Regulating hedge funds in the EU ? The case against the AIFM directive

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ABSTRACT : *The present article aims to offer a critique of the recent efforts to regulate hedge funds in the EU and illustrate the shortcomings of the EU's regulatory spree in the field of hedge fund regulation. The analysis suggests that the adoption of the AIFM Directive was not preceded by any thoughtful analysis of the risks emanating from the hedge fund industry but was rather the culmination of the EU's leading Member States, namely France's and Germany's, desire to impose a stricter regulatory regime on hedge funds. The rationales underpinning the adoption of the Directive are the protection of investors and the safeguarding of financial stability. On the one hand, the mandatory investor protection provisions of the Directive impose unnecessary costs to hedge funds managers and sophisticated investors who are unable to enter into mutually beneficial bargains. On the other hand, the provisions of the Directive seeking to tackle systemic risk utterly fail their goal to safeguard financial stability.*

I. Introduction

Hedge funds gained prominence in the late 1980s in part due to the phenomenal success of prominent global macro managers such as George Soros, Julian Robertson and Paul Tudor Jones, which were able to generate impressive returns by speculating on global macroeconomic trends.[1] Soros' large bet against the British pound, which forced the UK to exit the Exchange Rate Mechanism and devalue its currency, established hedge funds as a powerful force in the global financial system able to move markets.[2] The Asian financial crisis of 1997 was the next worrying incident with hedge funds criticized for speculating against the currencies of Asian countries and provoking a severe financial crisis gripping much of Asia.[3] The near-collapse of Long-Term Capital Management (hereinafter "LCTM") and its rescue under the auspices of the Federal Reserve vividly illustrated the potential contribution of the hedge fund industry to systemic risk. Even though these episodes were followed by calls for tighter regulation of the hedge fund industry, market mechanisms such as indirect regulation *via* prime brokers were considered by regulators to be the optimal solution to the risks emanating from hedge fund activities in financial markets.[4]

However, the recent financial crisis and the still unfolding sovereign debt crisis put the failures of the previous European but also global financial regulatory architecture in the spotlight. Hedge funds were one of the first targets of regulators in the US and the EU in their efforts to repair the broken financial system. In light of the perceived role of hedge funds in aggravating the financial and sovereign debt crisis, [5] regulators hastily moved forward with their ambitious plans to directly regulate the hedge fund industry. The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter "Dodd-Frank Act")[6] in the US and the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (hereinafter "AIFM Directive")[7] in the EU bring hedge funds under the regulatory radar and impose on them a variety of onerous regulatory requirements, which are expected to radically transform the industry.

The AIFM Directive was adopted on November 2011 after a long and heated fight between the UK and the hedge fund industry, on the one side and Germany and France on the other. The Directive's main goals are the creation of a harmonized Pan-European regulatory regime for hedge funds and an internal market for the managing and marketing of funds. The basic rationales underpinning the adoption of the Directive are the protection of investors in hedge funds and the safeguarding of financial stability. Nonetheless, it has attracted harsh criticism for raising the costs of hedge funds operating in Europe and impeding the development of a robust European hedge fund industry. In light of the growing debate revolving around the costs and benefits of the AIFM Directive, the present article aims to offer a critique of the recent efforts to regulate hedge funds in the EU and illustrate the shortcomings of the EU's regulatory spree in the field of hedge fund regulation.

The article will proceed as follows. Part II offers an introduction to the hedge fund phenomenon and the main rationales for hedge fund regulation upon which proponents of stricter

1 George Soros famously summarized the philosophy underlying his macro-investment style by saying "I don't play the game by a particular set of rules, I look for changes in the rules of the game." See G. Soros, *Soros on Soros Staying Ahead of the Curve* (John Wiley and Sons 1995), at p. 19.

2 D. Litterick, "Billionaire Who Broke the Bank of England", *The Telegraph,* 13 September 2002, available at : <http://www.telegraph.co.uk/finance/2773265/Billionaire-who-broke-the-Bank-of-England.html> (accessed 16 April 2013).

3 However, empirical studies have found that the criticism against hedge funds was unfounded. See S. Brown, W. Goetzmann & J. Park., "Hedge Funds and the Asian Currency Crisis of 1997" (1998) National Bureau of Economic Research, Working Paper No. 6427.

4 See for instance the conclusions of the Report of the President's Working Group on Financial Markets examining the causes of the failure of Long-Term Capital Management, the risks posed by hedge funds and potential regulatory responses. The President's Working Group on Financial Markets, *Report of the President's Working Group on Financial Markets : Hedge Funds, Leverage and the Lessons of Long-Term Capital Management* (April 1999).

5 See T. Corrigan, "Attacking Speculators is a Good Bet for Troubled Politicians" *Daily Telegraph* 12 March 2010, available at : <http://www.telegraph.co.uk/finance/financialcrisis/7423145/Attacking-speculators-is-a-good-bet-for-troubled-politicians.html> (accessed 16 March 2013).

6 Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub Law No. 111-203 (2010).

7 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010 [2011] O.J. L 174/1.

regulation make their case for regulatory intervention. Part III analyzes the main provisions of the AIFM Directive applicable to hedge funds. Part IV offers an overall assessment of the Directive adopting a rather critical approach towards the EU's regulatory spree while Part V concludes.

II. Hedge funds and the case for regulatory intervention

Despite the constant growth of the hedge fund industry and the attention that it has attracted from regulators, politicians and investors, hedge funds lack a formal and universally accepted definition.[8] Nonetheless, they share common structural and organizational characteristics allowing their distinction from other popular investment vehicles such as private equity and mutual funds. First and foremost, hedge funds offer investors absolute returns unlike mutual funds whose performance is evaluated against some market benchmark.[9] The unique compensation structure of hedge fund managers consisting typically of a management fee ranging from 1 % to 2 % of assets under management and an incentive fee usually fixed at 20 % of the fund's profits further enhances the incentives of managers to pursue absolute returns.[10] Managerial co-investments in the funds are an additional powerful device for aligning the interests between managers and investors.[11] What is more, due to the absence of regulatory constraints, hedge funds are able to engage in highly sophisticated investment techniques such as the employment of leverage and short selling.[12] Furthermore, hedge funds are predominantly open only to sophisticated investors subject to high minimum investment requirements.[13] Finally, in contrast to private equity funds, which make long-term investments in illiquid securities, [14] hedge funds mostly employ short-term investment strategies concentrating their investment activities in the public markets.[15]

Hedge funds adopt a variety of heterogeneous investment strategies further complicating the efforts to reach to an accurate definition. One can group hedge fund strategies into four broad categories : long/short, arbitrage and relative value strategies, event-driven strategies and directional strategies.[16] Long/short strategies involve a long position in an undervalued security and a short position in an overvalued one. They also form the basis for arbitrage and relative value strategies, which seek to exploit mispricings in closely related securities.[17] Event-driven strategies focus on extraordinary events in a corporation's lifetime such as bankruptcies, spinoffs and mergers and acquisitions. Hedge funds seek to exploit price fluctuations stemming from these events.[18] Finally, directional strategies capitalize on anticipated market movements. Managers of hedge funds profit by analyzing macroeconomic and geopolitical developments and taking bets across a variety of markets including foreign exchange, commodities and bond markets.

The operation of hedge funds in financial markets brings considerable benefits to their depth, liquidity and efficiency. Hedge funds' constant trading in financial markets provides liquidity to the financial system especially during adverse market circumstances.[19] Furthermore, by engaging in arbitrage, namely buying unvalued securities and shorting overvalued ones, hedge funds improve the efficiency of markets. In addition, by virtue of their complex investment strategies seeking to reduce exposure to market risk, they offer diversification to investors.[20] What is more, shareholder activism as practiced by hedge funds, leads to substantial benefits for investors and target companies.[21]

8 Various working definitions have been proposed. For instance the President's Working Group on Financial Markets described hedge funds as "*any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public"*. See The President's Working Group on Financial Markets, *supra* no. 4, at p. 1. Nonetheless, this definition is too broad capturing not only hedge funds but also other alternative investment vehicles such as private equity and venture capital funds. Hedge funds in the US and the UK are usually organized as limited partnerships with investors in the fund becoming limited partners. The hedge fund manager acting as a general partner will be responsible for managing the fund and making investment decisions. Limited partners are prohibited from interfering with the management of the fund and are subject to limits on their ability to withdraw their capital. See F. Lhabitant, *Handbook of Hedge Funds* (John Wiley and Sons 2006), at pp. 29, 85-90.

9 Financial Services Authority, *Hedge Funds : A Discussion of Risk and Regulatory Engagement* (DP 05/04), at p. 10.

10 S. Lederman, *Hedge Fund Regulation* (2nd ed., Practicing Law Institute 2012), at para. 2:2.3.

11 Agarwal, Daniel & Naik estimate that the mean (median) managerial ownership is 7.1 % (2.4 %) of hedge fund assets under management. V. Agarwal, N. Daniel and N. Naik, "Role of Managerial Incentives and Hedge Fund Performance", 64 *Journal of Finance* (2009) p. 2221, at p. 2231.

12 In contrast, regulations both in the US and the EU severely restrict the ability of mutual funds to engage in short-selling, derivatives trading and leveraged investing. See H.B. Shadab, "Fending for Themselves : Creating a U.S. Hedge Fund Market for Retail Investors", 11 *New York University Journal of Legislation and Public Policy* (2008) p. 251, at p. 283 & P. Athanassiou, *Hedge Fund Regulation in the European Union : Current Trends and Future Prospects* (Kluwer Law International 2009), at pp. 107-114.

13 For an overview of US regulations restricting the offering of hedge fund unit to sophisticated investors see H.B Shadab, "The Law and Economics of Hedge Funds : Financial Innovation and Investor Protection", 6 *Berkeley Business Law Journal* (2009) p. 243, at pp. 257-259. Furthermore, pursuant to the AIFM Directive the marketing of hedge funds should be directed solely to sophisticated investors. Nonetheless, individual Member States may allow the offering of hedge funds to retail investors. Article 43 of the AIFM Directive.

14 J. A. McCahery & E. P.M. Vermeulen, *Corporate Governance of Non-Listed Companies* (OUP 2008), at p. 171.

15 However, recent years have seen hedge funds and in particular hedge fund activists making long-term investments in public companies seeking to strengthen their corporate governance. See H. B. Shadab, "Coming Together After the Crisis : Global Convergence of Private Equity and Hedge Funds", 29 *Northwestern Journal of International Law and Business* (2009), p. 603.

16 For an overview of the different hedge fund strategies, see F. LHabitant, *Hedge Funds : Myths and Limits* (John Wiley and Sons 2002), at pp. 77-121.

17 A popular category is fixed income arbitrage where the trader seeks to profit from mispricings between closely related fixed income securities such as government or corporate bonds. *Ibid*., at p. 92-93.

18 For instance, securities of firms in bankruptcy often trade below their fundamental value due to investor risk aversion and/or irrationality and legal rules which require institutional investors to hold highly rated securities. Hedge funds engaging in distressed investing seek to profit from the market's undervaluation of the securities. *Ibid*., at pp. 99-114.

19 Aragon and Strahan find that stocks held by Lehman connected funds which suffered substantial losses as a result of Lehman's bankruptcy, suffered larger drops in liquidity than stocks not held by these funds during the last quarter of 2008. See G. O. Aragon & P. Strahan, "Hedge Funds as Liquidity Providers : Evidence from the Lehman Bankruptcy" (September 2009) National Bureau of Economic Research Working, Paper No. 15336.

20 Shadab, *supra* no. 13, at p. 263.

21 See L. Bebchuk, A. Brav and W. Jiang, "The Long-Term Effects of Hedge Fund Activism" (2013) Columbia Business School Research Paper No. 13-66.

Despite the benefits that hedge funds offer to financial markets, proponents of hedge fund regulation frequently invoke the dangers that hedge funds pose to market integrity, financial stability and investor protection in order to justify a stricter regulatory regime.[22] Market integrity concerns revolve around the propensity of hedge funds to engage in market abuse and insider trading.[23] Nonetheless, market abuse and insider trading are not specific to the hedge fund industry but are common phenomena in the marketplace for which an adequate legal regime is in place in virtually all developed economies.[24] The protection of investors is another commonly invoked rationale for regulating hedge funds.[25] The major fallacy of the investor protection rationale is that investors in hedge funds are sophisticated having both the expertise and the bargaining power to adequately protect their interests.[26] In a time when regulators around the world are faced with shrinking budgets, allocating resources to investors who are able to fend for themselves hampers the ability of regulators to achieve their fundamental objective, namely the protection of retail investors.[27]

In contrast to investor protection and market integrity concerns, the contribution of the hedge fund industry to systemic risk forms a sound rationale for regulating hedge funds. Hedge funds contribute to systemic risk *via* two channels. Systemic risk manifests itself the credit channel when the failure of an individual (or multiple) fund(s) imposes significant losses on creditors and counterparties such as prime brokers.[28] The market channel refers to the situation when adverse market movements cause an abrupt withdrawal of credit and investor capital forcing hedge funds to liquidate their positions in order to meet creditors' and investors' demands.[29] Widespread liquidations exert downward pressure on asset prices amplifying investor redemptions and the tightening of credit leading to further liquidations. This vicious cycle of forced sales at dislocated prices may cause a complete breakdown of financial markets.[30] These risks almost materialized in the case of LTCM, which was rescued by a consortium of its creditors under the auspices of the Federal Reserve.[31] The rescue was prompted by fears that LTCM's failure would cause significant losses to its counterparties and the rapid unwinding of LTCM's positions would lead to widespread dislocations in financial markets.[32]

III. The AIFM directive : europe's regulatory response

The final text of the AIFM Directive was adopted after heated and prolonged negotiations with a record of 1669 amendments proposed by Members of the European Parliament to the original draft directive.[33] The Directive creates a harmonized Pan-European regulatory framework for alternative investment fund managers (hereinafter "AIFMs") and an internal market for their activities.[34] It should be noted that the Directive does not directly target alternative investment funds (hereinafter "AIFs"). The requirements of the Directive are applicable to AIFMs established in the EU managing or marketing one or more AIFs irrespective of whether they are EU based or not and non-EU AIFMs managing EU AIFs or marketing AIFs in the EU, EU-based or not.[35]

The definition of an AIFM encompasses any legal person managing AIFs as a regular business.[36]Furthermore, an AIF is defined as any collective investment undertaking, which raises capital from multiple investors for the purpose of investing it pursuant to a defined investment policy and does not require authorization pursuant to article 5 of Directive 2009/65/EC.[37] As a result, the Directive is applicable to a wide variety of investment vehicles, including managers of private equity funds, hedge funds, real estate funds and commodity funds. An AIFM falling under the ambit of the Directive must be authorized by the competent authorities of its home Member State and comply with all the requirements of the Directive.[38] An exception is granted for AIFMs managing leveraged AIFs with less than 100 million assets or less than 500 million if the funds do not use leverage and do not allow investor redemptions for the first five years.[39] The rationales behind the complex and burdensome requirements set by the AIFM Directive are the protection of investors and the tackling of systemic risk.

Provisions aimed at the protection of investors include extensive conduct of business, valuation, depositary and disclosure requirements. Managers of hedge funds must implement organizational and administrative arrangements for identifying and managing any conflicts of interests that could adversely impact the interests of the AIFs that they manage or the

22 Lederman, *supra* no. 10, Ch. 3.

23 See C. Noyer, "Hedge Funds : What are the Main Issues", 10 *Banque de France, Financial Stability Review* (2007) p. 105, at pp. 107-108.

24 *Ibid*.

25 F. Edwards, "The Regulation of Hedge Funds : Financial Stability and Investor Protection" in Theodor Baums and Andreas Cahn (eds), *Hedge Funds, Risks and Regulation* (De Gruyter Recht 2004) p. 30-51, at p. 30.

26 T. Paredes, "On the Decision to Regulate Hedge Funds : The SEC's Regulatory Philosophy, Style and Mission", 5 *University of Illinois Law Review* (2006) p. 975, at pp. 990-997. Institutional investors such as pension funds, endowments, funds of hedge funds represent the largest source of capital for hedge funds. Preqin Global Investors, *Preqin Global Investors Report : Hedge Funds* (2012), at pp. 12-15.

27 See for instance D. C. Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets", 95 *Virginia Law Review* (2009) p. 1025, at pp. 1025-1026 noting that the SEC's core mission has historically been the protection of retail investors as opposed to institutional investors.

28 L. Dixon, N. Clancy & K. Kumar, *Hedge Funds and Systemic Risk* (Rand Corporation, 2012), at p. 4.

29 A. Shleifer & R. Vishny, "Fire Sales in Finance and Macroeconomics", 25 *Journal of Economic Perspectives* (2011) p. 29, at pp. 35-38.

30 *Ibid*., at pp. 38-43.

31 See R. Lowenstein, *When Genius Failed : The Rise and Fall of Long-Term Capital Management* (Random House Trade Paperbacks 2001) for an account of LCTM's rise and eventual demise.

32 See F. Edwards, "Hedge Funds and the Collapse of Long-Term Capital Management", 13 *Journal of Economic Perspectives* (1999) p. 189, at pp. 201-204.

33 J. Baird & G. Black, "Amendments Clog EU AIFM Directive Debate : The political backdrop is also evolving rapidly", *The Hedge Fund Journal* (March 2010).

34 Arts. 1 & 2 of the AIFM Directive.

35 Art. 2 of the AIFM Directive.

36 Art. 4(1)(b) of the AIFM Directive.

37 Directive 2009/65/EC commonly referred to as UCITS Directive (Undertaking for Collective Investment in Transferable Securities) governs undertakings for collective investments which collect investor capital from the public, operate according to the principle of risk spreading, invest in only securities and financial investments referred to in article 50(1) of the UCITS Directive and allow investor to redeem their units upon request and without any restrictions.

38 Art. 6(1) of the AIFM Directive.

39 The second exception applies essentially to private equity funds. Art. 3 of the AIFM Directive.

funds' investors.[40]The AIFM must act with due care, skill and diligence and in the interests of the investors in the AIFs and the integrity of the market.[41] Furthermore, the Directive's provisions require AIFMs to adhere to heightened depositary and valuation standards. Pursuant to article 21 a single depositary responsible for safekeeping the fund's assets and monitoring cash flows must be appointed for each fund under management.[42] In addition, the Directive introduces a near strict liability regime for depositaries which shall be liable for the loss of any financial instrument in their custody or held by any third party to whom a custody has been delegated except if the loss can be attributed to an external event beyond the depositary's reasonable control and only if all reasonable precautions to avoid the loss were taken.[43] With respect to the valuation of assets, fund managers must ensure that an independent valuation of fund assets takes place at least once per year.[44]

Disclosure requirements towards investors are a cornerstone of the European Union's policy of enhancing the transparency of the industry. Transparency requirements include the obligation of fund managers to disclose specific information to investors both prior to their investment and periodically thereafter.[45] Furthermore, pursuant to article 22 an audited annual report with respect to each fund managed and/or marketed in the EU must be available to investors on request.[46] Finally, the Directive imposes modest initial and ongoing capital requirements for AIFMs subject to an overall cap of EUR 10 million while in order to cover potential professional liability risks managers of funds must either have additional own funds appropriate to cover the potential risks or hold a professional indemnity insurance.[47]

The AIFM Directive was adopted based on the belief that hedge fund activities had a destabilizing effect on markets during the twin financial and sovereign debt crises. As a result, the Directive contains a wide array of provisions aimed at safeguarding financial stability. Hedge fund managers must devise and implement appropriate risk and liquidity management systems.[48] In addition, AIFMs must establish and apply remuneration policies that promote sound risk management and do not encourage excessive risk-taking.[49] Remuneration restrictions are also introduced for "identified staff" whose professional activities have a material impact on the fund's risk profile.[50] Furthermore, mandatory reporting requirements will allow national supervisors to assess the systemic risk posed by the activities of hedge funds. AIFMs must report regularly to regulatory authorities information on the main markets that their funds trade, their principal exposures, their risk and liquidity profiles and the details about the level of leverage if employed on a substantial basis.[51] The Directive obliges AIFMs to introduce leverage limits with respect to each AIF they manage while national supervisory authorities may impose limits in order to ensure financial stability.[52]

A positive aspect of the Directive is the introduction of a Pan-European passporting regime for AIFMs' management and marketing activities. AIFMs based in the EU are allowed to manage EU funds across the EU and market them to EU professional investors.[53] EU-based AIFMs authorized pursuant to the provisions of the Directive may also manage non-EU AIFs.[54]Until the European Commission allows the extension of the passporting provisions which is expected to take effect in 2015, the passporting regime will not be available to EU-based AIFMs marketing non-EU AIFs and non-EU AIFMs marketing EU or non-EU based AIFs in the EU. [55] As a result, their marketing activities to EU professional investors will have to be conducted according to national private placement regimes.

40 Art. 14 of the AIFM Directive.

41 Art. 9(1)(a)-(c) of the AIFM Directive.

42 Art. 21 of the AIFM Directive.

43 Art. 21(12) of the AIFM Directive.

44 Art. 19 of the AIFM Directive.

45 Art. 23 of the AIFM Directive.

46 Art. 22 of the AIFM Directive. The same report must also be made available to supervisory authorities.

47 Art. 9 of the AIFM Directive.

48 Arts. 15 & 22 of the AIFM Directive. One should note that the particular requirements can be viewed both from an investor protection and a financial stability perspective. However, the predominant rationale behind the adoption of these particular requirements was the protection of financial stability. Heightened liquidity management requirements respond to the risks of a run by investors and creditors. Indeed, during the financial crisis hedge fund investors massively withdrew their capital forcing hedge funds to sell their assets in a falling market. See U. Klebeck, 'Liquidity Management and Side Pockets in the Alternative Investment Fund Managers Directive'in Dirk Zetzsche (ed), *The Alternative Investment Funds Managers Directive, European Regulation of Alternative Investment Funds* (Kluwer Law International 2012) pp. 253-264, at pp. 253-254. On the other hand, the weaknesses of internal control, governance mechanisms and risk management that were revealed during the crisis of 2007-2008, have made robust risk management in financial institutions an indispensable tool for strengthening financial stability. See D. Zetzsche & D. Eckner, 'Risk Management in the Alternative Investment Fund Managers Directive'in D. Zetzsche (ed), *The Alternative Investment Funds Managers Directive, European Regulation of Alternative Investment Funds* (Kluwer Law International 2012), pp. 265-332, at p. 265.

49 Art. 13 & Annex II (1) of the AIFM Directive. Remuneration requirements can also be viewed both from a financial stability and an investor protection perspective. Nonetheless, the provisions of the AIFM Directive have been substantially influenced by the EU's initiatives in the field of remuneration policies for credit institutions in light of the role of executive compensation in causing the financial crisis. Therefore, sound remuneration practices are considered beneficial for enhancing financial stability. See Paulo Camara, 'The AIFM's Governance and Remuneration Committees' in Dirk Zetzsche (ed), *The Alternative Investment Funds Managers Directive, European Regulation of Alternative Investment Funds* (Kluwer Law International 2012) pp. 237-252, at pp. 237, 241.

50 Ibid. Remuneration restrictions to "identified staff" include requirements for deferment of a minimum 40 %-60 % of variable remuneration and payment of at least 50 % of variable remuneration in equity or equity-linked instruments. See Annex II (1)(m) & (n) of the AIFM Directive. Furthermore, the Directive mandates the introduction of remuneration committees filled with non-executives subject to the principle of proportionality. See Annex II (3) of the AIFM Directive.

51 Art. 24(1) of the AIFM Directive.

52 Art. 21 of the AIFM Directive.

53 Art. 32 of the AIFM Directive.

54 Art. 34 of the AIFM Directive.

55 Arts. 35-42 & 67(6) of the AIFM Directive. The extension of the passporting regime to non-EU alternative investment funds and managers and the concomitant opening of the European market to foreign funds and managers was one of the most hotly contested issues during the negotiations leading to the adoption of the Directive. See Stephen Fidler, "Hedge Fund Talks : The End Game" *The Wall Street Journal*, 28 September 2010, available at : <http://blogs.wsj.com/brussels/2010/09/28/hedge-fund-directive-the-end-game> (accessed 16 November 2013).

IV. An assessment of the AIFM directive

In general, the AIFM Directive has been forcefully criticized as a "*political piece of law making*".[56] Rather than responding to the specific risks posed by the activities of each different type of alternative investment vehicle falling under its ambit, the Directive adopts a one size fits all approach imposing uniform requirements on a diverse population of AIFMs. [57] Indeed, the adoption of the Directive is the culmination of some Member States', especially France's and Germany's, [58] longstanding desire to bring the hedge fund industry under the regulatory radar with the other types of AIFMs being swept along.[59]

Furthermore, a major concern that the provisions of the AIFM Directive seek to alleviate is the perceived lack of adequate protections for investors in hedge funds against hedge fund managers' opportunism. Various commentators have argued that the opaque nature of the industry, the superior bargaining power of hedge fund managers and high informational asymmetries allow managers to reap significant monetary benefits at the expense of their investors.[60] Nonetheless, the reputational market for investment management services is sufficiently robust ensuring the attention of hedge fund managers to investor concerns.[61] For instance, investors conduct extensive due diligence prior to their investments and during a fund's life demanding information on the fund's risk, positions, strategy and compensation arrangements.[62] What is more, distinct features of fund managers' compensation arrangements ensuring an alignment of interests with investors such as managers' co-investments in the funds have been instituted after investor demand.[63] There is also substantial evidence that investors are able to bargain substantial improvements in other areas as well such valuation of the fund's assets, an independent compliance function and management of internal controls and conflicts.[64] What is more, even if one accepts investor protection as a sound rationale for regulating hedge funds, the Directive contradicts its own stated goal by exempting small hedge funds below EUR 100 million from its requirements. The potential for fraud is much more severe in small hedge funds with no prior track record and unsophisticated internal controls.

In contrast to investor protection, the safeguarding of financial stability against systemic risk emanating from hedge fund activities in financial markets forms a sound basis for regulating hedge funds. The provisions of the Directive seek to curb excessive risk-taking, ensure robust liquidity management in order to prevent runs by fund investors and eliminate the perverse incentives created by excessive and misaligned compensation practices. However, hedge fund managers are already implementing adequate safeguards against the abovementioned risks making the provisions of the Directive rather trivial.

Indeed, hedge fund managers responding to investor demand implement robust risk management systems and controls, which contribute to prudent risk-taking.[65] What is more, the hedge fund industry has been extremely creative in devising mechanisms precluding catastrophic runs from investors. Managers of hedge funds utilize a variety of liquidity management tools including lock-ups, gates and side pockets.[66] Lock-ups prevent investors from withdrawing their capital for a minimum period after their investment usually set at one year or longer while gates limit withdrawals to a specified percentage of the fund's overall capital.[67] Furthermore, in order to protect the value of illiquid investments from investor withdrawals, hedge fund managers increasingly use "side pockets". "Side pockets" are sub-accounts where illiquid investments are placed. [68]Investors are not able to redeem their capital until the liquidation of the investments subject to the "side pocket".[69]

The recent financial crisis revealed severe weaknesses in the design of compensation arrangements of executives in financial institutions. The structure of executive compensation created incentives for excessive risk-taking.[70] Boosting short-term profits at the expense of long-term value became the preferred strategy for executives of financial institutions who were able to walk away with generous compensation packages and shift the losses from their institutions' demise to creditors, shareholders and taxpayers.[71] Nonetheless, there is

56 W. R. Henle & A. Murry-Jones, *Altemative Investment Fund Managers Directive* (Skadden, Arps, Meagher, Slate & Flom LLP Memo, 29 November 2010).

57 N. Robson, J. Terblanche & M. Roussel, "Preparing for Compliance with the AIFM Directive", *Financier Worldwide* (November 2012).

58 A. Monaghan, "U.K. Coalition Faces First Test as Germany, France Push for Tough EU Hedge Fund Rules" *Telegraph*, 14 May 2010, available at : <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7721923/UK-coalition-faces-first-test-as-Germany-France-push-for-tough-EU-hedge-fund-rules.html> (accessed 16 November 2013) & D. Awrey, "The Limits of Hedge Fund Regulation", 5 *Law and Financial Markets Review* (2011) p. 119, at p. 124.

59 J. Payne, "Private Equity and Its Regulation in Europe", 12 *European Business Organization Law Review* (2011) p. 559, at pp. 582.

60 S. Lack, *The Hedge Fund Mirage : The Illusion of Big Money and Why it's Too Good to be True* (John Wiley and Sons 2012) & S. Kolhatkar, "Hedge Funds Are For Suckers" *Businessweek*, 11 July 2013, available at : <http://www.businessweek.com/articles/2013-07-11/why-hedge-funds-glory-days-may-be-gone-for-good> (accessed 16 November 2013).

61 Indeed, the investment decisions of hedge fund investors are substantially influenced by the fund's quality of governance. See Alternative Investment Fund Managers Association, *A Guide to Institutional Investors Views and Preferences Regarding Hedge Fund Operational Infrastructures* (2011), at p. 7.

62 This is especially true after the negative experiences of investors during the financial crisis of 2008. See State Street, *Hedge Funds : Rebuilding on a New Foundation* (August 2011), at pp. 4-5 ; D. Harrison, A Battle Cry for Hedge Funds : Separate But Not Equal, *FINAlternatives*, 3 April, 2012 & PriceWaterHouseCoopers, *Transparency versus Returns : The Institutional Investor View of Alternative Assets* (March 2008), at p. 20.

63 Lederman, *supra* no.10, at para. 2:2.3.

64 Carne Global Financial Services, *Corporate Governance in Hedge Funds : Investor Survey* (2011), at pp. 30-40.

65 Awrey, *supra* no. 58, at pp. 16-17 & H.B. Shadab, "Hedge Fund Governance", *Stanford Journal of Law, Business and Finance* (forthcoming 2013) p. 1, at p. 32.

66 Lederman, *supra* no. 10, at para. 2.3.3.D(3).

67 *Ibid*., at para. 2.3.3. D(3)(a) & D(3)(b).

68 *Ibid*., at para. 2.3.3.E(1).

69 *Ibid*., at para. 2.3.3.E(1).

70 See generally L. Bebchuk & H. Spamann, "Regulating Bankers' Pay", 98 *Georgetown Law Journal* (2010) p. 247 & Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report : Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011).

71 See Bebchuk, Cohen and Spamann who report that during the 2000-2008 period top executives at Bear Stearns were able to cash out large amounts of performance-based compensation. The authors estimate that top executives at Bear Stearns were able to walk away with compensation reaching $1.4 billion while executives at Lehman Brothers derived cash flows

no evidence that compensation in the alternative investment fund management industry led to excessive risk-taking and jeopardized financial stability. Executive compensation problems were prevalent in mainstream financial institutions such as depositary banks, insurance companies and investment banks. In contrast, the unique structure of hedge fund managers' compensation consisting of a performance-based fee of 20 % of the fund's profits and a substantial co-investment by the manager ensures prudent risk-taking and an alignment of interests between investors and managers.[72] What is more, the complex provisions introduced by the Directive are more suitable for large publicly traded institutions and not hedge funds the majority of which are owner-managed small or midsized companies which do not have sophisticated governance structures.[73]

Under the provisions of the AIFM Directive, AIFMs must disclose a variety of information to national regulators who are entrusted with the task of monitoring systemic risk. Additionally, national regulatory authorities are granted the power to impose leverage limits in order to safeguard financial stability. While one should applaud the genuine desire of European regulators to tackle systemic risk emanating from hedge fund activities, the relevant provisions of the AIFM Directive fail to achieve this goal. The national regulatory authorities that are responsible for monitoring systemic risk and imposing leverage limits do not have the relevant expertise in assessing systemic risk and have an overall orientation towards investor protection and conduct of business regulation.[74] Taking into account that financial crises are rare events and a regulator's success in safeguarding financial stability cannot be easily observed, regulators charged both with a financial stability and investor protection mandate will devote their attention to investor protection. Regulators around the world have recognized the perils of combining financial stability supervision and investor protection in a single agency and have moved towards the so-called "twin peaks" approach.[75] Interestingly though, hedge fund regulation has been assigned to national agencies predominantly charged with investor protection and business conduct supervision.

Furthermore, the AIFM Directive leaves the fragmentation of hedge fund regulation across national lines intact. Home regulators have the exclusive authority to regulate hedge funds and monitor systemic risk. However, the global nature of hedge fund activities creates systemic risk in markets other than their home one. The objective of home regulators is to ensure financial stability in their own market.[76]As a result, they will not internalize the costs of increased systemic risk in foreign markets. Additionally, home regulators seeking to promote their financial industry have an incentive to adopt a lenient stance towards domestic hedge funds posing risks solely to the financial stability of foreign markets. In cases where hedge funds create systemic risk to markets other than their own, host regulators have no power to intervene leaving them exposed to the actions of home regulators.[77]

V. Conclusion

The present article has attempted to assess the recently adopted AIFM Directive, which creates a Pan-European regulatory framework for hedge fund managers. The analysis suggests that the adoption of the Directive was not preceded by any thoughtful analysis of the risks emanating from the hedge fund industry but was rather the culmination of the EU's leading Member States, namely France's and Germany's, desire to impose a stricter regulatory regime on hedge funds. On the one hand, investor protection, a major rationale underpinning the adoption of the Directive forms an unsound basis for regulating hedge funds. On the other hand, the AIFM Directive fails in safeguarding financial stability, a goal that any modern regulatory framework for hedge funds should strive to achieve.

reaching $1 billion. L. Bebchuk, A. Cohen & H. Spamann, "The Wages of Failure : Executive Compensation at Bear Stearns and Lehman 2000-2008" 27 *Yale Journal on Regulation* (2010) p. 257.

72 See Shadab, *supra* no. 65, at pp. 36-39 ; Hedge Fund Standards Board, *Response to the ESMA Consultation Paper on Guidelines on Sound Remuneration Policies under AIFMD* (27 September 2012), at pp. 1-2 & Awrey, *supra* no. 58, at p. 17.

73 Alternative Investment Management Association, *Response to ESMA's Consultation Paper-Guidelines on Sound Remuneration Policies under the Alternative Investment Fund Managers Directive* (September 2012), at p. 1.

74 Squam Lake Working Group on Financial Regulation, *A Systemic Regulator for Financial Markets* (May 2009), at p. 3. For instance, the regulators responsible for the authorization of AIFMs and the monitoring of compliance with the AIFM Directive are the Financial Conduct Authority in the UK, the Autorité des marchés financiers in France and the Federal Financial Supervisory Authority (BaFin) in Germany. See Financial Conduct Authority, *Implementation of the Alternative Investment Fund Managers Directive* (Policy Statement 13/5, June 2013), Kramer Levin, Naftalis & Frankel LLP, *Asset Management Update Regarding Recent Regulations Affecting Asset Managers in France* (July 2013) & Gibson Dunn and Crutcher, *Germany Adopts Capital Investment Act (KAGB) to Implement the European AIFM Directive* (22 July 2013).

75 See generally H. M. Vletter-van Dort, "Some Challenges Facing European Central Banks as Supervising Authority", 9 *European Company and Financial Law Review* (2012) p. 131.

76 See K. Pistor, "Host's Dilemma : Rethinking EU Banking Regulation in Light of the Global Crisis" in Grundmann Stefan *et al.* (eds), Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010, Unternehmen, Markt und Verantwortung (De Gruyter 2010) pp. 2339-2366, at pp. 2345-2346.

77 In response to the perverse incentives created by national supervision in the field of banking regulation, the European Union has moved forward with transferring supervisory authority for Eurozone countries' banking institutions to the European Central Bank, which will become a supranational supervisor. EU countries whose currency is not the euro can also decide to transfer supervisory authority to the European Central Bank. See Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions L. 2287/63 & G. Ferrarini & L. Chiarella, "Common Banking Supervision in the Eurozone : Strengths and Weaknesses" (2013), European Corporate Governance Institute Working Paper No. 223/2010.