive nor by the MiFID Directive. Thus, this is only monitored nationally.\textsuperscript{356}

Nevertheless, the practical benefit for such non-UCITS management firms is that they are not in the middle of two various Directives: the status looks relatively similar in terms of organisation and operation.

One needs to mention that in October 2008, the EC implemented a Communication entitled: “From Financial Crisis to Recovery: An European framework for action.”

Three main elements set the basis of this action plan: the EU level new financial market structure, the actions dealing with the manner in which it affects not only the real economy but also global co-operations to obtain an international answer to the economic crisis. On November 26th, 2008, “An European Economic Recovery Plan” was released. While the focus of the plan is on the macroeconomic situation, it also illustrates activities at the European level for the increase of the financing for infrastructure and sectors like cars, construction, and green technologies. The total package amount is approximately EUR200 billion, representing 1.5 per cent of total GDP of the EU.

Regarding the issue of financial markets and their appropriate supervision, in October 2008, the EC created a “Group of high level experts” conducted by Mr. De Larosière. The Group had the responsibility, inter alia, to analyse the organisation of European financial authorities, to guarantee prudent soundness, markets performance, and tighter European collaboration regarding financial security overlook, rapid warning mechanism, and crisis management, comprising the management of transnational and cross-sector risks. The Group presented its Report on February 25th, 2009. The Report includes thirty-one Recommendations. With regard to financial supervision, the Report suggests the establishment of a new body supervised by the ECB, which should identify systemic risks and issue binding risk warnings. With regard to micro-prudential supervision, the Report foresees a two-stage approach: first, the role of the existing Level 3 Committees and national supervisors should be strengthened; second, the three

358 Ibid.
Level 3 Committees should become the so-called Authorities with significant tasks and far-reaching powers on cross-border financial institutions in the EU.\textsuperscript{363}

In addition to the actions outlined above, the EC has initiated a general in-depth analysis and careful overview “of the supervisory and regulatory framework” applicable for every fundamental individual participant to financial industries, to ensure financial stability within the EU. The results of these initial reflections were set out in the Communication entitled “Driving European Recovery”, addressed to the Spring European Council and adopted by the EC on March 4, 2009, providing an outcome of the “European Economic Recovery Plan of 2008”, December, and approaching several measures in the context of the global down-turn of the real economy and the inevitable effects on employment. Under the heading “Restoring and maintaining a stable and reliable financial system”, the Communications refer to main conclusions “of the De Larosière Group”, but also outline an ambitious time schedule for the adoption by the EC of several legislative proposals regarding financial services, incorporating the establishment of the necessary legal framework for a new architecture of the European financial supervisory system.

It remains to see whether future solution will take the form of mere regulatory reforms, such as adaptations to and reinforcement of the current framework while observing the existing principles, or regulatory revolution, eventual necessary changes to the Treaty. So far, the intent to revise the MiFID is emerging, mainly on grounds of investor protection.

In 2011, more precisely on October 20, the EC issued its expected formal legislative recommendations on the amendment of the Markets in Financial Instruments Directive (MiFID II). However, deadlines for enacting MiFID II seem to occur in the far future, even if MiFID II is acknowledged as a major regulation in the broader regulatory reform perspective.

3.8 Regulation of hedge funds and the MiFID

MiFID’s impact seems actual due to its passport far wider objective.364 The wide-range of changes to the status quo ante caused by the MiFID, due to the abolition of the “concentration rule”365 together with its ambitious desire to bring within its fold the widest available spectrum of organisations366, have led to uncertainty in relation to its accurate remit in conjunction with its interrelation with other Community legal documents (especially, UCITS III). From a broad perspective, whilst it is quite difficult to acknowledge MiFID’s degree of influence on the European framework in terms of the financial services provision, little uncertainty is associated to the significant changes the entire asset management industry will have to undergo. For a correct assessment of MiFID’s possible impact upon the unregulated vehicles together with products, which are not harmonised, having to do with hedge funds, the examination of several question marks raised by its stipulations becomes imperative.

A major source of doubt concerning the MiFID implies its potential significance for the transnational promotion and distribution of products that are not harmonised.367

Contrary to the UCITS Directive dealing only with harmonised funds, the MiFID’s requests are also concerned with investments in “units in collective investment undertakings”, regardless of the harmonised or non-harmonised nature of the entity involved.368 Also, opposite to the ISD, which cover mainly conditional on the stipulation of “investment services”, MiFID deals with investment advice and portfolio management and investment processes.369

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364 The MiFID passport covers the provision of investment advice as a core activity, the operation of multilateral trading facilities or “MTFs”, trading platforms similar to electronic communication networks – (“ECNs”) in the US – and the provision of investment services on commodity and credit derivatives.
366 Entities that are not subject to the MiFID involve: “insurance undertakings (e.g. re-insurers), employee schemes (when dealing in the administration of employee-participation schemes), persons administering their own assets and undertakings which not providing investment services and/or performing investment activities; there is also an exemption for incidental business in the course of the pursuit of a professional activity regulated by legal or regulatory provisions or a code of ethics” (MiFID, Article 2).
367 MiFID, Article 2(1)(h), read in conjunction with Recital 15 thereof, are indicative of the indiscriminate bundling together by the MiFID of harmonised and non-harmonised funds.
368 MiFID, Annex I, Section C.
369 Ibid, Annex I, Section A.
On the one hand, the introduction of MiFID made the European asset management industry think that this was an excellent possibility for its non-harmonised products to take the benefits of novel, EU broad distribution potentiality, free of the duty to comply with the requirements of the national regulations, related either to their products or to their managers. On the other hand, both the CESR and several market associations and stakeholders\textsuperscript{370} have presented the so-called “diversion” of the MiFID as an opposite image within an indirect path in terms of non-harmonised products marketing. It was believed that the impact of this “liberal” perspective regarding its aim would be harmful for the \textit{effet utile} of the UCITS scheme and that it would damage the interests of the European harmonised hedge funds industry. It is really difficult to see how the guarantees, together with protections built into the UCITS regime would be dismissed within the framework of frequently \textit{light regulated} hedge funds in the absence of reasons for the existence of the harmonised funds regime which is currently under examination. Despite the fact that there is hardly no indication of MiFID providing intentional grounds for the transnational promotion of non-harmonised products, regardless of the host Member State where it had been registered or other various national distribution requirements\textsuperscript{371}, an explanation of its interaction with UCITS III is a major objective. This objective was given particular interest by a 2006 European Parliament Resolution which emphasized that “the interaction between UCITS III and MiFID and its Level 2 implementing measures leave undesirable scope for interpretation and require clarification and consolidation.”\textsuperscript{372}

A second important issue to consider refers to the assessment of the regulatory treatment of particular functions related to hedge funds. The text of the provision does not clarify at all, for instance, if subscriptions, together with redemptions of hedge fund shares or units should be dealing with the “best execution” obligation of Article 21 of the MiFID Directive. When the process concerning the subscription and redemption of hedge fund shares or units differs qualitatively from that concerning the buying but also selling of financial tools, subjected to the best execution obligation, the subscription and redemption of the shares or units of the hedge fund could prove problematic regarding


its coverage by the aim of the MiFID’s definition of “execution of orders”\textsuperscript{373}. This signifies that this limitation could not apply in the context of a hedge fund.\textsuperscript{374} Similarly, ambiguity encompasses the degree to which the subscription and the redemption of hedge fund shares/units might qualify as “reception and/or transmission of orders”\textsuperscript{375}, whether hedge fund managers can be considered “investment firms”\textsuperscript{376} or what the MiFID’s definition of “investment activity” supposes (a major issue on which an undertaking’s exemption from the remit of some of the MiFID’s key provisions turns)\textsuperscript{377}. Considering the fact that “the definition of an investment activity is far from clear”\textsuperscript{378} and that it is not easy to establish the difference between the follow-up of an “investment activity” and the provision of an “investment service”\textsuperscript{379}, there are ambiguities about the location of hedge fund activities on the “service” –“activity” sequence. The conclusive assessment of the MiFID’s rules on transparency, outsourcing and investor classification is difficult, despite the fact that the better view is that fund managers make investment advice and portfolio management functions falling within the scope of the MiFID.\textsuperscript{380}

For the moment, one cannot say much about the impact of the MiFID on hedge funds, at least not until some of these questions would have been answered. Also, little can be said of the extent to which its occurrence will eliminate the need to adopt EU-wide hedge fund-specific rules or, on the contrary, require their even more urgent implementation in order to cope with the “hedge fund exception” to harmonised EU financial regulatory framework.

\textsuperscript{373} MiFID, Article 4(1) and (5).
\textsuperscript{374} Janin, Stéphane, 2007, Op. Cit., 97. The element that distinguishes the subscription from the redemption of hedge fund shares or units from the buying and selling of other financial instruments is the different degree of discretion performed by the financial intermediary in each of these two contexts.
\textsuperscript{375} Only in the event of a positive answer to that question then the subscription and redemption of hedge fund shares or units would be covered by the “best execution” obligation. Subscribing and redeeming funds’ units may be difficult to bring within the definition of the “reception and transmission of orders” since, according to Articles 45 (2), (4), (5) and (6) of the MiFID, that service is always connected to the subsequent service of “execution of orders” which may not be applicable to the process of subscribing and redeeming funds’ units.
\textsuperscript{376} While there is no indication that the MiFID was intended to regulate hedge funds by treating them as “investment firms”, its Article 4(1)(1) definition thereof is very broad, leaving much to the interpretative discretion of the individual Member States Authorities.
\textsuperscript{377} These include conduct of business obligations (MiFID, Article 19), obligations relating to conflicts of interest (ibid, Article 18), best execution (ibid, Article 21) and client order handing (ibid, Article 22).
\textsuperscript{379} Considering the MiFID’s definition of “client” in Article 4(1) thereof, those of the MiFID requirements that apply to “clients” would not seem to come into play where an entity merely undertakes an “investment activity”.
Still, MiFID II will be far stricter than MiFID I. Three particular aims of MiFID II differentiate it from MiFID I. Thus, (a) MiFID II sets up more rigorous regulatory requirements, which would supervise the technological evolutions and market infrastructure in the financial industry; (b) MiFID II intends to enhance investor protection as a result of the major collapses occurred during the credit crisis; (c) the target of MiFID II is to increase transparency as much as possible, and at the same time decrease the fragmentation of information. Due to these three targets, the strategic, commercial and technological implications of the MiFID II will be wider than those of the MiFID I. Although the expected implementation time for MiFID II was 2012/2013 MiFID II implementation date changed for the time being, and it is expected to be implemented around 2014/2015.

3.9 The regulation of hedge funds and other sources of Community legal rules

The UCITS Directives and MiFID are not the only European Directives with direct/indirect effects regarding the evolution of asset management business in the EU. The other Community legal acts significant to the market activities of hedge funds include the “E-Commerce Directive”381, the “Prospectus Directive”382 and the “Savings Tax Directive”.383 Considering the specific aspects of the cross-border provision of alternative asset management services addressed by these directives and the fact that they facilitate the hedge fund products marketing in the Member States which do not specifically regulate their public marketing, these acts need to be briefly described384.

The rules employed for electronic cross-border consumer transactions have been adopted by means of the E-Commerce Directive. This adoption was explained by the EC’s intention to establish a set of basic rules to promote E-commerce activity and EU-wide information society services. Based on mutual acknowledgment and on the home country norms, the E-Commerce Directive could prima facie seem at first sight to let the transnational marketing of domestic hedge fund shares/units on the internet based on the tenderer’s home country authorisation.

The application of the “E-Commerce Directive” to financial services has led to many concerns regarding both the account of their highly regulated nature and the risk that could be brought up by market players to surround host European Member State product regulations together with marketing norms (implying rules relevant for non-harmonised products). Nevertheless, this “country of origin principle application” of “the E-Commerce Directive” is restricted by derogations concerning, in particular, obligations stipulated in a contract of a client, advertising the UCITS investments, the act of issuing E-money through the “waived” electronic money institutions and other rules in the insurance field.

From the point of view of the impact on hedge funds, it should be noted that the EU E-Commerce Directive, once it has been completely adopted by the Member States, can highly impact on-line cross-border hedge funds marketing. However, the E-Commerce Directive imposes a "country of origin" approach to regulation, in the sense that, for instance, UK managers marketing funds in other EU Member States are to be subject to the applicable UK marketing rules instead of having to comply with the regulations of the other countries. Nevertheless, this is only going to apply to promotion via the Internet; other regulations, among which laws on tax and information protection or against unsolicited email, still need to be observed.

The Prospectus, Market Abuse Directive and Savings Tax Directives represent other sources of Community legal rules relevant to the business activities of onshore alternative investment vehicles. As far as the MAD is concerned, it seems obvious that the insider handling with market manipulation interdictions enclosed therein could treat the dealings of onshore hedge funds in tools allowed to enlist in regulated markets functioning in the EU, “particularly with respect to potential market manipulation.”

This reform mirrors several recent cases and discussions both in the US and in Europe that will be analysed in the last chapter. In the US, for example, the conviction and sentencing of the hedge fund manager Raj Rajaratnam to eleven years in prison due to

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386 UCITS Directive, Article 44(2).
insider dealing, as well as the payment of US $25 million by Moore Capital Management to settle charges of market manipulation were carefully considered. These cases concern the MAD\textsuperscript{389}. Under MAD, regulators try to protect investors against market abuse and to expand supervisory and enforcement possibilities.

In the end, regarding the Savings Tax Directive and considering that its scope is to make sure that where an “interest payment” is made to a particular “beneficial owner”\textsuperscript{390} located in an EU country by a “paying agent”\textsuperscript{391} domiciled in a jurisdiction falling within the scope of the Directive, the paying agent is going to provide data on the interest payment towards the tax authorities from the jurisdiction in the tax residence place of the beneficial holder. The most desirable perspective is that this should not affect the payments received by hedge funds (the latter cannot qualify as “beneficial owners” since they are not individuals). It could continue to be important to payments made by funds investing in fixed interest instruments, where the involved funds are deemed to fall within the Directive’s rationae personae scope. Meanwhile, the largest part of hedge funds could not be apprehended through the Savings Tax Directive, due to their classification as non-UCITS or UCITS equivalent funds in most jurisdictions. It is still unclear how the competent authorities are going to investigate its provisions and how changes in the national categorisation of hedge funds could impact their treatment from the point of view of their (possible) interest payment duties\textsuperscript{392}.

### 3.10 Concluding remarks

The current chapter presented a comprehensive overview of the European legislative framework regarding, \textit{inter alia}, hedge funds: UCITS Directives (IV, V and VI), AIFM Directive and MiFID (Level I and II) and other major sources of Community Legal

\textsuperscript{389} Market Abuse Directive
\textsuperscript{390} Savings Tax Directive, Article 2. The notion of “beneficial owner” captures individuals only.
\textsuperscript{391} Ibid, Article 4. “Paying agent means any economic operator paying interest to or securing the payment of interest for the immediate benefit of the beneficial owner, whether the operator is the debtor of the debt claim which produces the interest, or the operator charged by the debtor or the beneficial owner with paying interest or securing the payment of interest.”
\textsuperscript{392} Question marks also occur in connection with the onshore hedge fund implications of the Third Anti-money Laundering Directive (which, although imposing a detailed set of customer due diligence, reporting and record-keeping requirements, \textit{inter alia} on “collective investment undertakings marketing [their] shares or units”, does not specify whether its reference to CIS captures harmonised funds only) and of the recast Capital Adequacy Directive (which, while applicable to prime brokers, is bound to also affect hedge funds themselves where its national implementation expressly covers alternative investment vehicles).
Rules. The UCITS Directives, the AIFMD and the MiFID introduce a harmonised investment protection and product regulation framework, focusing on improved investor disclosure.

In the author’s opinion, AIFM Directive has a great potential to overturn the alternative investment market within and beyond the borders of the EU, proposing a way to redesign the UCITS investor protection architecture. Currently, the statistics regarding the AIF market provided by the EC stated to have EUR2.2 trillion in AUM. Although this is merely a fraction of the almost EUR6 trillion in AUM held by the UCITS sector, it provides a great opportunity for the expansion of AIF industry in the EU. In fact, this represents the indirect purpose of the EU regulatory officials to encourage several “Newcits” strategies into moving out of UCITS within the legislative context of AIFM Directive exactly when it passed.

The most attractive option in the author’s opinion, seen also as a *quid pro quo* in favour of the adhesion to the new coordinated standards, is that EU AIFMs would be provided the favourable circumstances to market their AIFs in the EU by means of a passport. New distribution channels will develop while providing their access to markets that found it invariably difficult and even impossible (at times) to enter. Similarly, non-EU AIFMs might have the opportunity to “opt-in” starting with 2015. At the same time, the previous phobia against the so-called European “fortress” barriers experienced by the non-public offering of third country AIFs – *inter alia* Cayman or British Virgin Islands – could be prevented due to the non-public offering regimes within Member States expected to last until 2018, the minimum, considering that the passport option could open up in 2015. The non-EU AIFM’s opting in to the AIFM Directive will be of great interest, as well as the use of the passport for their own benefit or the maintenance of privately located funds up to 2018.

However, the author considers that both managers and investors welcome the option of allowing them to perform both tasks. The Directives are considered to become in time a brand for *investor protection* in relation to high-standards, in a similar manner the UCITS funds proved successfully not only inside, but also outside the EU. There is no doubt that the UCITS Directives are a successful instrument for facilitating cross-border investments in AUM schemes while offering at the same time a high level of investor
protection. However, when the industry and regulators refer to the success of UCITS in reaching a high standard of investors’ interests protection, they are mainly referring to a product that tightly regulates on the one hand the asset management company and on the other hand, the depositary in order to mitigate possible conflicts of interest, operational risk, as well as other risks connected to entrusting a person’s savings to a money manager. This does not exclude the fact that the AIFM Directive might pose several major challenges regarding the compliance costs that will affect especially the small managers.

Meanwhile, Article 3 of the Directive establishes minimum AUM threshold norms regulating leverage calculation and the lack of certainty regarding the possibility for Member States to impose very exact limits for the small manager exemption – both situations lead to the opinion that these thresholds could not prove very efficient in practical applications. *Ad consequentiam*, negative impacts are expected under certain circumstances: costs related to the appointment of a depositary according to the new liability rules stipulated in Article 21, the lack of certainty over delegation, the lack of compatibility with MiFID, the remuneration controls together with the third country cooperation settlements issues. Overall, there are major concerns regarding an efficient and balanced implementation. In this respect, the successful implementation of AIFM Directive requires the maintenance of a level playing area between EU and non-EU organisations.

The author of this thesis identified several important disadvantages so far: the AIFMs located in EU are already required to obtain authorisation according to the MiFID. Therefore, they are already subjected to registration, regulatory capital, compliance and reporting requests. At the same time, the AIFM Directive will apply similar standards and requests, even if this directive establishes by far more oppressive reporting requests. In this respect, the author would like to underline that the EU regulatory authorities from Brussels, including the EC, have explicitly inserted within the AIFM Directive many of the principles stipulated within the MiFID and overall UCITS Directives (IV, V and even VI), most of the times using exactly the same words. Positive and negative comments were provided as the above-mentioned approach proves the EU’s willingness to harmonise the norms in the financial services field, but at the same time proves, to a certain extent, its low comprehension level regarding the AIFs operation, requiring the
AIFMs to comply with the norms set up for the UCITS funds managers (fund tools particularly meant for retail investors), unlike the most part of AIFs.

Further on, the author proposes a brief comparison of the three major directives analysed herein: UCITS Directive, MiFID Directive and AIFM Directive, all focused on ensuring investor protection.

The convergences of these three directives represent major issues in addressing them. Therefore, overlaps regarding MiFID and the UCITS Directive imply the regulatory framework regarding the sales of UCITS, because the UCITS sale is included in the aim of MiFID’s conduct of business norms. So far, MiFID II, within the EC’s draft proposal, considers that the UCITS are either “complex” or “non-complex”. From this point of view, there are significant distinctions between MiFID II and UCITS Directive. Therefore, according to MiFID, only the non-complex particular financial instruments may be sold to clients based on an execution ground in the absence of the tool suitability control for the client. The above-mentioned issue contradicts the UCITS Directive, as UCITS tend to be particularly considered appropriate for retail investment, being also tightly regulated by the UCITS Directive. Conclusively, the conflict emerging between these two directives becomes very clear in this context. The author considers that these issues should be carefully considered and that the distinction between UCITS/non-UCITS should be made.

Nonetheless, while an AIFM is outside the aim of MiFID, one anticipates that similarly to UCITS, many of the investor management activities of alternative investment funds will occur in investment companies, subjected to the regulation of the MiFID. Consequently, managers will manage funds covered not only by MiFID, but also by AIFM Directive, and this implies the fact that they will be compelled to comply with both directives. This raises the significant question whether tracing refined differentiations between these two directives makes any sense.

It is therefore necessary that several approaches be implemented when developing MiFID II: the prevention of the duplication between the two directives; in case the duplication cannot be avoided, the clarification of stipulation guides so that these are easily comprehended in terms of which directive should be followed or is going to
prevail, or at least a clear sign of the more rigorous requests observance; the notification of direct remarks to both UCITS and AIFM Directives where appropriate, as the major aim is to prevent the occurrence of overlaps between the two directives.

As one could see, the UCITS Directives, AIFM Directive and MiFID have all negative and positive impacts. As a final concluding remark, the real advantages of these directives will be observed in the forthcoming future, as a follow-up of dust settlement and of the passport availability to a broader extent – if such be the case.

The author considers that disclosure and operating provisions must be at the core of investor protection architecture, as they will ensure a gold standard applied worldwide.
CHAPTER FOUR

REGULATION OF HEDGE FUNDS IN THE UK AND SELECTED SINGLE EUROPEAN JURISDICTIONS: ITALY, FRANCE, IRELAND, LUXEMBOURG, MALTA AND SWITZERLAND. THE IMPACT OF THE AIFM DIRECTIVE

4.1 Introduction
This chapter provides a comparative overview of how different and diverse the hedge fund regulation throughout Europe is. Even if the author does not go into details when describing the laws identified in the different selected single European jurisdictions: UK, Italy, France, Ireland, Luxembourg, Malta and Switzerland. The intention is to give the reader an idea of how diverse and dissimilar the different legislators’ approaches can be, instead of presenting a detailed description. Also, such a description would not correspond to the scope of this chapter that aims to focus on investor protection principles, not on the detailed international rules.

4.2 Regulation of hedge funds in the UK

Although after the recent financial crisis, the British regulatory system of the financial sector shares many common principles with the American and European systems, the particularities characterising each of them are still prominent.

The FSA is still the main regulator in the UK, although this country has undertaken on a reforming plan resulting mainly in the subdivision of the FSA into two official bodies. The first is represented by the PRA\textsuperscript{393}, and the second by the FCA.\textsuperscript{394} FSA is a non-governmental body created in 2001 with “statutory powers by the Financial Services

\textsuperscript{393} Prudential Regulation Authority.
and Markets Act 2000” to regulate hedge funds industry and all pyramid institutions. Therefore, the hedge funds regulations are issued according to this Act and are enforced and supervised by the FSA. This was the UK financial architecture before the 2007-2009 financial crisis.

On the 16th of June 2010, the Chancellor of the Exchequer presented the Government’s projects in terms of reorganisation of the UK system of financial regulation. In July, a consultation followed this speech, named, “A new approach to financial regulation: judgement, focus and stability”, pointing out its recommendations in more details. According to this document, the next step of the Government’s recommendations is set out, according to the conclusions revealed by the examinations in July and carrying on the approaches started by the Treasury, “Bank of England”, but also FSA.

In February 2011, “the Treasury” presented to the Parliament a consultation paper entitled “A new approach to financial regulation: building a stronger system.” The Government’s reform focuses on three major organisational modifications. First of all, a recent FPC is going to be set up inside the Bank of England, being in charge “with macro-prudential regulation”, supervising the financial security and flexibility of the entire economic structure. Secondly, the PRA intends to manage significant risks, ensuring “micro-prudential regulation” of financial organisations. PRA is an autonomous branch subordinated to “the Bank of England.” Thirdly, responsibility regarding corporation management regulation will be moved to a different professional regulator, previously called “Consumer Protection and Markets Authority”, authority whose name was changed, this one being already completed by Government as “the FCA”, further on in charge of the supervising problems emerging inside the entire series of financial processes. Under this organisation, the financial stability is the responsibility of the Bank of England, the Treasury and FSA. At the beginning of 2012, the “Financial Services Bill” to Parliament was implemented.

“The Financial Services Bill” was adopted by Parliament, offering bigger transparency for the modern organisation of financial legislation on the territory of the UK. Not entirely unexpected, this Bill calls up the most important reforms of the Government to establish another new “twin peaks” organisation of the financial regulatory from UK.

395 http://www.fsa.gov.uk/
396 Financial Policy Committee.
This new organisation implies the replacement of the FSA with two new regulators, as mentioned above: the PRA and the FCA.\textsuperscript{397} Similarly, this Bill “also proposes to establish the Financial Policy Committee within the Bank of England as the UK’s macro-prudential authority.”\textsuperscript{398}

Thus, the legislative system will establish a FPC responsible with the identification and monitoring, but also acting for the removal or mitigation of systemic risk in order to protect and enhance the resilience of the British financial industry. At the beginning of the summer of 2012, it was communicated by the Chancellor “that the Government would amend the Bill to give the FPC a secondary objective to support the economic policy of the Government.”\textsuperscript{399}

According to the present governance authority, FPC will represent one Committee of the Bank of England’s Court of Directors. At the beginning of 2011, the same Court developed an interim FPC to undertake all forthcoming statutory macro-prudential roles of the FPC. Despite the fact that the interim FPC lacks the suggested statutory qualifications of Direction and Recommendation of the statutory FPC, this has a great contribution in maintaining the financial security. This is performed by identifying, surveying but also by advertising the risks to the security of the entire financial sector. Careful guidance activities for mitigation of risks are performed. At the same time, preparatory jobs but also studies are developed before the set up of the permanent FPC. The interim FPC had its first policy meeting in June 2011.\textsuperscript{400}

At the beginning of 2012, after the HM Treasury’s previous requirement, the interim FPC came to terms without dissent a declaration describing its recommendations regarding the possible powers to be attributed to the Direction for the statutory FPC. According to this, the FPC must search for powers of Direction over a countercyclical capital buffer, sectoral requests of capital, and a leverage rate. At the same time, this Committee apprehended secondary desirable possible tools, even if it made the decision to leave them out of its recommendations concerning the first powers of Direction.\textsuperscript{401}

\textsuperscript{397} Which will develop supervision of regulated firms and take the functions of the UK Listing Authority.
\textsuperscript{398} http://www.linklaters.com/, accessed on 12.05.2012.
\textsuperscript{399} http://www.bankofengland.co.uk/, accessed on 29.07.2012.
\textsuperscript{401} http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx, accessed on 29.07.2012.
Setting up FPC represents only one small segment from a larger set of financial anti-crisis measures. Therefore, one main focus is on mitigation of risk at global and individual firm level. In order to achieve this, the need for macro-prudential and micro-prudential regulation was promoted. The set up of a “PRA within the Bank of England” is necessary for these purposes.

Consequently, according to the governing groupthink report, the FPC meetings will be held minimum four times a year. One record from every official meeting needs to be made public. At the same time, another responsibility will be that of being in charge with the Bank’s bi-annual “Financial Stability Report”, covering the Committee’s appraisal of the security expectancy, but also of the resilience of the financial system as well as of the policy activities recommended to mitigate the risks to security.402

The “ring-fencing” concept is a new and original element introduced by the Financial Services Bill. This concept tries to separate the more risky activities of the banks such as for instance “investment banking” and “proprietary trading” from those functions considered to be the “core-business” of banks such as: the payment systems, the deposits, the interbank market, the loans, considered to be the main activity of the commercial banks. The Vickers Report is in favour of this separation between the commercial and investment activities within the banks403, but the creation of a “Chinese wall” between the two sectors would be artificial and might lead to assuming very high risks on behalf of the banks, and these risks might cause “moral hazard” in the financial system.

Comparing the regulatory system of the financial and banking sector in the UK with the EU regulations in this field, one may notice a certain note of protest from London, the most important investment and banking financial centre in the world, towards some regulations in this field.

On 19 December 2012 the Financial Services Act 2012 received royal assent and came into force on the 1st of April 2013. A major stipulation of this act is the making of a new regulator, the newly formed Financial Conduct Authority. The FCA takes over responsibility for investor protection as well as market oversight in the UK, marking the final dissolution of its widely-criticised predecessor, the FSA. The FCA is going to have an active role in shaping policies and driving the investor protection agenda in Europe and globally, not only in the development of broad standards but also of detailed regulations affecting UK investors and corporations. The FCA has three key operational objectives focusing on the integrity of the market, consumer protection and competition. Also, investor protection represents the first of three general objectives in securities regulation according to the International Organisation of Securities Commissions ("IOSCO"). As seen before, countries like the UK have adopted the three IOSCO objectives without modification, proving their increased attention towards this subject.

The FCA adopts a renewed focus on wholesale conduct, with major attention paid to retail investors and conflicts of interest, both being concerned with investor protection. Thus, according to them, activities in retail and wholesale markets are related and risks due to poor wholesale conduct may be transmitted between them. The failure to adequately manage frequent inherent conflicts of interest in wholesale markets represents the major cause of risk for market integrity and consumer protection. In this context, for the enhancement of trust and confidence in the integrity of markets, FCA is planning on taking a more assertive and interventionist approach to risks which are a consequence to wholesale activities and, if needed, to protect a larger range.

Two types of wholesale conducts are promoted by the FCA: the good and the bad conduct. The first one relies on effective policing of market abuse, but investors also must be safeguarded against activities exploiting differences in either expertise or market power. The second type of conduct is not a victimless action just due to the fact that it occurs between sophisticated market participants, and at the same time it is not limited to criminal behaviour among which fraud or market abuse can be mentioned. These types of conduct imply an ample range of activities that take advantage of varieties in expertise or market power with the purpose to undermine confidence in the integrity of markets or simply harm retail investors.
According to the policies of FCA, misconduct in wholesale markets can affect much more the integrity of, as well as confidence in markets as compared to a narrow interpretation of the principle of sophisticated market participants. FCA is planning on enhancing trust and confidence in the integrity of markets.

The message they are trying to transmit is that FCA seeks to ensure that hedge funds financial markets are sound, stable, orderly and resilient and that investors, whether they are retail or wholesale, enjoy an appropriate degree of protection from risks arising from their exposure to wholesale activities, be it in a direct or indirect manner.

Another major objective of the FCA is to direct an increasing part of their work towards adopting, supervising and enforcing EU, as well as international standards. The FCA is going to actively bring its expertise to international debates and rule-making, in order to make sure that the standards fixed on both investor protection and market integrity are deeply connected with their objectives. Accordingly, the FCA imposes itself a comprehensive understanding of consumers’ interests and on making sure that there is no dilution of consumer protection at domestic level.

4.3 Hedge funds regulation in selected EU Member States jurisdictions

4.3.1 Italy: overview of hedge funds regulatory regime

4.3.1.1 The evolution of hedge funds regulatory regime in Italy

Italy is the second largest European market for UCITS funds, amounting to more than EUR177 billion in AUM\(^{404}\), as it is amongst the first European jurisdictions to explicitly adopt, in 1999, specific regulations for hedge funds as well as FoHF.\(^{405}\)

“Hedge funds” represent “not a legally defined term under the Italian law”, known rather as “speculative funds” (“fondi speculativi”)\(^{406}\), a designation making no difference between single-manager funds or FoHF.\(^{407}\)

The key norm is Treasury Decree n° 228, as amended (the “Treasury Decree”)\textsuperscript{408}, further developed, mainly through the 1999 and 2005 Bank of Italy Regulations\textsuperscript{409} with the latter indicating the adoption of a somewhat more liberal approach to alternative investment fund regulation. There were several regulations acknowledging hedge funds, or for a better accuracy, their Italian synonym: \textit{fondi speculativi/speculative funds} in compliance with the Italian regulatory system. These regulations were the Decree n° 58/98 and the already mentioned Ministerial Decree n° 228\textsuperscript{410}. Therefore, it was only in 2008, with the enactment of the Law Decree n° 185, that the international concept of hedge fund started to be acknowledged in Italy, too.\textsuperscript{411} These will be further approached in this chapter. The minimum initial investment or threshold for speculative funds was set at EUR500,000 while the Italian law also stipulated a maximum of 200 investors per fund\textsuperscript{412}. Moreover, speculative funds could only be distributed on a private placement basis, with authorisation of CONSOB\textsuperscript{413} - the regulator for Italian securities.\textsuperscript{414} Hence, while Italian law did not statutorily restrict hedge funds to designated categories of professional investors – the Treasury Decree did not explicitly require that the 200 investors should be “qualified investors” – its effect was to limit the marketing of speculative funds exclusively to those public or private investors having increased net value.

\textsuperscript{409} “Provvedimento del Governatore della Banca d’Italia del 20 settembre 1999 (Regolamento recante disposizioni per le società di gestione del risparmio)”, and to the “Provvedimento della Banca d’Italia del 14 aprile 2005 (Regolamento sulla gestione collettiva del risparmio).” The latter flashes out several of the provisions of Decreto Legislativo 1 agosto 2003, n° 274, transposing UCTIS III.
\textsuperscript{410} Of 24 May 1999.
\textsuperscript{412} Treasury Decree, Articles 16.3 and 16.2. A July 2008 report advocated a decrease by half of the investment threshold and the elimination of the maximum amount of investors allowed within one fund. “This threshold was the result of the amendment brought by Ministry of Treasury Decree N° 47 of 2003” (Gruppo di Lavoro sui Fondi Comuni Italiani, “Fondi Comuni Italiani: Situazione attuale e Possibili Linee di Intervento”, Rapporto, Luglio 2008, 41-42)
\textsuperscript{413} Commissione Nazionale per le Società e la Borsa.
\textsuperscript{414} Treasury Decree, Article 16.4.
In terms of investment policy, speculative funds can invest freely, without any restrictions, adopting the investment strategy of their choice, without being subjected to the prudential supervision rules of the “Bank of Italy” (BoI), which apply to common collective investment schemes.\textsuperscript{415} Similarly, there are no restrictions regarding the portfolio diversification applicable to Italian speculative funds.

However, Italy is the only EU jurisdiction examined herein, where the offer of hedge fund products is reserved to specialised asset management companies, appointed as “Società di gestione del risparmio speculative” (“speculative SGRs”), endowed with legal personality and established under the law of contract.\textsuperscript{416}

The fee rate levied for speculative funds reaches 12.5% in terms of the accumulated managerial outcomes towards the end of the year. According to the Italian main norms, the return acquired through any investment fund is levied before deductions by withholding fees at source or swap fees. Similarly, both the capital subjected to the deduction fee at source and the fee-exempted capital in Italy tend to be removed from the managerial outcome, falling under the 12.5% fee. Speculative SGRs fall under the corporate fee reaching 33%, and under the regional fee reaching 4.25%, based on regional regulations.\textsuperscript{417}

Italian law submits the distribution of foreign non-UCTIS funds in Italy to the same BoI prior authorisation requirement. The grant of an authorisation is explicitly made conditional.\textsuperscript{418}

Nowadays, “speculative funds are regulated by article 16 of the Ministry Decree n° 228 of 24 May 1999, as amended by the Ministry Decree n° 256 of 14 October 2005 and the Ministry Decree n° 47 of 31 January 2003 (Decree n° 228) that implement article 37,

\textsuperscript{415} Treasury Decree, Article 16.1.
\textsuperscript{416} Although speculative SGRs only differ from ordinary ones in terms of their objective, with Italian law prescribing no special requirements for speculative SGRs to secure a BoI management license. “Regolamento della Banca d'Italia 20 settembre 1999, pubblicato nella Gazzetta Ufficiale n° 230 del 30 settembre 1999, sostituito dal provvedimento della Banca d’Italia 14 aprile 2005, pubblicato nel supplemento ordinario alla Gazzetta Ufficiale n° 109 del 12 maggio 2005.”
\textsuperscript{418} Testo Unico della Finanza, Article 42(5).
Similarly, there are also secondary norms regulating speculative funds, namely:

- “the BoI regulations of 14 April 2005, as amended by the BoI Order of 16 December 2008 that provides the implementing rules of the EU Directive 2007/16/EC on eligible assets.” These regulation contain typical norms with regard to SGRs and to the manner they are managed;
- the “BoI Order of 21 June 2007, amending April 2005 BoI Regulations”\(^{421}\), with regard to scopes concerning SGRs but also the regulation of funds;
- “the BoI and the CONSOB joint regulations of 29 October 2007 providing the MiFID Directive 2004/39/EC implementing rules;
- the Decree n° 185 and the implementing December 2008 BoI Regulations.”\(^{422}\)

To ensure a very effective operation of Italian hedge funds on the financial industries’ liquidity crises but also, simultaneously, to guarantee similar interests and support for all invested individuals, the BoI issued Regulation 785/08\(^{423}\) on December 16, 2008, adopting “Section 14, paragraphs 6, 7, 8 and 9, of Law Decree n° 185 of November 29, 2008.”

In agreement with Law Decree n° 185\(^{424}\), taking on Italy’s finances and coming up against this financial tumult,\(^{425}\) several recommendations were made by Italian regulatory texts, up to the end of 2009:

(i) First, in case the SGRs receive overall redemption requirements higher than 15% of the NAV\(^{426}\), at some particular date or extent of time, then the SGRs will be able to perform partial redemptions. According to this, all units that were not repaid - surpassing all thresholds that were previously mentioned, also named entries/gates – are going to be seen

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\(^{420}\) Ibid.

\(^{421}\) Ibid.

\(^{422}\) Ibid.

\(^{423}\) The BoI Regulation 785/08 was published on December 22, 2008 in the Italian Official Gazette and entered into force on the same date.

\(^{424}\) Law N° 2 of 28 January 2009 (Decree 185). (so-called “Anti-Crisis Decree”)


\(^{426}\) Net asset value.
like reimbursement requirements that the investors newly submit during the first day following that above-mentioned partial redemptions;\(^{427}\)

(ii) Second, if it is absolutely compulsory for SGRs to satisfy every redemption request, sell “the fund’s illiquid assets, and if this may adversely affect the interests of the investors, the SGR can solve a withdrawal thereof and transfer the illiquid assets in a new closed-end fund, whose units are assigned to each participant to the original fund proportionally to the amount of units owned in the latter.”\(^{428}\) These newly created funds, also named side-pockets, are not allowed to release new units, while the old ones are going to face reimbursement when the assets liquidation will occur.

Provisions find that a SGR is able to face problems in the reimbursement of customers meaning that these are going to need to divest every illiquid asset.\(^{429}\)

The highest amount of participants in hedge funds is set at 200. In fact, the previously mentioned limit had led to the making of similar duplicates of hedge funds. Such innovation has been suggested in a recent study advanced by the Group responsible with the hedge funds reform in Italy, as this was also “established before the BoI.”\(^{430}\)

According to the previous statements, Regulation n° 785 of December 2008, adopted by BoI focuses generally on features regarding side-pockets, definition of *illiquid assets*, estimation of the manner in which new norms affect the industry, especially at the time the unitary worth is below half a million EUR and last but not least, regarding the approval act of “procedures for the amendments to the fund’s regulation.”\(^{431}\)

“The *Characteristics regarding side-pockets.*” Art. 14\(^{432}\) of the above-mentioned Decree, considers that side-pockets represent closed-end funds. According to this, they focus on the disinvestment of their assets which are difficult to sell in compliance with a given disinvestment program previously confirmed by the managers of the SGR. Similarly,

\(^{427}\) *Law Decree n° 185 of 28 November 2008*, issued by the Italian Government published on the same day in the *Official Gazette n° 280 (Ordinary Supplement n° 263/L).*
\(^{428}\) Ibid.
\(^{432}\) Paragraph 6, let. (b).
they are forbidden to make a single transfer or to merge. However, they might ask for loans but not more than 10% of its net worth, while the allowed period is half a year, the most. Also, this “is entitled to cash holdings - other than those necessary for redemption – for hedging and ordinary administration only.”

The creation of a fund implies several conditions for SGR, which must first clarify the main motivation regarding the illiquid assets transfers. Secondly, this must acknowledge all norms imposed by side-pockets. Thirdly, the individualisation of those illiquid assets that need to be moved to the side-pockets is necessary. In the fourth place, the solving of the hedge fund separation and the transference concerning illiquid assets to side-pockets shall be ensured. In the fifth place, one needs to establish fundamental appraisal standards regarding illiquid assets, and then to receive the approval of a controlling strategy regarding the illiquid assets transfer. Lastly, the approval of the study regarding the establishment of side-pockets will be forwarded towards the investors.

Defining “illiquid assets.” Several standards need to be promoted to assess the fund in terms of its financial tools liquidity:

(i) Undertakings for UCITS or other similar financial tools:
   - long-term act of suspending regarding calculations of the shares’ worth;
   - sectional or overall act of suspending redemptions;
   - fund termination;
   - making side pockets/similar tools;
   - the act of amending regular buybacks of the shares;
   - worth rates instability due to assets difficult to sell, to whom this industry is not pointing out trustworthy costs.

(ii) Secondary financial tools. The following data are considered:
   - size, regularity and trading firm;
   - a consistent price;
   - buying tendency as well as selling costs during a given interval;
   - distribution of costs by means of trustworthy materials.

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436 Ibid.
These recent rules affect the market for two reasons, especially when the unitary price exceeds EUR500,000:

(i) The hedge fund can be separated. At that time, the investor, who is by no means guilty of the unitary price decrease, cannot be forced to replace the minimal amount mentioned;

(ii) Adding a gate, when the redemption is verified, with regards to the subsequently expiration periods until the last redemption, the only exception accepted is when the investor subscribes for the amount requested to reinstatminimal thresholds.437

The processes confirming all rectifications of the fund’s regulation to the hedge fund’s norms regarding the introduction of the so-called gate, regarding the set up of side-pockets, but also/or regarding the cancellation of the norm lowering the upper limit of the amount of hedge funds investors tend to be similar to those for normal amendments to the fund’s norms.438

Due to the financial crisis, as well as to the systemic generated risks bursting out generally due to low mastery instruments for alternative investments439, there is a general agreement about EU, which is expected to introduce an innovating system of rules. Therefore, the published “Directive 2011/61/EC of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, as well as the amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) n° 1060/2009 and (EU) n° 1095/2010440 focus on regulating managers of alternative investment funds. These imply the overall collective investment institutions that are not included in the UCITS directive, or in other words, that cannot be defined as harmonised investment funds.441

4.3.1.2 The Italian regulatory regime: scope and objectives

438 Ibid, p. 43.
441 The AIFM Directive is analysed in detail in section 3.6. of Chapter three of this thesis.
It is important to point out that this Anti-Crisis Decree and the collapse of the BoI, as well as the subsequent implemented regulations have led to the measures recently adopted in Italy to ensure transparency, the orderly exchanging but also the investors’ protection. For instance, the latest limits on short selling presented by the Italian Listed Entities but also by CONSOB intend to keep away speculation in trading from causing an abnormal decrease of share prices. This also leads to the restriction of hedge funds processes. Still, two urgent costs of the short-selling ban, designed to reverse the decrease of financial assets prices, can supply additional decrement of prices.

Firstly, many security companies tend to restrict alternatives for commercial dealings regarding clients, leading to unexpected “short positions upon exercise”, for example purchasing puts, exchanging calls. Secondly, a certain number of individuals taking part to the industry and coming from financial stocks tend to be hedge funds using “short-term long-short” exchanging tactics in important quantities. This group of active participants, usually providing high amounts of money for the industry, have reduced inventory, particularly nowadays. This decrease of liquidity will have an effect on the overall financial entities, particularly on smaller financial organisations. In return, they are going to affect the retreat of these stocks investors and further discourage their prices that will be facing liquidity deterioration.

Outcomes are expected from the above-mentioned scenarios. Thus, on the one hand, the most recent regulations adopted by the BoI concerning hedge funds could be appreciated since these measures might be seen as a means of controlling the uncertainty caused by the financial crisis, by enhancing investor protection. Additionally, this might mentally bring about an adverse consequence, a counteraction that could be leading to a speed-up in redemptions. Substantial redemption demands could affect their administration in a pessimistic manner, consequently restraining their contributors’ interests.

Furthermore, the BoI the lowest entry amount necessary for taking part in a hedge fund of EUR500,000 for each partner - despite a suggestion made by Assogestioni (Italian professional association for Italian investment management industry) in favour of diminishing this amount by half of it - further restricts any development or arbitration of this tool amid private investors.

4.3.1.3 The advantages and disadvantages of the Italian regulatory regime

Italy has a special treatment that is a quite flexible approach to hedge fund regulation. Italian hedge fund industry is certified as the topmost complete hedge fund regulatory administrations in the world. Hedge funds “have proved to be a useful instrument for diversifying investment portfolios.”

Nevertheless, the Report issued by the BoI, CONSOB and the Ministry of Finance in 2008 concluded that the hedge funds Directive needs modifications for the time being, and this occurred 10 years after its enactment in Italy. The necessity of this shift comes from the need to allow new progresses on the part of this investment type, but, at the same time, it comes from the need to encourage competitiveness within the market of funds from Italy at the global level. Generally, these new regulations are expected to bring forth a double set of goals: (a) significant decrease of the minimum subscription amount of the hedge funds’ investments, which is currently half a million EUR; (b) diversification of regulation through FoHF, as well as hedge funds, with the major purpose of making the offer available to a more comprehensive public.

Nevertheless, this regulatory purpose stipulated or suggested in the above Report does not seem to be so simple, if we take into account the recent financial crisis. This idea is also supported by the speech of BoI Deputy General Manager, who said that the international hedge funds markets are subjected to extensive restructuring with unpredictable results for the time being. Under these circumstances, it seems rather

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advantageous to clarify these tendencies at the global level before going on with these internal law changes.  

A benefit is that, in Italy, hedge funds are not accessible to the public and the minimum subscription amount is half a million EUR. This indicates that the holders of Italian hedge funds shares are institutional investors. This also suggests that the protection regime already provided is sufficient to such investors.

It is not the manager’s obligation to “publish a prospectus”, though he has an obligation to distribute all the latest norms related to the fund to all subscribing investors. These hedge funds norms need, inter alia, to illustrate firstly the risks that arise (if they exist) in foreign hedge funds (for example if hedge funds are controlled from off-shore centres); secondly, they need to illustrate the highest quantity of mortgages but also leverages. Furthermore, overall bookkeeping records will be accessible both for investors and for the public in the manner prescribed in the hedge funds guiding norms.

The latest “crisis has shown that hedge funds may be subject to considerable systemic risk”, and because of this, central banks, endowed with macro-prudential supervisory responsibilities look for information on their portfolios and their performance in the markets of at least the biggest of these funds. Hedge funds are obliged to inform the BoI about the structuring of their portfolio, every six months. The SGR discloses to BoI, with indication to each fund or sub-fund controlled only: a duplicate of the half-yearly report of the fund in 60 days from the end of the semester; a copy of the balance fund sheets, together with the information of the directors and the audit reports in the last 90 days of the year.

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On the negative side, the Italian exchange market was at first regulated by the Italian Stock Exchange. It was only afterwards that the Market Abuse Directive came into force.\textsuperscript{458} At the same time, no actual file cases concerning market abuse were revealed.\textsuperscript{459} Alternatively, hedge funds have been blamed for damaging companies by excessive leverage. They also have been blamed for destroying jobs\textsuperscript{460}, but despite an opinion in Italy which considers this a negative phenomenon for the market, the Italian Government is not aware of any specific employment cases or firms ruined by excessive leverage.\textsuperscript{461} In October 2011, the EC brought forward several regulatory recommendations: “Market Abuse Regulation” (MAR) and MAD.\textsuperscript{462} Their intention was to update but also to straighten the current construction regarding market integrity protection brought out by the 2003 MAD. Accordingly, the Italian market was forced to update all its internal regulations in compliance with the European ones, to cover, for instance, the widening of market abuse regulations so that it can comprise all new financial tools.\textsuperscript{463}

\textbf{4.3.1.4 Could a more regulated hedge funds industry at European level lead to an increase of this sector?}

The general opinion is that, a more regulated industry at European level could turn into an obstacle to future development of the Italian hedge funds market. So far, foreign managers have increased complexity\textsuperscript{464} in setting up a presence in Italy, which will be further explained. First, planning an office there lasts longer and is more expensive than in most European countries. In the UK, for instance, the FSA makes available registration of funds within approximately four months. At the same time, the Italian manager registration process takes three months, while the funds’ authorisation takes

\begin{thebibliography}{9}
\bibitem{460} From European Venture Capital Association: “Investments by European private equity and venture capital firms amounted to EUR73.8bn in 2007, and approximately 5,200 European companies received private equity investments.”
\end{thebibliography}
four extra months, which is also very expensive.\textsuperscript{465} The first application implies that the paid-up worth reaches at least EUR1,000,000\textsuperscript{466} while associated costs are generally a lot higher.\textsuperscript{467} Additionally, the more regulated the hedge funds industry will be, the less appealing hedge funds managers will find to settle their funds in Italy.

4.3.1.5 The AIFM Directive impact on the Italian regulatory regime

The AIFM Directive aims to prevent any negative consequences for “all financial market participants” as well as the underlying market security through specific rules regarding inter alia, own funds, gearing ratio, conduct of business rules, rules regarding manager’s remuneration, information and/or disclosure rules, financial accounts provisions.

The Inconveniences of the Previous Fiscal Regime. “The previous tax system of Italian investment funds was based on the principle of taxation of the increase of the funds’ net asset worth during each year which was falling under a tax at the rate of 12.50% that had to be paid at fund level instead of by the investors.”\textsuperscript{468} The income from foreign funds with EU passport falls under a withholding tax at a rate of 12.50%\textsuperscript{469} (20% for the income payable and realised starting from January 1, 2012), the investors being the ones paying this tax in accordance with a cash basis when they receive the income realised, through the periodic distributions by the fund or through the trade or redemption of their units.”\textsuperscript{470} There were several disadvantages associated to the application of this different tax regime for Italian investment funds. First, Italian investment funds presented the lowest performances even when their returns equalled those achieved by the other foreign funds with EU passport because they had to pay an yearly tax on the increase of their net asset worth and to indicate in their financial statements their net returns of this tax. Second, by paying the tax on the increase of their net asset value each year, Italian investment funds were unable to reinvest the money used for paying this tax.

\textsuperscript{469} Article 2, paragraph 6, of Law Decree of August 13, 2011, n° 138.
\textsuperscript{470} Ibid.
Consequently, they obtained lower yields than those of the other foreign funds with EU passport not subjected to the tax in their location country.\textsuperscript{471} The factor with the greatest impact on the different investment market in Italy related to risks and opportunities is represented by the initiation of marketing of European passport products if tax harmonisation issues are solved.

Giulio Tremonti\textsuperscript{472} best advocated the need for hedge fund regulation, also requesting the tighten of regulations in this industry. Similarly, he requested the supervision of funds by banks.\textsuperscript{473} Therefore, the threat to the domestic industry is evident: there will be no further need for Italian hedge funds and the path will be clear for the repositioning of management, and for UCITS products. There is another explicit risk (though for customers it may turn into a chance): the decrease of the number of domestic players in the industry, all to the advantage of global asset managers with centres of expertise positioned in other European capitals. By contrast, this process could be a benefit for the market, if its transparency, the interests and benefits of final customers are considered.

According to the above-mentioned, the general opinion is that a more regulated industry at European level could become an obstacle for future development of the Italian hedge funds industry. Therefore, it seems that Italy will be on the same side with the UK and the US, as all three are in favour of an adjustable point of view on hedge fund regulation.

\textbf{4.3.2 France: overview of hedge funds regulatory framework}

\textbf{4.3.2.1 The hedge funds regulatory framework evolution in France}

The COB\textsuperscript{474}, the French securities regulatory authority that was to be incorporated in the “Autorité des Marchés Financier” (AMF) in 2004, regulated between the late 1980’s and the early 1990’s the set up of a number of specialised funds falling outside the framework of the UCTIS I Directive.\textsuperscript{475} Alternative management activity has increased

\textsuperscript{472} The Italian Treasury Minister, in \textit{Reuters}, 11 October 2008.
\textsuperscript{473} \textit{Financial Times}, 23 February 2009.
\textsuperscript{474} Commission des Opérations de Bourse.
\textsuperscript{475} The reference is to the “Organismes de Placement Collectif en Valeurs Mobilières (OPCVM) à procédure allégée” (simplified procedure CIS), to the “Fonds Communs d’Intervention sur les Marchès à
by the late 1990’s, mainly thanks to the French FoHF\textsuperscript{476}, until the declining yields of low-risk fix income vehicles, in conjunction with the 2000-2003 bear equity markets, generated interest in alternative investments.\textsuperscript{477}

In 2003, the COB published a “position on multi-management”, specifying the conditions under which French investment managers could make “alternative investments”, either based on a discretionarily investment management settlement\textsuperscript{478} or through a new type of FoHF. In August 2003, the Financial Security Law\textsuperscript{479} was adopted. In November 2004, the new Règlement Général de l’AMF (AMF General Regulation) introduced detailed rules set up under the Financial Security Law.\textsuperscript{480} An AMF Instruction of January 2005\textsuperscript{481} formalised the description of the contents and procedures for the submission of the prospectus necessary for the authorisation of leveraged and contractual hedge funds.

The newly introduced legal framework sets up two categories of authorised on-shore hedge funds, without providing a definition thereof: “ARIA funds” and “Contractual funds”. On-shore ARIA funds and FoHF\textsuperscript{482} are established on different rules. They can be established as investment companies, typically “Société d’Investissement à Capital Variable” (SICAVs) or, more often, subject to law of contract (as – FCPs).\textsuperscript{483} Contractual funds are the most flexible of the newly introduced alternative investment tools. Their purpose is to invest in any of the financial instruments listed “in Article L. 211-1 of the Monetary and Financial Code”, as well as in bank deposits.\textsuperscript{484}

\textsuperscript{476} These were regulated under Articles 14 to 14-6 of Décret n° 89-623 du 6 septembre 1989(JORF du 7 septembre 1989) thereafter repealed by “Décret n° 2005-1007 du 2 aout 2005 relatif à la partie réglementaire du code monétaire et financier” (JORF du 25 aout 2005).


\textsuperscript{478} COB monthly bulletin, issue 378, April 2000.

\textsuperscript{479} “Loi 2003-706 du 1er aout 2003, Loi de Sécurité Financière” (JORF du 2 aout 2003), as amended and consolidated.

\textsuperscript{480} Règlement Général de l’AMF (JORF du 24 novembre 2004), as amended.


\textsuperscript{482} Minimum subscription requirements apply also in the case of RIA FoHF$s$, notwithstanding that these are accessible to retail investors (AMF General Regulation, Article 413-13).

\textsuperscript{483} Fonds communs de placement, devoid of legal personality, managed by a management company.

\textsuperscript{484} Monetary and Financial Code, Article L. 214-35-2, paragraph 1.
In September 2007, ARIA FoHF was amended.\textsuperscript{485} Articles 313-54 and 411-34 of the AMF General Regulation were revised (as was Article 29 of \textit{Instruction n° 2005-02}) to ensure that the eligibility of foreign target funds would be determined on the basis of applying a selection model founded on four fundamental principles covering the key operational/organisational procedures of the underlying funds, their legal status, the rules established for their segregation and value of their assets, as well as the certification of their financial statements by an external auditor.

Hedge funds are taxed across France similarly to UCTIS “mutual funds.” The marketing and distribution of foreign non-UCTIS funds is subjected to the requirement of a prior AMF operational license like the domestic alternative investment vehicles. That licence will be issued under the achievement of AMF regarding the subjection of the applicant to prudential supervision and transparency rules similar to those used in France and to the existence of a mutual arrangement between AMF and the supervisory officials in charge of the applicant’s state of origin to facilitate the information exchange.\textsuperscript{486}

Hedge funds located outside France cannot be disseminated there unless they are authorised by the AMF, acknowledged by identification of some equal disclosure regimes and by the presence of a settlement for the entire data trade.\textsuperscript{487}

FCIMT, ARIA, and Contractual OPCVMs are allowed to be exchanged only for particularly sophisticated investors. The qualified investors are the only ones allowed to purchase and hold entity shares or stock, or other lawful firms/investors investing minimum half a million EUR. Still, the Financial Markets Authority can grant the shares or stock signed by different investors, according to the investors’ type but also according to the funds’ degree of risk.\textsuperscript{488}

After the French authorities took measures for tackling this ongoing financial crisis in order to stay aligned with the global agreement regarding absolute necessity of improving financial regulations for avoiding similar future crisis, a new regulation was

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\textsuperscript{486} “\textit{Instruction n° 2005-01 du 25 Janvier 2005 relative aux procedures d’agrément des OPCVM à l’information périodique des OPCVM et des OPCVM étrangers commercialisés en France.}”

\textsuperscript{487} Eddy Wymeersch, “\textit{The Regulation of Private Equity, Hedge Funds and State Funds},” The XVIII\textsuperscript{th} International Congress of the International Academy of Comparative Law, 2010, Financial Law Institute, p. 6.

\textsuperscript{488} KPMG SA, “\textit{France regulation. Hedge funds \textquotedblright},” 2010, p. 5.
\end{flushleft}
implemented by the French Parliament, namely, the “Banking and Financial Regulation Act n° 2010-1249” of October 22, 2010 (the Act). In many aspects, the Act may be seen as a “Dodd-Frank Act à la française.”

4.3.2.2 The French regulatory framework: scope and objectives

The advantages of hedge funds are widely recognised. In France, the 1990 - 2000 period led to significant reforms for the financial industry, concerning deregulating matters, but also liberalising financial processes. The tendency to become highly diversified financial markets widely accessible for various investment vehicles, starting from a classical bank-fundamental standard, occurred together with different regulatory limitations regarding hedge funds. Besides, this issue resulted into major political debates in France concerning major risks associated to asset industries. Hence, these disputes focused mainly on the Tobin fee matter, which had been imposed on financial exchanges. Thus, France demanded for a tighter legal regime for hedge funds.

France has introduced new legislation (legal instruments for hedge funds in 2003-2004) with the purpose of mitigating the prudential risks associated to extremely leveraged institutions.

It is supposed that there are three basic subjects to be regulated in terms of hedge funds. Thus, the primary objective of the strategic plan established by France is the investor protection. The second objective is to reinforce their risk policy, and the third objective is to encourage Paris as a capital, but also France as a financial

489 Published in the Journal Officiel on October 23, 2010.
crossroad develop a fine relation involving the investor security and a dynamic financial market.

4.3.2.3 The advantages and disadvantages of French regulatory framework

France has always been a regulated country with a fervent legislative agenda. Establishing a hedge fund in France is difficult because France limited very much the establishment of hedge funds on its territory, while French taxation officials regarded with great disapproval offshore investments, but this can be applied to a manager’s advantage that investors are attracted by “super protective” regulatory regime. The Financial Markets Authority’s focus on tight regulatory systems but also transparent ones signifies that many hedge funds settled in France are developing easily accessible but also instructive homepages, especially as compared to their counterparts from UK.

Still, hedge fund managers acknowledge the fact that France is an atypical country to set up a hedge fund, but it can be a good idea as competition is not an issue, since hedge funds managers usually avoid France. On the one hand, AMF makes its presence felt through control rather than proactive attendance in encouraging new fund management business. In this respect, instead of being encouraging, the Financial Markets Authority behaves somewhat impartial while having to do with advancement and ambitious development of hedge fund managers but also it does not look like forthcoming with regard to supporting new arrivals. Thus, it will be extremely difficult for France to compete with major European alternative hubs. Therefore, the comparisons between France and other UK or Luxembourg located funds is useless.

Nevertheless, the AMF’s reputation for being strict can be beneficial. Many investors, among which “the high net worth individuals” and private investor’s targets rely on the

French regulatory system and the sense of security that it provides. France also has a good reputation in terms of the quality of its service providers. It is true that France may not be able to compete with England and Luxembourg in terms of numbers, but it could develop a distinct competitive edge.

4.3.2.4 Could a more regulated hedge fund industry at European level lead to an increase of this sector?

The French regulations of hedge funds reduced their development. Nevertheless, if the last improvements were to be taken into account there would be indeed a major shift on behalf of the officials from France. In compliance with these improvements, significant progresses and numerical increases are expected in the future for the French hedge funds market. Accordingly, this particular market has the necessary resources but also professionalism to help customers create new funds.500 Nevertheless, a more regulated industry at European level could lead to a small increase of the sector in Europe, or even to stagnation.

4.3.2.5 The impact of the AIFM Directive on the French regulatory framework

France is somehow in the middle of a battle against the UK due to its over-zealous government controlled by beliefs and national concerns. Some British observers tend to appreciate that the AIFM Directive represents a straight assault on the UK, orchestrated by French officials.501 Since around “80% of the hedge fund industry is located in London or more generally in UK, while for France there remain few funds to settle in, it becomes clear why the French did not have too much to lose.502 At the same time, a French-German alliance (“for the single market in financial services they joined forces”503) in terms of regulation reform in global finance appeared to be crucial for the AIFM negotiations. If at first, the common concern in hedge fund regulation started in

500 http://www.sjberwin.com/Editor/assets/brochure/15519_hedgefunds%20bro(e).pdf.

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“2007, in Heiligendamm, the city where the G8 summit took place”\textsuperscript{504}, at the time the French request for a stricter regulatory approach had little impact. Later on, when the financial crisis became visible, French politicians understood this was their chance to proclaim their main goals. Nevertheless, in the end, France failed in casting offshore funds out of the European market. It has however acquired a regulatory frame of reference with regards to hedge funds looking very much alike to that which at first supported the structure of the retail mutual funds industry.\textsuperscript{505} Still, as the French government insisted, the main issue is not the origin of funds, if legislative requests imposed on “hedge fund managers” are being respected. Accordingly, any comprehensive regulatory framework is appealing, as they hold the minimum number of their industry’s financial interests at stake.

The AIFM Directive should not significantly affect French managers because the French regulators already control investment managers. Since French regulatory framework is strict, an even stricter one will not affect managers that much. However, the French authorities are deeply aware of the improvement in the UCITS area, as this is the main cause that makes many French asset managers prefer to move their operations to Luxembourg. With the growing employment of the UCITS tools by alternatives managers, the development of Luxembourg as a major fund centre appears quite probable. Against this, France is keen to retain its very large and well developed funds sector. Several French asset managers are not only major players at home, but the owners of leading asset managers based elsewhere around the world. The interaction between the AIFM and these global giants gives the regulator a uniquely well informed image on developments across the investment management sector.

As a final comment, France will protect national benefits and current industry organisations. Also, the French government is deeply concerned with the industry claims and takes all possible actions to ensure the protection of important components of economy against the supervision recommendations.

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4.3.3 Ireland: overview of hedge funds regulatory system

4.3.3.1 The Irish hedge funds regulatory system evolution

Ireland is an alternative asset management jurisdiction, with major global alternative investment administrators who have significant operations in Ireland. The legislation concerning the establishment of non-UCITS collective investment schemes was introduced in this jurisdiction one year after the transposition of the UCTIS I Directive into the Irish law. The legal alternatives were extended in the middle of 1990’s with the enactment of a law regulation Irish non-UCTIS investment limited partnerships and, more recently, through the adoption of a law regulating “Common Contractual Funds” (CCFs).

At the end of 2008, 10,855 Irish and non-Irish funds representing over EUR1.4 trillion in net assets were in aggregate. The total number of regulated investment funds (including sub-funds) established in Ireland set down their best performance ever attained also surpassing “EUR1 trillion mark.” In accordance with the statistical data provided by the Central Bank reports, the overall worth regarding funds located in Ireland increased by 40% since 2009, reaching the amount of EUR1,008 billion towards the end of 2011. Currently, the Irish funds total more than 11,000, while there are over 895 fund sponsors coming from more than 50 states using Ireland with the purpose of a global fund focal point.

506 According to a survey undertaken by the Dublin Funds Industry Association (DFIA), assets in excess of USD200 billion (about 25% -30% of the world’s hedge funds assets) were administered out of Ireland in 2003. During 2011, the “total value of Irish domiciled assets hit an all-time high of in excess of EUR1 trillion.” See http://www.mccannfitzgerald.ie/india---ireland---the-connection-grows---issue-two/domicile-of-choice-for-ucits-and-alternative-inves.aspx, accessed on 03.05.2012.

507 Non-UCITS vehicles were first regulated under the “Unit Trusts Act 1990” (S.I. No. 37 of 1990) as non-UCITS unit trusts and under “Part XIII of the Companies Act 1990” (S.I. n° 336 of 1990) as non-UCITS open-ended variable capital investment companies.


510 Based on figures provided by “the Irish Financial Services Regulatory Authority” (the “Financial Regulator”).


The Central Bank Reform Act 2010\(^{513}\) was enacted on the 1st of October 2010. This document merged roles held by “the Central Bank and the IFSRA”\(^{514}\), setting the foundation for the Central Bank of Ireland. Accordingly, “IFSRA” is to be dissolved. The Irish alternative management legal framework is constantly updated through non-UCTIS Notices (NUs) and Guidance Notices\(^{515}\) published by the “Irish Financial Services Regulatory Authority” (IFSRA).\(^{516}\) Ireland’s leading position as a hedge fund administration centre was consolidated by allowing the listing of hedge fund units in the Irish Stock Exchange.\(^{517}\)

Irish law acknowledges four different types of hedge fund-like non-UCTIS collective investment schemes: “Professional Investor Funds” (PIFs), “Qualifying Investor Funds” (QIFs), “Common Contractual Funds” (CCFs), but also “Retail Funds of Unregulated Funds” (Retail FoHF). The classification of non-UCITS is presented in the scheme below:

\(^{514}\) Irish Financial Services Regulatory Authority, in “Opinion of the European Central Bank of 7 April 2010 on the restructuring of the Central Bank and Financial Services Authority of Ireland” (CON/2010/30)
\(^{515}\) NUs and Guidance Notices inter alia govern the operation of non-UCTIS funds, setting out the detailed requirements for their authorisation, including investment and borrowing policy restrictions.
\(^{516}\) In May 2003, “the Central Bank of Ireland”, now “the Central Bank and Financial Services Authority of Ireland” (CBFSAI), was restructured as the IFSRA became autonomous within the CBFSAI (CBFSAI Act 2003, Article 33).
\(^{517}\) The listing, on “the Irish Stock Exchange” of the majority of hedge funds administered in Ireland attracted hedge fund promoters to Ireland.
Non-UCITS collective investment schemes can be constituted as unit trusts, open-ended “or closed-ended variable capital investment companies, investment limited partnerships or CCFs.” “Unit trusts”, as well as “investment companies” can develop “as single funds or as umbrella funds.” PIFs and QIFs are sophisticated investor funds that can be set up either as single-manager or as FoHFs. PIFs have “a minimum investment requirement of EUR125,000”\textsuperscript{518} and need to comply with investment restrictions (in regard to diversification and borrowing) which can be waived or relaxed by the IFSRA “on a case-by-case basis.”\textsuperscript{519} The QIFs used which have minimum investment requirement around the amount of EUR250,000, could market their shares or units to “qualifying investors” only\textsuperscript{520} and were not falling under some investments

\textsuperscript{518} NU 12, paragraph 2.
\textsuperscript{519} NU 12, paragraph 1.
\textsuperscript{520} NU 24, paragraph 3. “Qualified investors means any natural person with a minimum net worth in excess of EUR1,250,000 (excluding main residence and household goods) or any institution which owns or invests on a discretionary basis at least EUR25 million or whose beneficial owners are qualified investors.”
or leverage limitations. Therefore, these are the ideal hedge-fund vehicles. In accordance with these modifications, there have been some diminishments of the subscription, from EUR250,000 to EUR100,000. Similar reductions are expected. If these reductions are going to occur, reductions alike will conduct to the establishment of EUR50,000, representing the lowest subscription released by PIFs.

PIFs and QIFs that are FoHF can make investments around 100 percent of their net worth in unregulated schemes, subject to a maximum of 20% and 40% in any such unregulated scheme, respectively. It was in 2007 that a recently created authorisation action for QIFs was implemented by the FR. According to the new authorisation structure, depending on meeting the pre-arranged criterion, QIFs are currently able to be legitimated “by the FR on a filing only basis so that once a complete application for authorisation is received by the FR on Day X, a letter of authorisation for the QIF can be issued by the FR on Day X +1.” No further pre-examination will be made.

Many alternative investment strategies may for the time being become fit as a product of UCITS III (receiving more elasticity as soon as UCITS IV new Directive is adopted) or within QIFs from Ireland.

Other model of new funds market from Ireland consisted in launching the so-called CCF, designated with the pooling of pension fund investments in mind and are defined in the 2005 Act as unincorporated collective investment schemes established by an

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521 At the beginning of 2007, IFSRA published “Guidance Note 1/07” (Authorisation or QIF – Application process) according to which, subject to the fulfilment of certain substantive and administrative conditions, QIFs are to be authorised on the next working day following receipt of a complete authorisation application.

522 “The range of investors for which the minimum subscription may be waived has also been expanded and now includes the promoter, an entity within the promoters’ group or a director of the promoter.”, see “Qualifying Investor Funds: Reduction of Minimum Initial Subscription Level and Changes to Eligible Investor Definition”, 2010, http://www.mop.ie/news-and-insight/insight/pages/qualifying-investor-funds-reduction-of-minimum-initial-subscription-level-and-changes-to-eligible-investor-definition, retrieved on 05.05.2012.

523 Guidance Note 1/01, section 5 (d).

524 An anomaly arising from the recent changes is that this minimum subscription level is now higher than the level which applies to QIFs. David Lawless et al. “Investment Funds – How the taxation environment in Ireland continues to lead the way”, in Mullaly, Stephen et al, (2009), “Taxation of Investment Funds 2009”, Tax Planning International: Special Report, BNA International Inc., p. 111.

executive firm, whose members share by contractual agreement in the undertaking’s assets as co-owners. 526

Until 2002, Irish retail FoHF that were neither PIFs nor QIFs, were allowed to invest maximum 10% of their “net assets” into unregulated funds, restriction removed once new rules on Retail FoHF were introduced.

Tax-resident regulated funds from Ireland are exempt from charges on their revenues or earnings, regardless of investors’ residence. Similarly, “no Irish stamp, capital or other duties apply on the issue, transfer or redemption of shares or units” 527. Withholding tax does not apply to distributions for individuals not residents of Ireland but it must be deducted by a fund on payment to Irish residents at the standard rate plus 3%.

Third country investment funds wanting to market their shares or units to or from Ireland can only do so after obtaining a CFSAI authorisation. The process is conditional on the CBFSAI’s “approval of the funds’ promoter and of the fund itself”, including specificity in terms of service suppliers (mainly, its fund manager and custodian).

QIFs cannot deliver for sale into other countries. However, this change in 2013, when the AIFM Directive will be introduced. New EU legislation in 2009 anticipated the adoption of the new UCITS IV Directive with a target implementation date of 1 July 2011. Ireland is one of the first EU States to implement the AIFM Directive into the national regulation, as it implemented this Directive on time. 528 This should deliver a number of benefits, including simplified cross-border distribution procedures, an European passport for UCITS management entities but also a framework for cross-border consolidation of UCITS. In December, the legislation designed to provide an efficient framework for re-domiciling a fund to Ireland was passed by the parliament. 529

“The Companies (Miscellaneous Provisions) Act 2009” was enacted into law not long ago. Its main objective is to increase efficiency regarding the migration of funds to

526 “Investment Funds, Companies and Miscellaneous Provisions Act 2005, section 6(1).”
527 A restricted category of Irish residents, including pension funds and charities, can make declarations to a fund in order for withholding tax not to apply.
Ireland, but also to reduce any burden caused by the regulations to the migrating entity.\textsuperscript{530} This represents one major optimistic move forward to funds, which might therefore be attracted to re-domicile in Ireland in order to establish within a location where it will be much easier to treat all possible demands of the AIFM Directive.\textsuperscript{531} This new process will be accessible additionally to anterior lawful practices, comprising assets transfers, and at the same time it is anticipated to precipitate the onshore move.\textsuperscript{532} According to the statistics provided by the Central Bank of Ireland, barely two of the 477 investment entities receiving authorisation (1,249 including sub-funds) were re-domiciling in Ireland.\textsuperscript{533}

4.3.3.2 The Irish regulatory system: scope and objectives

The hedge funds regulatory background in Ireland is essential in terms of the next dynamics of the funds market. Pragmatic regulation of hedge funds is vital if substitute investment products are to grow in the flexible environment in which they must work to achieve their objectives. “The IFSRA”, officially promoted clear expansion of the funds industry from Ireland and its success was unquestionably due mostly to the legal and regulatory framework which is in force and the reputation and integrity of the IFSRA. On this account, it should be noted that better regulation is the secret to find a balance between defending the investor and giving fund managers sufficient scope and flexibility to accomplish their job properly. In this context, there are several major objectives: first, to make sure that suitable but also efficient regulation will be enacted for financial entities but also for the entire industry; second, to minimise all risks that might lead to failure. This could be achieved by ensuring the observance of prudential conformation and other requests.\textsuperscript{534} The third will be to make sure that all actions will be taken for the well-being and best protection of clients involved in financial services.

\textsuperscript{533} Ibid.
The certain way to do this is by taking care of clients but also of investors through business norms conduct and other protective procedures. 535

4.3.3.3. The advantages and disadvantages of the Irish regulatory system

Ireland’s reputation of international leader in hedge funds and management centre for international alternative investment funds (AIFs) signifies that any legislation related to the management of funds will be analysed to determine whether it will convey negative costs for what has been a flourishing industry in Ireland. Also, “Ireland’s popularity as a fund domicile is no surprise,”536, given its robust regulatory and highly developed fund-services environments. Its attractive tax regime, under which UCITS and other alternative funds remain entirely tax free, also offers it a key advantage over its competitors. 537

Irish hedge funds structure alternatives, the present regulatory framework and also the strong management model represent an advantage for investors, to whom Irish regulation of hedge funds offer the necessary transparency538 and comfort levels. Ireland’s regulations offer structures that fit well the different investor profiles, various fund strategies and aims.

The major issue in maintaining the confidence of hedge funds investors has to be Ireland’s ability to control the current wave of international regulatory reform. Currently, Ireland is experiencing what could be called a continuous regulatory change.

4.3.3.4. Could a more regulated hedge funds industry at European level lead to an increase of this sector?

Lately, Ireland is apprehended in a positive manner, even “highly regarded and well regulated environment for investment funds”539, serving diverse forms of funds. It also

535 Ibid.
539 Price Waterhouse Coopers, “Ireland the One Stop Shop for Investment Funds.”
provides cautious regulatory not only for retail but also for refined funds. Accordingly, these are crucial reasons setting the basis of their prosperity in Ireland. Moreover, “the Irish Financial Regulator” tends to be acknowledged as adaptable, accessible but also as receiving ideas favourable for fixed time limits for exempting the funds. A wide range of persons wishing to invest seek exposure to alternative asset classes, still, they lack the desire to invest in lightly-regulated jurisdictions (for instance British Virgin Islands, Cayman). Apparently, they currently value their status of being under authorisation of the “Irish Financial Regulator.” In addition, this organisation becomes gradually used for hosting secondary tools, for example both CDOs and CLOs, since they encounter problems in their promotion as debt services, within this ongoing industry background. Therefore, a more regulated industry at European level could lead to a growth of the hedge funds sector in Europe.

4.3.3.5. The AIFM Directive impact on the Irish regulatory system

The idea to harmonise the level of hedge funds regulation in Europe is generally acknowledged in Ireland. Particularly, the projected European passport and the appreciation of the meaning of using professional service providers are considered as positive aspects of the AIFM Directive by the IFIA. Yet, other aspects of the AIFM Directive have been met with suspicion.

The AIFM Directive advances restrictions that exceed by far the regulatory level currently existing in Ireland. Provisions related to a “valuator” and “depositary” include particular problems identified by the Financial Regulator in Ireland, the IFIA and the Department of Finance. Nevertheless, the main concern in Ireland refers to the effects on the funds administration industry in Ireland. The possible protectionist interpretations of certain provisions referring to the third countries have caused great concern, mainly due to Ireland’s significant contribution to non-EU funds management.

http://download.pwc.com/ie/pubs/pwc_ireland_the_one_stop_shop_for_investment_funds.pdf, accessed on 04.03.2012.


IFIA.

The IFIA considers the legislative burden charged on managers and service providers to be also disproportionate and likely to result in funds complete operation outside the EU, with negative impact on business and employment favourable circumstances of the industry here.

Ireland is prepared and very well located for the implementation of the EU’s AIFM Directive. Most academics consider that this Directive will offer considerable increase for the thriving Irish investment funds market. In its position of essential midpoint for a substitute investment fund, Ireland connects more than 40% of total worldwide hedge fund capital, reaching the amount of EUR183 billion shares invested in non-UCITS funds located in Ireland. Out of this amount, EUR133 billion are invested in highly qualified QIFs. Under these circumstances, the alignment of the Irish regulations with major AIFM Directive requests becomes predictable.

As mentioned before, “the Irish Funds Industry” received the AIFM Directive very well. Consequently, Ireland considers itself prepared for the AIFM Directive. At the same time, since it is an EU member and an onshore country, the QIFs inevitably meet all the requirements of the AIFM Directive. Also, the proceedings made by the Central Bank from Ireland and by the Regulatory bodies from Ireland will automatically guarantee that QIFs stay prepared for the AIFM Directive, proving to be a very attracting product and trying at the same time to benefit from the European passport starting with 2013. In this respect, it is expected that the AIFM Directive will be efficient and will highly impact the Irish alternative funds market.

4.3.4 Luxembourg: Overview of hedge funds regulatory framework

4.3.4.1 The evolution of hedge funds regulatory framework in Luxembourg

“Luxembourg is one of Europe’s leading financial centres and is second only to London in terms of concentration of financial and banking activity.” About 150 international banks are located in Luxembourg.

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In 1983 the first complex “investment fund legislation in Luxembourg” was implemented. Ever since, investment funds developed thoroughly, under the name of “Undertakings for Collective Investment” (UCI). Net assets under management have reached EUR2,225,600 billion in Luxembourg investment funds at the end of April 2012. This represents an increase of 6.16% since the end of December 2011. Currently, there are minimum EUR143 billion in Luxembourg in AUM in minimum 700 hedge funds, but also FoHF. In addition to the foregoing, Luxembourg has also considerable experience in administering non-Luxembourg domiciled hedge funds but also FoHF. The main aspects that attract the international promoters of Luxembourg investment funds are the favourable legal environment, the know-how of well-established service providers and the pragmatism and reactivity of the supervisory authority.

The establishment of on-shore non-UCTIS funds in Luxembourg was made possible with the enactment of the 1988 UCTIS law, complemented soon thereafter by a law on non-publicly traded institutional investor funds (the “1991 Law”).

Luxembourg’s non-UCTIS legal framework was silence on a number of key issues handled on item-by-item by “the CSSF” (for example, prime brokerage and shore sales) and the discretionary nature of the approval of domestic non-UCTIS collective investment schemes launching. These prompted the “Commission de Surveillance du Secteur Financier” (CSSF), Luxembourg’s financial sector supervisor, to adopt a Circular in December 2002, laying down rules that apply to funds pursuing alternative investment strategies (the “2002 Circular”).

Luxembourg’s regulatory regime was complemented with the adoption, at the beginning of 2007, of a regulation regarding the specialised investment funds, which repealed

548 “Loi du 30 mars 1988 relative aux organismes de placement collectif.”
550 Commission de Surveillance du Secteur Financier.
551 Circulaire CSSF 02/80.
“the Law of 19th of July 1991.” Other significant developments included the abrogation of the restrictions imposed by a 1991 Circular on the listing of offshore funds’ units on the “Luxembourg Stock Exchange” (LuSE) and the issuance of a Ministerial Order amending its internal regulations on the listing of foreign funds, as well as the adoption of a subsequent CSSF Circular laying down the contents of the prospectus of foreign funds intending to become listed on the LuSE.

This being said, the Luxembourg regulator has created an innovative and flexible framework for qualified investors. The introduction of the new Law on “Specialised Investment Funds” (SIF) in Luxembourg means that there are now the following possibilities for launching an undertaking for collective investment structure:

![Diagram showing possibilities for launching an undertaking for collective investment structure]

Figure 9. “The new Luxembourg Law on Specialised Investment Funds (SIF)”

Luxembourg law acknowledges two different types of hedge fund-like non-UCTIS collective investment scheme: alternative funds and FoHF falling under 2002 Circular and “Specialised Investment Funds” under the SIF Law. While used in the preamble of the 2002 Circular, the “hedge fund” concept is hardly explained, being accepted as an

introducing an alternative to established Luxembourg law vehicles (notably, hedge funds) and broadening the pool of investors eligible to invest in non-publicly traded UCTIS.

553 “Circulaire CSSF 04/132 concernant l’abrogation de la circulaire CAB 91/3 du 17 juillet 1991 concernant l’admission à la cote officielle de la Bourse de Luxembourg d’organismes de placement collective ("OPC") étrangers.”


555 “Circulaire CSSF 04/151 concernant les dates devant figurer dans le prospectus d’admission à la cote officielle.”
umbrella definition for funds subject to Part II of 2002 CIS regulation pursuing alternative investment strategies. The 2002 Circular does not expressly separate the “single-manager alternative funds” from FoHF.

The 2002 Circular encompasses restrictions in terms of borrowing and asset transfers, investment policy and short sales. Specialised investment funds, do not fit any quantitative investment limitations. The purpose of their eligible investors covers both institutional and qualified investors (within the meaning of the MiFID) and the so-called “informed investors” (investisseur avertis). These are individual investors who formally adhere to the status of sophisticated investors. They either invest at least EUR125,000 in a Specialised Investment Fund or have received very promising assessments from a bank, an investment entity or maybe a management entity regarding their capacity to properly appraise SIF investments. Similarly, to ensure continuity according to the 1991 law, the SIF Law provides that institutional investors’ funds established under the 1991 Law are automatically forced falling under the objective imposed by the new rules as of the commencement of the SIF Law.

Investment funds from Luxembourg are subject to “subscription tax” levied on a quarterly basis on the fund’s “net assets on the final day of the relevant quarter at a rate of 0.05%. A reduced rate of 0.01% is applicable, inter alia, to those funds subject to Part II of the CIS Law adopted in 2002, including their umbrella funds and classes of shares, if products are traded only on behalf of institutional investors and SIFs.

The Directive has been implemented in “the European Parliament” plenary session “on 11 November 2010”, after almost one year and a half of controversial debates.

556 The title of the 2002 Circular refers to “OPC luxembourgeois adoptant des strategies d’investissement dites alternatives (Collective Investment Schemes pursuing alternative investment strategies).”
557 2002 Circular, Rule B. “This shall however not prevent the fund from granting additional guarantees or a pledge on its assets to its lender if such arrangements will not result in a transfer of ownership of those assets or if the counterparty risk is limited by other means.”
558 2002 Circular, Rules D and A.
559 The principle of risk spreading applicable to Part II UCIs is maintained under Article 1(1) SIF law.
560 SIF Law, Article 2 (1).
561 SIF Law, Articles 77 to 78.
562 Taxe d’abonnement.
563 SIF Law, Article 129.
564 For a complete analysis of the AIFM Directive see paragraph 3.6. of Chapter three of this thesis.
The impact of the enactment of the Directive will be significant to Luxembourg, as it provides major proposals for present “AIFM business models.”

Hence, present SIF legislation in particular corresponds even at present to most forthcoming requests of the AIFM Directive. Another significant aspect is that SIFs gather now more than one third of the overall funds established in Luxembourg. These statistics demonstrate that Luxembourg is not only an UCITS, but also an alternative fund centre. According to EFAMA, currently “Luxembourg is the second biggest European fund domicile for regulated non-UCITS funds.”

However, Luxembourg seems to be very well located to face the challenges brought by the AIFM Directive, as many of the requirements of the new Directive exist today in the Luxembourg legal and regulatory framework applicable to non-UCITS funds (e.g. the need for a depository). Besides, in agreement with Luxembourg’s banking assessment within the field of regulated alternative products, there is a general opinion that Luxembourg will be able to quickly but also efficiently respond to all implications of the AIFM Directive.

In conclusion, the AIFM Directive could turn out to be a new and major opportunity for the Luxembourg financial sector. It will require investments and efforts but Luxembourg has all the key attributes to become the future global AIF platform.

4.3.4.2 Luxembourg’s regulatory framework: scope and objectives

Transparency, a never ending topic of discussion for hedge funds, received new but also heightened focus in “the wake of the credit crisis” and the Madoff fraud. This will become a major issue for “the regulation of funds in Luxembourg.” At the same time,

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570 http://www.taxjustice.net/cms/upload/pdf/TJF_4-2_AABA_-_Research.pdf, accessed on 06.05.2012.
a new regulation is critical for the defence and improvement of Luxembourg’s competing stand.571

Also, another essential aim of the Luxembourg regulatory regime572 is to ensure adequate protection, in a similar manner as the European provisions of an investment fund’s assets for its investors.

4.3.4.3 The advantages and disadvantages of Luxembourg’s regulatory framework

In view of the alleged Madoff fraud573, the Stanford International Bank fraud574 and the ongoing financial crisis, the increasingly regulated funds will be considered by investors the best choice for hedge fund investment. Accordingly, several institutional investors decided to move to onshore vehicles and address the larger, more regulated industries, such as Luxembourg. In this particular situation, it seems that regulation is an advantage, mainly due to this ongoing trend in hedge funds to settle down to better regulated jurisdictions like Luxembourg. Still, even if the measurement of the force of trans-jurisdictional regulations is pursued, most of the time there are concerns regarding the failure to find out overall significant inputs of regulation.575

The mixture of Luxembourg’s pragmatic regulatory expansions, strengthening of efforts between classical and alternative asset classes and new marketing favourable circumstances in areas such as the Middle East and Asia are all to the country’s advantage.

4.3.4.4. Could a more regulated hedge fund industry at European level lead to an increase of this sector?

575 Jackson, Howell E., “The Impact of Enforcement: A Reflection”.

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Luxembourg is appealing because of its background on hedge funds and FoHFs since two models of law are used. The very first is tighter but also strictly controlled by regulations, and this enables their distribution them towards an unlimited public while the second, the SIF, “is a more flexible system open to qualified investors.”576

Mainly due to the financial crisis, Luxembourg’s hedge funds framework and legislation, which used to be perceived by several investors and promoters as quite heavy, operates now to its advantage. At present, both the Luxembourg Government and the CSSF have a good record in implementing EU directives, by regulation and clear understanding, expressing optimism in supporting industry guidance and new best practices. Accordingly, a more regulated industry at European level could lead to an increase of the sector in Europe, particularly in Luxembourg.

4.3.4.5 The impact of the AIFM Directive on the hedge funds regulatory framework in Luxembourg

Many French asset managers have already moved operations to Luxembourg due to the French authorities sensitiveness about the expansion in the UCITS space. With the growing use of the UCITS wrapper\textsuperscript{577} by alternatives managers, the development of Luxembourg as a fund centre gives this country a good opportunity to move forward. The AIFM Directive enactment has an essential effect on Luxembourg.\textsuperscript{578}

Most of the AIFM Directive proposals are not at all new, being quite familiar for hedge funds experts domiciled in Luxembourg. Currently, many are already integrated into their management, audit, or other processes. Part of them are designed for UCITS, while others are designed for “non-UCITS.”\textsuperscript{579}

At the same time, it circumscribes an across-the-board goal,\textsuperscript{580} applied for every EU manager handling either EU or non-EU domiciled funds. This Directive is applicable to all managers operating outside the EU but managing EU funds, as well as to managers marketing EU funds or funds not established in the EU, although marketed within the EU.\textsuperscript{581}

Similarly, it represents an across-the-board AIFM Directive in terms of asset types for investments. In this regard, it comprises “hedge funds, fund of hedge funds, private


\textsuperscript{580} Outside of that covered by the UCITS Directive.

\textsuperscript{581} http://www.ehp.lu/uploads/media/GMB_2011_European_framework_for_microfinance_investment_funds.pdf, accessed on 06.05.2012.
equity funds, real estate funds, commodity funds, but also funds investing in traditional assets such as shares, bonds and money market instruments (if they are not UCITS).”

One particular easy registering system appears to be granted for all administrators holding “assets under management” which encompass either maximum EUR100 million or maximum EUR500 million in connection with non-leveraged funds, situation when no redemption is allowed for investors within five years. Several exempting amendments are relevant for existing funds as well, which are not accepting extra registrations.

Certain “investment vehicles” models have no goal because they are not considered proper “investment funds”, and the author mentions: retirement funds, “saving schemes”, holding companies, but also “securitisation vehicles.”

AIFM Directive considers that AIF represents “Collective Investment Undertaking.” This takes finances out of several investors. Accordingly, those particular funds with only few individual investors do not fall under the amendments of the AIFM Directive. To illustrate this, the recommendations of the AIFM Directive bring up one case: “family office vehicles which invest the private wealth of investors without raising external capital.”

According to the above-mentioned items, this means that non-UCITS in Luxembourg and their administrators theoretically fall under the AIFM Directive – “Luxembourg Undertakings for Collective Investment” (UCIs), SIFs and “Investment Companies in Risk Capital.”

583 http://www.deloitte.com/, accessed on 06.05.2012.
586 Regulated by “Part II of the Law of 17 December 2010.”
One major goal of the AIFM Directive is to regulate managers, the AIFM but at the same time, although if not directly, their funds management (AIF).

Most of the requests do not involve major changes “for Luxembourg UCIs, SIFs and SICAVs” since all need to comply requests alike in compliance with the present legislated situation.

Although not only the “Group of Twenty” but also the EC had the primary focus of controlling the market of alternative investments and the main objective to manage and prevent the systemic risk, currently, AIFM Directive imposes the European passport for AIFM. They will possibly get approved in an EU Member State to exchange their supervised AIFs to sophisticated investors from EU Members states.

Therefore, one may consider that Luxembourg paid attention to advantages that the passport offers and could further change into one major global authority “for retail cross-border distribution.”

A relevant topic of debate in the AIFM Directive’s drawing proposals was the mention regarding the third states, for example investment administrators but also investment funds registered within non-EU Members. The concessive opportunity presents mixed laws applicable both for “AIFM and AIF” located in EU non-member states:

- During the first two years, only “AIFM” located in EU and their administered “AIFs” shall conform to every provision stipulated by the AIFM Directive. Consequently, they benefit from “the European passport” used by experienced investors to sell across Europe;
- During that 2 years period, administrators not residing in the EU are not allowed to benefit from the passport although they may, under positive auditing but also clear requirements, keep on handling the trading of the

593 From July 2013 until July 2015.
funds on a non-public offering basis, in relation to private placement norms, because it can enter into force in every state within the EU;

- As soon as the 24 months period has passed, on the one hand, funds non-domiciled in the EU are allowed to benefit from this EU passport in case the requirements of the AIFM Directive are met. Thus, they convert AIFM under the Directive. On the other hand, they can keep on marketing based on “local private placement” systems up to 2018, when “the EC” intends to eliminate this type of regulations.

In Luxembourg this signifies a clear advantage “of the European passport for selling to professional investors” for those AIFM located in EU and their AIFs, starting with the second half of 2013.

At the same time, AIFM located outside EU (such as US, Switzerland) and their AIFs will confirm their ability to maintain the EU market based on “local private placement” norms (similar to the present example) restricted to complying to several requests contained within the AIFM Directive. If the private placement regulations seem excessively restrictive, the restructuring through introduction of Luxembourg AIFMs between the Luxembourg AIFs as well as the AIFMs located outside the EU may be considered.

In this case, the AIF could turn out to be managed by an AIFM, assigning the capital management operations to the AIFM located outside the EU. Therefore, AIF is going to benefit from the passport starting with the second half of 2013.

According to the primary AIFM Directive draft, it was taken into consideration that the AIFM might entrust processes concerning investment administration to a sub-manager.
although requested that the latter should receive himself authorisation as an AIFM.\textsuperscript{599} Currently, these amendments are no longer stipulated. These two processes, investment but also risk controlling might be entrusted to a third party only if this third party is authorized to provide investment management products but also if this third party placed under the act of supervising.\textsuperscript{600} In case the funds are domiciled outside the EU, the need to cooperate is one of the main conditions. This collaboration must be established between regulatory officials of the AIFM but also between the supervising authorities within that particular state where investment managers are located.\textsuperscript{601}

According to the above-mentioned issues, AIFM comprising “UCITS management companies” enabled that (see also below). The administration of investment will be entrusted to those particular administrators who do not meet the criteria like AIFM, together with investment administrators\textsuperscript{602} acknowledged in states that are not EU Members.

“UCITS” executive firms might also be permitted to act like “AIFMs”, if they comply with all of the requests of the AIFM Directive. Therefore, in that case, one executive corporation will be allowed to supervise not only “UCITS”, but also “AIF.”

The aforementioned aspect offers an auspicious and supreme advantage for the fund managers in Luxembourg.\textsuperscript{603} There have been many cases of investors who developed individual proper “UCITS” executive firms, while professional suppliers of services organised “UCITS” executive firms so that they can provide professional executive services for “UCITS” established in Luxembourg by managers which do not have a physical attendance here. Continuing this idea, the managers mentioned above are able to extend their authorisation and run AIFs.\textsuperscript{604}

\textsuperscript{599} Elvinger, Hoss & Prussen, (2011), op. cit., p. 4.
\textsuperscript{600} Ibid.
\textsuperscript{601} Elvinger, Hoss & Prussen, (2011), op. cit., p. 4.
According to all prior mentioned issues, many adopting proposals are going to be organised by ESMA while their adoption will be carried out by the EC.

The preparation for the implementation of these proposals came together with a discussion activity where the Luxembourg investment fund market revealed itself as an active participant.

Lately, the Luxembourg market has become a major global financial centre. It owns complex laws and regulators suit investors’ requirements for now, and it is undoubtedly expected to become even more adaptable while also putting into practice the AIFM Directive requirements. The Luxembourg market has a vast experience in investments services, advertisers and administrators. Acting proficiently in terms of services, it will add supplementary benefits due to its regulators, expected to support this particular market in developing one rigorous AIFMs and AIFs pattern.

4.3.5 Malta: overview of hedge funds regulatory system

4.3.5.1 The funds regulatory system evolution in Malta

In Malta, ISA\textsuperscript{605} enacted in 1994 sets up a particularly regime regulating the approval of CIS, but also fund administrators, paving this road for the establishment of “retail funds and local fund managers.” Six years later, MFSA\textsuperscript{606} issued particular standards for the so-called “Professional Investors Funds” (PIF) with the purpose of putting Malta in the role of “European hedge fund location.”

Three major symbols characterise the PIFs regime. The first is the obligation of “fund service providers to be established in Malta.”\textsuperscript{607} The second, PIFs can have every lawful structure at the same time taking advantage “from a full tax exemption at fund level and for non-resident shareholders.”\textsuperscript{608} The third and last symbol is that PIFs are forced to hire a locally resident individual compliance officer and a prevention of money

\textsuperscript{605} “The Investment Services Act”.
\textsuperscript{606} “Malta Financial Services Authority”.
\textsuperscript{607} http://www.iflr.com/Article/2213411/Malta-Collective-investment-schemes.html, accessed on 09.05.2012.
\textsuperscript{608} Ibid.
laundering reporting officer. These officers should monitor the observance of PIF with its licence conditions and with the money laundering obligations prevention.\textsuperscript{609}

The ISA’s definition of PIF is a CIS, namely a scheme or an arrangement whose object is the “collective investment of capital acquired by means of an offer of units for subscription, sale or exchange.”\textsuperscript{610}

The PIF regime makes reference to several categories of funds.\textsuperscript{611} If one refers to “an umbrella fund, the minimum investment thresholds below are applicable on a per scheme basis rather than on a per fund basis.”\textsuperscript{612}

The so-called “Experienced Investor” is a person with the necessary expertise, experience and knowledge who is in the position to make his own investment decisions and understand the associated risks.\textsuperscript{613} The minimal investment threshold is EUR10,000 or USD10,000 or the equivalent, except for PIFs which has applied for a licence prior to the 1\textsuperscript{st} of January 2010. In this case, the threshold is EUR15,000 or USD15,000 or the equivalent. In case of joint holders, the minimum investment limit is still EUR10,000/EUR15,000 or USD10,000/USD15,000 (as applicable) or the equivalent in another currency.\textsuperscript{614}

“A Qualifying Investor” should either have more than EUR750,000/USD750,000 net assets \textsuperscript{615} or should be a member of some individuals having more net assets than EUR750,000 or USD750,000.\textsuperscript{616}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{609} Ibid.
\item \textsuperscript{611} The Experienced Investor Fund, the Qualifying Investor Fund and the Extraordinary Investor Fund.
\item \textsuperscript{612} \url{http://www.mfsa.com.mt/} accessed on 11.05.2012.
\item \textsuperscript{614} Ibid.
\item \textsuperscript{615} Or equivalent in a different currency.
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Other provisions must be met in order to become *Extraordinary*. These provisions include the fact that an investor should have net assets in excess of EUR 7.5 million, he should be an employee or director of service providers to the PIF, or he should be a PIF promoted to Extraordinary Investors. In addition, there is a minimum primary investment set up at EUR 50,000. “In the case of joint holders, the minimum investment limit remains as before.”

Hedge fund administrators and individuals marketing assets outside or inside Malta must receive authorisation from the MFSA. In Malta, “the private limited liability company” represents the common organisation used by a fund management company, usually alongside a holding company for tax efficiency reasons.

Article 6 of the ISA stipulates that MFSA is not allowed to grant “an Investment Services License unless it is satisfied that the applicant is a fit and proper person to provide the relevant Investment Services and that all the appropriate rules and regulations are applied and observed by the applicant.” The goal of this Act is very ample, and it covers a large range of domains. Still, in all situations “the MFSA” practices similar “standards relating to the fit and proper status to the applicant, his performance history, his associates’ history, as well as “the nature of the business.”

Currently, the management of the funds located in Malta from other locations is allowed. At the same time, Malta represents the only country worldwide which enables “funds to be self-managed in the same way as UCITS funds can be.” In addition, minimum two officers are compelled to always stay in Malta. They have no obligation in terms of management positions within the firm, although they are demanded to prove a sufficient level of professionalism.

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618 Or equivalent in another currency.
MFSA’s ability to impose executive penalties is one of the powers given by the ISA. In 2007, the MFSA, other laws, but also the 3rd “level MFSA Rules” have been changed in order to bring Malta’s regulation in strict conformity with other EU laws. The secondary legislation falling into the ISA includes the “Investment Services Act (Control of Assets) Regulations, from 1998” which provide requests regarding customers’ protection, but also contractors’ CIS which need to be complied.

The MFSA adopts a risk-based approach to supervision. According to this, a hedge fund manager shall be evaluated by reference to the risks that it represents to the MFSA’s statutory objectives. This assessment will develop when the fund manager is first authorised and periodically thereafter, depending on the risk assessment. Breach of the MFSA Rules may give rise to disciplinary action being taken against the offending licence holder. Furthermore, certain breaches may also constitute a criminal offence under the ISA.

There are two types of collective investment schemes: “prescribed or non-prescribed funds.” Usually, the first type means that a Maltese-located fund, have declared their value of Maltese assets at minimum 85% of the “total assets value of the fund.” Consequently, those funds that are not overexposed “to Maltese assets and all non-resident funds are treated as being non-prescribed.” When “the MFSA” authorises one fund, the latter receives “a tax exemption”, regardless of the legal type of the fund. This represents an important advantage in certain structures vis-à-vis jurisdictions restricting the tax exemption to certain individual corporate types.

According to the Banking Act of 1994, the fund is subject to “15% withholding tax on bank interest payable by licensed banks and a 10% final withholding tax on interest, discounts or premiums” from different sources like: Malta’s government; legal firms,

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628 Ibid.
officials; firms, authorities “resident in Malta or otherwise (public issues)”\(^{629}\); firms, authorities “resident in Malta (private issues)”\(^{630}\).

4.3.5.2 The Maltese regulatory system: scope and objectives

Malta’s law on hedge funds is complex and flexible. Most of the island states consider it a model for onshore directive of hedge funds and think international and European measures in regulation of industry would probably bring other countries closer to the Maltese model. Its major advantage is its bilingual legislation. All laws in Malta are issued both in English and in Maltese\(^{631}\), the official languages in the Maltese state.\(^{632}\) This legislation provides clarity and simplicity of understanding, sometimes absent in some other onshore jurisdictions. An advantage resides in the fact that Malta melded the legal traditions of the Continent with the Anglo-Saxon model.\(^{633}\)

During the last decade and a half, the Maltese regulatory body was thoroughly modernized. This complex regulatory outcome was meant to attract investments from abroad and firms across Malta.

The country has a single “financial services regulator, the MFSA.” In contrast to many of its counterparts, it can quickly modify the existing rules and change the old ones in order to make sure that regulation complies with industry innovations. The principal proposer and driver of new financial services legislative initiatives, MFSA succeeds in winning new business within the tough competition by ensuring “an efficient combination of a robust and yet highly flexible regulatory framework.”\(^{634}\)

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\(^{629}\) Ibid.


\(^{631}\) Chapter 492, the Laws of Malta (available online in the English and Maltese languages - http://docs.justice.gov.mt/lom/Legislation/English/Leg/VOL_16/Chapt492.pdf), retrieved on 19.03.2012.


Generally, the legislation makes available a wide-ranging, flexible regulatory structure for the establishment, “licensing and marketing of all kinds of CIS and institutional funds and investment service providers.” The laws also provide a guideline for several selected financial processes of non-credit institutions and for the establishment, but also multinational identification. “Maltese company law” is side by side with all applicable EU corporation laws. The island state is well-known for the prompt adoption and harmonisation of EU directives. This means the state is fully compatible with all EU legislation and that it provides companies established in Malta many of the benefits these laws provide to companies thriving to develop in other EU Member States.

In addition to the adoption of EU directives, Malta’s laws also comply with OECD provisions on the control and stop of money laundering and insider dealing.

The government considers that foreign investors are completely reassured by the consolidation of the various provisions in Maltese law on professional secrecy, without obstructing the supervision of fiscal and regulatory compliance or the investigation of serious crimes such as money laundering and insider dealing.

Malta encourages an environment that stimulates the development of investment in a professional and sound manner. The protection of investors’ interests is extremely important. This shows that MFSA has been given full powers to act. At the same time, the MFSA understands the importance of enabling the financial services, and especially the fund sector to autonomously innovate but also develop new products.

Whenever pleased with a candidate or firm candidate, the MFSA offers a certificate, each of its principals and secondary connected parts are “fit and proper”. Generally, there are three criteria that need to be fulfilled: integrity, competence and solvency.

635 Camilleri, Joseph, “Re-Domiciliation of Funds”, Malta Funds Industry Association Newsletter 34, Quarter 2 - 2010, p. 3.
636 Which is essentially based on the UK’s company law.
639 Azzopardi, Charles, “Malta - a Flourishing Domicile for Hedge Funds”, Malta Funds Industry Association Newsletter 34, Quarter 2 - 2010, p. 4.
In spite of the minute legislation, the culture existing in Malta tends to make things happen rather than stop them. Combined with the accessibility and proactive development at the MFSA, this makes Malta an alternative jurisdiction by many funds, and particularly start-ups. 640

4.3.5.3 The advantages and disadvantages of the Maltese regulatory system

Hedge funds managers consider that the regulation in Malta is very flexible and also knowledgeable. “Thus, Malta prepares itself to challenge the well-known hedge fund jurisdictions in Europe. The government is very cautious in stating its competition head-on with the dominant players in the industry – Luxembourg and Dublin. However, the country has an advantageous position after the financial crisis” 641. Its rivals do not look as good as Malta. Although Malta is a long way behind Luxembourg and Ireland, the jurisdiction is moving in the right direction and the country’s advantages of low cost and highly skilled workforce, together with an accessible and flexible regulator will attract more funds.

Even if the cost advantage is transitory and will eventually disappear as Malta’s economic growth equals that of its EU counterparts, it does provide the jurisdiction a short-term advantage that Malta is eager to exploit. The domicile related costs in Malta are lower by a half to a third than in the other states of Europe. However, cost is not the only important issue for hedge fund managers and promoters of the island 642. The MFSA 643 has made a name for flexibility together with meticulous attention to detail. Although the regulation was considered too strict by many – especially as compared to Luxembourg and even Ireland – in a world distressed by negligent regulation, it is quickly gaining advocates. As an onshore EU authority with advantageous tax rates 644 and a population that is acknowledged “for its hard working, fast learning and elevated

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moral principles”, the combination seems to make Malta win even more businesses during the next period. Even though the total number of funds domiciled in the jurisdiction is still small as compared to the more established centres, the industry started to grow.

Currently, Malta is creating a niche for itself. This state builds its reputation as the jurisdiction chosen by smaller, start-up funds that consider the high costs and crowded service sectors of Dublin and Luxembourg to be unfriendly. Under the circumstances of a cost-dependant world, funds intend to show investors that their goal is to keep management fees low. “They can point to the cost savings offered by Malta as well as the safety of an onshore EU jurisdiction.” In Malta size is not important. This “openness has already gained the MFSA” prestige among managers.

Joseph Bannister, chairman and president of the MFSA, believes that Malta’s strong regulation is among its greater advantages. The robust regulation is adapted to hedge fund managers. The objective is to provide a secure [hedge funds] regime in Europe. The policy of pursuing numbers is abolished and quality is the driving force, which is very important. The idea is to develop the regime and respond to new ideas from managers who are in close contact with the Maltese state. “The aim of the regulation is to develop MFSA quality control”, he adds. It looks like the hedge funds sector in Malta is growing slowly.

4.3.5.4 Could a more regulated hedge funds industry at European level lead to an increase of this sector?

MFSA, Malta’s regulator is considered stricter as compared to Ireland and Luxembourg, although it has a reputation for approachable and flexible authority. According to Tonio, Fenech, tight regulation is nowadays considered good worldwide. Malta’s position is very good to capitalise on its reputation, as well as its clear legislation. The real

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646 Hedge Funds Review, (2010-2011), Malta Supplement.
challenge for Malta will be to ensure that it has the necessary skills to provide quality services for the industry. Malta’s legislation is pragmatic and well-organised and at the same time it provides strong and efficient regulation.\textsuperscript{650}

The Maltese regulatory authorities have stated that they are committed to guarantee market participation in compliance with regulations but, at the same time, they have confirmed a pro-business attitude and the adaptability that can only survive in a small-sized jurisdiction. As part of the EU, Malta is almost certainly closer to Ireland or Luxembourg in terms of strength and depth of its rules than Bermuda or the Caribbean jurisdictions. Of course, regulation within the EU is more coherent and stronger than that in more classical “offshore” countries. On the other hand, as mentioned above, Malta enjoys the advantage of being a small jurisdiction, which has the pragmatic complete authority in implementing legislation and regulation. The Maltese regulator continuously encourages more custodians to establish in their jurisdiction.

4.3.5.5 \textit{The AIFM Directive impact on the Maltese regulatory system}

Lately, Malta has a reputation of home-based EU land, which has the ability to draw together investment from funds in Europe. The country’s regulatory body is preparing “for the effects of the future AIFM Directive”, especially because this regulation appears like a major opportunity for Malta to take place as one of Europe’s prime financial centres. According to Lawrence Gonzi, in 2012, Malta “ranked among the top five emerging financial centres in the world in the City of London’s Global Financial Index.”\textsuperscript{651} Malta provides a perfect entry opportunity for hedge funds managers who desire to establish an onshore fund, because the Maltese law is strict and in line with EU requirements. Additionally, the MFSA has proved itself practical and business friendly, providing an active support to find a key within the context of the laws and legislations.

The effects of this AIFM Directive on Malta are so significant that the hedge funds EU market is assumed to increase considerably, probably driven by the presence of a high number of funds trying to achieve EU status. Malta is a rather new domicile if we

\textsuperscript{651} Opening Speech by the Hon Lawrence Gonzi, Prime Minister, During The Finance Malta 3\textsuperscript{rd} Annual Conference - Floriana – Friday 30\textsuperscript{th} April 2010, https://opm.gov.mt/finance_malta?l=2, accessed on 09.03.2012.
compare it to the other jurisdictions set in the EU. It looks like the growing rate of funds during the last five years, the expansion of asset “management companies which moved their operations in Malta” and the presence of a comprehensive regulatory framework for PIFs is favourable for further industry development.

At the same time, the existence of only one regulator, considered accessible and capable by the industry itself, further consolidates Malta’s strong position. During the following years, Malta will be heading towards challenges and favourable circumstances arising from the AIFM Directive. From Malta’s perspective, the following “main elements of the UCITIS IV Directive are expected to create further opportunities for growth:

- first and foremost, the possibility for UCITS management companies to effectively make use of their European passport rights, not only in terms of units distribution, but also in terms of UCITS management on a cross-border basis;
- the possibility to establish master-feeder structures and the opportunity for existing UCITS to convert into a UCITS feeder fund, whereby the master and feeder UCITS may be located in different Member States and may have different depositaries, auditors and management companies;
- the streamlining of the procedure and requirements for the cross-border marketing of UCITS throughout the EU/EEA.”

The AIFM Directive is extremely relevant for Malta, which prevails as a well-regulated choice of domicile for AIFs, especially following the success of its PIFs regime. Though it remains see the practical implementation of the AIFM Directive, it is definitely expected to provide new opportunities rather than major restraints for Malta as a centre for AIFs and their managers.

As with all new directives, the AIFM Directive will further challenge the international funds industry. However, some consider that the benefits will outweigh the challenges.

and the success of the UCITS Directive, if any, will exercise powerful growth traction in the EU alternative investment funds industry.\textsuperscript{654}

In a number of offshore domiciles in particular, non-UCITS retail funds and non-retail PIFs are already subjected to particular regulation and control by the MFSA.\textsuperscript{655} Fund management companies operating either in or from Malta, are also regulated and controlled by the MFSA in a very similar manner to that of the investment companies offering investment management services being covered by MiFID.\textsuperscript{656} The tight but flexible regulatory regime regulating the alternative investment industry has assisted to Malta’s turning into a financial services area and a main onshore fund domicile, and has also allowed the MFSA, local practitioners and service providers gain the expertise and professionalism necessary to operate and grow in a regulated area. This in itself should provide comfort for managers in order to choose Malta as a base for their actions, without losing its promising side, that is maximum flexibility (to the extent permitted by the AIFM Directive).

Starting from early 2013, the EU managers, qualifying as AIFMs controlling EU AIFs, will be provided by the AIFM Directive the right to exercise their passport rights in the EU.\textsuperscript{657} This means making available services according to the authorisation given in its home Member State without asking authorisation agreement from the host Member State(s). In addition, in 2015, it could also allow EU managers to manage “non-EU AIFs and non-EU managers to manage EU AIFs or non-EU AIFs”\textsuperscript{658} to take advantage from the third country EU passport (simultaneously with the national private placement system for a further transitional time of three years).

The EU passport accessible to the manager, related to the management and marketing of AIFs, will give managers more freedom to choose where they settle and the AIF they control. This will enable them to focus their fund management and marketing activities

to reach or involve different European jurisdictions within one EU Member State (and have benefits from the cost savings which naturally bring about). Among the EU alternative domiciles, Malta would be a pioneer, with the advantages mentioned above. These advantages will be discussed further on. At this stage, it seems that the options accessible to the managers would be based on whether “one or both the manager and the AIF is/are based inside or outside the EU.” The EU managers who want to capitalize the European market will be given a strong incentive to set up or move their AIFs in or to the EU, in that they are going to “manage and market EU AIFs” across the EU as from the Directive’s transposition date, which is believed to be early 2013 (the single passport from July 2013) – namely, two years prior to the other managers.

EU managers of non-EU AIFs may be facing various problems before they will be able to take advantage from the third country EU passport if they try to market within the EU, as from 2015. In addition to the manager’s need to comply with the AIFM Directive generally, its aptitude for trading AIFs outside the EU under the third country EU passport will depend on whether its home Member State meets a number of provisions.

A very significant aspect consists in “the introduction of the third country EU passport itself, and the phasing-out of the national private placement regimes in 2008, will ultimately depend upon the outcome of the ESMA Report and the EU’s positive decision on the matter. On this basis, an EU Manager seeking certainty may prefer setting up an EU AIF rather than a non-EU AIF or relocating its non-AIFs to an EU jurisdiction,” (which enables inward re-domiciliation of funds, just like Malta). The case of “non-EU Managers managing and/or marketing EU AIFs”, but also/or non-EU AIFs may demonstrate to be even more questionable. Besides the problems already relayed to EU managers of non-EU AIFs and several supplementary conditions which could be relevant for the manager to acquire AIFM Directive authorisation, it will also be essential to set up equivalence especially with those third countries where managers are usually domiciled to enable direct application of the “equivalence test” if the manager wishes to be exempted from special provisions of AIFM Directive. Still,

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661 Ibid.
662 Ibid.
although the AIFM Directive requires the location of the EU funds depositary in the same EU Member State of the fund, when implementing the AIFM Directive, Malta is expected to make use of the transitional provision under the directive that will enable funds established in Malta to appoint a credit institution located in another Member State until 22 July 2017. The fund managers will thus be more encouraged to establish in Malta.\footnote{Cassar, Laragh, (2012), Op. Cit., p. 8.}

Managers will certainly be very careful and selective in identifying the most suitable EU domicile, which possibly fulfils all their requirements. Despite the many doubts concerning the implementation of the AIFM Directive, Malta is believed to compete productively for this place, both as a domicile for the fund and for the respective fund management operation, thanks to various factors where Malta provides advantages no matter of priority order. Malta provides unique environment tax benefits\footnote{Farugia, Jean, “Malta: A Safe Alternative”, HFM Week Special Report, Malta 2012, Published by Pageant Media Ltd London, 2012, p. 18.}, especially for managers and their shareholders with a small resultant tax leakage and has the advantage of a wide network of double taxation agreements, while ensuring tax neutrality at the fund level. Tax is not, however, the main and only element attracting managers to Malta. In addition, the flexible authority, affordability of regulator, availability of high professional workforce and the adequate funds infrastructure are important elements in turning Malta into the preferred domicile for managers, whose number is expected to grow. Especially given the fact that the AIF industry is under Anglo-Saxon\footnote{Zammit, Andrew J., “Attracting the “Best of Breed” for Malta’s Financial Services Industry”, HFM Week Special Report, Malta 2012, Published by Pageant Media Ltd London, 2012, p. 11.} players’ control, Malta’s being an English-speaking country has also proved to be an influential factor. Another main and attractive point is undoubtedly the cost related to locally based service providers, together with those of legal auditing and auditing. In addition, another relevant support of the investment services industry in Malta is the appropriate accounting and reporting.\footnote{http://www.financemalta.org/content.aspx?id=333935&count=0, accessed on 12.05.2012.}

To conclude, the introduction of the EU Passport (counting the third country EU passport) should give managers new distribution opportunities inaccessible before through the national private placement regimes. As mentioned above, the most secure option and scenario for managers wanting to (continue to) target European investors,
now seem to be that of an EU manager managing an EU AIF and availing itself for the EU passport. Meanwhile, other EU fund domiciles will be eager to compete for this rank. However, Malta is likely to be the obvious choice for many managers who want to access the EU market and this country will continue to support its position as a first choice fund domicile and service centre in the EU, considering also its relatively simple re-domiciliation procedure.

As the Finance Minister Tonio Fenech said, “Malta has witnessed a rapid growth in the number of domiciled funds in the past year”667, a tendency which will probably continue in the years to come.

A negative aspect affecting the hedge funds industry is the rule that every AIF must assign a depositary in the same jurisdiction in which it [the AIF] is established. The growth of the funds services providers network equals the magnitude of Malta’s success in attracting funds and their managers. This simultaneous growth represents the essential infrastructure necessary to any funds jurisdiction to thrive. The jurisdiction can now be proud of a very wide choice of big name fund administrators and auditors, as well as lawyers specialising in the funds and financial regulation. One cannot say the same about the depositary services providers. Their number is limited at the moment and not all of them are internationally recognised brand names. This issue might hinder the further industry development.668

However, one thing should be remembered: the Maltese hedge funds industry is still significantly small as compared to medium-sized hedge funds markets in Europe and not only. At the same time, Malta’s industry attracts especially small hedge funds.

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4.4 Regulation of hedge funds in Swiss jurisdiction

4.4.1 Overview of hedge funds regulation in Switzerland

There is no specific legal regime that applies to hedge funds and private equity in Switzerland. Assets invested in hedge fund products represent approximately 5% of the assets invested in Switzerland at present time. This is partially due to the fact that fewer restrictions are applied to hedge funds than any other investment vehicles in terms of the investments types they can make.\(^{669}\)

The drawing power of establishing a hedge fund in Switzerland comes first of all from its tax favourable jurisdiction, secondly from the light regulatory pressure and thirdly from the credibility and lack of uncertainty of the sector. Numerous articles\(^ {670}\) have predicted in 2009 and 2010 a massive relocation of the hedge fund sector from their traditional location in London towards the more attractive Switzerland, especially from a tax point of view. The anticipated move came in the aftermath of the adoption by the British Government of an increase in taxes towards banks and investment firms. Several Swiss credit institutions, as well as financial counsellors have therefore made “an expertise in alternative investments. Pension funds, insurance companies and even retail investors are also increasingly investing in hedge funds, giving them the opportunity to diversify risks.”\(^ {671}\)

4.4.1.1 The hedge funds regulatory regime evolution in Switzerland

4.4.1.1.1 Legal and regulatory framework

The main Swiss legal and regulatory overview in terms of hedge funds is represented by the “Collective Investment Schemes Act” of 23 June 2006 (“CISA”) enacted on the 1\(^{st}\) of January 2007 and adopted by the Swiss Federal Council and the “Swiss Financial

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Market Supervisory Authority” (FINMA)⁶⁷². FINMA issued several circulars relevant decisions, respectively, on the 29th of August 2007 updated guides on public offering and private placement enacted on the 1st of October 2007, regarding the private employment of non-Swiss collective investment schemes.

The CISA was under consultation for revision. The consultation phase lasted from July to October 2011. “The Federal Council published the Communication on the Changes to the CIS Act and the corresponding draft of the law, subsequently CISA-draft or DCISA. Deliberations concerning the revised law should take place in parliament this year and enter into force at the beginning of 2013. The law’s revision is urgent because Swiss institutions cannot operate foreign domiciled collective investment schemes in Europe without approval as asset managers of collective investment schemes following expiration of the two year implementation deadline of AIFM Directive in mid 2013.”⁶⁷³

The aims of the CISA partial revision are filling certain gaps in regulation, as they are exclusively triggered by the introduction and implementation of the AIFM Directive. This being said, lawmakers must be cautious so that rules which go beyond the necessary (“Swiss Finish”) do not endanger the competitiveness of Switzerland’s highly significant asset management sector. In relation to this, it must be noted that Swiss asset managers must also be covered by the duty for authorisation even if they have no points of contact to EU Member States in compliance with the AIFM Directive or the UCITS-Directive. As compared to the initial draft from the 6th of July 2011, liberalisation possibilities were introduced in various points within the new CISA-Draft issued by the Federal Council on the 2nd of March 2012 and as a result, the “Swiss Finish” was somewhat reduced. For the implementation of the corresponding possibility for exemption, reference is often made to the Collective Investment Schemes Ordinance CISO (“the Federal Council may”) or to the practices of FINMA (“FINMA may”).

In order to avoid a “Swiss Finish”, the manner to implement the new CISA rules at the ordinance level and the degree to which FINMA makes use of the possibility to grant exemptions will be decisive. The consultation period led to numerous recommendations highlighting the need for measures in order to promote the Swiss fund industry.

⁶⁷² The FINMA replaced the Swiss Federal Banking Commission (SFBC) as the regulator responsible for the oversight of the financial markets as of January 2009.
Unfortunately, these measures have to be considered. Clearly, Switzerland is no longer operating outside the “rest of the world.”

4.4.1.1.2 Swiss hedge funds

Looking at the FINMA registered Swiss funds market from the outside to the inside, of the 7494 of the total registered funds listed in the Swiss Fund Data database as at 8.2.2011, 342 registered funds were listed under the asset class “hedge funds”.

Despite the above-mentioned issues, several structures were located across Swiss. Thus, since 1996, the Swiss regulator decided to set up the Swiss FoHF as “high risk funds” under the old “Investment Funds Act” of 1994 (IFA). Over time, this structure has turned highly popular and its flexibility to use single hedge funds was further enhanced (e.g., via improved leverage, broader scope of permitted investments), with the enactment of the CISA on the 1st of January 2007. The net growth in the amount of registered “other funds in alternative investments” – proved however quite “non-existent in 2007 and 2008.”

Currently, the CISA provides a highly flexible legal background for hedge fund processes in Switzerland, setting up innovative regulations for collective investments. Yet, very restrictive norms are applied by the relevant Swiss regulations in terms of investment restrictions (e.g., permitted investments, limited leverage, etc.), fund administration and subscriptions/redemption. “In the past, these may have seemed too

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678 “As of 31 December 2008, there were 135 so-called “high-risk funds” registered in Switzerland, of which most were funds and four single-hedge funds.” Swiss Federal Banking Commission Annual Report 2008, p. 105.
680 As defined in Article 25 et seq. in conjunction with Article 68 et seq., especially Article 70 of the “Swiss Federal Act on Collective Investment Schemes of June 23, 2006” (CISA)
681 Starting with 31 December 2008, there were 135 “other funds in alternative investments”, proving a net growth of only 15 new collective investments over a two-year period.
many to place Switzerland at a regulatory disadvantage as compared to traditional hedge fund jurisdictions, such as Cayman Islands.  

The recent difficulties felt by the financial sector and by the hedge fund market in particular, but also “the fall-out of Madoff fraud”, may change this perception going forward.

Another form of collective investment schemes is represented by the investment firm. Since CISA enactment, these firms came under the jurisdiction of fund regulation (and designated SICAFs), except those companies listed on a Swiss exchange, or not allowed to “qualified investors”. The largest part of the pre-existing investment firms come under the incidence of one of the exemptions and stay uncontrolled. According to regulations, the Swiss investment firm is closed-ended and this often let to a decrease of the share price as compared to its net asset value. What came out in these structures is much less popular than offshore open-ended hedge funds.

4.4.1.2 Swiss regulatory regime: scope and objectives

The regulatory framework for the regulated hedge funds focuses mainly on investor protection. This is achieved primarily through transparency and control of the professional qualifications of fund managers and representatives. Mutual funds have been authorised since the early ‘90s to register FoHF in Switzerland as a particular category of investment, which offers individuals no qualification of investors. Besides, FoHF also work under the lawful type of investment firms in compliance with “the self-regulating directives of the Swiss Exchange” and are traded as freely available shares to small investors.

684 As of 31 December 2008, no SICAFs were registered with the FINMA, Swiss Federal Banking Commission Annual Report 2008, p. 105
The legislative and supervisory construction of hedge funds and FoHF from Switzerland focus on investor protection, with emphasis on the professional value of fund management firms. In most cases, the licensing procedures for hedge funds but also FoHF are stricter compared to those applying to traditional funds. They involve audiences with fund managers and a better evaluation of risk management systems, fund managers, reporting lines and internal risk management, and a review of other parties involved in the investment scheme, together with the custodian bank, external principals and adviser, prime brokers, and managers. Although not formally presented in the regulations, registered hedge funds are placed under strict surveillance. External controllers are compelled to have professional background in alternative investments, and particular audits must be performed by external professional auditors once every three months in the first 24 months after establishment, focusing particularly on the structure and risk-return features of individual funds.

The protection of hedge fund investor is also achieved by means of transparency. Even funds of managers who are seeking immediate application for an AIFM Directive passport and who wish to continue operating under the private placement regime until 2018 have to comply with various transparency measures. Hedge fund prospectuses are compelled to include a particular warning provision that has to be accepted by the SFBC, as well as complete data on the fund investment policy, features, and special risks.

Thus, according to UCITS IV, the KII is going to “replace the simplified prospectus.” Target funds are most of the times revealed in the yearbook and semi-annual summaries of FoHF, and investors need to be given an opportunity to exert their redemption right at

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693 “The Federal Council adopted an amendment to the Ordinance on Collective Investment Schemes in order to introduce the key investor information document (KIID). The amendment entered into force on July 15 2011 and established the regulatory basis for the introduction of the KIID applying to foreign undertakings for collective investment in transferable securities (UCITS), non-UCITS and most Swiss retail funds, thereby replacing the previous simplified prospectus.” (on June 29 2011) Swiss Funds Association, SFA News Spring 2012, Edition 1/2012.
least four times every year. Legal restrictions on hedge funds operations are minimal and these focus primarily on protecting the particular structure of the FoHF. FoHF are allowed neither to carry out short sales, nor to invest in another FoHF. These are prohibited to invest more than 30% of their assets in target funds if these are managed by the same manager or management company. Moreover, funds are not authorised to have a leverage for more than six (this used to be a precedent SFBC practice which has been now properly incorporated in the provisions of the regulations).

4.4.1.3 The advantages and disadvantages of the Swiss regulatory regime

Lighter regulation and less costly compliance in present Switzerland appear as an alternative to more strictly regulated EU Member States from the perspective of asset management. Present regulations stipulate that managers of foreign CIS do not necessarily need a regulatory licence to act as managers. This licence is necessary only for managers of Swiss-based funds (“mandatory licensing only for managers of Swiss funds”). Certain monitoring duties were delegated to the industry itself by the Swiss regulator, setting out industry standards by self-regulation. The configuration of management operations in Switzerland is quite simple. Regarding the Swiss-based funds, the Swiss regulatory provisions enable the structuring of hedge funds for trade investors and/or accredited investors with no smaller amount of investment boundaries. This is an important asset for marketing objectives. The fact that there is no compulsory minimum investment (for hedge fund strategies also) allows managers to easily list the fund exchange and produce actively managed ETFs traded on secondary markets. An extremely attractive alternative is given to other jurisdictions by the lack of minimum investment thresholds in Switzerland, under the circumstances that one seeks liquidity in secondary market trading. “Except for the AIFM Directive, Switzerland is a very stable country.” It is a country with very stable and static regulatory and tax system.

700 Ibid.
4.4.1.4 A more regulated hedge funds industry at European level could lead to an increase of this sector?

Switzerland is very important with respect to investor base, enabling hedge funds to be close to their main client segments, which is a vital advantage, especially in times of crisis when demand for accessibility of managers increases. Switzerland hosts a wide range of hedge funds (FoHF), and it also provides managers broad exposure to institutional clients, in terms of sizeable pension funds, family offices and very large diversity of independent asset managers. Apart from this proximity to customers, Switzerland overruns many of its European counterparts in terms of political stability and quality of life, which is frequently considered by managers as a central reason for relocating. The expected hedge funds migration from London to Switzerland and the exodus of entire organisations has not started yet, but managers are expected to keep opening offices in Switzerland.

While profitable functions such as trading will be moved to Switzerland, many hedge funds have started, and are likely to continue to keep at least parts of their staff in their original locations. Interest in Swiss-domiciled fund structures could increase because Switzerland is not directly under the jurisdiction of the AIFM Directive. The “Swiss Collective Investment Schemes Act” also provides relevant favourable circumstances with its moderately flexible investment boundaries for alternative funds. Thus, the “other alternative investment fund” enables short-selling, leverage of up to 600% and the possibility to employ a foreign prime broker.

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4.4.1.5 The impact of the AIFM Directive on the Swiss regulatory regime

The AIFM Directive does not apply because Switzerland is not a member of the EU\textsuperscript{704}. Still, the FINMA has made no statement whether some transparency aspects of the AIFM Directive should still be adopted, and whether co-operation agreements between the targeted EU country, the Swiss authorities and the fund domicile’s local authorities should be in place\textsuperscript{705}. At this moment, the FINMA license is binding only for hedge fund managers of Swiss-based hedge funds. Offshore fund managers should not seek a regulatory license in Switzerland. Switzerland, as an offshore centre, will also change several aspects to suit the AIFM Directive\textsuperscript{706}.

The AIFM Directive had a direct impact on the Swiss alternative market: Switzerland has become more appealing to the EU managers, mainly to those managers in the UK that seem to be most adversely affected by the new rules, besides the impending tax reform adopted in the country. Since the implementation of the AIFM Directive, local consultants and lawyers have been overwhelmed with inquiries from UK asset managers questioning about setting up in Switzerland. The Swiss law has become more attractive as a result of its light regulation background. Cantons such as Zug or the city of Pfäffikon in the canton of Zurich will become more attractive to hedge fund managers from the UK. The same trend is noticed by Lecocq\textsuperscript{707}. For example, provinces around Zurich have succeeded to attract a considerable number of hedge funds managers due to tax reasons. As a final remark, Switzerland offers high quality of life and acceptable to very low taxes.

Nevertheless, recommended changes to be incorporated within the laws of investment market in Switzerland raised several concerns because European regulation is already very strict and it seems that this country intends to implement even stricter regulations.

\textsuperscript{704} According to Dominique Lecocq, attorney at law, partner of Lecocq associate, a law firm specialized in regulatory banking law.
\textsuperscript{705} http://www.hfmweek.com/article_assets/articledir_1749/874642/HFM212_SwissRT.pdf, accessed at 10.05.2012.
4.5 Conclusions drawn from the comparison of national hedge fund regulatory regimes in single selected European jurisdictions

This chapter has examined the laws and regulations governing the marketing of hedge funds in Italy, France, Ireland, Luxembourg, Malta and Switzerland. Given the lack of harmonisation of such laws and regulations, the author raised a series of questions to order and to compare, at least to a certain extent, the position in these above-mentioned, different jurisdictions.

This chapter provides a comparative summary of the legal forms applicable to hedge funds in six jurisdictions. It focuses on and explores five EU Member States’ hedge fund regulations plus Switzerland.

The author has chosen Ireland, France, Luxembourg, Malta and Italy because they are relevant from the point of view of the diversity of regulatory frameworks that co-exist in the EU. In addition, the chosen European countries represent the countries with highly developed financial sectors inside the EU. Although Switzerland is not an EU member, it is also included in the analysis, mainly because, in the international financial world, Switzerland is an important player and accordingly, especially as a consequence of its foreign policy, many, if not all global financial organisations are to some extent present in Switzerland.
### Figure 10. National legislative measures governing hedge funds

<table>
<thead>
<tr>
<th>Country</th>
<th>Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>1. Financial Security Law of 1 August 2003:</td>
</tr>
<tr>
<td></td>
<td>• Art. L.214-35 and L.214-35-1,</td>
</tr>
<tr>
<td></td>
<td>• Art. L.214-35-2 to L.214-35-6</td>
</tr>
<tr>
<td></td>
<td>3. Commission des Operations de Bourse position of 3 April 2003;</td>
</tr>
<tr>
<td></td>
<td>4. Autorité des Marches Financiers general regulation (November 2004);</td>
</tr>
<tr>
<td>Ireland</td>
<td>1. Unit Trusts Act 1990;</td>
</tr>
<tr>
<td></td>
<td>2. Part XIII Companies Act 1990;</td>
</tr>
<tr>
<td></td>
<td>3. Investment Limited Partnership Act 1994;</td>
</tr>
<tr>
<td></td>
<td>4. Irish Financial Services Regulatory Authority Non-UCITS Notices: NU Notice 1, 12, 13, 16, 19, 20, 21, 24, 25;</td>
</tr>
<tr>
<td></td>
<td>5. Irish Financial Services Regulatory Authority Guidance Notes: 1/97, 1/01, Draft -04.</td>
</tr>
<tr>
<td>Italy</td>
<td>1. Treasury Ministry Decree n° 228 of 24 May 1999;</td>
</tr>
<tr>
<td></td>
<td>2. Specific regulation:</td>
</tr>
<tr>
<td></td>
<td>• IML Circular 91/75 of 21 January 1991,</td>
</tr>
<tr>
<td></td>
<td>• CSSF Circular 02/80 of 5 December 2002.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Investment Funds Act 1994 with Ordinances</td>
</tr>
<tr>
<td>Malta</td>
<td>The legal structure is based on the civil law model of continental Europe, but most administrative, financial and fiscal laws is based on British law. Laws are published in both English and Maltese. The Malta Financial Services Authority (MFSA) is the single regulator for financial services activities in Malta. Investment Services Act, (Cap 370 – Laws of Malta).</td>
</tr>
</tbody>
</table>

### Figure 11. Definition of the hedge fund concept

<table>
<thead>
<tr>
<th>Country</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>No</td>
</tr>
<tr>
<td>Ireland</td>
<td>No</td>
</tr>
<tr>
<td>Italy</td>
<td>No</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>No</td>
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<tr>
<td>Switzerland</td>
<td>No</td>
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<tr>
<td>Malta</td>
<td>No</td>
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</tbody>
</table>
Currently, none of the countries subjected to study has a clear definition of the term hedge funds, and this conclusion could be applied to all the countries in the world. For instance, hedge funds in France are called “multi-market category of funds”, while in Italy, they are known as “fondi speculativi” (or speculative funds). It seems that all nations agree on the broad concept that hedge funds represent “other fund additional to the ones defined”, which can actually mean anything.

The EU can define hedge funds and make a regulation proposal to enable and facilitate hedge funds trading outside borders, similar to UCITS funds. Currently, “a hedge fund” undeniably represents “an investment vehicle”. The lack of interdictions is the main reason for not being defined according to its features, but rather according to what it is not. Still, “the EC’s Expert Group on hedge funds”708 proposed to “the EC” to start regulating mainly because this will positively affect the trading of FoHF across frontiers. However, this Group considers that “the EC” should not start the negotiations again regarding essential proposals of the UCITS directive and consequently change it one more time, but instead it should start to authorise “UCITS to invest in derivatives on fund indicators.”709

<table>
<thead>
<tr>
<th></th>
<th>Single Hedge Fund (SHF)</th>
<th>Fund of Hedge Funds (FoHF)</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Italy</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Luxembourg</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Switzerland</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Malta</td>
<td>Yes</td>
<td>Yes</td>
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</tbody>
</table>

**Figure 12. Categories of hedge funds which may be set up**

Every country enables the setting up of funds, by means of its regulation. They do it because there are many returns and knowledge coming from the hedge funds, and if they would not, the market and the investment professionals would abandon the countries moving in a more auspicious location. For this purpose, countries do not wish a tightened hedge funds rule, mainly due to their high relevance for liquidity and portfolio diversity. Most of the time, risk mitigation is discovered in the manner how

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709 Ibid.
“funds are exchanged to investors and the manner how the domestic funds invest the funds’ capital.”

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<table>
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<th></th>
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<tbody>
<tr>
<td>France</td>
<td>Yes, if the fund is registered</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes, if the fund is registered</td>
</tr>
<tr>
<td>Italy</td>
<td>No</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Yes, if the fund is registered</td>
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<tr>
<td>Switzerland</td>
<td>Yes, if the fund is registered</td>
</tr>
<tr>
<td>Malta</td>
<td>Yes, if the fund is registered</td>
</tr>
</tbody>
</table>

Figure 13. Hedge funds allowed to advertise

Accordingly, various states anticipate the risks connected to hedge funds in various ways. The only country that does not allow advertising at all is Italy, while countries like France, Ireland, Luxembourg, Malta and Switzerland do not consider that advertising represents a problem if the funds are properly registered.

<table>
<thead>
<tr>
<th>Country</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>
| France     | Regulated limits depending on the type of structure:  
  “Simple Funds”:  
  • use a leverage up to 200% of the fund's net assets (like UCITS);  
  • invest up to 50% of the fund's net assets in share/units issued by a single collective investment scheme and up to 35% of the fund's assets in bonds or equities issued by a single entity.  
  • “More Advanced”;  
  • use a leverage up to 400% of the fund's net assets. | “Advanced funds”: No legal limits, but detailed investment rules, instruments and limits must be disclosed in the prospectus. |
| Italy      | No limits | No limits |
| Luxembourg | 1) Risk diversification rules relating to short sales;  
  2) Borrowings;  
  3) Supplementary investment restrictions. Use of financial derivative instruments and other techniques. | No limits |
| Switzerland| Restrictions to be found in the fund's own rules | No limits |
| Malta      | No limits | No limits |

**Figure 14. Limitations regarding how SHFs may invest**

One can notice in the above table that various states use different standards. Quite often, domestic funds are limited by a certain concentration and therefore have to obey rules concerning risk spreading. As already seen in figure n° 12, Italy does not allow advertising but when it comes to limits concerning the manner of investing the funds capital, there are none. However, if admission “to hedge funds for retail investors” proves easy, limitations can frequently be found in the funds’ way of investing their financial assets.
Table: Hedge Fund Manager Regulation

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulated</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Yes</td>
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<tr>
<td>Ireland</td>
<td>Yes</td>
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<tr>
<td>Italy</td>
<td>Yes</td>
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<td>Luxembourg</td>
<td>Yes</td>
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<tr>
<td>Switzerland</td>
<td>Yes</td>
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<tr>
<td>Malta</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Figure 15. Is the hedge fund manager regulated or not?

All the analysed states regulate the hedge fund administrator in order to mitigate the risks.

Table: Hedge Fund Regulation

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulated</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
</tr>
<tr>
<td>Italy</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes</td>
</tr>
<tr>
<td>Malta</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Figure 16. Is the hedge fund itself regulated or not?

All the analysed states preferred to regulate the funds directly for risk mitigation.

Since Luxembourg and Ireland accommodate a significant part of the EU-based investment funds, it is important to provide an efficient framework on their regulatory regime, but also on the regulatory regime in the UK and the rest of the analysed countries. Many hedge funds from UK tend to be controlled from London, although they are located within small tax jurisdictions. On the contrary, regulation from Luxembourg and Ireland was introduced with the aim of allowing them to set up and thus re-domicile within their own jurisdictions.

Luxembourg regulatory body enables hedge funds to set up according to the stipulations of the 2007 law regarding private investment funds. Accordingly, funds may behave like common funds, SICAVS or SIFs, net assets worth EUR1,250 million being imposed. SIFs are subject to malleable regulations such as: decrease to 30%, similar investment in securities issued by the same entity. According to regulations, a prearranged meeting between a Luxembourg - governmental official and an investor, on behalf of a Luxembourg fiscal organisation or an institution located in Luxembourg, but originating in another EU country is compulsory. It is also binding that assets are
evaluated fairly. While proceeding “to a public offering, a prospectus will be required as approved by the CSSF.”\textsuperscript{711}

The Irish regulatory regime, similar to that of all EU countries, is founded on a clear differentiation between UCITS – which may be exchanged throughout the EU, and non-UCITS, which may be exchanged cross borders in case the local regulation allows this, most of the time relying on some particular investment. Only under exceptional circumstances, “non-UCITS” may be sold out for “retail investors”: this can be applied usually for “Funds of Hedge Funds” which may become thus an investment in an expanded group of non-regulated funds. Thus, “hedge funds or private equity funds” should usually select “non-UCITS” models, for instance, “the QIF”, a recipe for which the investment and borrowing requests tend to be flexible. These are meant for both organisational and high net value persons. Also, funds are compelled to appoint a custodian from one bank in Ireland, “or a branch of an EU bank settled in Ireland.”\textsuperscript{712}

Administration has to be provided by management companies, either “licensed by the Irish supervisor”\textsuperscript{713}, or acknowledged according to MiFID regulation.

Many states are very restrictive with hedge funds on their territory, enabling only the set up of certain hedge funds. In addition, some countries have enacted detailed regulation, while others have not.

For instance, the \textit{Italian regulations} are elaborated by BoI, a credit institution which regulates the organisation together with all hedge fund-related processes. Accordingly, the latter can be given maximum two hundred persons, each contributing with at least half a million EUR. Therefore, BoI does not seem to supervise “hedge funds” directly.

A similar case occurs with the \textit{Swiss regime}, which does not set up lawful requests upon hedge funds, and at the same time, certified and/or experimented investors are given without restrictions funds domiciled outside Swiss. While Swiss set up funds are

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{711} Seimetz, M., in, \textit{“General Reports of the XVIII\textsuperscript{th} Congress of the International Academy of Comparative Law”}, Edited by Brown, Karen B. and Snyder, David V., Springer, Washington, 2012.
\item \textsuperscript{712} O’Sullivan, D., in \textit{“General Reports of the XVIII\textsuperscript{th} Congress of the International Academy of Comparative Law”}, Edited by Karen B. and Snyder, David V., Springer, Washington, 2012.
\item \textsuperscript{713} Ibid.
\end{itemize}
\end{footnotesize}
compelled to register, those not domiciled in Swiss can hardly register according to money laundering laws.

As already mentioned by the author, in terms of legal regime, *regulating hedge funds* knew two phases: before the financial crisis, the largest part of the jurisdictions had not implemented particular regulations regarding hedge funds. In France, for instance, regulation is very closely connected with the regulation on common investment funds. However, all national analyses stipulated that investment administrators were usually regulated regardless of the processes developed within the hedge fund market. Additionally, some nations adopted a more liberal approach as far as “funds of hedge funds” are concerned, and these countries implemented particular laws in this respect. Therefore, their brief overview is considered useful, trying to recognise their common characteristics.

*The Maltese regime* provides low tax rates, low costs and lighter regulation, making it a fashionable alternative over other regulatory paradises such as Switzerland or Ireland. The low rates of tax, easiness of incorporation and light touch taken by the MFSA have made Malta an increasingly attractive destination of choice for many hedge funds. Its low cost but high standard of living and warm climate also contributed to Malta’s attractiveness for many who seek to relocate. With no sign of improving fiscal and regulatory conditions in the UK, many more hedge funds may yet become vulnerable to the lure of the Maltese falcon.

*In terms of hedge funds exemption*, the private offering exemption represents a frequently used technique to manage hedge funds. Funds are therefore allowed to be exempted in spite of not being given freely “to the public”, although normally they might fall under the regulatory approaches of “investment fund”. There are several methods to define a private type: by mentioning a number of investors, or by stipulating the lowest start up investment. In some countries, “qualified” or expert investors can be solicited, while in other states, the number of investors per fund is limited. For instance, the Irish and the Luxembourg systems enable access for individual investors through a “qualified investor scheme.”
The French and Maltese systems are also connected to the lowest investment (USD125,000) and to the investor’s wealth. The Italian system requires a minimum start up investment of EUR500,000. Switzerland relies on the interference of authorised brokers, with an examination of the supervisor’s prospectus for fullness and consistency.

In terms of the FoHF, in locations where FoHF can be made available to the public, norms tend to be mild. For example, in France, they reach the lowest amount of EUR10,000, and a similar action is also used in Italy. In case of the Irish regime, FoHF are accessible only by means of the listing regime.

In terms of the “private law aspects”, hedge funds can be classified in various manners: often as lawful authorities located in a jurisdiction with minimal requests, and low taxes, if any. In Ireland, the fund can be managed outside the area of authority with “advanced financial markets.” At the same time, the depositary function, as well as that of backing up will be set up or managed outside “the latter jurisdictions.” Initially, funds used to be organised under small alliances, with administrators acting like proactive associates and investors behaving like limited associates. This institutional category is noticed in several jurisdictions, for instance, in Switzerland.

Simple “contractual funds” are often used mainly due to taxation impartiality. Usually, they are not mentioned in regulations, apart from the point of view of the asset managers’ obligations. For example, in France, this particular fund is under control of severe requirement in case it intends to address itself to external investors. This trust type is also used in Ireland and other states whose regulators have implemented the trust use for business aims.

The risk of anxiety due to complicated and advanced financial services makes the author ask himself: should the financial market and its services be supervised by politicians both in the EU and internationally, or should they be supervised by particular regulators like “the FSA” from the UK? It is undeniable that it worked in the UK if one thinks of the fact that UK represents the largest financial market in Europe. Also, UK did not experience many problems, or at least less than in other jurisdictions where there are no national similar authorities such as FSA from UK to legislate. The financial
industry has become so complicated and innovative that it takes particular amount of intelligence and professionalism to understand it. Innovative services are often discovered and exchanged due to their high request by investors and individuals who try to manage risks. Therefore, is the inability of the officials to regulate rapidly enough or stop financial services from being traded a good enough reason to allow the parliaments and policy-makers located in the EU stop the aforementioned individuals from handling their risks? Or is the inability of the former to understand the latter and therefore, their fear of them a good enough reason?
CHAPTER FIVE

REGULATION OF HEDGE FUNDS IN THE US

5.1 Introduction

The most important “federal securities regulations” setting up the solid foundation for hedge funds’ regulation on the US territory have been approved at the beginning of the Bourse collapse in 1929. The regulatory documents are:

- “the Securities Act of 1933”\(^{714}\);
- “the Securities Exchange Act of 1934”\(^ {715}\);
- “the Investment Company Act of 1940”\(^ {716}\);
- “the Investment Advisors Act of 1940”\(^ {717}\).

These acts are described in the first part of the chapter. The last part of this chapter analyses “the Dodd-Frank Act”\(^ {718}\), whose enactment was the direct consequence of this ongoing crisis. The above-mentioned legislation stipulates under title IV\(^ {719}\) several recommendations which highly change the act of registering requests and investment advisers’ regulation.

The vast majority of hedge funds were not compelled to fill in a registration form with the SEC, be it according to the “Investment Company Act” or in accordance with “the Investment Advisers Act,” both from 1940. Also, the present chapter addresses the premises of hedge fund reforms, particularly in terms of exemption from registration for hedge funds advisers and reporting requirements, which culminated with the enactment of the “Dodd-Frank Act”. The present chapter represents a survey and research

\(^{714}\) 15 U.S.C. §§ 77a et seq.
\(^{715}\) 15 U.S.C. §§ 78a et seq.
\(^{716}\) 15 U.S.C. §§ 80a-1 et seq.
\(^{717}\) 15 U.S.C. §§ 80b-1 et seq.
\(^{719}\) “Regulation of Advisers to Hedge Funds and Others”.
regarding the hedge funds regulation in US, but also a general presentation of “how hedge funds together with their managers are to a large extent exempted from regulation.”

Hedge funds but also various private pooled investments usually try to decrease the amplitude of their regulation in the US (and elsewhere). They have historically counted on exemptions from registering according to the most important “US Securities and Commodities Laws” available for PIV but also for their promoters. The present chapter adds to the research field in several ways. First of all, this study contributes to the fast-growing literature on hedge funds regulation, with a detailed research regarding the evolution of hedge funds regulations in the US. Also, it contributes to an increased understanding of hedge funds operation during unstable periods in America. Another contribution worth mentioning is represented by the analysis of future necessity in terms of tighter regulation of the US hedge funds, necessity supported by the deep preoccupation for financial security and “investor protection.” Also, the study considers the features of the Dodd-Frank Act focusing mainly on its accomplishments or errors. In this context, another contribution resides in the significance of the analysis for individuals interested particularly in the financial ongoing reform from the US affecting other jurisdictions as well. The reasons for the author’s belief are fully supported by the fact that the US enactment of financial regulations will definitely turn into an inevitable indicator directing the efforts towards the international development of financial regulations. Therefore, although the chapter adds to the understanding of the analysis of the US regulatory framework for hedge funds, it can also be seen as a contribution to the international regulatory development dimensions, from a comparative perspective.

The author declares that this chapter will enable academic scholars not only to discover data requested for future studies in the field, but especially, in general, (1) to gain comprehension with regard to general reputation of the “hedge fund” market throughout the US, and in particular, (2) to gain a broad understanding of contemporary debates regarding financial regulation with focus on the protection of investors against the growing complexity of financial markets, new risks, and other changes brought about by financial innovation.

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721 Pooled Investment Vehicles.
5.2 The Investment Company Act 1940

The “Investment Company Act” (hereinafter also presented as the 1940 Act) generally governs investment funds in the US. Most alternative investment funds are defined, in the absence of an exemption, according to an “investment company” and therefore registered with the SEC.\(^{722}\) Registered funds comply to several constraints incompatible with many investment strategies pursued by alternative investment funds.\(^{723}\)

The 1940 Act was issued for the protection of investors who use other persons in their investments management and diversification. Every investment company\(^{724}\) included in the definition without being “exempted from the act”\(^{725}\) is bound to register with the SEC.\(^{726}\) Only if an investment entity acts in compliance with all stipulations specified in the 1940 Act, is this entity allowed to become actively involved in some securities-related processes.\(^{727}\) Also, different associations but also the particular interest manifested by the managers, counsellors, as well as staff working within an investment entity are included.\(^{728}\) Thus, for instance, investment companies are allowed to have executive principals with maximum 60 percent from individuals who are members within the entity, seen as “interested persons.”\(^{729}\) Also, these companies are bound to submit income and other various reports.\(^{730}\)

In agreement with section 3(a) of the Investment Company Act, investment companies include every vehicle involved in securities investment. Alternative investment funds generally use the exemptions mentioned in sections: 3(c)(1) as well as 3(c)(7)\(^{731}\) and abandon registration and its substantial associated restriction. Thus, “these private investments” firm exclusions were mentioned in two Sections.\(^{732}\) According to the above-mentioned exclusions, some pooled investment vehicles are exempt from

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\(^{725}\) Exemptions may be found at 15 U.S.C. § 80a-3(b) and (c).

\(^{726}\) 15 U.S.C. §§ 80a-7 and 80a-8.

\(^{727}\) 15 U.S.C. § 80a-7(a), (b), and (c).


\(^{729}\) 15 U.S.C. § 80a-10(a).


\(^{732}\) 3(c) (1) and 3(c) (7)
definition according to the term *investment company*, and at the same time, they are exempt also from substantive regulation in accordance with the Investment Company Act.

Out of the two exclusions, the oldest and most frequent seems to be Section 3(c)(1). The requests are doubled: first, interests in funds are basically placed personally to investing persons; second, the maximum acceptable number of investors is 100.

What constitutes public offerings for objectives mentioned in the 1940’s Act is understood in practice to be similar subject to section 4(2) stipulated in the Securities Act.733 As a result, funds endeavouring to count on this exemption will perform their offerings as subjected to regulation “506 of Regulation D”734, which is the safe harbour for section 4(2). Furthermore, private placements of fund interests in the US complying with rule 506 from “the Securities Act” will not be incorporated with an offshore public offering of the interests. Consequently, foreign funds may have up to “100 US beneficial”735 owners without falling under the public offering prohibition of section 7(d) as per the co-called *Touche, Remnant & Co* doctrine.736

The discussion about the counting of only up to 100 investors, for the purpose of section 3(c)(1)737 is not entirely self-evident and is subject to various rules and clarification. In some cases, beneficial owners of distinct funds can be combined according to the integration assumption, if the two vehicles represent a distinct fund. Resemblances in investors’ profiles and investment strategies are of great interest for this study. The experts of the SEC concluded that neither onshore nor offshore funds with similar investment aims cannot be merged where the vehicles concern investors with different tax positions.

Typically, only investors who are US persons are considered when a fund is organised outside of the US. As a result, “for purposes of the 100 ownership limit”738, “the number

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733 Section 8.4 of the Securities Act of 1933.
of other investors in the fund would only be subject to limits imposed in the funds’ jurisdiction of domicile." At the same time, new regulations have been introduced regarding offshore CIS under section 7(d) as well as section 3(c)(1). According to the above-mentioned sections, all the offshore funds which are not registered have the possibility to disclose private offerings inside the US borders, while simultaneously performing public offerings outside the US borders without breaching section 7(d). There is, however, one condition which needs to be considered, namely that these offshore funds are enabled to have maximum 100 asset holders who must be American residents.

The major regulatory exemption concerning hedge funds is available under the provisions of this Act. Unlike regulated investment firms, private funds do not fall under the “1940 Act” limitations regarding the participation in financial strategies among which one can enumerate: leveraging, “short selling”, and making focused standings within one particular sector, company or industry. At the same time, they are exempted from worth requests generally applied to investment entities which are registered and thus forced to evaluate the entire portfolio securities daily, according to the trading price.

In order to qualify for the exemption stipulated by Section 3(c)(1), the hedge fund has to fulfil two major conditions. The first one is that maximum 100 holders are allowed. The second one is that public offerings are not allowed.

“A qualified purchaser” term refers to persons with more than USD5 million in investments/firms, but also minimum USD25 million invested. One very relevant issue is represented by the presented exceptions, according to which a fund can count on whether the fund’s securities are exchanged in a private placement according to the 1933 Act.

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5.3 The Investment Advisers Act 1940

An important piece of US securities legislation, namely, “the Investment Advisers Act of 1940”, is probably better known for its conciseness. Especially if it were to compare it to its companion statute, “the 1940 Act”, “the Investment Advisers Act” does not hinder much the entities that fall within its registration requirements. This Investment Advisers Act settles some particular prohibitions on conduct, with emphasis on broad proscription of illicit conduct by investment advisers.

This Act appoints every “investment adviser” in the position of every individual paid to provide assistance to people on funds value and investments, “purchasing or selling securities”, and the persons who analyse securities. Also, the Advisers Act includes fundamental requirements for some investment advisers who meet established thresholds, including: SEC registration, maintenance of business portfolios, delivery of disclosure statements for clients, but also the prevention of customers deceiving because of ethical/legal confidence to act in the best interests of the client. There are however several exemptions. Thus, Section 203(b)(3) stipulates that those persons called investment counsellors with maximum 15 customers “during the preceding twelve months”, must not present themselves usually in front of the public as investment counsellors, and they do not represent counsellors for any “registered investment” firm.

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746 “The Investment Advisers Act” deals generally with persons providing money management advice. “Investment Advisers Act of 1940, 15 U.S.C. § 80b” (2000). This deals generally with pooled investment vehicles whose shares are available for purchase by the public. “Investment Company Act of 1940, 15 U.S.C. § 80a” (2000). Both were originally adopted as part of the same bill and reflect a complementary effort to regulate the investment management industry in the US following the turbulence of the 1930s. Sections 12, 15, and 17 of the Investment Company Act, e.g., establish comprehensive but also detailed rules of conduct for companies that come within the Act's definition of “investment company.” Id. §§ 80a-12, -15, -17.
Nevertheless, the individuals eligible for the exemption have to follow the SEC antifraud provisions, but they are not required to file registration forms to identify themselves, keep business records according to SEC provisions, apply compliance plans or ethical norms or subordinate themselves to SEC supervision. Also, if it is not registered with the SEC, no investment adviser can use mails or other methods of interstate trade in relation with his/her profession of “investment adviser.” The latter may register by filling in particular data “with the SEC.”

Further on, the definition of the investment adviser will be presented. Section 202 (a) (11) states that this profession includes every individual involved in the marketing industry either dealing with the value of the shares, or with suitability regarding the investments in securities, doing this for compensation. Therefore, the concept presented above largely includes every individual who provides advice about securities as part of a regular business, in order to get a compensation. In the absence of an exemption, their registration according to the Act of 1940 is required as per section 203(a).

Several exclusions from the definitions are made for persons who incidentally provide advice to their own businesses, including:

- Professional individuals, among which one can mention lawyers, as well as accountants;
- Individuals engaged in publishing printed material;
- Broker dealers;
- Credit institutions.

In addition, a number of exemptions are provided for advisers with limited operations only. Of primary importance are “private investment advisers”, with maximum 15

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758 Investment Advisers Act Of 1940, Sec. 202, p. 4.
customers during the last year, who are not making them generally available like the public advisers.\footnote{Spangler, Timothy et al. (2010), Op. Cit., p. 111.}

Registering as an investment adviser implies fiduciary duties\footnote{Gibbons, Gary and Stone, Heather M., "PE Managers as Registered Investment Advisors", \textit{The Journal of Private Equity} Winter 2011, Vol. 15, n° 1: pp. 8-15, DOI: 10.3905/jpe.2011.15.1.008} owed to clients, as well as substantial requirements that must be met. In the first case, this includes providing appropriate advice, best execution and full disclosure of conflicts. In the second case, “a registered adviser must comply with detailed rules addressing, among other things: advertisements, custody, performance fees, record keeping and privacy.”\footnote{Spangler, Timothy et al. (2010), Op. Cit., p. 112.}

According to Paul F. Roye\footnote{Director of the Division of Investment Management.}, US SEC, managers of funds need not to forget their obligation towards their customers despite their light regulation. He also warns them that not only the Commission but also other authorities and individuals pay attention to ensuring the ability of fund managers to meet all legal and ethical responsibilities.\footnote{Nat’l Regulatory Servs. & Inv. Advisers Ass’n, 2007, “Evolution Revolution Report 4”, available at http://www.investmentadviser.org/public/evolution_ revolution-2007.pdf (reporting on investment adviser industry demographics).}

This statement was triggered by suits of hedge fund fraud which led “to regulators’ investor protection concerns. Even if many enforcement litigations have implied investment registered advisers, the number of investment advisers continued to increase lately. Still, the most challenging characteristic of companies that comply to the provisions of the Investment Advisers Act does not reside in their number but rather in their variety; advisers nowadays “run the gamut from financial planners to separate accounts managers, to mutual fund advisers, to hedge or other private fund managers.”\footnote{See, \textit{SEC v. Burton G. Friedlander}, Civil Action n° 01 Civ. 4658 (S.D.N.Y.), Lit. Rel. n° 17021.}

Nowadays, litigations are filed on various grounds, from portfolio inflating, failure to achieve investment purposes, non-achievement of performing high-quality work, as well as breaching fiduciary duties.\footnote{See, \textit{SEC v. Burton G. Friedlander}, Civil Action n° 01 Civ. 4658 (S.D.N.Y.), Lit. Rel. n° 17021.}

\subsection*{5.4 The Securities Act of 1933}

\footnotetext[759]{Spangler, Timothy et al. (2010), Op. Cit., p.111.}
\footnotetext[761]{Spangler, Timothy et al. (2010), Op. Cit., p. 112.}
\footnotetext[762]{Director of the Division of Investment Management.}
\footnotetext[763]{IA Compliance Summit and Best Practice Update (8 April 2002).}
\footnotetext[765]{See, \textit{SEC v. Burton G. Friedlander}, Civil Action n° 01 Civ. 4658 (S.D.N.Y.), Lit. Rel. n° 17021.}
One main aim of the “1933 Act” resides in protecting the investors. In this respect, it is illegal to either offer or sell securities transparently if they were previously recorded under the SEC (Commission). Its major occupation is represented by the first securities’ distribution and less by the subsequent exchange. To reach that aim, a request of registration with the SEC needs to be submitted and data distribution of securities should be performed before being publicly exchanged. “A registration statement” turns operative 20 days after it has been submitted to the Commission, except when this is either postponed or interrupted. This is composed of two parts: the first part is the prospectus, offered to each security’s purchaser, and the second Part, includes information and exhibits which are not compulsory, offered to purchasers and also accessible for public inquiry. Similarly, Section 7 in the 1933 Act refers to “Schedule A” and presents data that has to be included in the registration declaration. This program demands a high amount of data, like the underwriters, business type, relevant associates, debits and possessions of the firm and beliefs concerning legitimacy. “Section 10(a)” of the 1933 Act presents general data commonly contained by the prospectus. Also, the Commission issues many rules which include new aspects regarding the possibilities of registering as per the 1933 Act.

When marketing an alternative investment fund to investors from the US, exemptions in connection with the fund’s potential status as an “investment company” are necessary, simultaneously with the guarantee that every offer and trade of interests in the fund is exempt from registering according to the Securities Act. Embodied as a limited association, “a unit trust” and even a corporation, the interests of a fund will be subject

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766 The definition of the security concept can be found largely within 15 U.S.C., more precisely in section 77b(1). According to this section, it represents each “note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organisation certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any instrument or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing”, in Seitzinger, Michael V., “Overview of Major Federal Securities Laws”, CRS report for Congress, p. 2.

772 17 C.F.R. Parts 230, 231, and 239.
to the “security” definition. In the absence of a suitable exemption, the registration with the SEC will be required for the offer and trade of such interest.\textsuperscript{773}

The objective of the Securities Act is to provide the necessary disclosure of data to investors when offers are made to the public. Exemptions to the registration requests are reachable to some offers and trades that can take place in the secondary market or can represent private placements. Therefore, hedge funds are forbidden from general advertising and this implies securing investors through consultants, registered representatives, brokers or investment advisors. The decreased public disclosure by hedge funds leads to decreased transparency and therefore to a low degree of investor protection. But these new exemptions exemplify the SEC’s inclination towards regulating by exemption. Still, although the SEC’s purposes are laudable, the question that remains is whether this represents indeed a sound regulatory strategy.

To evade from registering their securities, a high amount of “private funds”, comprising hedge funds count on exemptions stipulated “in section 4 (2)” referring to private placement. According to this section, the exchanges that do not involve “public offerings are exempted”\textsuperscript{774} as per the 1933 Act. According to this, they will be exempted from registering unless the interests are traded without involving public offering. Usually it will not be regarded as public offering if the investment manager does not advertise the selling, and if the selling is available only to a limited number of experienced investors.\textsuperscript{775}

The logic of believing this resided in the fact that it was considered that there was no need to protect the potential investors, since they could protect themselves. Still, as it can prove difficult to know what the term public offering actually supposes, there are many fund managers confiding in the legal safe harbour in Regulation D under the 1933 Act.\textsuperscript{776} “Regulation D effective on April 15, 1982”\textsuperscript{777}, provides a manner to establish that you did not make an open, “public offering” for goals stipulated at section 4(2). In this context, as an unregulated entity, the hedge fund investment manager has the

\textsuperscript{775} http://www.moneymanagerservices.com/tour/sales.cfm
\textsuperscript{777} Securities Act Release n° 6389.
freedom to undertake greater risk on more volatile positions and by doing this, he can expose investors to possible substantial profit but, at the same time, to substantial losses as well.

In this respect, there are many funds trusting Rule 506 from Regulation D to meet the particular exemption concerning the refusal of making public offerings. Accordingly, not one “public offering” occurred in the case when the institution issuing it failed to engage to an overall request of its securities. This request is available for at least “35 investors” without accreditation. This law enables selling to a limitless range “of accredited investors”, like most financial organisations, which are either an individual who at that moment of purchase has a net worth surpassing USD1 million, or an individual who had a profit exceeding USD200,000 in the last 24 months.

“Accredited investor” is a basic concept from Regulation D. Only if the other stipulations under Regulation D are complied with, a limitless number of accredited investors can invest in a fund without giving up the private placement exemption stipulated by Section 4(2). Maximum 35 persons can invest in the fund, individuals who are not “accredited investors”.

Meanwhile these exemptions were a consequence of push backs against a strict and ample framework for the registration of public offerings and the governance of mutual funds, anomalies emerged in the financial markets, questionable and not in the interests of the retail investors that the SEC tries so hard to protect. The achievement of SEC exemptions was made through the use of the above-mentioned “accredited investor” approach, implemented into “Securities Act” by a Congress intolerant to the SEC’s denial of being more flexible in its views of the private offering exemption.

In compliance with the Securities Act, “an accredited investor” according to stipulations under Regulation 501 stipulated by Regulation D implies the following:

778 17 C.F.R. § 230.501
780 Meanwhile Rule 506 allows accredited investors having maximum 35 non-accredited investors, many funds find it unworthy to get involved in that particular type of investing persons.
782 15 U.S.C. § 77d(2) (1982);
(i) Somebody with a net income (it is also allowed the joint net income by adding his/her wife/husband’s worth) on that occasion, of investments exceeding USD1 million (excluding the value of their main residence);

(ii) Somebody with a net worth (it is also allowed to include additional worth on behalf of his/her wife/husband) exceeding USD200,000 during the last 24 months. At the same time, joint worth on behalf of his/her wife/husband exceeding USD300,000 is also allowed, on condition to be gained during the last 24 months at the same time being requested to gain similar profit during the next period\textsuperscript{784} (current year).

Sales of interests must be limited to persons who qualify as “accredited investors”, together with up to 35 additional persons who, although failing to meet that definition, qualify for “sophisticated investors.” Thus, the latter represents the person with very good information and skills regarding financial and entrepreneurial issues, who is at the same time able to evaluate both advantages, but also risk processes regarding potential investments.\textsuperscript{785} An individual might also qualify for a \textit{sophisticated investor}, in case he/she acquired this qualification together with a purchaser representative.\textsuperscript{786}

In addition, the issuer or his/her agent must know that the future purchaser has the financial means and sophistication to make such an investment. Even after all the potential purchasers would otherwise qualify for “accredited investors” or “sophisticated investors”, the marketing of securities may still be deemed a “general solicitation” where, for example, a mass marketing is conducted. A comment needs to be added: the Madoff fraud (see chapter six) exposed a surprising lack of critical diligence on behalf of various sophisticated investors. And this occurred in the context of sophisticated investors having been expected to defend their own interests especially since they did have the means to do so. Thus, one cannot help to ask himself which was the reason that \textit{so many sophisticated investors fall prey to Madoff’s fraud. Why were these institutions and individuals not able to defend themselves?, why did they not ask questions?, why did they refuse to defend themselves?} As a consequence of this - and in opposition to legislative intention, the operation of the sophisticated investor exemption seems to have undermined the SEC’s capability to fulfil its objective to adequately protect the

\textsuperscript{785} Kling, Lou R et al., \textit{“Negotiated Acquisitions of Companies, Subsidiaries And Divisions”}, Volume 1, 51 \textit{Miami University Law Review} 779 (1996-1997), Summary of Acquisitions Agreements; 5-34.
public financial markets. In this vein, the author considers that a new regulatory framework focusing on increasing transparency within these industries is of great need.

What needs to be clear is that SEC proposed an increase for the accredited investor standards under the above presented Regulation only after the Goldstein decision, Regulation D, with the main purpose to *increase antifraud protection for investors*[^787]. For a long time, SEC has long been very clever at using its power to define terms to fill gaps or solve problems in the hedge funds laws, but as the court showed in Goldstein, such an effort needs to be reasonable. When dealing with the concept of the accredited investor maybe the SEC has been too wise and not consistent enough in defining its purposes and thinking through the results of its regulations.

### 5.5 The Securities Exchange Act 1934

If the 1933 Act refers mainly to offering and registration actions, the 1934 Act refers mainly to secondary trading[^788]. The 1934 Act was based on the concern that hedge funds investors were provided unsatisfactory protection with regard to fraudulent schemes, misleading, but also inappropriate disclosure[^789]. Hence, this Act addressed various issues, comprising also the act of disclosing the information to investors, which can be performed through permanent but also up to date filings to the Commission[^790].

Thus, this Act allows “the SEC” to require certification but also data communication at fixed intervals by authorities issuing publicly exchanged securities. Also, section 12 (g) imposes an issuer to have at least 500 owners with classes of stock[^791], but also at least 10 million dollars in holdings for registering stocked items. At the same time, the Act stipulates that every issuer with classes of securities exchanged on the NSE[^792] owns also, in some given situations, overall holdings which exceed USD1 million. Also,

[^787]: See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230 & 275) (proposing a new rule to allow the SEC to bring enforcement actions against investment advisers who defraud investors or prospective investors of hedge funds).


[^792]: National Stock Exchange.
classes of stock with minimum 500 holders need to register according to the above-mentioned Act. Any authority issuing bound to record according to “the 1934 Act” is obliged to make a repository at fixed intervals, and secondary reports to the SEC.

Marketing efforts in the US may also give rise to broker-dealer registration problems. The central issues here are which of the fund manager’s employees are engaged in marketing and how are they compensated. The broker is being defined according to section 3(a)(4) as every individual involved in entrepreneurial securities trade on behalf of different investors. No distinction is made between privately – placed and publicly-offered securities. If a fund manager’s employees receive commissions from the sale of participations in a fund, they will be deemed brokers. As a result, they must be joined individuals of the 1934 Act officially recorded broker-dealer. The main reasons for tight regulation of this broker-dealer industry are “its economic importance” together with “the possibility of investor abuse.” As observed along the entire Exchange Act but also in the regulation of broker-dealers, the important role of investor protection and fairness is widely spread.

Pursuant to Regulation 3(a)(4) - 1 under the 1934 Act, the safe harbour can be set up, allowing counsellors, managers or employees of either the fund or the fund manager to trade involvement in a fund which does not necessary have to register. The requirements of the safe harbour include the following:

- the individual has not been associated with a broker-dealer during the last 12 months;
- the individual must not have participated in the marketing of any fund during the last 12 months;
- the individual needs first to make considerable duties for the fund manager others than marketing the fund;
- the individual must not be compensated for the marketing effort by officials or various remuneration due to selling securities.

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795 15 U.S.C. §§ 78l, 78m, and 78n.
Where the safe harbour is not available, employees of the fund manager should limit their discussions with prospective investors to the investment objectives of the fund. A registered broker-dealer should be left with the responsibility to require, negotiate and accept participations from the investors.

The major “thrust of the 1934 Act lies within Section 10b and Rule 10b-5.”\textsuperscript{798} Section 10(b)\textsuperscript{799}, one of the main antifraud sections, and “Rule 10b-5”\textsuperscript{800} offer one motivation of action for damages either caused by exclusions, misstatements, or manipulations of material data within declarations different from the ones registered in reports within SEC.\textsuperscript{801} Accordingly, these provisions have turned into powerful tools in fighting securities fraud. Still, even if the three sections of Rule 10b-5 offer wide indications of conduct violating Rule 10b, the negative issues are that no details are provided (within the text of the law) regarding the elements or conduct representing a violation of Rule 10b. In spite of Congressional desire to protect the investors, none of the two Rules mentioned above offers a cause of action for plaintiffs affected by securities fraud. Federal courts involved Congressional intention for a private cause of action according to Rule 10b, which is similar, “but is not identical to, common law actions for deceit and misrepresentation.”\textsuperscript{802}

\textit{Additionally to this aim of protecting investors}, the 1934 Act also intends to authorise “adequate disclosures from companies who are being registered with the SEC under Sections 12, 13 and 15.”\textsuperscript{803}

Section 12\textsuperscript{804} implies the registration of a comprehensive declaration regarding the firm when the latter registers for the first time under the 1934 Act. According to rule 12h-3, an issuer having more than USD10 million in assets, which could to the contrary be submitted for filing requests in compliance with section 15(d), is exempt from offering reports if less than 500 individuals hold its securities on record. Most of the time, hedge

\textsuperscript{798} 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. 204.10b-5.
\textsuperscript{799} 15 U.S.C. § 78j(b).
\textsuperscript{800} 17 C.F.R. § 240.10b-5.
\textsuperscript{801} State Teachers Retirement Board v. Fluor Corp., 654 F. 2d 843 (2d Cir. 1981).
\textsuperscript{803} 15 U.S.C. §§ 78l, 78m, 78o (2007).
\textsuperscript{804} 15 U.S.C. § 78l.
funds try to maintain the amount of registered owners below 500 individuals to avoid falling under these registrations and reporting requirements.\textsuperscript{805}

\subsection*{5.6 The Dodd-Frank Act of 2010}

In 2006, the SEC adopted a rule asking investment funds to register as investment advisers, in response to the impetuous growth of hedge funds’ assets under management (AUM) and growing concern over their operations and transparency for better protecting investors. Nevertheless, during the same period, “the US Court of Columbia Circuit” abrogated this law considering that it was not compatible with the 1940’s Investment Advisers Act.

Immediately after the beginning of this financial crisis, hedge funds became again a target for increased regulation. Due to the increase of negative investor feeling, hedge funds found their inclusion in the Dodd-Frank Act, which became law in July 2010.

The aim of the Dodd-Frank Act was generous: to avoid another financial crisis. Also, its strategy proved to be really respectable: increase transparency, investor protection, prevent credit institutions from assuming extreme risks, stop harmful financial actions but also prevent institutions apparently too large to fail through authorising regulatory authorities to apprehend every large, collapsing financial company and gradually diminish it.\textsuperscript{806} However, Dodd-Frank Act is much more complex. It has 848 pages and it might be compared to Glass-Steagall (the famous reform following the 1929 Wall Street failure). Additionally, every page requests that regulators make further studies. Some parts of these examinations are presented on hundreds of pages. Only one tiny part, the Volcker rule, aiming at curbing risk asset exchanging by credit institutions, comprises 383 interrogations divided in no less than 1,420 sub-questions.\textsuperscript{807} All in all, the hedge fund registration and disclosure requirements stipulated in the Dodd-Frank Act increase

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hedge funds supervision and seem to solve the “tension between the industry and the regulators”.

From a critical point of view, adverse consequences for clients have already emerged. As is often occurs, measures meant to defend investors can lead to harming them. Due to Dodd-Frank’s breadth, these consequences vary from probable threats to privacy, as involved in the Title I section, to low investor choice as opposed to high consumer costs, as involved in the Title X and XIV sections. Taking a careful look at Title XIV section an obvious example of a troubling trend in regulatory policy can be noticed - the opinion that government knows better than investors what is best for them. In this direction, government authorities have taken on “the paternalistic role of safely steering citizens toward “better” or “safer” products and services.” Consequently, investors are going to be increasingly confronted with a one-size-fits-all market that implies higher costs and provides fewer choices.

Consequently, America urges a more intelligent approach for regulation. Thus, total major laws need to be analysed from the “cost-benefit” point of view by an autonomous caretaker. More imperative, laws must be simplified. Regulators must propose clear laws, and they must be allowed to enforce them.

Section 404 and Section 406 from “the Dodd-Frank Act” combine in several pages. On the 31st of October 2011, two agencies which were supervising US’s financial market turned the above several data into one complex, 192 pages file, which needs to be expanded by hedge funds and by several different companies. Filling it out for the first time could cost, in accordance with one unconventional research of hedge fund administrators, around USD100,000 – 150,000 every company. The second time, costs might fall to USD40,000. Dodd-Frank’s wide and equivocal data-collection purposes were interpreted by the SEC and the CFTC in the new Form PF. Because of its length, complexity, and generally unclear data requirements, Form PF represents a major

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810 Ibid.
burden on the advisers to which it is applied. Along with other regulatory costs, the costs of these new laws are going to be passed on to investors.

The general conclusion was that, nowadays, compassion towards hedge funds is not common. On the contrary, officials understand the urgency for more regulatory enforcements. Thus, the officials’ assigned job implies a lot of bureaucracy, although this represents only an example of all the requirements involving taxes but also office work used by Dodd-Frank Act to cover one ample part from the American economics.\textsuperscript{811} Many organisations came into sight for enjoying the support of “the taxpayer” as they were said to be “too big to fail.”

When the “Dodd-Frank Act” was authorised, its promoters considered that combining its unsolved issues could last between one year to one and a half year. After one year and a half, the previous predictions seemed desolately childish. Policy-makers and authorities in charge of “Dodd-Frank Act” appear somewhat optimistic regarding achievements and future challenges, when addressing to the community. Still, one banker deeply involved in this matter is in agreement with lots of people while predicting a decade of turmoil, with permanent debates in court and governmental bodies, in the end exhibiting one set of rules damaged due to exemptions or shades which can, due to its complicated form, aggravate systemic risks instead of mitigating them.\textsuperscript{812} Still, while bankers are concerned, lawyers are happy. Constant Dodd-Frank-related updates by Davis Polk and Morrison &Foester are very popular. Thus, 93 of 400 requests ordered by Dodd-Frank Act were made, while deadlines were omitted for 164.

In the summer of 2011, on the 22\textsuperscript{nd} of July, the American “Court of appeals for the District of Columbia” accepted one dispute between two commerce entities about a law from “Dodd-Frank Act” regarding shareholding voting promoted “by the SEC”. The Tribunal considered that particular law unsupported by studies regarding the prices paid or the advantages involved. On December the 2\textsuperscript{nd}, another similar case was filed at some “Washington DC District Court” versus the “Commodities Futures Trading Commission” (CFTC), dispute between two securities-market commercial corporations,

regarding “restrictions on derivative holdings.” In case the tribunal pleads also in favour, litigants predict an avalanche of new lawsuits (see chapter 6).

New era

The 21st of July 2010 was the day when the American President ratified “the Dodd-Frank Act”. By signing this Act, the US President initiated a new era in financial regulatory reform. In this respect, the above-mentioned regulation provides an ample regulatory reform, with the main goal of “the promotion of financial security in America” through the establishment of careful observing regarding risk-exposure, through an overview of the entire system. While the Act focused primarily on banking institutions regulations and related matters, it has also significantly changed the landscape affecting investment advisers and many aspects of the investment management industry, including, among others, the regulation of domestic and foreign investment advisers assisting various types of private investment vehicles and investors.

A major Dodd-Frank Act aim resides in limiting the risk of “the shadow credit institution system”. Another objective is to limit the damages inflicted after the crash of important financial entities in order to minimise costs to society and taxpayers (negative externalities).

According to the first Title of the Act, the “Financial Stability Oversight Council” (FSOC) is made up of different managers which are members of the financial regulatory authorities, but they are also secondary persons. Dodd-Frank Act states that the above-mentioned Council is entitled to monitor the potential risks endangering US financial security, but also to require from the Board of Governors of the FRB to supervise the indicated non-credit financial institutions which might induce major risks to the US financial security under various circumstances, such as: material financial distress, crash or as a consequence of own businesses. Similarly, the Dodd-Frank Act provides for the FSOC the recommendation towards FRB of highly prudent norms in respect to

813 “Too big to fail- Flaws in the confused, bloated law passed in the aftermath of America’s financial crisis become ever more apparent”, The Economist, 18th 2012, p.18.
816 Federal Reserve System.
817 See the Dodd-Frank Act, Section 112.
several selected non-banking institutions, being aware of the fact that FSOC is going to be helped by several regulatory authorities. In this respect, Dodd-Frank Act remedies several statutes, among which the Investment Advisers Act, for the authorisation or orientation of some Federal authorities in supporting FSOC. Accordingly, FSOC needs to find the appropriate level of oversight in order to satisfy, on the one hand, the requests of the industry for lower levels of oversight as opposed to, on the other hand, the need for investor protection.

Title IV revises “the Advisers Act” to impose the need for advisers of hedge funds and those of various private funds to register under the SEC. That request was made by the Congress mainly since it considered data concerning dimension, strategies but also status of funds might prove essential for regulatory efforts with regard to possible, yet to come, crisis. At the same time, this implies registered investment advisers to keep records and any other data that could be necessary and suitable for avoiding systemic risk, preventing fraud, and providing investors with useful data about the funds, thus trying to increase the protection of investors. Title IV builds up a new, innovative legislative regime for advisers to private funds. Accordingly, Dodd-Frank menaces to drive funds offshore, harm investors instead of protecting them, and make it more likely, not less, that these funds are going to be someday the recipients of government largesse. However, this represents an unfortunate evolution, as hedge funds and other private funds have usually appeared and disappeared as a consequence of market forces and not due to government intervention.

In particular, it is the Dodd-Frank Act that grants secondary obligations concerning “advisers to private funds.” These types of funds might be considered entities acting as an “investment company” according to the “1940 Act”, except the exemptions further specified in the 1940 Act. These two exemptions are the most commonly used. Also, “the Dodd-Frank Act” points out the net value requirements that need to be met by the investors in a private fund.

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818 15 U.S.C. § 77g
819 Section 202(a)(29).
820 Senate Committee Report, supra note 4, at 38.
821 Section 3(c)(1) and (7).
Specifically, the Dodd-Frank Act eliminates the 14-or-fewer “private adviser exemption from SEC registration” that was previously offered by the Advisers Act.\textsuperscript{822} However, it was only after the Madoff Ponzi scheme in 2008 (see chapter 6), that regulators and commentators have turned to the question of whether and how the regulatory regime in force at the time was adequate to protect investors, forcing the Congress to remove the private adviser exemption. Dodd-Frank Act creates innovative exemptions from SEC registration, involving non-US based advisers meeting several conditions, advisers to family offices, and “advisers to venture capital funds.”\textsuperscript{823} The result of these changes was that many previously exempt advisers had to forcibly become registered to the SEC.

The SEC is bound by the Dodd-Frank Act to exempt from registering requirements for investment advisers holding no more than USD150 million in AUM.\textsuperscript{824} Nevertheless, this is available only for investment advisers acting only as advisers for private funds while having also maximum USD150 million AUM in the US.

Another exemption stated by the Dodd-Frank Act consists of “venture capital fund advisers from registration under the Advisers Act.”\textsuperscript{825} In order to qualify for this, every adviser has to act like an investment adviser either for a single or for more venture capital funds.

One final exemption stipulated by Dodd-Frank Act is that of registering the \textit{foreign private adviser}. This is defined as the investment adviser who places his financial company outside the American borders, who does not have more than 15 customers in America and American investing individuals investing money in private funds in compliance with the adviser’s advice, but who also has maximum USD25 million in total AUM on behalf of this type of customers or investors.\textsuperscript{826}

The Dodd-Frank Act asks “FSOC to monitor the financial services marketplace”\textsuperscript{827} in order to identify risks that might affect the US economic stability. Similarly, the Act

\begin{itemize}
\item \textsuperscript{822} Through Section 203(b)(3).
\item \textsuperscript{824} Ibid.
\item \textsuperscript{825} Ibid.
\item \textsuperscript{826} Ibid.
\item \textsuperscript{827} Section 112(a)(2)(C) of the Dodd-Frank Act.
\end{itemize}
enforces FSOC to gather facts from associated authorities in order to support its objectives. According to Section 404, the SEC must compel advisers of private funds to maintain reports and fill in records, due to the significance of their data for the SEC regarding the interests of the public. Other reasons are the assessment of risk-exposure and the protection of the investors. Therefore, if considered compulsory, FSOC could guide the “Office of Financial Research” (OFR) in gathering extra data from non-bank financial firms, in order to increase investor protection.

A key aim of the Dodd-Frank Act consists in minimising future systemic risk-exposure. This can be achieved through empowerment of regulatory authorities to impose higher financial asset requirements, but also new limits in the control of corporations by creating regulatory, and market structures for financial derivatives, and by setting up systemic risk surveillance and provide particular officials to intervene.

The author of this thesis considers that a major problem emerges as the Dodd-Frank Act is generally focused on monitoring systemic risk, and consequently, the new legislation leaves many of the investor protection issues created by the hedge fund industry, unsolved.

There are two exemptions abolished by the Act. The first is stipulated under Section 403, removing “the de minimis exemption from the Advisers Act.” This can be applied to that particular adviser: having maximum 15 customers along one year; not holding himself out under the title of investment adviser but also not advising registered investment firms. Usually, this exoneration is driven by individual fund administrators marketing maximum 15 funds due to the fact that each fund is usually considered one singular customer of the administrator regardless of the necessary number of investors. Secondly, the same Section states the following: “advisers to private funds

828 Section 112(d)(1) of the Dodd-Frank Act.
829 Section 404 of the Dodd-Frank Act.
830 Sections 153 and 154 of the Dodd-Frank Act.
835 According to “Rule 203(b)(3)-1 of the Advisers Act.”
are not eligible to use the current exemption for investment advisers whose clients are all residents of the adviser’s home state.”

Section 406 imposes authorised investment counsellors of “private funds” to provide secondary data regarding every “private fund” administered by them to “the SEC and FSOC.” According to the Act, the SEC has this obligation to lead examinations at regular intervals for the verification of every document “of private funds” administered by licensed investment counsellors. Those documents are under the confidentiality clause without being disclosed to the wide public. These provisions become operational a year after the enactment of the Act.

Dodd-Frank Act additionally subjects every registered investment adviser who is adviser for private funds to new recordkeeping and reporting obligations. A registered investment adviser may be required to keep records but also to file with the SEC some data regarding every advised private fund and to make such information available to the FSOC, and Federal department or agency, and to every self-regulatory organisation. This information which should remain confidential will include:

- AUM and leverage use;
- correspondent credit risk disclosure;
- evaluation tactics and procedures;
- categories of owned assets;
- side agreements;
- sale procedures.

In addition, the SEC and the FSOC are allowed to request additional data, as established at certain regular intervals. However, it is questionable whether the Dodd-Frank Act provides hedge fund investors with sufficient information in order to adequately defend themselves from the unique informational challenges that are connected with hedge fund investments. These unique issues include a total lack of standardisation in the hedge funds industry, especially as far as its disclosure practices, risk assessments and valuation procedures are concerned. This lack of standardisation, together with a narrow public disclosure regime, puts investors into difficulty to adequately study a certain hedge fund investment. Additionally, investors are not able to effectively choose an

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optimal hedge fund investment since the above-mentioned informational challenges make it hard to adequately compare a large range of hedge fund opportunities. It is our belief that this limits significantly investors’ choice and competition within the industry, and as a consequence, investors’ protection.

The standards controlling the qualification of natural persons as investors in private funds have also been changed. The net worth requirement to qualify “as an accredited investor under the Securities Act” shall not include the worth held by “the primary residence of such natural person.” In addition, for this four years period which starts at the coming into force of the Act, the net worth threshold will be USD1 million, and thereafter the threshold will be in excess of USD1 million.

A significant consequence of registration is that an investment adviser is restricted in his capability of charging effectiveness taxes on clients. Rule 205-3 provides an exemption for clients having minimum USD750,000 AUM with the counsellor. At the same time, the same exemption is available for those with a net value reaching at least USD1.5 million. Customers who are “qualified purchasers” and certain employees of the adviser are also exempt.

“International Collaboration”

In order to evaluate risk, FSOC is compelled by the Dodd-Frank Act to coordinate its policies with those of the international authorities. The collaboration can be individually essential for the systemic risk assessment connected to hedge funds and to different private funds since they usually operate internationally and make major investments in companies and financial markets at the international level.

840 Ibid.
841 Section 175 of the Dodd-Frank Act.
842 Alexander, D., “Global Hedge Fund Assets Rebound to Just over $1.8 Trillion, Hedge Fund Intelligence” (2010).
Several actors already admitted that it was absolutely necessary that an international regulation was enforced, particularly due to the globalised markets where both managers and funds alike operated.\textsuperscript{843}

To this end, international regulatory coordination has been considered, mainly having in view the future financial crises. It becomes obvious that collecting constant and comparison-relevant data would definitely help with the international reporting of systemic risk and thus improve the usefulness of data dividing through US and foreign financial regulators. The first step towards this accomplishment were Basel III and Dodd Frank macro prudential measures which focused on facilitating financial stability\textsuperscript{844}. In this regard, a more effective coordination and communication is required among standard setters and supervisors like the Basel Committee and national supervisors implied in the adoption of Basel III and the Dodd Frank Act regulatory reforms, more transparent and more “authoritative” mandates are needed in making sure that the objectives of financial stability are achieved.

\textit{Provisions regarding hedge funds}

The Dodd-Frank Act introduced enhanced prudential standards for hedge funds and included particularly strict prohibitions regarding proprietary exchanging, but also hedge fund holding, innovative risk-based capital, leveraging and liquidity stipulations. Indeed, the “Dodd-Frank Act”\textsuperscript{845} represents a significant progress in tightening the regulation.

The 2010 “Dodd-Frank Act” plays an innovative role in prohibiting some assets exchanging processes by credit institutions associations, insured depository organisations and their partners. This condition or stipulation was called “the Volcker Rule.” It is named after the previous “Federal Reserve Board Chairman”, who supported and encouraged its adoption. The major objective of the Volcker Rule\textsuperscript{846} is to draw some boundaries or limits on bank activities as far as businesses with high degrees of


\textsuperscript{844} Ojo, Marianne, Harmonising Basel III and the Dodd Frank Act through greater collaboration between standard setters and national supervisors, Online at http://mpra.ub.uni-muenchen.de/36164/ MPRA Paper No. 36164, 2012, p. 3.


\textsuperscript{846} Section 619 of the Dodd-Frank Act.
risk are concerned, including asset exchanging but also hedge fund and private equity activities.

“The Volcker Rule” states that no credit institution can become involved in asset exchanges, sponsorship or investment, be it in hedge funds or in private equity funds. This Section, besides additional issues considers that a credit institution entity is considered “an insured depository institution, a company that controls an insured depository institution, a company treated as a bank holding company and any subsidiaries of such institutions or companies, including broker-dealer and fund manager subsidiaries.”

Nevertheless, despite the aforementioned interdiction, credit institutions can however promote either private equities or hedge funds, only if a certain number of requirements can be met. Thus, the first requirement is that the bank offers “bona fide trust”, depositary or investment consultative assistances for the fund. Another condition stipulates that the fund is offered only in relation to consultative assistances and just for clients of the bank. Also, another condition is that the credit institution and its branches are not engaged in “covered transactions” with the fund and consider the fund to be some associate in order to attain the objectives contained in the Federal Reserve Act, to be more precisely, in Section 23B. It is necessary that the credit institution lacks assurance of responsibilities or efficiency of the hedge fund or every umbrella fund. Another requirement is that neither the credit institution nor the fund are allowed to share one denomination or similar names. Another important condition is that only principals or credit institution staffs offering services in order to fulfil certain purposes of the fund are allowed to hold legal proprietorship interests in that particular fund. At the same time, the bank must disclosure to investors that the credit institution is not going to cause failures. One last condition is that the credit institutions make the so-called “seed investment”, which means use of money to set up a new business or company, or different “de minimis investment” within funds.

852 Ibid.
Another relevant rule of the Dodd-Frank Act is that it forbids credit institution holding firms, depository corporations, and their associates to promote or withhold “any equity, partnership, or other ownership interest in a hedge fund or a private equity fund”\(^{853}\), including several exemptions. Despite the fact that some restrictions will not go into effect for several years, companies are examining their proprietary trading desks and internal hedge funds, partly because of the concern that employees move to other funds.

On the one hand, the so-called Volcker Rule imposes no interdictions on those companies controlled by the Board, which are not bank financial firms\(^ {854}\) although, on the other hand, it does require that they are subject to additional capital conditions and assets exchanging, hedge fund but also private equity fund activities. Even otherwise admitted processes, including promotion and investment both in a private equity and in a hedge fund, where the relevant requirements are met, the “Volcker Rule” forbids them to do this if the activity might lead to a conflict of interests with regards to materiality, which could occur between the credit institutions, on the one hand, and its clients, customers and third parties, on the other hand.\(^ {855}\) Moreover, any transaction that would lead to risk-exposure or put forward any risk concerning the security and soundness of either credit institutions or the American financial security is forbidden. Regulatory authorities are implementing regulations explicitly preventing processes in such a way.\(^ {856}\) While the conflicts of interest represent indeed the main harm that regulators are trying to address, the author considers that it may make sense to consider other solutions like additional disclosures and regulations to defend the public from that kind of conflicts. Therefore, it is the author’s opinion that legislators focus on conflicts of interest that can be solved, as already mentioned above, through other methods, without any cost to diversification, economies of scope, and global competition.

As a result of the Volcker Rule, leverage may become less readily available to, or more expensive for bank-affiliated private equity funds because of increased risk weightings by financial institutions for loans to bank-sponsored funds. The Volcker Rule’s ban on assets sale and significant limitations on promoting or “investing in private funds”\(^ {857}\)

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\(^{855}\) Ibid.
\(^{856}\) Ibid.
\(^{857}\) “Indeed financial institutions have already begun to divest their interests in private fund businesses.” e.g., Or, Amy, “Front Point Managers Take Back Majority Stake from Morgan Stanley”, Wall Street
could result in financial institutions restructuring their private equity or hedge fund businesses or spinning out existing groups.

Half a year later after “the Act’s enactment”, the Council has to fill in terminology and limits of the Volcker Rule. Nine months later, Regulators must agree upon suggestions and changes to be made.

In terms of timeline for implementation, the Volcker Rule does not become effective until 21 July 2012. Following the effective date, it is one transit interval comprising 24 months subject to, if needed, three 12 months prolongations. The fact that Regulators decide changes in less than 12 months after the Volcker Rule enactment is not likely to happen. This means that, the Volcker Rule shall turn enforceable 24 months later from its enactment. Another possibility is that there will be no effective regulation within 24 months. Hence, the law becomes enforceable without any guidance.

As a concluding remark, all in all, the real challenges of the Dodd Frank consist of:

1. Increased government reporting=> increased investor protection
2. Increased reporting to investors => increased investor protection
3. Disclosure to both governing authority and investors=> increased investor protection

On the whole, one can say that the financial community has approved of the higher reporting requests concept under Dodd-Frank.

However, according to the above-mentioned issues, the Volker Rule has three different drawbacks. The first one is that it relies very much on regulatory interpretation and an equivocal separation of trading activities that are permitted and prohibited. Due to these ambiguities concerning the legal line, banks could avoid appropriately hedging risks. The second one is that restricting bank activities may increase bank fragility by restraining diversification, and thus, less diverse banks could be less secure. Last, the Volcker Rule, due to the fact that it restricts proprietary trading, can harm market liquidity, although it is clear that liquid markets are those supporting economic growth, the transparency of their prices and the decrease of their costs of capital.

Journal Online, 20 October 2010,
Closing remarks on Dodd-Frank Act

In the author’s opinion, the Dodd-Frank Act represents a step towards better regulation regarding hedge funds. According to the Dodd-Frank Act provisions, the hedge fund industry has been strongly affected. According to this Act, the large hedge funds might be seen as systemically major companies. The Act does not clearly state the size thresholds, the “Federal Reserve System” (FED) and FSOC being the ones who would have to decide on this matter. Hedge funds considered systemically crucial will fall under severe regulatory monitoring. At the same time, hedge funds could be under the impact of some extra conditions, as registering with the SEC in case their assets are larger than or equal to USD150 million. The result of all these will be: stricter reporting and recordkeeping.

All the above-mentioned requirements will lead to consequences such as: limited gross margin, re-appraisal “of their balance sheets, amendments to their operational and legal entity structures and modifications to their tax procedures.”858 In this respect, it becomes obvious that the severe regulatory monitoring and the main clarifying requests on derivatives, might force funds to rearrange their own activities and diminish their own balance sheets to respect all provisions of the Act. The hedge funds margins of profit are likely to diminish in the future.

According to Davis Polk’s Dodd-Frank Progress Report, an amount of 221 rulemaking requests deadlines have passed. The figure below shows a clear view of the current situation:

The Report also states that it represents 55.5% of the 398 overall regulatory requests, but also 78.9% of the 280 regulatory requests with specific time limits. From all these, 221 already exceeded the deadlines, 136 representing 61.5% were skipped, while 85 representing 38.5% reached final stipulations. At present, the authorities’ recommendations are missing for 19 from the 136 omitted laws. Similarly, from the 398 overall regulatory requests, 30.9% (123) reached final stipulations and there have been suggested stipulations which might reach other 134 (33.7%).

5.7 Concluding remarks

This chapter analysed the evolution of the hedge funds regulation in the US. Thorough consideration has been given to the financial reform adopted via the ratification of “the Dodd-Frank Act”, particularly regarding the regulation of investment advisers, and specifically of hedge fund managers and other alternative investment managers who were previously able to organise their operations in such a way as to avoid registration with the SEC.

The author of this thesis considered necessary to first describe and examine all the laws concerning hedge funds regulation and the manner these contributed in the past to the
shaping of this industry, in order to fully understand the revolutionary financial reform implied by “the Dodd-Frank Act.” Thus, the ability of hedge funds to mitigate the risk of loss to investment portfolios has an important relationship to a fundamental policy objective of U.S. regulations. By disclosing material information and reducing the exposure of investment capital to losses, hedge funds complement the legislative and regulatory objective of investor protection.

This reform has to be read and analysed also in the context of the 21st century depression which has affected the world of global finances. In the aftermath of the crisis, governments were asked to implement strong financial reforms in order to avoid a Lehman Brothers scenario in the future.

In addition, the author points out the strong impact that this reform has had on the hedge fund market. The so-called father of this post-modern hedge fund industry, George Soros, has decided to close all his hedge funds and establish a family office explaining his choice by the burdensome impact of “the Dodd-Frank Act” on this industry. The consequence of his decision could lead other hedge fund managers to end their businesses or to relocate towards other more lightly regulated jurisdictions.

As seen so far, investor protection is a hallmark goal of federal securities law and the author accentuates the fact that this reform would really impact “the hedge fund industry” focusing mainly on investors’ interests protection, and that it would be challenging to study how the sector will cope with all these massive changes and in particular whether hedge funds will decide to stay and comply with all the reporting requirements or to relocate towards other more lightly regulated jurisdictions, ignoring the SEC’s major principle oriented towards investor protection.

This chapter argues that the beneficial outcomes attained by hedge funds for their investors are widely attributable to the legal regime under which they operate.
CHAPTER SIX

LITIGATION AND ARBITRATION REGARDING HEDGE FUNDS

“A lawyer with his briefcase can steal more than 100 men with guns”.

Don Vito Corleone

6.1 Introduction

Besides the prosecution of major fraud and insider trading schemes, including the Madoff, Stanford and Petters cases, there has been a wave of litigation and arbitration cases filed against hedge fund managers during recent years. Such cases would have been extremely rare in the previous years. Indeed, litigation and arbitration cases with regard to hedge funds now regularly feature in the legal press, astonishing the global community and illustrating the lack of investor protection. These cases represent evidence that hedge funds investors need more protection. They relate to a diverse range of problems, as described below. For instance, in a process taken to court from the initiative of several funds versus a firm from Germany, it was concluded by the SDNY, according to “the Exchange Act”, respectively, Section 10(b), that this has no intention of changing agreements referring to foreign accumulates. Another example is given by the “Financial Industry Regulatory Authority” (FINRA) legal procedure declaration versus Goldman Sachs concerning its failure to perform the analysis of its hedge fund client’s cheat. Similarly, disputes arose between top broker Morgan Stanley and a hedge fund concerning a trading account limit condition that determined the failure of the hedge fund. Meanwhile, the New York Appellate Division concluded that

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863 Southern District of New York.
a hedge fund compliance agent tending to use the funds with no liability, working in retaliation due to analysing duplicity, does not have a national regulatory countermeasure. In addition, tribunals from Cayman Islands and from British Virgin Islands, too, have concluded several cases referring to the equities of hedge fund stockholders who petitioned for bankruptcy.

Besides well known the Madoff case, a similar case in dimension and scale can be seen with the scheme of Tom Petters, the architect of a USD3.7 billion, ten-year deceit that was discovered in September 2008. A similar situation is that of Robert Allen Stanford, whose scheme emerged in February 2009 and is thought to have lasted ten years, involving the enormous amount of USD 8 billion, and S. Rothstein, who admitted to managing an approximate USD1.2 billion Ponzi scheme at the end of 2009.

The question arises as to why these unprecedented legal actions have occurred at this time. This chapter demonstrates exactly how this ongoing crisis effectively exhibited the vulnerabilities as expected for the traditional hedge funds pattern. After almost a decade of prodigious, yet unbelievable development, major hedge funds seem now very passive and even damaged by litigation and arbitration. In fact, some hedge funds are entirely vanishing. Therefore, this chapter focuses on the conflicts of interest faced by hedge fund managers and the regulatory measures necessary to better protect hedge fund investors. This chapter provides general background information about litigation and arbitration cases of hedge funds. Then it discusses the numerous conflicts of interest inherent in the hedge funds management, and makes the case that hedge fund investors are poorly protected from the injurious effects of these conflicts by both state and federal law. The conclusions of this chapter present, from the author’s opinion, different proposals for mitigating and preventing conflicts of interest in hedge funds and therefore, recommend how hedge fund investors can be better protected from these cases and other risks they are exposed to.

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864 At-will.
865 In a Ponzi project, existing investors are rewarded with purported returns out of the funds that new investors add as a contribution. “Ponzi schemes tend to crash when it is hard to find new investors or when a great number of stockholders ask to cash out” (US SEC 2010).
Recently, many investments were lost due to hedge fund frauds. This has nourished important contradictory debates about whether authorities are able or not to control the hedge funds market. The hereby chapter presents several performance notices, which would be set on abnormal incomes generated by funds, as these are markers in terms of fraudulent risks-exposure. Several cases of hedge funds being charged with violating the law are collected but also studied over the course of this chapter, in view of the idea that regulation carries with it an implicit promise that laws are being enforced and at the same time, law breaches can be detected, because if this were not true, a misleading safety feeling could be indulged to investors.867

This chapter also addresses some of the main legal aspects involved in the extensive round of hedge fund litigation that is currently underway, namely, lawsuits - brought by one or more plaintiffs on behalf of a large group on a common legal claim. These are already developing, regardless of the fact that the lawsuits are against credit institutions, versus rating agencies or against “mortgage-backed securities” (MBS) and/or CDO purchasers.868 The author highlights in this chapter several probably major categories in the resolution of these cases:

- The differentiation of feasible *ex ante* presumptions, and active development concerning *ex post* profit losses;
- The differentiation of complete openness concerning the description of all underlying securities which are under securitisation, but at the same time the openness to which industry members are being subjected regarding hedge funds profit losses;
- The differentiation between aspects apprehended by investors and industry members and things apprehended by particular corporations from inside the organised investment activity.

Similar to any debate on the future of hedge funds facing uncertainty as a result of the crisis and concerns about the effects of the Madoff fraud, this chapter discusses recent significant litigation cases brought to the courts of justice or to arbitration. These stories such as Stanford, Petters and Madoff can be labelled as not typical, due to the size of their collapse or due to the level of malfeasance connected with the fraud, but, however,

868 Ibid.
the author considers that they help illustrating the reason why both regulators and supervisors must pay greater attention to hedge fund industry regulation and protection of investors.

6.2 Civil litigation

6.2.1 Previously reported cases

Many relevant cases are ongoing. This sub-section provides an update of the civil arbitration and litigation cases and highlights the last cases of civil litigations, focusing also on enforcement processes related, particularly, to hedge funds industry. The main purpose is to present and analyse risks of investors induced by the absence of hedge funds regulation in the US until the Dodd-Frank Act. Regarding the first case, it has been noted that tribunals largely used *Morrison Company* to include derivative securities referencing foreign assets. The next presentation uses at first two cases of exploring the high disorientation following “the *Morrison* holding”. Hence, the file regarding *Elliott Associates fund against Porsche Company* will be presented. This involves one agreement to swap concerning foreign assets. Furthermore, a similar case will be analysed, consisting of the SEC against F. Tourre. These two cases are important in revealing the limitations of the international regulatory frameworks at the global level, and therefore the limitations regarding investors protection before the enactment of the Dodd Frank.

Section 10(b) does not apply for swap agreements regarding Foreign Securities, and here one can mention the case file of Elliott Associates against Porsche. The complainants from Elliott involve several types of hedge funds – a part of them being structured according to American regulations, while others are organised according to non-US regulations. However, these have one thing in common: they are managed by administrators whose location is New York. These entered in agreements to

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869 Haynesbone, 2012, “*Securities Litigation Year in Review 2011*”, Haynes and Boone, LLP.
870 A former Goldman Sachs executive.
swap concerning assets value of “Volkswagen” multinational from Germany. The litigant is represented by “Porsche”, another multinational from Germany.

In the spring of 2010, an association of hedge funds brought legal charges in New York, more precisely in its Southern District against Porsche, alleging that it hid their real intention to buy VW, also arguing that its adoption in calculating exchanges aimed at hiding its correct stock standing was illegal. In compliance with hedge funds, most of them being retailers in VW stock, several misstatements were made, and also several laws were breached by Porsche, namely: Section 10(b) as well as Rule 10b-5. This determined the hedge funds to be deprived of more than USD2 billion in protecting their own short sales. Complainants lost more than USD2 billion the very moment when suspects brought about the so-called “massive short squeeze”, according to Reuters, but also “a short squeeze” having outstanding dimensions, according to New York Times. Subsequently to the amendment of this accusation of funds, according to the decision of the Supreme Court’s agreement in the file conducted by Morrison against NAB, Porsche attempted to dismiss the legal suit claiming mainly that the deceit dispositions in accordance with Section 10(b) was by no means available for securities undertakings which were not catalogued according to the American trades. Because most assets were held by the state or by different index funds, individuals who were short-selling had “to close their positions at hugely inflated prices”, which tripled VW’s share prices. This turned VW into one of the biggest corporations at the global level, according to the estimation of the business shares. The severe liquidity impact emerged although the industry for “Volkswagen” shares proves usually highly productive.

874 Of the Exchange Act  
876 Ibid.  
Towards the end of December 2010, every hedge fund-related complaint registered in the Southern District of N.Y. was rejected.\textsuperscript{880} The court of law declared that \textit{Morrison} had put a limit to exchanges of securities according to Section 10(b)\textsuperscript{881} catalogued on internal transactions and to internal exchanges in different securities. The funds were involved in domestic securities based on change settlements, which highly credited foreign VW capital.\textsuperscript{882} Accordingly, VW denied their implication within internal exchanges in other securities, claiming to have done this only according to the aim of Section 10(b). Nevertheless, the tribunal discovered how change settlements have been the functional equal\textsuperscript{883} to exchanging all implicit Volkswagen dividends within the Germanic stock and declared that it was revoltingly creating laws which could cause the falling of external issuers not closely connected with America under their scope and thus their involvement in lawsuits for the simple fact that autonomous parties from that state signed a securities agreement regarding the foreign capital of the respective institution.\textsuperscript{884} Pursuant to this, funds petitioned a Second Circuit at the very beginning of 2011.

It has been remarked that a major interrogation which emerges as a consequence of Porsche’s reached resolution refers to the fact whether this predicts one tendency towards broadening the Morrison case above its initial objective. If this proves to be true, all funds having to do with the stock of a foreign issuing institution, or just signing financial agreements referencing the stock of a foreign issuing institution – are going to encounter no securities fraud remedies in the American tribunals.\textsuperscript{885} The real issues revealed by Elliott law case show that the so-called “bright line test” that Morrison fixed, might prove all-encompassing, allowing American regulation application within apparently absurd contexts.\textsuperscript{886} Thus, Courts might carefully take into consideration making attractive or acceptable “the bright-line test” through sustained efforts for a sensitive test use. Therefore, similar consequences are expected: rapid growth “of

\begin{itemize}
\item[880] Simpson, Tatcher, (2011), “\textit{Securities Law Alert, the Southern District of New York Dismisses Securities Fraud Actions against Porsche, Finding that Section 10(b) does not Protect Swap Agreements Referencing Foreign Securities}”, p. 1.
\item[882] Ibid.
\item[883] 130 S. Ct. 2869 (2010).
\end{itemize}
vaguely related variations on the test, which was harshly disapproved by the “Supreme Court” being considered one failure of the “old conduct and effects tests.” In this case, political interests in diplomacy and accordingly, dispute avoidance, compete with political interests which favour the achievement of certainty and transparency of American regulations. All in all, it becomes clear that such failures are both unfair and inconsistent in terms of investor protection aim of the US securities laws. In this respect, the European Commission “strongly urge[d] … against” a cross-border extension of Section 10(b), stated that an “extraterritorial application of the antifraud provisions of the United States’ securities laws … where the nexus is stronger with a foreign jurisdiction [] is liable to violate the EU’s and its Member States’ sovereignty, and to impede the proper development of [the] EU’s securities regulation.” This point was supported by several comment letters which also noted that other jurisdictions offer investor protection that can be compared to the level of investor protection provided by the US securities laws. A common argument advanced which supports enactment of the conduct and effects tests for Section 10(b) private actions is that this action could increase investor protection due to stronger enforcement of the federal securities laws.

Therefore, as seen above, the high pressures placed by liquidity and price will be probably more appreciated within markets that are less efficient than in those with increased performance indicators. Bayou and Goldman Sachs have proved to be highly negative hedge fund misconduct examples, especially considering the great losses the investors were subjected to, and also the period and goal of the fraud.

6.2.2 New developments in securities litigation

Starting with the spring of 2010, many signs of litigations to come could be seen. First, the crisis filings were rejected, while around 1/2 of the decisions to date were motions

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887 Morrison, 130 S. Ct. at 2880.
889 See, for instance, letters from Government of France; Australian Government; Government of Switzerland; Canadian Bar Association.
to dismiss. Nevertheless, it is obvious that not only accusations but also products and
defendants keep on changing, while lawsuits against particular accused litigants, among
which one can mention especially those involving mainly CRAs\(^{892}\), successfully
survived some motions for dismissal and will continue to do so. In addition, the current
cases brought by the SEC increase insecurity regarding future directions, but also
central points of the litigation.\(^{893}\)

SEC v. Goldman Sachs & Co. They say about hedge funds that they used to be
important buyers not only of Collateralised Debt Obligations, but also of CDO
tranches\(^{894}\) with subprime exposure. In this section, the author of this thesis identifies
the major issues occurring due to the overestimation of investment tools like CDOs and
“Residential Mortgage-Backed Securities” (RMBSs) which are considered to have
significantly contributed to the international economic crisis. According to data supplied
by public area, the author of this thesis also explores the manners in which investment
banks used to manage their assets, considered mainly the estimation of investment tools
and whether there has been any conflict of interest in their study, this involving a
conflict emerged from the banks’ interests and those of their investors. The author
analyses as paradigm case the context resulting from an unrelated US case regarding
civil proceedings, respectively, Goldman Sachs.

In 2006, Goldman Sachs & Co was the 4\(^{th}\) most important Collateralised Debt
Obligation contributor in America, pledging securities and investments equivalent to
USD16 billion\(^{895}\). After Goldman Sachs became conscious of an important decrease in
value of RMBS assets, it started to acquire short positions in order to gain advantage.
Goldman Sachs was essentially hoping for the decline of RMBS industry. However,
according to the American SEC, he kept on advertising as well as selling CDOs.

\(^{892}\) Credit Rating Agencies.
\(^{893}\) Ibid at 934.
During the same period, the SEC registered one civil implementation action within United States District Court for the SDNY\textsuperscript{896} versus Goldman Sachs\textsuperscript{897} but also versus one manager, F. Tourre, who confessed an undisclosed short interest. The SEC’s complaint referred to the fact that at the end of 2004 and the commencement of 2005, Goldman Sachs delivered a correlation-trading portfolio, providing, among other things, the manufacture and marketing\textsuperscript{898} of synthetic CDO generally known by the name of ABACUS.

It seems that the so-called Abacus 2007-AC1 was a financial tool made to fit precisely Paulson, an intimate organisational customer.\textsuperscript{899} Starting with 2006, Paulson & Co, Inc. (hedge fund) changed its investment technique because they believed that some “mid- and-subprime RMBS rated Triple B”\textsuperscript{900}, namely debts at the supposed value BBB by Standard & Poor’s or, according to the rating of Moody - Baa2, might be exposed to negative circumstances causing the significant fall of their value. In reality, Paulson considered that not just secondary place RMBSs, but also more senior AAA-rated tranches, could turn worthless. Paulson aimed at several RMBSs triple-B rated\textsuperscript{901}, considering them as encountering significant difficulties. After that, Paulson discussed with Goldman Sachs and asked them to help it ensure safety by means of payment, through CDSs, by shorting an investment portfolio containing these RMBSs in an advantageous manner.\textsuperscript{902}

The SEC stated that Paulson, assisted by Goldman Sachs, produced a synthetic CDO\textsuperscript{903}, which included a portfolio of assets chosen by Paulson that Goldman Sachs could advertise to stockholders. The SEC Complaint provided a number of examples of Goldman Sachs’ data on the diminishing trend of the CDO market from 2007,\textsuperscript{904} when they had a discussion with

\textsuperscript{896}Southern District of New York.
\textsuperscript{900}Litigation, SEC v Goldman Sachs & Co, 2010, para 12.
\textsuperscript{901}Ibid, para 15.
\textsuperscript{902}Ibid, paras 15–16.
Paulson. For instance, the SEC prepared for testimony an e-mail from the litigant Tourre to a friend written on the 23rd of January, 2007, in which Tourre confessed that due to the highly leveraged system, there was an imminent crash risk of the entire foundation at any moment.

With that piece of information at hand, SEC affirmed that both Goldman Sachs and Tourre started to prepare the concealment of the fact that the short investor, Paulson, took part in this data hiding from other investors by saying that a professional, but also autonomous collateral manager from third-party selected those credit portfolios. Goldman Sachs discussed ACA - a director they allegedly thought would consent to the choices of Paulson - to help as the “Portfolio Selection Agent.” ACA’s part was of major relevance to the advertising and delivery of this CDO.

In the meantime, Paulson managed a verification of triple-B RMBSs. This verification was for the benefit of RMBS. It involved elevated scores of “rate mortgages, low borrower FICO scores, and a high concentration of mortgages” in countries with high growth rates of houses value. On the 9th of January 2007, an amount of 123 RMBSs emerging from Paulson’s verification were e-mailed to ACA, to be studied. On the 26th of February 2007, Paulson and ACA consented to a citations portfolio of 90 RMBSs for ABACUS 2007-AC, which was made up mostly of Paulson’s choices. The SEC has confirmed that ACA did not know of Paulson’s intention to actually short that RMBS portfolio it was assisting.

Thereafter, a few months after the managers at Goldman Sachs anticipated the decline of the RMBS market, a notice of almost 200 pages on ABACUS 2007-AC1 was finished. Paulson was not mentioned in this file. The SEC has affirmed that Goldman

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906 Ibid;
909 Ibid, para 25.
911 Ibid.
Sachs’ advertising products used for ABACUS have been neither true, nor accurate.  

The SEC further argued that during the organisation of this business, Goldman Sachs made ACA falsely believe that Paulson planned to make investments in the fairness of ABACUS. This is very important because a fair play holder is the first to have a loss in case the portfolio fails. Thus, a fair play holder manifests the same permanent interest as other stockholders. In reality, on the 10th of January 2007 Tourre e-mailed ACA informing them that Paulson was an advocate of the equity tranche.  

During the organisation phase of ABACUS 2007-AC1, both Goldman Sachs and Tourre started to search for investors. During the first four months of 2007, Goldman Sachs sent the bullet-point document, pictures book and offering reminder to IKB, a commercial bank having the headquarters in Dusseldorf. The SEC has declared that neither Goldman Sachs nor Tourre informed IKB of Paulson’s role in the election activity of assets and its short position. Starting with the 26th of April 2007, ABACUS 2007-AC1 was ended and bought “USD50 million worth of Class A-1 notes and USD100 million worth of Class A-2 Notes”, both rated in a similar way AAA by both S&P and Moody. In this regard, it has been stated that Goldman Sachs was expected to have the ability to acquire minimum USD15 million and maximum USD20 million for organising but also advertising ABACUS.  

Both weak results “of ABACUS 2007-AC1” and consequent payout to Paulson are clear for all to see. IKB was effectively deprived of an investment comprising almost USD150 million. Paulson received most of that invested amount, through successive transactions that Goldman Sachs and Paulson performed themselves. Around the 7th of August 2008, the RBS, having bought the highest place in ABACUS 2007-AC1, offered Goldman Sachs an amount of USD840 million to “separate its position.” It is clear that a substantial money part went from Goldman Sachs to Paulson.  

The SEC litigation asserted in relevant part that [Goldman Sachs] as well as Tourre deliberately, riskily or maybe simply in a negligent manner mislead investors through

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914 Ibid, para 47.
917 Royal Bank of Scotland.
918 Ibid.
material terms, presentation book and also through the memorandum offered regarding
the ABACUS product, making them believe that it was ACA the one who selected that
particular portfolio and omitting to mention that, in fact, Paulson held a major part in
that selection. At the same time, the fund had strong financial interests in transactions,
truly adverse not only to IKB, but also to ACA, as well as to ABN AMRO.919
According to the same SEC litigation, [Goldman Sachs] as well as Tourre mislead
ACA, persuading it about Paulson’s investments “in the equity of ABACUS 2007-
AC1”920, but also about the fact that the interest Paulson manifested in the collateral
section activity was very similar to that of ACA. De facto, there was a conflict of
interests.

A week later, on the 27th of April 2010, after the registration of the SEC Complaint, the
Permanent Subcommittee on Investigations to the “Committee on Homeland Security
and Governmental Affairs”921 sustained several hearings examining several grounds but
also impacts of recent financial crisis.922 The fourth section focused on the part of
investment banks and moved around the attestation of a few head representatives from
Goldman Sachs. The rumour came after the Subcommittee examined 18 months worth
of documents that Goldman Sachs and various organisations had acquired with
particular reference to the RMBS market.923

In his declaration from the start, Senator Carl Levin depicted the results of the
Subcommittee in connection with the operations of Goldman Sachs and various
investment credit institutions. According to the proofs, most of the time, Goldman first
took care of his own returns and incomes to the disadvantage of those of his customers.
Similarly, his wrong use of glamorous but also complicated economic constructions
contributed to the spreading of harmful mortgages all over the globe within the entire
financial practices. What happened later was the rationale: global finances crashed due
to the above-mentioned harmful mortgages. Obviously, Goldman took advantage of

920 Ibid.
921 Mitchell, Mark, (2010), “Goldman Sachs, John Paulson, and the Hedge Funds that Pumped and
Dumped Our Economy”, Posted on 20 April 2010, in Deep Capture.
Dr. Ing. h.c. F. Porsche A.G.; Wendelin Wiedeking and Holger P. Haerter, and Black Diamond Offshore,
Ltd., et al. v. Porsche Automobil Holding SE, f/k/a Dr. Ing. h.c. F. Porsche AG; Wendelin Wiedeking and
Holger P. Haerter, N’s. 10 CV 0532 and 10 CV 4155 (S.D.N.Y. Dec. 30, 2010).
923 http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=f07ef2bf-914c-
494c-aa66-27129f8e6282, accessed on 12.05.2012.
this. According to the company’s data provided later to the SEC, it became clear that, although the Corporation used to sell risky derivates regarding mortgages, in the same manner it placed major confidence in this American industry. The company continued to deny having taken significant bets despite all the proofs. The problem here is that Goldman misled their investors about the inexistence of any conflict of interest occurring between their company and the investors they had to counsel. The disputed aspect is that whenever the investors were having financial problems, Goldman was doing well, while on the contrary, when their investors gained profit, Goldman was not. 

These realities reveal that Goldman’s operations amounted to much more than being a simple market-marker, connecting buyers and sellers in a place. On this point, it has been noted that they acted as important speculations that the pledge securities industry, assisted at creating by Goldman, joined for an impressive comedown.

On the 14th of July 2010, Goldman Sachs reached a concluding judgment. Goldman Sachs offered USD300 million in amends and USD250 million as compensation to investors. IKB was declared to obtain USD150 million while RBS was stated to obtain USD100 million. Moreover, while declaring that it neither recognised nor rejected the allegations of the complaint, Goldman affirmed that they were lacking data within those marketing products used for the ABACUS 2007-AC1 transaction. Most important, the biggest error consisted in the fact that those products stated that it was ACA who selected the portfolio, without mentioning Paulson’s primordial function in its selection activity, but also that Paulson’s financial interest has been contrary to CDO investors. In the end, Goldman regretted the missing data from those staffs.

Goldman Sachs seems to have developed a market in CDOs, and then asked certain bonds for customers. Apparently, their customers could benefit from the trade failure,

but also from the bankruptcy.\textsuperscript{929} Thus, a major criticism is that CDO originators offered investors inadequate disclosure and warnings concerning different risks.

The SEC implementation operation against Goldman Sachs illustrates the problems faced by managers in resolving difficult securities transactions that involve a lot of groups and significant \textit{conflicts of interest}. As a conclusion, in these cases, investors’ interests are prejudiced by fund manager's conduct in the pursuit of their own interests at the fund investors’ expense. In most cases, there was awareness among regulators regarding the risks beyond the regulatory perimeter and several steps should have been taken in order to address them by supporting self-regulatory approaches (for example, codes of conduct). Arguably, such behaviour urges for the introduction of conduct of business regulation even in the context of unregulated funds. Any endeavour by the Department of Justice to register an identical complaint in a criminal operation would have encountered powerful resistance i.e., it would have been claimed that Goldman Sachs lacked the intention to defraud IKB or other stockholders. On the other hand, the civil action caused indeed a settlement.

This represents an issue whose implicit meaning consists of the fact that the place where the location of transactions of investments is connected to the place of occurrence of the final agreement/settlement. This last act provides legal responsibility\textsuperscript{930} for buying and selling. However, the parties are able to manipulate this.

One way to understanding the aspect presented above can be considered like a continuation of the principle according to which parts involved in the transactions of securities can employ forum clause, and stipulations from the regulation for selecting the policy that will govern the transaction.\textsuperscript{931} Nevertheless, the above-mentioned approach worked in a very restrictive manner.

\textsuperscript{929} The Goldman PR made a statement saying that [Goldman] held no position within the organisation, and that they were not “making markets in the company’s bonds or credit-default swaps”. This was however contradicted by Bloomberg news reports, according to which there existed emails that Goldman was transmitting to customers regarding these markets; in Paulden P.& Harrington, S. D., \textit{“Hoffa Says Goldman Sachs Driving YRC into Bankruptcy (Update1)"}, Bloomberg news, 17 December 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=apCmuH.AP.VA [accessed 27 May 2010].
\textsuperscript{931} In, for instance, Richards v. Lloyd’s of London, 135 F.3d 1289 (9\textsuperscript{th} Cir. 1998); Roby v. Corp. of Lloyd’s, 996 F.2d 1353 (2d Cir. 1993); Bonny v. Soc’y of Lloyd’s, 3 F.3d 156 (7\textsuperscript{th} Cir. 1993). They are largely discussed in Buxbaum, H. L., \textit{“Conflict of Economic Laws: From Sovereignty to Substance"}, 42 Vancouver Journal of International Law 931, 959–62 (2002).
Several issues were noticed in this regard. First, this was not broadened largely after the Lloyds case studies, which involved investing individuals who were truly experienced professionals. Then, the regulation selected for the above-mentioned cases seemed particularly similar to the US antifraud regulation.932 Likewise, it has been stated that probably the Courts would have been made no enforcement on those particular stipulations and that no removal of those claims would have been made from the attention and apprehension of the US regulation if the discussed foreign regulations were not so similar.933 However, these provisions represent a consequence of a definite settlement934, the mediation of which needs to offer clearness, but also fairness. The ongoing perspective is that every individual selling stocks may easily locate himself/herself in other location than US while officially accepting, but also avoiding being subjected to the US regulation935. In this regard, it has been noted that acting in such manner means not only being manipulative, but might as well signify being confusing for the other party. The allowance of determining the relevance of US regulation can thus withdraw some exchanges by protecting that particular regulation in the lack of protective stipulations usually attending “the contractual exercise of party autonomy.”936 Several measures were taken after this scandal. If implemented properly, they could restore investor confidence and prompt a new wave of primary issuances. For instance, Dodd-Frank Act recently resolved an issue concerning the necessity to inform investors and disclose information to them. Thus, Title IX, Subtitle D requires the SEC to pass disclosure requirements for asset-backed securities, including CDOs. Accordingly, these upcoming SEC rules need to clarify what information CDO originators are obliged to disclose. In the future, when CDOs are going to regain their status as a viable and trustworthy financial tool, confidence is going to need to be restored. The author considers that effective regulation may accomplish this. To be sure, different statutory measures were introduced, but it takes time to establish their ultimate impacts. As an alternative, the industry can eventually correct itself by learning from its past mistakes.

933 In, for instance “Bonny, 3 F.3d at 162” (focusing on the accessibility of remedies under British regulation which are not offending the policies regarding American securities regulations).
936 Ibid.
This chapter presents several Ponzi schemes. Some of these schemes imply the study of SEC’s motivation policy failure to encourage thorough examinations of possible securities fraud. Also, the chapter analyses whether previous SEC employees currently working as independent professionals standing for customers investigated by the SEC induce excessive pressure on present SEC employees while solving litigations falling under the breach of securities regulation.937

6.3. Regulatory enforcement

6.3.1 Recent development in Ponzi schemes litigation

Investment fraud comprises every type of action taken with the purpose of getting some financial profit from investors by using deceit.938 These types of frauds may be uncomplicated (for instance, the total stealing, when investors do not recover their money), or on the contrary, complicated schemes (for instance, Ponzi frauds). Similarly, these corporations may also act as governed either by the rule or principle or law, or not, capable also of taking various statutory shapes, starting from “joint stock companies to hedge funds or simple pools of assets.”939

Prior to approaching the Thomas Petters, Robert Allen Stanford and Bernie Madoff’s schemes, it is important to understand first the Ponzi scheme concept. A Ponzi scheme represents mainly an illicit financial investment scheme where people who invest receive payment of their interests from the investments that new investors are making.940 Regarding the operation of the scheme, the operator is said to guarantee in most cases huge profits regarding return rates. Also, this one makes sure that interest is going to be paid quickly941, as agreed, by generating significant spoken communication advertising sent on behalf of pleased investors.942

941 In re United Energy Corp., 944 F.2d at 590 n.1.
942 Ibid.
In this regard, the more new investments are performed, the more these schemes thrive. Still, the real problem emerges when not a single investor (or very few) is left and thus the operator finds himself incapable of paying the interest. It is then when the entire scheme crashes. Similarly, it has been noticed that scammers have been using Ponzi schemes for some decades. The only difference is that, lately, they started to initiate bigger and by far more highly qualitative, quite exceptional schemes.

The present economic crisis issued out of the real estate crisis revealed many Ponzi schemes starting with the Madoff scheme to the Palm Beach Capital scheme. These used to be schemes no longer capable of masquerading and pretending to be an entity enjoying profitability, while in reality, the industry was melting down. Fraudulent actions not only hurt investors, but also competitors. Also, investors are going to shy away from investing when there is the perception that neither the SEC nor other authorities are looking after their interests or protection.

Despite the fact that Madoff’s story happened four years ago, its consequences regarding hedge funds remained relevant. Even now, the SEC brings law implementation actions with regard to recently disclosed Ponzi schemes. Meanwhile, the SEC brings to trial different issues originating in ancient Ponzi schemes that have trapped new persons and new funds. The most popular of them is by far the “Bernard Madoff’s Ponzi scheme”, of course. This has been described as being of great amplitude, which apparently started two decades ago, involving far beyond USD 65 billion frauds money actually lost by investors. However, it was in December 2008 that everything became known. Similar to the Madoff scandal in size and amplitude stands the fraud of Tom Petters, the planner of a USD3.7 billion ten-year
deceit discovered in the autumn of 2008. It is also the case of Robert Allen Stanford, whose fraudulent actions became known at the beginning of 2009, although they are considered to have lasted for ten years, and involved a total of USD8 billion. Another similar case is that of S. Rothstein, who towards the end of 2009 admitted to have managed a Ponzi scheme estimated to around USD1.2 billion.

The above Ponzi schemes have triggered major complaints in tribunals from US and other states. There are several ongoing cases against the authors of the Ponzi schemes themselves, while in other cases, complainants have filed against feeder funds, banks, investment councillors, audit companies and other groups who allegedly had a role in causing investors’ losses.

While some cases still continue, many Courts where this type of cases was pleaded conducted to essential resolutions regarding actual culpability of financial inspectors.949

Several recent litigation and arbitration cases are discussed below.

6.3.1.1 Thomas Petters
The above mentioned fraud scandals widely-covered by the media950 have led to an increase in the hedge funds regulation.951 For this reason, these cases are important for the understanding of the nature of regulation and enforcement of hedge funds. The first case discussed in detail here is the Thomas Petters litigation case.

Some hedge funds and their presidents were accused of complicity in fraud to an amount of USD3.5 billion under the Ponzi scheme managed by Th. Petters.952 Towards the end of 2009, he was found guilty.953 Four months later, he received a 50 years954  

951 An unfortunately long list of proven and alleged fraudulent schemes is to be found on the hedgetracker.com website. See http://www.hedgetracker.com/halloffraud.php, accessed on 05.05.2012.
Petters defrauded a large number of investors, including more than 100 clergy participants, several non-profit institutions, and some hedge fund managers. Many victims were deprived of their jobs while others were deprived of their entire life savings. Two of the legal actions in Petters’ case are discussed here, the case of SEC v. B. F. Prévost and D. W. Harrold, but also that of SEC v. Marlon Quan.

“SEC v. B. F. Prévost but also D. W. Harrold.” After charging Petters with fraud, the SEC filed secondary accusations against Prévost, but also against Harrold on the account of facilitating Petters’ Ponzi scheme.

In October 2010, the SEC accused the above-mentioned two Florida fund directors of several laws infringements, including breaches of “Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5-communicated there under, Sections 206(1), 206(2) and Sections 206(4) of the Advisers Act and Rule 206-4(8).” The two directors were said to have deceitfully inserted within Petters’s scheme more than USD1 billion.

These two directors supposedly, intentionally and deceptively guaranteed stockholders that their amounts of investments were going to be kept safely in auxiliary accounts. They similarly depicted to investing individuals some false actions capable of ensuring the safety of investors’ money. When Petters’s scheme was discovered, Prevost and Harrold contrived some false paper exchange transactions with Petters having the intention to trap stockholders. Prevost and Harrold plainly traded old IOUs in exchange to new IOUs, falsely guaranteeing investors in monthly correspondence that the hedge funds had gained profits due to their money. Indeed, the SEC asserted that both Prevost and Harrold have injected capital into Petters’ account over a period of 4 years, from 2004 to 2008, removing at the same time almost USD58 million during the same period.

At present, there are several pending actions including a liquidation process for Petters

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955 US v. Petters, No: 0:08-cr-00364 (D. Minn.)
958 See U.S. District Court District of Minnesota, (Dmn) Civil Docket for Case #: 0:10-cv-04235-PAM - SRN (Filed: 10/14/2010).
Group Worldwide, a SEC operation against Petters and one of his hedge fund customers who avowedly took part in the fraud, and a lot of civil legal processes, some of which contain claims against auditors.

Sec v. Marlon Quan. Another lawsuit related to the fraudulent scheme of Petters, dating back at the beginning of 2011, more precisely since March, testifies that the SEC authority received one imperative interdiction stopping M. Quan, who at that moment was a hedge fund director located in Connecticut, from moving in his own accounts settlement funds. These funds had been raised specifically for victims of these schemes. M. Quan, as well as all the companies he managed, have been found to have previously transferred capital in the accounts held by Petters during the 2001-2008 period. Therefore, because of the above-mentioned issues not only Quan but also the funds he managed are considered to have breached “Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 there under, Section 206(4) of the Advisers Act, and Rule 206-4(8) there under.”

At the same time, Quan was found to have made false guarantees to investors that his firms would ensure the security of investors’ money. Rather than doing this, Quan is thought to have planned some complex exchanges together with Petters which were supposed to have reached the large value of almost USD187 million. This occurred with the particular desire of hiding the fraud made by Petters. These exchanges resulted directly in the fact that Quan’s actions led to maintaining a fraud, counterfeit image of Petters, according to which, he was in fact delivering fees for all companies.

In order to prevent Quan from transferring more than USD14 million into his own pockets, the SEC took into consideration the idea of creating a tribunal for critical situations. In this respect, Quan was forced to direct his capital to credit institutions from Germany or even from Bermuda, which was actually to his own benefit. Another accusation that the SEC brought to Quan dealt with him helping Petters to maintain his fraudulent activities, while receiving about USD90 million during the period of the

963 http://hedgefundfraud.wordpress.com/2012/01/23/case-study-petters/, accessed on 06.05.2012.
fraud. In this regard, Robert Khuzami stated that their actions proved once more that they were determined to steadily hunt illegal returns which were actually inappropriately taken out of the pockets of trustful investors by means of various Ponzi schemes.  

Furthermore, the Robert Allen Stanford scheme represents the second Ponzi scheme of major relevance discussed herein. This particular lawsuit research enables the consideration of different ignored messages or major conditions characterising the above-mentioned Ponzi scheme conducted by R. A. Stanford through his Financial Company.  

6.3.1.2 Robert Allen Stanford

It becomes clear that, in recent years, there were many Ponzi schemes thriving apart from Madoff’s, in spite of its being the most substantial. Thus, at the next level of financial frauds, one can find that of the Stanford Company, whose basis was set by A. Stanford, who also performed the managerial work while owning it. The Group crashed in 2009, after it was proved to be nothing but a Ponzi scheme.

From 1997 onwards, the SEC suspected “R. Allen Stanford” of managing a Ponzi scheme, which eventually cost stockholders almost USD7 billion, but it took more than ten years before the SEC began to investigate him in a serious manner. During 1997-2004, the SEC undertook four personnel searches, but it was unable to verify his businesses thoroughly until 2005. The first one was performed in 1997 and occurred two years after Stanford registered his company under the SEC. Thus, a SEC testing employee informed the local top-manager about carefully watching over that company and its managers, as for him everything looked similar to some Ponzi scheme that was

967 Texas financier.
about to burst sooner or later.

However, SEC implementation officials did not pay attention to negative signals received from staff working at Stanford.

Robert Stanford was put under investigation for alleged deceit at the beginning of 2009. As mentioned in the allegations, Stanford sold deceitful deposit attestations in his bank, Stanford International Bank for at least ten years by deceiving the stockholders about the returning fees they could obtain on their investments while in fact planning a “USD8 billion Ponzi scheme.”

When confronted with the illicit allegations against him, Stanford pleaded not guilty. The case went to court in January 2011. The only one who actually recognized the charges was the former Chief Financial Officer. The SEC case against Stanford and his avowed co-partners still awaits a decision in connection with the illegal charges.

The pertinent question is why did the SEC fail to charge Stanford earlier? It seems that the SEC has been suspicious about Stanford’s Ponzi scheme since 1997, a scheme which eventually cost investors nearly USD7 billion. Yet, the SEC started to really investigate ten years later. Four SEC examinations occurred since 1997 until 2004. “None of them managed to reveal his scamming before 2005.” In 1997, one SEC official examined the company and asked the branch supervisor to examine it as well, because the official suspected there was a Ponzi scheme involved, which will eventually erupt. However, there were multiple warnings that the SEC authority received and ignored the warnings coming from internal employees working at Stanford. One particular example resides in the request made by Fort Worth authority, when it started to examine Stanford due to high returns, which could not have been real because the investment approach was a traditional one. Thus, when the SEC asked for particular data, Sanford declined. Similarly, there was no reaction from the SEC, which, in the end, stopped pursuing this issue despite having obligatory empowerment. Another example supporting these statements is that of Leyla

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970 Ibid.
Wydler\textsuperscript{978} who has been asking demands regarding the company’s doings regarding customers’ investments.\textsuperscript{979} Obviously, the bosses felt threatened, which led to her being fired.\textsuperscript{980}

Leyla Wydler complained first to the NASD in 2003.\textsuperscript{981} One year later she went to the SEC. She wrote a letter explaining that she was convinced that Stanford was seriously involved in fraudulent actions.

SEC did not contacted her before early 2009 – when a case against Stanford was filed. At that moment, they contacted her to find out which were her accusations, finding out that officials from Fort Worth had hardly analysed the document again, deciding that they should neither examine it, nor open investigation on that particular issue.\textsuperscript{982}

This case raised two major problems. First, it was clear that the study of various Ponzi schemes was considered at that time to be a foolish waste of time, money and other things involved. Second, the SEC refused to examine what was so easy to notice,\textsuperscript{983} as the officials were concerned about the resources involved. These issues are backed up by the fact that former SEC employee, R. Sauer, stated that at the time, the local authorities were mainly concerned about the fact that examining this issue could take far too much time, and consequently decrease the number of reported lawsuits.\textsuperscript{984}

Senior officials from the region where it all started considered vast lawsuits as being disapproved\textsuperscript{985} since they were seen as too complex, so no rapid strike. This is why they were not encouraged to pursue them. Attorney Sauer also added that it is the state system the one creating shameful instigations. To impress legislative appropriators, the SEC’s reported cases continued to increase yearly, which consequently led to new ways of

\textsuperscript{978} Vice President of the company at the time.
\textsuperscript{981} National Association of Securities Dealers, Ibid.
\textsuperscript{984} http://online.wsj.com/article/SB10001424052748704738404575347011129892600.html, accessed April 13, 2012
favouring rapid lawsuits also against everything new or speculative.\textsuperscript{986} Nevertheless, not all cases similar, while the easiest cases are seldom the most important. The employees who are captive to the state treadmill, most of the time, implied increasing managerial problems which resulted in growing difficulties in either opening recent cases or in closing unsuccessful ancient cases. Most of the time, the official authorities tend to become slaves of the mass opinions, reacting very late to publicised frauds (and to allegations regarding the circumstances of its occurrence) through different examinations. Regrettably, the SEC often ignored all evidences of fraud presented by renowned financial academic scholars\textsuperscript{987} until the press made an issue out of it.

6.3.1.3 Bernard Madoff

As discussed above, the SEC has experienced a number of recent significant defeats, including a shameful one: SEC did not understand “Ponzi schemer Madoff.” Several conservatives claimed that investor protection under the SEC was worse than without any investor protection at all, as the SEC was “just fostering the illusion of genuine regulatory effort-its own version of a con game”\textsuperscript{988}. However, moderate voices were more temperate, even if these admitted that the SEC was a hardly troubled institution in need of a massive reform. The so-called “Madoff case” is very instructive.

SEC’s lack of success leads us to the idea of endless, highly-connected problematic issues, beginning with the fact that frauds appearing too complicated tend to be ignored, and continuing with the regulatory officials who are not aware and do not know how hedge funds operate. Therefore, these officials are unable to prevent frauds. Finally, the list of debatable issues ends with the general opinion that the companies and the authorities attempt to regulate are seen as possible individuals to provide jobs if they abandon their career as public servants. So everything is inter-correlated.\textsuperscript{989} Therefore,

\textsuperscript{986} http://online.wsj.com/article/SB10001424052748704738404575347011129892600.html. accessed on April 13, 2012.
the request for legislative freedom, not only in fact but also in display, appears threatened and in this context, the regulatory enforcements become obligatory.

Bernard Madoff perpetrated the most complex economic crime from the entire American history.\textsuperscript{990} In December 2008, federal researchers discovered what is thought to be the greatest Ponzi scheme ever, reportedly lasting for a period of twenty years and involving more than USD6.4 thousand million. The scheme was devised by Bernard Madoff, who had been previously an investment advisor and the organiser of “Bernard L. Madoff Investment Securities, LLC (BLMIS).”

The information recently disclosed to the public regarding JP Morgan’s handling of incensement securities provided by Bernard Madoff raises different, yet related thoughtful concerns. The custodian entrusted with the liquidation of Madoff’s company\textsuperscript{991} started a lawsuit at the Tribunal in Manhattan against JP Morgan Chase & Co seeking USD6.4 billion, on the 2\textsuperscript{nd} of December 2010. In 2008, according to Davis Louis et al., JP Morgan litigation got down payments on behalf of Madoff’s investors totalling USD5.5 billion.\textsuperscript{992}

Madoff’s fraudulent action caused many complaints, ranging from illicit accusations of Madoff and the individuals who supposedly participated in or alternatively helped at his fraudulent procedure, to parallel civil operations supported by the SEC and particular groups and cases brought to court by state attorney generals, and liquidation proceedings. Most remarkably, stockholders who were allegedly deprived of money for Madoff’s benefit have started numerous civil lawsuits in the US and Europe area, in their attempt to recover funds from the credit institutions who provided them assistance or who made investments using their finances.

Madoff used to be president of this Corporation before his arrest at the end of 2008, on a criminal charge. He confessed to securities deceit. The Department of Justice’s information against Madoff, registered on the 10th of March 2010, included more allegations: securities fraud, investment adviser trapping, mail fraudulent actions, false declarations, false testimony, filing false documents to the SEC, and stealing from an employer-sponsored retirement plan. Bernard Madoff continued his fraudulent action by never processing any trades for his stockholders. In the summer of 2010, federal accusers registered civil fine charges contra A. Bongiorno and J. Crupi, Modoff’s back-office employees “seeking USD5 million in assets.” The allegations state that each litigant consciously perpetrated the fraud, although no criminal charges have yet been made against Bongiorno and Crupi.

His fraud illustrates two sides of this issue: on the one hand, major deficiencies in coordinating things and in supervising with regard to market trade regulations. Thus, an obvious weakness of the internal controls meant to protect investors’ assets from fraudulent activities could be observed. Also, at the feeder funds the Madoff or BMIS names were never mentioned. Final investors were thus not necessarily aware that they were investing with Madoff. When questioned on this point, the feeder distributors generally answered that their contract did not allow them to mention the Madoff or BMIS name. So this was another risk the investors were subjected to. However, while the Madoff scandal shows well how not only financial but also operational risks are related, it is primarily for investors a case of operational risk realisation. The Madoff scandal clearly illustrates a bias which overtook many investors in whose minds performance overshadowed risks.

994 In the U.S. District Court for the SDNY.
997 US v. $304,041.01 on Deposit at Citibank, N.A., N° 10-cv-4858 (S.D.N.Y. filed June 22, 2010).
Madoff has been sentenced on June 29, 2009.\textsuperscript{1000} The Madoff case has brought light into these matters, raising public’s and investors’ attention, and that of financial market as a whole, with regards to this form of financial investments, but also securities fraud.\textsuperscript{1001} However, the SEC was hardly criticised because they did neither recognise, nor reveal this fraud which lasted for more than two decades, particularly since it was provided precise and frequent warnings.\textsuperscript{1002}

Similar to the Stanford case, the SEC was informed about Madoff and his company several times before he confessed. Unknown parties filed at least three complaints to the SEC about Madoff, while another fund administrator examined alleged profits. In addition, several economic journals wrote about Madoff’s unusual silence reputation and the unusual “consistency of his company’s financial statements.”\textsuperscript{1003} While SEC officials were in an unrelated thorough check of another company, they found Internet messages\textsuperscript{1004} showing that Madoff’s records were false. Most importantly, in 2001, 2005 and 2007, H. Markopolos, the person who exposed this fraud, had filed clear but also meticulous complaints.\textsuperscript{1005} Nobody listened to him.

As seen in the Stanford case, although the supposed scheme was printed in the news, this was neglected as proof by the SEC, which therefore missed this chance of catching Madoff. Consequently, several reports published in Barron’s and in MARhedge raised questions about SEC’s examination procedures.\textsuperscript{1006} Following the above-mentioned warnings SEC initiated about five inquiries, some of whom lasted 12 months, including thorough examinations of Madoff’s reports.\textsuperscript{1007} Unfortunately, SEC officials did not go to the next phase required to expose the fraud. Why did not the SEC’s officials reveal his lack of managing sales? Still, when criticised for failing to answer to all the

\textsuperscript{1004} E-mails from that company’s audit examination of Madoff.  
complaints it had previously received, SEC preferred to mention the number of new investigations opened.\textsuperscript{1008}

Again, as seen in the Stanford case, the SEC made the wrong decision that complex investigation was a waste of resources. Professor Macey supports this idea that investigating Ponzi schemes was regarded like a burning of resources.\textsuperscript{1009} He also concluded that the issue which seemed unusual consisted of the fact that, in reality, such a thorough check would have involved less resources than primarily considered.\textsuperscript{1010} Although the SEC received six major detailed complaints regarding Madoff, none of them was careful analysed. Macey noticed:

According to the SEC authorities’ testimony, a thorough check seemed very costly but also monopolizing. At the same time, the SEC was unable to really see the proof, despite being conscious about it.\textsuperscript{1011}

All in all, it is the author’s opinion that, for many investors, being caught in a hedge fund fraud can also have major reputation and business connotations which go far beyond the value of the actual investment loss. In this context, the role of the operational due diligence function is not only to stop monetary losses in the portfolio but it can also be considered as a key function meant to protect the asset management business itself and, by this, investors as well.

Larson and Hinton found that, before the disclosure of Rothstein’s fraudulent activity, the first two largest schemes filed by the SEC consisted of: first, Madoff’s (USD$50 billion), second, Stanford’s (USD$8 billion).\textsuperscript{1012} Since Larson and Hinton wrote their study, Tom Petters was convicted in a USD$3.7 billion Ponzi scheme.\textsuperscript{1013} That would

mean that Rothstein’s lawsuit currently represents “the fourth largest Ponzi scheme”, revealed until now.

6.3.1.4 Scott Rothstein

One of the many important Ponzi schemes discovered so far is that of the American lawyer Scott Rothstein. The moment when his plan started to reveal itself, in the winter of 2009, Rothstein made a confession in front of the federal accusers, admitting fraud, money laundering, mail fraud and wire fraud. Considering the allegations against him and his company, stockholders have attempted to procure shares in private settlement decisions. In fact, the settlements did not exist, and the investor hedge funds had already been used in order to continue Rothstein’s Ponzi scheme.1015

In January 2010, Rothstein admitted his guilt to all the criminal accusations against him and six months later he was convicted to 50 years in prison. Besides Rothstein, Debra Villegas, former Chief Operating Officer in his law company confessed her guilt.

At present, Rothstein’s law company, Rothstein Rosenfeldt Adler, PA (“RRA”) is in the process of liquidation operations in “the Southern District of Florida.”1016 The Rothstein act of deceit has also caused civil lawsuits, most remarkably a 2,200-plus page litigation in Florida State Court of Justice.1017

The development of a cohesive regulation to respond to nefarious corporate behaviour directed by managers who use their respective corporate entities is stringent. This necessity is further emphasized by the case describing how fraudsters can indirectly punish victims and creditors in relation to the current lack of coordination between the authorities and bankruptcy trustees. Protection of investors from undue losses can be performed with agreement among regulators to strongly consider prosecuting corporations used as vehicles for investment fraud aims. In these circumstances, doing

1017 Razorback Funding LLC v. Rothstein, CACE09062943 (Fla. Cir. Ct. Broward Co. filed Nov. 20, 2009)
so would be theoretically justified and also, from the practical point of view, adoptable, but also would further victim and creditor recovery so that would increase the equitable nature of both criminal forfeiture and bankruptcy proceedings connected to corporate fraud.

The Petters, Rothstein, Madoff and Standord cases illustrate how the existence of pessimistic motivation structures for investigation can effectively prevent the investigation of several types of cases. In this regard, it becomes a necessity for the SEC to carefully consider all the above-mentioned matters and to approach them, otherwise this will be considered amateurish, inefficient, or even worse, chained to particular stakes, other than those of the truthful individuals investing in hedge funds.1018

Moreover, the next sub-section will exhibit market manipulation and misrepresentation cases.

6.3.2 Market manipulation

It has been stated that, usually, plaintiffs in the US use two major claims.1019 The first refers to material misleading and information deficiency, while the second one makes reference to market manipulation in exchanges. It has been noted that although these are very different, there has been a tendency to consider them quite similar from the legal point of view. Thus, plaintiffs were asked by the tribunals to bring about proofs alike, which would further make investors trust the market exchanging the assets and thus acquire their status of being reliant. Main motivations considering why these proofs were required cannot be applied to both misrepresentation cases and market manipulation cases.1020

Complaints regarding industry manipulation must not be imposed to prove an efficient market for taking advantage of the fraudulent actions on the market philosophy’s

1019 Under section 10(b) of the Securities Exchange Act of 1934.
assumption of confidence. In case the complainants “are made to make any showing at all,”1021 they must prove the causes of their losses.

A significant case is that of SEC v. Ficeto. On the 24th of February 2011, two hedge funds experts, a dealer, and two companies involved in a allegedly case removing plan involving stocks with a very low amount of market capitalisation, have been accused by the SEC. Supposed infringements comprised “Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Section 15(c)(1) of the Exchange Act, Section 17(a) of the Exchange Act and Rules 17a-4(b)(4) and 17a-8, and Sections 206(1) and 206(2) of the Advisers Act.”1022

All the accused persons used manipulative trading practices firstly to increase the returns of funds, and secondly to overstate net assets, as mentioned by SEC. Then, consequently, in accordance with this authority’s point of view, litigants managed to get several USD million in performance1023 shares, but also certificates they did not have the right to own. The litigants allegedly transferred matched orders; they removed orders that established the daily closing price while they managed wash sales, made for one main scope: exaggerating stock values by artificial means.1024 The accused persons allegedly used even some different IM1025 program enabling free chat/talk about non-legal performances and there was little chance of being discovered. In 2007, the investment representative rapidly resigned, which led to the fact that both funds and their shareholders found themselves in debts. The debt was between USD440-530 million.1026 The SEC is searching ongoing “injunctive relief”; unwillingly surrender of illegal benefits with “prejudgment interest”1027 and financial penalties.

The usual type of fraudulent breach of law for hedge funds is represented by the abusive securities and associated misleading.1028

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1023 Ibid.
1024 Ibid.
1025 Instant messaging.
1027 Ibid.
There is usually no permission for hedge funds regarding investing in any form of assets whatsoever. At the same time, their advisers are exempted from specifying what categories of investments or which particular strategies are going to use for investment purposes. The following sub-section will present misrepresentations regarding investments.

6.3.3 Fraudulent misrepresentations to investors

Cases on fraudulent funds have been thoroughly mediatised, illustrating the various manners the managers devoid of scruples can cause losses to investors and this is the main reason for regulating hedge funds. Hedge funds must pay attention in order to ensure that any declarations and representations made to stockholders are entirely correct. The cases below suggest large-scale deceitful operations on the part of the funds and their agents. Even careless incorrect declarations can lead to a great deal of trouble down the road.

In SEC v. Kowalewski, on the 6th of January 2011, SEC registered a civil injunctive lawsuit accusing St. Kowalewski and SJK Investment Management, LLC, with infringements of the federal profits regulations, for depriving stockholders inappropriately within two funds managed by the latter. Violations contain several regulatory sections. It was claimed that the litigants took USD65 million for two hedge funds. The litigation were supposed to state that: (a) the money placed in repositories are going to be deposited in independent latent funds searching complicated techniques for investing; (b) not even a single underlying reserve could be distributed an amount of above 15% from the total funds’ currencies; (c) all repositories should be liable to pay either for their “institutional” or for their beginning expenditures at the

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1034 Ibid.
same time according to specific functioning expenses; last, (d) as a reward for offered assistance, SJK company should get maximum 1% security management share in one year and 10% returns incentive share. Indeed, this litigation confirms the litigants’ creation of an unique, unravelled reserve to which they removed stockholders’ investments for individual and entrepreneurial costs, but also administrative taxes; In reality it proved to be USD5million that were to be found in Kowalewski’s wage accruing.

These fundamental reasons for the hedge funds’ industry performance request are “not applicable to manipulation claims.” In this regard, it has been remarked that industry performance did nothing to suggest that there is a causative relation between having faith in the financial value provided by the industry and the scheming behaviour. On the other hand, parties undertaking “market manipulation” must be asked to determine causes for losses “at the class certification stage” for linking that confidence with the supposed manipulative actions. Requests like this should act in favour of coherence and efficiency, like a doorkeeper for “class certification’ avoiding “violence to Supreme Court precedent.”

6.4. Arbitration cases

It was noticed that those investments made by hedge fund managers and directed towards their proper funds (among these one can mention loans coming from a certain fund to a manager) are to be found at completely opposite parts on the illegal scale. First, the generally called “skin in the game” represents a particular situation when an executive in a publicly-traded entity makes use of his/her own money to buy stock in that company. This is considered as aligning interests of both investing individuals and managers. On the contrary, the other tends to be considered like compassioning their interests which are at conflict. It is however certain that, from various motivations, investors wish to know everything about them.

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1037 Ibid.
SEC v. Quantek Asset Management LLC.

The SEC considers it suitable and important to citizens that public administrative and C&D processes be implemented according “to Section 8A of the Securities Act of 1933 - Securities Act, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 - Advisers Act, and Section 9(b) of the Investment Company Act of 1940 Investment Company Act” against Quantek Asset Management, LLC (Quantek), Bulltick Capital Markets Holdings, (LP Bulltick), Javier Guerra (Guerra), but also Ralph Patino (Patino) all in all considered Respondents.

Recently, on May 29, 2012, the SEC accused a fund adviser located in Miami of having deceived investing individuals regarding the managers’ investments made in a fund located in Latin America.

According to the examination performed by the SEC, it was discovered that different misleading representations have been made by Quantek regarding “skin in the game along with investors in the USD1 billion Quantek Opportunity Fund.” Similarly, it has been noted that “skin in the game”, under this fund management given circumstance, represents that particular situation in which the adviser/executive decides to invest his/her own capital in that company. This is considered, in the opinion of each fund investor a major means of aligning all advisers’ interests to his/her own, leading to a better control and to a better risk management.

In fact, Quantek’s managers never invested their capital in the Funds. Similarly, the SEC’s research revealed how Quantek manipulated investors regarding investments of those funds it managed, but also some connected-party exchanges involving manager Guerra, as well as his previous owning corporation Bulltick LP.

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1040 Cease-and-desist.
1043 Ibid.
1044 Ibid.
In the enactment process conducted by the SEC, Quantek, and several persons including Bulltick, Guerra, and Ralph Patino have been accused together.\textsuperscript{1046} They paid the total amount of USD3.1 million, while Guerra, just like Patino were forced to assent to securities industry bars.\textsuperscript{1047}

Besides, the SEC has discovered a crucial element, namely, that information was not accurately revealed to investors by neither Quantek nor Guerra or Bulltick. This proved to be another key element in this file. Thus, around four or even five years ago, due to the fact that Opportunity Funds allowed related-party exchanges between the parent entity belonging to Quantek, Bulltick but also various associates, investors had been alerted with regards to exchanges improperly disclosed. Both Quantek’s and Bulltick’s staff took care but also backdated omitted capital lent data.\textsuperscript{1048}

Javier Guerra resigned on September 28, 2011.\textsuperscript{1049} According to press reports\textsuperscript{1050}, the portfolio manager of QAM\textsuperscript{1051} and Quantek Opportunity Fund, LP (Partnership or Feeder Fund), submitted his relinquishment of responsibility (he resigned) leaving the job due to losses in arbitration to Aris.\textsuperscript{1052} According to the arbitration bureau, it was reported that Quantek Asset Management introduced Aris by fraud for investing in the Feeder Fund (USD15 million were invested\textsuperscript{1053}) while, at the same time, it commanded Guerra to pay losses worth USD1 million.

Quantek procured incorrect notifications to investors regarding some connected-party exchanges by the funds. Through its processes, Quantek broke several anti-fraud, compliance and records management agreements from ‘the Advisers Act and Securities

\textsuperscript{1047} Ibid.
\textsuperscript{1050} “New York State Supreme Court Dismisses Hedge Funds of Funds’ Complaint against Accipiter Hedge Funds Based on Exculpatory Language in Accipiter Fund Documents and Absence of Fiduciary Duty Among Constituent Limited Partners,” The Hedge Fund Law Report, Vol. 3, No 7 (Feb. 17, 2010).
\textsuperscript{1051} Quantek Asset Management.
\textsuperscript{1052} Aris Multi-Strategy Fund.
Act.’ Guerra, Quantek’s manager and its former operations manager, Ralph Patino, had made misstatements concerning Quantek’s account. Bulltick had helped and encouraged this, causing several of Quantek’s violations.\textsuperscript{1054}

Quantek\textsuperscript{1055}, Guerra\textsuperscript{1056}, Bulltick\textsuperscript{1057}, and Patino\textsuperscript{1058} established charges in the absence of any guilt confession.

In this regard, Quantek and Guerra decided in favour of paying around “USD2.2 million in disgorgement and pre-judgment interest, and financial penalties of USD375,000 and USD150,000. Bulltick agreed to pay a penalty of USD300,000, while Patino accepted to pay a penalty of USD50,000. Guerra consented to a five-year securities industry bar, and Patino consented to a securities industry bar of one year.”\textsuperscript{1059} Censorship was granted by Quantek and Bulltick.

As seen above, this claim of malpractice was resolved by monetary penalties, censorship and securities industry bars. Nevertheless, it should be clear that every broker’s obligation is stated to investors as accurate as possible, always providing them the best solutions and recommendations which best suit each investor. Accordingly, the stage of life, soundness, but also financial complexity, or its lack, must represent major indexes for each broker. The law and the SEC are there to help protect investors, and here they helped in that particular case to correct a dangerous path the company was taking.

6.5 Concluding remarks

The cases presented above are some of the most recent and most famous. According to Poser, unlike Madoff’s scheme, which seems to have been an impressive, immense

\textsuperscript{1054} Forkey, R., “Investment Advisor and Broker/Dealer Investment Fraud and Mismanagement Litigation and FINRA”, Investment Advisor on Saturday, June 9, 2012.
\textsuperscript{1055} Quantek Asset Management, LLC.
\textsuperscript{1056} Javier Guerra, from Miami, Florida, “the lead principal of Quantek and the portfolio manager for the Opportunity Funds.”
\textsuperscript{1057} Bulltick Capital Markets Holdings, LP founded by Javier Guerra and his associates, parent company of Quantek and two Commission registered broker-dealers.
\textsuperscript{1058} Ralph Patino from Miramar, Florida, Quantek’s director of operations.
\textsuperscript{1059} Forkey, Russell, Investment Advisor and Broker/Dealer.
fraud, most of litigations and arbitrations involved fraudulent actions widely spread in the entire funds market,\textsuperscript{1060} seriously affecting investors. Poser noted that due to SEC’s inability or unwillingness to fulfil its enforcement responsibilities investors have lost billions of USD.\textsuperscript{1061} Since 2000, regulators were unsuccessful in taking appropriate and efficient action to restrict abuses in relation to hedge funds, which leads to the conclusion that both regulatory enforcement and investors’ protection are highly necessary.

With regard to why the regulators failed in the above cases it has been remarked that:

The explanations include conflicts of interest among employees, poor employees’ training, constraints related to finances, and a devised nature of the regulatory system.\textsuperscript{1062} The various players in these litigation and arbitration cases acted in ways that in the end turned out to be against their own interest. A high number of sophisticated but also ordinary hedge fund investors favoured these funds for a long period and lost money. The administrators and the auditors were willing to accept the manager’s explanations, if any. Still, this acceptance led to disastrous consequences for their funds or business. Above all, the SEC did not assure too much protection for investors.

Nevertheless, the basic motivation explaining failures is the anti-regulatory atmosphere, supported by academically generated anti-regulatory approach that has pervaded government during the last twenty or thirty years. Apparently, the SEC’s major aim shifted: it no longer protects investing persons but rather it protects those firms and investment companies that it regulates. As one commentator concluded, in spite of having been made particularly for protecting investors, the SEC changed into some authority protective with financial scammers.\textsuperscript{1063} This is an exaggeration, of course, but it needs to be taken into consideration.

Now, it is likely that conflicts concerning both redemptions and distressed hedge funds will end up in court during the years to come. The conflicts of interest in these cases

\textsuperscript{1060} Ibid.
concern not only instances of confessed fraud that emerge as bankruptcy declines and losses rise, but also valuation conflicts and controversies between stockholders and hedge repositories over the timing of salvations. Many of these demands have been litigated in other countries, but US complaints are also on the rise.

A shift in the modern view of hedge fund investments but also organisational audit is underway. These consequences rising from the Madoff crisis together with the current recession is going to affect hedge funds’ due diligence, mainly with respect to operational risk. On this point, it has been remarked that not only investors, but also funds are going to obligatory reconsider prior rigorous due diligence assumptions. In order to survive in the post-Madoff world, they ought to make themselves ready to paying prices related to the growing resources necessary to be invested in order to efficiently solve “operational due diligence.”

During recent years, new regulatory modifications have been suggested. The political requirement to enact new measures quickly, however, has led to proposed alterations that are adapted to the specific features of the hedge reserves fraud. Unfortunately, there does not seem to have been a complete assessment of the present regulatory system for hedge funds.

This chapter described several case studies concerning various claims that financial organisations and investors might encounter if a regulatory enforcement crashes. It is certain that, due to the worldwide financial circumstances, claims against financial institutions are going to grow. The following quote from Johnson et al. sums up much of the recent debate following these cases:

“In the aftermath of a Ponzi scheme’s collapse, financial institutions, whether direct or indirect participants, will almost certainly face litigation risks for even the most remote involvement in financial frauds.”

Recently, it was seen that litigations and arbitrations are changing, respectively, persecuted investors tend to become more and more innovative, prosecuting every financial sound company, generally financial companies which could have played significant roles. The economic situation is

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standing still while indignation is going stronger in people’s lives due to light regulation of the financial market, which can become a model.

While stories such as Stanford’s, Petters’ and Madoff’s can be labelled as atypical due to the size of their collapse or due to the level of malfeasance connected with the fraud, they help to illustrate the reason why both regulators and the public in general must pay greater attention to hedge fund industry regulation and the protection of investors.

As highlighted above, substantive regulation directed towards the elimination and governance of conflicts of interest has its limits. It is the author’s opinion that where these limits emerge, only mandatory and voluntary disclosure is able to offer the necessary protection by shifting part of the responsibility for the protection of investors to the investors themselves. This is especially because, as well known, disclosure offers the foundation for the regulations and especially of investor protection laws.

In addition to explaining many of these risks and conflicts of interests associated to hedge fund management, this chapter has demonstrated the risks that they induce to hedge fund investors, particularly sophisticated but also indirect investors who are often not aware of their hedge fund investment.

Lately, due to the increase of arbitration and litigation cases, hedge fund investors, specifically institutional investors, have been intensifying their requests for better safeguard. Therefore, investors within the hedge fund industry lost their confidence and have come to understand that improved investor protection is imperative.

The increased attention on the issue has led to the creation of hedge fund “best practices” documents, making a multitude of suggestions that, if made, could greatly improve the level of investors’ interests protection. Still, best practices are generally voluntary suggestions that, so far, hedge fund managers have proven little desire of adopting and implementing.

As a concluding remark, it is necessary that regulators take action to ensure that hedge fund investors receive adequate protection from the funds’ many risks and conflicts of interest. Through the introduction of increased transparency to hedge fund investment
and standardisation of the valuation process, regulators are able to defend investors’ rights without eliminating the specific flexibility that enables hedge funds to confer major benefits on the markets.
FINAL CONCLUSIONS

The main goal of this thesis is to establish the framework for a global regulation of hedge funds, focusing on investor protection, in a continuously changing regulatory field. This part reveals the closing conclusions of the thesis by comparing and presenting the results of the current research. It also recommends several aspects for efficient enactment and implementation of hedge funds regulation.

Due to the fact that a number of concerns have been raised on the growth of investor interest in hedge funds, this thesis concludes that there is indeed a strong case for increased investor protection in hedge funds. Hence, as financial products become more complex and innovative, financial regulation and investor protection need to be equally innovative, creative, and proactive. A comprehensive research on the possible costs and benefits of such regulation concludes that the benefits are likely to be greater than the costs, stipulating that regulators need to be aware of regulation excesses and over-regulation dangers. Therefore, an international hedge funds regulation focused on investor protection and risk mitigation is the best answer to a global financial area.

It is a proven fact that the shifts in the legal field have seriously affected hedge funds operations. These shifts were caused among others by the financial crisis, the desire to mitigate risks, the necessity to better control hedge funds, the need to increase investors’ protection and hedge funds transparency. Consequently, all regulators began to acknowledge the potential benefits but also the shortcomings of tighter regulation such as for example a strategic method to face risks in the hedge funds area and increase funds competitiveness, controlling their impact on the hedge funds market and the international financial system, on the one hand. On the other hand, tighter regulation was thought to illustrate “diversification, competition and price discovery.” Nevertheless, according to Photis Lysandrou, there are regulators who still hesitate “in tightening the controls on hedge funds”\textsuperscript{1066}, although they are no longer exclusively in the area of the sophisticated investors. The more pension plans, endowments, charitable institutions, and other institutional investors invest in hedge funds, the biggest the

exposure of “ordinary” investors to these lightly regulated investment vehicles. Consequently, ordinary investors tend to be subjected to the myriad conflicts of interests connected with hedge fund management. In addition to explaining many of these conflicts, this thesis has proved the risks they induce to hedge fund investors, particularly to indirect investors with a frequent low awareness level of their hedge fund investment.

The European and American authorities have much considered lately hedge funds, and in this direction, the author acknowledges the cross-border nature of the hedge funds sector and therefore the need to create an internationally harmonised regulation regime for hedge funds. As they have fallen beyond the boundaries of global public regulation, hedge funds have often been considered the proof that international financial markets have exceeded the states’ ability to competently regulate and control them. In addition, because private industry groups rather than public institutions appeared as major rule-makers for these markets, this industry seemingly reinforced arguments about the transnational ascension of the authorities. The present international financial crisis confronted these ideas as nationalities and states have now proclaimed their regulatory authority in a globally coordinated manner over this industry. At the same time, there was a close connection between the regulatory course of the European authorities and the corresponding regulatory actions in the US. While European hedge funds regulators were capable, to a certain extent, of generating innovative issues but also legislative answers, in some cases they ran behind the Washington’s policies. This is the main reason highlighting the necessity of an international regulatory hedge funds regime.

This thesis has examined and compared the hedge funds regulation in several jurisdictions such as the US, the UK and the EU, focusing on several single jurisdictions in Europe such as Italy, France, Ireland, Luxembourg, Malta and Switzerland after the 21st century depression. The thesis pursued to depict the progress achieved at regulatory level after the financial crisis, with major focus on investor protection. Along our journey, the reforms introduced in the regulatory field are described and illustrated, such as “the AIFM Directive” in the EU and “the Dodd-Frank Act” in the US. After the enactment of “the Dodd–Frank Act”, funds from the US needed to register with “state or federal financial authorities” while simultaneously complying with standards regarding transparency and disclosure. Simultaneously, funds in the EU will be allowed
to operate within every EU Member State on condition that they are registered with the ESMA observing also the approved guidelines.

The present research confirms that the lack of global regulation in this industry before the crisis simply indicates the preferences of the two prevailing financial world leaders: the US and the UK. In return, these two powers were mainly following pressure from private financial groups, competitiveness responsibilities and the opinions of major elite policymakers concerning superiority of market discipline and self-regulatory mechanisms. At that moment, when the shockwaves produced by the current financial crisis generated a shift in the domestic politics of the largest financial powers, the essence of international rules changed accordingly. The abnormal politicisation of financial regulatory politics caused by the widely usage of taxpayers’ money to save financial institutions released popular and legislative pressures in the US and Europe for policymakers to regulate. In doing this, they acknowledge the complicity of hedge funds to the subprime crisis, although one should mention that despite the fact that hedge funds contributed to the development of the crisis, they cannot be held responsible for it. All in all, the author considers that regulators must develop their registration rules and reporting requirements, by gathering a substantial collection of data from all these advisers/managers. This collection is intended to help investors and assist the regulatory and examination efforts of both the United States Securities and Exchange Commission (“SEC”) and the European Parliament, in prompting investor-centric regulation and in enhancing protection for investors’ interests, by mitigating some of the higher risk behaviour of hedge funds.

Major regulators also changed their opinion on the merits of market discipline and self-regulation according to the lessons learned during the financial crisis. At the same time, it was assessed that many private actors also came to approve the regulation not only for defensive reasons at a time of weakened political legitimacy, but also for more positive reasons of improving the operation of their hedge funds industry, bringing back confidence, and/or increasing market shares. As the most powerful states agreed, to a greater or smaller extent, to move towards tighter official regulation for domestic purposes, they had major reasons - as noted in the thesis - to become sure that the content of international rules changed in the same direction of investor protection.
Analyses emphasizing inter-state power relations could be tempted to consider the end of self-regulation to be a result of the decrease of the US and UK power and the favourable outcome of states with more interventionist predilections among which one mentions France and Italy in overcoming their rivalry. In the author’s opinion, however, this interpretation would neglect the importance of the domestic changes in the US and the UK in explaining the shift to direct regulation. Accordingly, this thesis stated that analysts focusing on inter-state power relations would be right to consider the growing capacity of the EU to act as a whole both unilaterally and at global level as an important development in this story. As shown above, this shift increasingly constrained UK’s autonomy in global regulatory politics, simultaneously with causing global outcomes be influenced by more powerful countries, such as France and Italy, as well as regulatory bodies such as the ECB, the EC and the European Parliament.

Both the US and the EU have imposed major regulation and reporting requests on hedge funds, which were completely analysed and approached both in the US (chapter five) and in the EU (chapter three). The AIFM Directive, thoroughly examined and discussed in this thesis (chapter three), comprises authorisation, risk management, operational risk, depositories, valuation tools, liquidity, capital, leverage, conduct of business and marketing for these funds. The AIFM Directive will have to be implemented in the national legislations in the EU by July 2013. The impact of the AIFM Directive on local jurisdictions in Europe is also described (chapter four). The hedge funds in the US will be compelled to keep records on the SEC inspection regarding most of these issues. Additionally, the “the Dodd-Frank Act” introduces a reform which restricts the capacity of banks to own hedge funds (chapter five). Therefore, this confines the development of “the shadow banking” system. In the author’s opinion, a major problem occurs as the Dodd-Frank Act is generally focused on monitoring systemic risk, and consequently, the new legislation does not succeed in solving many of the investor protection issues created by the hedge fund industry.

As a closing comment, one question arises: could this mean the end of self-regulation? In an article from 2004, Danielsson et al. argue that regulation of hedge funds should not be made in absurdum.1067 The opportunities of the hedge funds cannot cease to exist

only to eliminate all the risks. This is also something that should be carefully considered. The answer to the above question is certainly positive, meaning that public authorities have approved formal responsibility over hedge funds regulation. Nevertheless, it should also be noted that until now, they have refrained from supporting heavy handed and detailed types of global regulation such as constraints on the investment strategies of hedge funds. At the same time, public authorities continue to depend on various elements of self-regulation. The long life of these patterns is an issue to be pursued in the future. Whether the domestic pressures caused by the financial crisis fade away and competitive concerns raised by the industry recover strength, regulatory bodies in major financial centres will be under pressure to scale back the perimeter of public regulation and to go back to more market-driven regulatory mechanisms. If the lessons learnt from the crisis generate a more profound ideational change or if the alliances of private sector interests intending to gain from greater regulation become institutionalised, then the movement away from self-regulation may last and may even become more intense in the forthcoming years.

After examining this multitude of attempts to mitigate risks by means of legislation, another major conclusion of the study refers to the involvement of jurisdiction. There are two major concerns regarding hedge funds, consisting in very small charges and little or no divulgement. Generally, hedge funds have the opportunity to choose the most sympathetic location. Also, when a state changes major stipulations, be it taxes, laws or divulgement requests, principals and fund managers can change location easily. This effortlessness in changing the location does not prove providential at all for any state because funds are synonymous with high revenues, as this is the essential reason of jurisdictions not agreeing to funds changing their residence. Every residence change reduces not only incomes, but also risk mitigation efforts. Therefore, state cooperation has a double purpose: first, to solve problems that involve residence authority, and second, to diminish global risk that can otherwise cause depressions as the present one. These risks, also called “systemic risks”, are widely analysed by global authorities and officials.

Every risk assumed by each particular person investing in funds, every component of the economic and financial structure, as well as Europe’s objective of making “a single market” place nowadays funds on the first place in terms of interest not only at the
European, but also at international level. Starting with 2007, when Germany became President of the “Group of 8”, funds turned into a major issue discussed within multiple meetings, with transparency as the main focus. Nowadays, it seems that hedge funds market understood that there are many advantages for everyone involved within this business, if scammers were annihilated. Accordingly, regulatory bodies and funds managers cooperate in the attempt to build a healthy funds market regardless of the fact they are based onshore or offshore.

Nevertheless, the author of this research considers that emerging risks cannot be completely mitigated. It is clear that it is impossible to mitigate risks directly since there is no efficient global regulation (although the Basel laws are quite useful). In the context of industry powers moderating the risks, one question arises: “will the world have to experience a complete financial crisis first? And if this happens, would it be worth it if we can avoid it?”

Another concluding remark is that EU and US legislators are deeply concerned both about the hedge funds’ strategies and about the associated risks, in terms of the fund’s properties estimations and investor protection. Vast legislation resulted from these concerns regarding systemic and particular risks affecting especially the investors. Still, the main question which emerges is whether “this massive regulation is really necessary for regulatory bodies to interfere and legislate against the promoting of the funds or at least fund of funds to investors”. Legislators and regulatory bodies must understand hedge funds and the impact of such tighten regulation on the achievement of a reasonable legal framework that will not jeopardise their activities and their very existence. This is the reason for stimulating and developing initiatives such as the researches on the AIFM Directive and the Dodd-Frank Act developed in this thesis.

Another quite intuitive observation is necessary: in the present world, globalisation leads to interconnection of markets, as financial aspects ignore state borders when the law is enclosed within a defined location, creating a disjunction between territorial regulation and international activities. This remark is general, but it can easily apply to hedge funds and could prove to be one of the biggest challenges faced by the financial law. Indeed, operations and investors in various jurisdictions come together with likely conflicting regulations problems, and with high compliance costs. At the same time,
another risk should be emphasized - that of forum shopping, since the lack of globally coordinated approach enables hedge funds to move away to less rigid jurisdictions out of the regulatory authority’s reach, which is certainly not good news for the systemic risk mitigation efforts. The author considers that global economic challenges require a global answer. International multilateralism within intergovernmental and supranational fora is the *sine qua non* of an effective resolution to the analysed industry crisis and a sound reform of the international hedge funds industry.

Florence Lombard\textsuperscript{1068} highlights the above-mentioned aspect, urging for a system of mutual recognition of global standards both from onshore and especially from offshore jurisdictions. Overall, despite all regulations and regulators, offshore funds regulation is still one major issue to be solved. All regulatory reforms seem passive as compared to it. It is clear that a coordinated onshore-offshore approach to regulation could prove much more effective and it could lead to costs cuts.

The achievement of an international harmonised legal framework for hedge funds does not seem utopian now. To the contrary, the international financial architecture developed as a solution to the necessity of a common system of global financial risk oversight. The author considers that policies must be structured around global institutions to achieve collective objectives such as prudential/financial stability regulations, market conduct regulations and trading practices, general market integrity regulations and investor protection regulation. The international financial architecture is intended to deal with international financial regulation. Supervision and regulation are two sides of the same coin. As demonstrated in this thesis, there are common objectives of the US and the EU financial regulatory frameworks, but the current reform proposals did not size yet the opportunity of contingency for promoting a coordinated international approach. Even in 2013, there is still no consensus on the form and subject of the regulation. This happens both in the US and in the EU, where Member States fight to impose their own perceptions of financial regulation and do not seek to be eager to compromise and proceed towards even greater harmonisation. One thing needs to be pointed out clearly: this thesis supports the idea of global financial regulation; it only acknowledges the idea that there are some structural and cultural elements that must be carefully considered by

\textsuperscript{1068} Executive Director of the Alternative Investment Management Association (AIMA).
anyone who wants to overcome those difficulties and encourage an international framework.

Indeed, several deep philosophical and cultural differences have shaped various perceptions regarding regulation in general and hedge funds regulation in particular. On the one side, there seems to be the UK and the US but also, to a smaller extent Italy, which is in favour of a flexible approach to hedge fund regulation. On the other side, there is France, which keeps pushing for more regulation, mainly because it has nothing to lose. Acknowledging these divergences is the first step to overcome them and to develop a global legal framework. It is true that these differences may first of all originate in the very perception of the state role. While France has a tight state intervention tradition, the US and the UK have a quite liberal one. This may also come from the role of the law itself in each of the above-mentioned countries. Hence, France has always been a highly regulated state with a massive legislative activity, while the US and the UK regulate more lightly and only if necessary.

The hedge funds approach of each of the states discussed in this thesis is at the same time influenced by the significance of the funds industry in these states. Accordingly, France is not really concerned about the impact of hedge fund regulation on its economy due to the fact that this impact could not be so significant (since funds based in France are few, although diverse). On the contrary, the UK and the US have a strong motivation to maintain their competitiveness, as they are the two major financial centres for hedge funds. Finally, and despite the efforts of the G20, there seems to be a competition between the jurisdictions analysed in this thesis to impose their own regulation perceptions in a very chauvinistic manner, which may prove prejudicial in the author’s opinion.

In the present financial world, financial markets can no longer afford this patriotism of another age. Particularly, certain statements made by regulators or politicians could be seen as regrettable, since they threaten the efforts to build an effective global cooperation.

Beyond any philosophical and cultural differences, one competitiveness problem that detains the internationalisation of financial regulation. Indeed, even if the achievement
of a level-playing field seems compelling in various respects, many states fight to keep their competitive edge in sometimes a very protectionist manner. Joseph Stiglitz develops this idea in a recent article, stating that each country weights every proposal and assesses its effect on its own financial system competitiveness. Most of the times, the aim is to find a regulatory regime that affects competitors much more than their own companies. He quotes the saying according to which “all politics is local”, as finance represents indeed a major political player in the US and many other jurisdictions.

If everybody agrees on Joseph Stiglitz’ above statement, especially because it identifies a real issue, the remedy he advocates for cannot be agreed on. Indeed, he considers that since international coordination is difficult to achieve, the international communities should not lose time in trying to do so. Due to the difficult “systemic risk” phenomena and to the interconnection of financial industries, one can barely conceive all delayed attempts to establish a consistent, ordered, international fundamental structure for multinational operational companies. The author of the thesis insists on emphasizing that, in her opinion, this is not a viable choice. Since the PFIARA and the AIFM are simultaneously discussed, one can regret that the opportunity to promote an international approach to hedge fund regulation was not seized despite the recommendations made by G20, many committees, research organisations and academic scholars.

Failure to achieve international standards in the present reform proposals does not mean that attempts in this regard are completely missing. Examples of these efforts to establish international cooperation may, for instance, be presented through the existence of bilateral agreements between regulators such as the “memorandum of understanding on consultation, cooperation and information exchange related to the supervision of financial services firms and market oversight” between “the FSA” in “the UK” and “the SEC” in “the US.” The above-mentioned “strategic dialogue” between the two regulators began in 2006 and several meetings took place to discuss, among other things, the regulation of hedge funds and investment advisers. Efforts are also made for instance in the “G20, IOSCO, ESMA”, as well as in different forums and authorities to

\[\text{\cite{Stiglitz2007}}\]

\[\text{\cite{PFIARA2010}}\]
develop global models, and these efforts need to be supported and stimulated. Nevertheless, if such initiatives exist, they tend to be rather conventional; therefore, they seldom conduct to regulatory harmonisation, mainly because regulators are not willing to walk down that path.

The most advanced example of international cooperation until now remains at the Self Regulatory Organisations' level. They easily generate consensus within the industry. The directions they provide to the industry are moderate and easily transposable at international level. Andrew J. Donohue1071, at the SEC, referred to such rules as “serving as an excellent model for the way in which industry can work together with regulators around the globe to develop smart and sensible solutions to hedge fund regulatory issues and to strengthen and enhance confidence in all of our markets.”1072

The author’s firm belief is that, unless action is taken to harmonise the regulation of hedge funds at global level, the confidence of investors in the safety of invested assets through a collective investment vehicle would continue to be poor. The other way round, it seems it is a favourable moment for an international legal framework in the hedge fund industry but, unfortunately, governments and regulators still struggle to overcome their national particularities, which leads to a deadlock. Harmonisation of legal frameworks seems to be illusory since regulators continue to contemplate national-based reforms when an effective prevention of systemic risk requires international cooperation. The proposal presented in this thesis considers this structural situation requiring significant effort. It acknowledges the obvious tendency of jurisdictions to handle regulation on a national-basis. The national prerogatives to regulate as each state sees appropriate are not denied by the creation of a global database of systemic risk. Instead, this promotes an international cooperation framework via an information sharing system superimposed on national regulations. This would be for sure one of the most far-reaching innovations of post-crisis financial regulation, as it will oversee the market as a whole, particularly monitoring investor protection.

The fundamental acquis of the crisis is universality, for the post-Lehman finance design achievable by means of international regulation and supervision as well as harmonised national policies and rules. The system of concurrent rules and institutions,

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1071 Director of the Division on Investment Management.
interconnected by their fortunes represents the finance. The sustainable nature of the entire financial system and the capacity of international norms to prevent ambiguities and unclear aspects, and the systemic financial stability all depend on how powerful single institutions are and how effective national rules prove to be. The crisis was followed by an immediate predisposition to protectionism and then by the reaction to build a structure that reacts to the regulatory system: the enactment of global norms and founding of global institutions capable of managing a global system.

Despite the lack of difficulty in finding risks related to funds, regulatory bodies are bound to remember the reasons for hedge funds’ existence: their high request. Except the request of individuals (persons who want to invest their money in funds), this industry failed to develop. This thesis mentions practical regulations and their recommendations issued for some selected European countries, the US and the UK. Yet, these policies and the arguments supporting these regulatory tools might prove real for every jurisdiction in the world.

Under the circumstances of the entire financial system stability being the main goal of macro-prudential policy, this should also include the “shadow banking” system - money market funds, hedge funds and structured investment vehicles. They have a significant impact on the global market. During the financial crisis, the loaning by means of the “shadow banking” system slightly exceeded the traditional banking system. The financial system is infinitely populated by ambiguities as far as regulation can only be applied to registered institutions classified according to their qualification as a bank or financial institution and not according to their function/role or to the de facto activities. The current regulation covers only half of the financial activity developed in global markets. The author concludes that this global financial crisis marks the passing to post-modern finance, while revealing the excesses of finance and the failures of a lightly regulated and self-regulated system. This is why investor protection should be placed at the top of all rules and principles, be they national or European. And above all, global hedge funds regulation represents a stringent necessity.

Additional regulation is yet to come as regulators continue to focus on “shadow banking” system. Similarly, the abundance of information due to the new regulation will probably compel the regulators to new reinforcements. It is sure that neither the Dodd-
Frank Act, nor the AIFM Directive is the “final piece” of hedge funds regulation. On the contrary, these represent only a new wave of enforcements in the US and European financial market. Their key characteristic is represented by transparency. Investor protection is their major aim. Together, they resume the major objectives of hedge funds regulators: transparency and investor protection. These are complementary, as transparency means better information, risk mitigation, but also better understanding and control. As already stated, the author presumes that the information received from fund managers will be used to articulate improved regulation, with major focus on leverage, disclosure and investors. Therefore, new waves of regulatory proposals in the funds industry are expected to come in the following period. In this context, the author considers that disclosure and operating provisions should be at the centre of the investor protection architecture, as they will provide a worldwide applied gold standard.

One issue emphasized by the author is the impressive and continuous increase of hedge funds set up costs for fund managers. This represents a significant impact of the new regulation. The researcher is similarly concerned about the anti-competitive trend resulted from these high costs, as they will imply an undermining of the funds competitiveness. In this respect, both the European and American regulators must review their regulations in order to increase hedge funds competitiveness, especially under this financial crisis circumstances.

Regarding to the contradictions and difficulties of practical applicability (antitheses), the researcher considers that in terms of hedge funds regulation it is necessary to coordinate the term and regulation of the European countries and those of the US, while simplifying and concentrating the financial regulatory system. These suggestions request structural reform, and in the author’s point of view these reforms can be made within the discussion of the future international hedge funds regulatory framework. In addition, considering the common core elements, the differences outlined by the analysis of the American, British and European regulatory systems could be harmonised in a new architecture of the financial regulation. This would ensure structural stability, dynamics and adaptability to this field’s inherent disruptions. Therefore, the author of this thesis opts for a global hedge funds regulation because she considers that the rationale for international financial regulation establishes prudential rules for hedge funds operating in various states on the global financial services market. A
comprehensive global financial regulation is able to meet the challenges in coordinating highly divergent national regulations that frequently overlap other higher level regulations.

Altogether, it is the PhD student’s intent and hope that this research stimulates the careful debate of this issue by global scholars and regulators.
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D. LEGISLATION

a) EC LEGISLATION


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**b) NATIONAL LEGISLATION**

**France**


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**Italy**

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Ireland


**Luxembourg**


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F. CASES


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