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The regulation of private equity, hedge funds and state funds

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Abstract

This text contains the general report for the XVIIIth Congres on Comparative Law to be held in Washington DC. It gives a comparative overview of the three types of funds to be discussed, and some of the problems that have been raised about them. On hedge funds, the analysis indicates that most regulators have avoided them to be offered to the retail investors, but the way this is achieved is quite different. Therefore, regulation often is limited to this negative ambit. Some regulatory provisions apply in connection with the prime brokers or the depositaries. Much of this will chance after the entry into force of the future EU directive on Alternative Investment fund management, providing for a substantive regulation of hedge fund activity along with a European pasport. On private equity funds, the focus has been put on their relations with investee companies. On sovereign wealth funds, the international conduct rules have been mentioned along with different ways states follow for prohibiting foreign invetsment in their economy. This general report is based on the input from national reporters, and own research.

The report has been updated to take account of recent measures adopted in the EU (Alternative Invetsment Fund Management Directive, or AIFMD) and the Dodd -Frank Act.

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III A. The regulation of private equity, hedge funds and state funds

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A. Introduction

During the recent financial crisis, some types of collective investments have been the subject of criticism due to the destabilising role – real or presumed – that they may player have played in the economic and financial systems. The money market funds appeared not to offer the safe investment they purported to be, shaking investors' confidence and leading to massive divestment, and withdrawals that urged the need for public intervention. The hedge funds created a similar scare, as their leverage might have created risks for the financial institutions that financed them, triggering massive disposals of their portfolios in case of urgent liquidity needs, even engulfing their financiers and prime brokers. The case of the private equity funds is different as their impact on financial stability was mainly linked to the leverage of their investment. Often heard, rather populist, criticism related to their conduct on the markets – from their massive trading, their short selling, high frequency trading, to excessive build up of leverage or predatory activism as shareholders. The political world and the media called for more transparency, more regulation, more control on their activities[2]. These developments lay at the basis of the present waive of regulation of their activity. Strikingly, concerns address mainly the issues of financial stability and systemic risk, less concerns of investor protection or market conduct. Another wave of uneasiness addressed the "sovereign wealth funds" that were feared to menace the economic sovereignty in some states.

A common denominator between these different groups of collective investment schemes is their potential impact on the larger equilibria in the developed economies, leading to concerns about financial stability, systemic risk, predatory market conduct and creation of economic disequilibria. However, the issues confronting each of these three groups are quite different and therefore they will be dealt with in three different chapters.

Part 1. The "hedge funds"

1. Definition and scope

Up to now, there is no generally accepted definition of a " hedge fund". The wide variety of legal structures in which they operate, the diversity of investment strategies and the diversity and versatility of asset types they have invested in, makes any precise definition very difficult and imprecise. The term "hedge fund" refers generally to pools of assets, usually securities, that are managed by a professional manager, using innovative investment strategies, but normally not registered as a traditional investment undertaking. Most hedge funds have only a limited number of investors, usually wealthy individuals or institutional investors, who are supposed to be able to take themselves care of their interests. The relationship with investors is mostly a contractual one, adapting to the specific needs of the investors. The management contract typically provides for a management fee on the basis of the assets managed, and another fee on the value increase of the fund (usually, 2% and 20%). Managers frequently hold themselves a large stake in the fund, aligning their interests to the investors'. All these differences have resulted in international statements to refer to hedge funds by way of

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[2] See § 31 of the Progress Report on the Actions to promote Financial Regulatory reform issued by the US Chair of the Pittsburgh G-20 Summit, 25 September 2009, stating "Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on leverage, necessary for assessment of the systemic risks they pose individually or collectively. Where appropriate registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management."

enumerating their most frequently found characteristics[3]. IOSCO used this approach in defining hedge funds as all those investment schemes displaying a combination of some of the following characteristics:

- borrowing and leverage restrictions, which are typically included in collective investment schemes related regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;
- significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually;
- often significant 'own' funds are invested by the manager;
- derivatives are used, often for speculative purposes, and there is an ability to short sell securities; and more diverse risks or complex underlying products are involved.

The designation of hedge funds is also very diverse and often confusing. Hedging refers to covering one's risk, but that is not always the case for the funds that are viewed here. Most funds use leverage, whether in their assets (derivatives) or in their balance sheet (usually loans from prime brokers). But here again not all funds use leverage. Sometimes these funds are designated as "speculative" funds[4], what is a confusing designation, as all investments are based on some form or another of speculation. The investment strategies followed by these funds are different from the long only strategy of the traditional investment funds: there is an indefinite variation of investment strategies, among which the "long-short" or the "constant return" strategy are frequently found. But these are only examples: the managers determine freely the strategies they will pursue, and some funds may specialise in commodities speculations, others engage in activist actions, while leveraged trading, short selling or concentrated investing is left to the choice of managers and investors.

The designation of hedge funds in national regulations is equally confusing, and reference is made to the national reports to convince the reader of the diversity, whereby differences in substance further contribute to the confusion. Moreover, apart from hedge funds, some sources also view under similar terminology the private equity funds, and even the sovereign wealth funds. Even the topics as identified for the present comparative law conference testify about the lack of clarity: it originally was termed, "La réglementation des fonds spéculatifs/ The regulation of private equity, hedge funds and state funds" whereby apart from the difference between the two languages, a more precise title was proposed in the English version. It is the latter that will be followed in the present general report.

This lack of clarity as to the scope has lead to difficulties in national legislation defining the ambit of their laws. Different techniques have been used, going from submitting hedge funds in principle to investment fund regulation, but exempting them as being restricted to sophisticated investors, thereby avoiding the need for a precise definition. In several cases, the funds have been exempted but not the asset managers that run them: this is the approach followed in the US, the UK and in the EU directive: the directive would apply to fund managers to the extent that they manage Alternative Investment Undertakings being collective portfolios to which a number of investors have contributed with a view of developing a defined investment policy for their own benefit. As this definition is very far reaching some entities have to be excluded: traditional investment funds or UCITS, pension funds, international institutions and central banks, governments and local authorities including social security and pension funds supported by them or securitisation SPVs have all been exempted. Interesting is the exemption for international group entities such as cash pooling

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[3] See IOSCO, Hedge Fund Oversight, Final report, June 2009, § 5.
[4] This terminology is used in Italy.

schemes. But one cannot conclude that this definition gives a very clear image of the scope of the directive and also of the activities not covered.[5]

2. Overview of the present state of regulation of hedge funds in a selection of legal systems

In several jurisdictions, hedge funds are subject to the general regime applicable to investment funds, and hence have to be registered under that heading[6]. However if the fund is distributed to retail investors additional requirements would apply. This is the case in *Australia*, where in case of retail distribution the fund has to appoint non-executive directors, adopt a compliance plan, have valuation procedures, and publish a disclosure statement that is subject to ASIC[7] supervision. A comparable scheme is found in *Brazil* with respect to Brazil domiciled funds: they have to be registered, are subject to rules on conflicts of interest and risk controls, and adopt a charter to comply with legal provisions of the law. Foreign funds offered to Brazilian investors must be registered with the securities commission[8] and can only be sold through authorised brokers. Initiatives are being considered i.a. about valuation methods for the funds' assets. *Canada* distinguishes between offerings with a full prospectus in which case the fund can be offered to the public, while the fund will have to publish regular financial statements, and the offerings without a prospectus that can only be addressed to a defined class of more sophisticated investors[9]. All fund managers must be registered and are subject to the usual rules on minimum capital, proficiency and experience, but stiffer rules are reported to be considered. The distributors generally have to be registered; however as in some provinces, some dealers are still excepted, it is proposed to subject them to a uniform regime.

At the opposite end of the spectrum, there are those states that do not directly regulate hedge funds, although they may have approached the phenomenon from another angle.

In the *United States* the regulation applicable to hedge funds derives from several bodies of law: the Securities Act 1933 for the public issue of securities; the Investment Company Act 1940 for the definition of the fund, the Securities Exchange act for defining the distribution and finally the CFTC laws as to whether the fund qualifies as a "Commodity pool". In all these cases the law defines the limits within which the regulation would not be applicable, as most hedge funds function outside the boundaries of the regulatory oversight. In addition, in some states, so-called blue-sky laws may also be applicable.

According to regulation D under the Securities Act, offers to "accredited investors" without general public solicitation or intention to resell are exempted from the act[10].

The fund itself would qualify under the Investment Company Act, unless it has less than 100 investors that are at the moment of investment "qualified purchasers". The conditions are more demanding than those used for defining "accredited investors".[11]

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[5] The EP report proposed to exempt credit institutions and insurance companies managing their internal AIF: see Committee on Economic and Monetary Affairs Draft report by Mr. Gauzès on the proposal for a directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC
(COM(2009)0207 – C7-0040/2009 – 2009/0064(COD))

[6] This overview is partly based on the IOSCO survey, Hedge Fund Oversight, Consultation Report, March 2009, annex 5. For more details, also on the country reports, see: P. Astleford & D. Frase (eds), Hedge Funds and the Law, Sweet and Maxwell, 2010.

[7] ASIC is Australian Securities and Investments Commission

[8] CVM or Comissao de Valores Mobiliarios, Brazil.

[9] E.g. investment for more than cdn $ 150 000.

[10] The regulation contains a detailed list of categories of "accredited investors", i.a. persons with income in excess of $ 200.000 and $ 1m. net worth. But the limitation to 100 investors does not apply.

The distribution of hedge fund shares would take place through registered brokers-dealers: that requirement does not apply to certain persons that perform substantial functions in the fund, or when it only involves sales to institutional and other financial institutions. The offer by non-US brokers is allowed for limited business activity and provided the foreign firm is “chaperoned" by a US broker-dealer. As a consequence, only institutional investors can be solicited.

The Investment Advisors Act calls for registration of managers of hedge funds with more than 15 clients, a fund being calculated as one client. The act allows fund managers to be exempted from the prohibition to receive any portion of the profits from the fund with respect to the funds invested by “qualified clients”[12]

The CFTC regime applies to “commodity pools” if the fund deals in futures or commodities. Registration will be avoided under the exemption for “sophisticated” investors, essentially the qualified purchasers under the securities act.

In the *United Kingdom*, the hedge funds as such are not supervised, but the managers located in the UK are subject to UK rules on the basis of MiFID and FSA rules. Hence the capital requirements directive is applicable to the management firm, along with the FSA rules on conduct of business. Some hedge funds are traded on regulated markets and subject to the disclosure rules applicable to listed companies. Indirectly the FSA also obtains information from the banks, that act as prime brokers or offer other financial services, or from institutional investors under the FSA oversight. The FSA has been monitoring the hedge fund activity since some time closely overseeing the activity of the 40 largest funds, standing for about half the market.

The *German* system is based on the difference between the so-called single hedge funds, that can only be offered privately, and the Funds of Hedge Funds that can also be offered to the public. For both types a prospectus is needed, which is more elaborate for the FoHF. This regime includes the public offer of foreign FoHF, originating from jurisdictions with equivalent regulation and supervision, and provided there is an agreement between competent supervisors for the exchange of information. The management is in the hands of a capital investment company[13], to be licensed by Bafin. In addition, German law recognises more flexibly with respect to regulated “special funds” that are exclusively addressed to legal persons, e.g. institutional investors

The *Italian* regime is based on the regulation of the asset management company by the Banca d’Italia who regulates the structure and the activities of the fund. Hedge Funds may only be offered to not more than 200 investors who contribute at least €0,5 million to the fund. Hence hedge funds are not regulated directly, but indirectly by the central bank.

The *Spanish* regime is also based on the distinction between single hedge funds, that can only be offered to qualified investors, with a minimum investment of € 50.000, and with at least 25 participants. Fund of hedge funds may be freely distributed to the public, provided they count at least 100 investors The funds are managed by a management company, that is registered with the CNMV. The marketing and sale of these funds in Spain is subject to the prior authorisation of the CNMV, triggering a certain number of obligations. Hence, actual practice

[11] Individuals with at least $ 5m. in investments, or companies and trusts with $ 5m. in investments.
[12] This refers to clients with $ 1,5 m. invested.
[13] Kapitalanlagegesellschaft according to Investment Gesetz 2003 and Investmentaktiengesellschaftgesetz allowing entrepreneurs to associate investors to the common venture. see /www.gesetze-im-internet.de/bundesrecht/invg/gesamt.pdf

is very concerned about avoiding the moment that distribution could be considered "marketing" to the public.

According to *French* law, the contract-based funds enjoy wide freedom in their investment policy, in the calculation of NAV and lock-up periods, and they may freely be constituted by a management company that is licensed. Access is restricted to qualified and wealthy investors. French regular investment funds may invest up to 10% in other assets i.e. hedge funds and foreign funds. This limit does not apply to the so-called ARIA funds, in which access is restricted except for the funds that offer a guarantee for the capital subscribed. These restrictions take account of the volume of the initial subscription or the criteria for defining professional investors[14]. The management of these funds is subject to the same rules as those applicable to the main group of UCITS management companies. Foreign hedge funds cannot be distributed in France except with the authorisation of the AMF, which is granted on the basis of a finding of an equivalent disclosure regime and the existence of an agreement for the exchange of information. Here too there are discussions what "marketing" really means, but it certainly does not allow for a private placement regime.

As *Luxembourg* and *Ireland* house a large part of the investment funds in the EU, it is useful to give of short overview of their regulatory regime. Differently from the UK, where most hedge funds are managed in London, but domiciled in low tax jurisdictions, Luxembourg and Ireland have introduced legislation that allow hedge funds to establish their domicile in their jurisdictions.

According to the *Luxembourg* legislation, a hedge fund may be constituted under the 2007 law relating to investment funds not placed with the public. The funds can take the form of common funds, sicavs or Specialised investment funds (SIF). In each case net assets of € 1,250m are required. "Specialised investment funds" are subject to flexible rules, e.g. restricting to 30%, investment in securities of the same type of the same issuer. The SIF can be offered to "well informed investors" being apart form institutionals, persons with €125.000 in the fund or assessed so by the bank with respect to their experience and knowledge. The law requires the appointment of a Luxembourg central administration agent and a depositary, a Luxembourg financial institution or one established in Luxembourg from another Member state. Assets have to be valued at fair value, the latter as defined in the fund's charter. When proceeding to a public offering, a prospectus will be required as approved by the CSSF.

Traditional investment funds can also develop investment strategies followed by Hedge funds, such as 130/30 strategies, or may borrow in some cases up to 400 % of net assets. Fund of Funds may invest up to 20% in non-regulated funds, but sub funds of an umbrella fund are treated as separate funds[15].

The *Irish*[16] regulatory regime is based on a distinction between UCITS – that can be offered for sale throughout the European Union, and non-UCITS, that can only offered abroad if the local regulation allows so, often on the basis of a private placement. Exceptionally non-UCITS funds can be offered to retail investors: this applies especially to Funds of Hedge Funds that can be entirely invested in a diversified range of unregulated funds. Hedge funds or private equity funds would normally choose one of the other non-UCITS forms, i.e. the Professional Investment Funds, or the Qualifying Investor Funds, in the latter case a formula for which the investment and borrowing requirements are relaxed. Both types are addressed to

[14] On the basis of the three pronged threshold: € 20 m. balance sheet, $40m turnover and equity of € 20 m or more.
[15] See M. Seimetz, Luxembourg Hedge Funds, in: Astleford & Frase, nt. 5, 12-041 e.s.
[16] For further details see: D. O'Sullivan, Hedge Funds in Ireland, in: Astleford & Frase, nt. 5 12-074.

institutional or high net worth individuals[17]. Funds must appoint a custodian being an Irish credit institution, or a branch or subsidiary of a EU credit institution established in Ireland. The management should be entrusted to a management company, licensed by the Irish supervisor, or qualifying for recognition under the EU MiFID regime[18]. Irish hedge funds often are listed on the Irish stock exchange.

Most other countries have only a limited number of hedge funds established on their territory. Some have, other have not enacted elaborate regulation.

In *Belgium*, the existing UCITs regulation and its investment restrictions prevent hedge funds to be created under this form. Tax and disclosure obligations would prevent the use of the common corporate form. Hence there are practically no hedge funds on the market.

In *Denmark*, hedge funds and private equity funds are limited to the sphere of private investment: if investors from the public are solicited, the entire securities regulatory system would apply. However, there are two types of “association” that can call on the public for investing in SME and Hedge funds activities[19], but these two are strictly regulated and supervised and would not meet the expectations of the usual hedge fund or private equity manager. Their managers have to be licensed by the Danish supervisor.

In *Poland,* although there are a certain number of hedge funds active on the market, and certain companies act as private equity funds, there is no regulation applicable to these funds.

Under *Greek* law, there is no regulation for hedge funds or private equity funds, although venture capital firms have been the subject of regulation. There also is a market in venture capital firms, often subsidiaries of a bank.

The *Swiss* regime does not impose legal requirements to hedge funds, and foreign funds are freely offered to qualified or professional investors. Swiss based fund managers of Swiss funds need to be registered, while manager of non-Swiss funds are merely registered under money laundering rules.

In *Croatia*, the general regime governing investment funds is generally applicable to hedge funds and private equity funds, both being open-ended funds with redistribution restricted to private offerings. This applies to the general rules on the structure of the funds, the role of the depository, valuation, etc. Entry into these funds is restricted to qualifying investors i.e. institutional investors and wealthy individuals. The requirements are significantly higher for investing in a venture capital fund. Investors are mainly insurance companies and pension funds, that can invest part of their assets in investment funds. Management companies must be appointed and are regulated by the securities supervisor Hanfa.

In *Japan*, investment managers that manage funds open to public investment have to be registered with the Japanese FSA. If the fund only targets qualified financial investors, no such registration is needed, but the manager has to be notified to JFSA.

Taiwan law provides for limited use of local hedge funds by institutional and financial investors and retail investors (up to 35persons). The range of investments is negatively defined in the regulation, and would exclude all securities for which there may be a danger of a conflict of interest, but in other cases the supervisor can step and forbid any investment type. Moreover remunerations are restricted, and in the absence of the limited partnership

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[17] The thresholds are €1.250.000 assets and € 250.000 for an initial investment. For institutions a minimum of assets under management of € 25m is required.
[18] In the board of which at least 2 Irish, mostly non-executive directors have been appointed.
[19] Called the SME association and the Hedge Association, the latter being entitled to invest in a wider range of assets.

form, there are only contractual funds. As a consequence, hedge funds are mainly constituted abroad while Korean funds act as hedge funds. Investment in Taiwanese assets by off shore funds is closely monitored by the Investment Commission, but these funds may also be restricted as to trading activities (e.g. shorting). Offshore funds must appoint a local agent and an approved custodian.

3. Some characteristics of the legal regime

The regulation of hedge funds can be divided in two periods: before the financial crisis, most jurisdictions – with some exceptions[20] – had not adopted specific regulations addressing hedge funds. The applicable regulation if any derived from the application of existing rules that had mainly been conceived to deal with asset management activities in general[21], or with investment funds in particular. So in France and Spain, and to a certain extent in the US as well, regulation is deeply linked to the existing regulation on common investment funds. All national reports mentioned however, that asset managers were generally regulated, irrespective of their activity in the hedge fund field. Moreover, several states took a more liberal attitude with respect to funds of hedge funds, for which they adopted specific regulations.

This first type of regulation essentially addressed investor protection concerns, whether by excluding retail investors, insuring sufficient disclosure, warning about risks, and requires organisation measures within the fund, or within the asset manager. Rare were the concerns that since the crisis are dominating the debate, essentially focusing on systemic risk issues. This difference in approach explains why the "private offering" exemption and similar rules on distribution or on scope have now become less central to the regulators' concerns, who are more focusing on matters of risk management, valuation, ethical conduct, remuneration and reporting to the supervisors. In that respect there is real change in the regulatory philosophy.

At the moment of writing, the main approach to regulation consists of exempting the solicitation of investors or the issuance of securities from the existing regulation[22]. Hedge funds were considered investment instruments only accessible to wealthy investors or at a later date to larger institutionals. This leads to the paradox that in many jurisdictions, hedge funds regulation is essentially non-regulation, but this statement is to be nuanced as the asset managers are regulated. As mentioned above some limited form of indirect supervision – especially through the prime brokers and the asset managers – is being exercised. This feature also explains why several of the country reports declare that no regulation has been in force, but elaborate on the exemption rules. A short overview of these, trying to identify their common features is therefore useful.

-a- Hedge funds may be offered to the investors

The restrictive attitude towards hedge funds is not found in all jurisdictions. Some allow hedge funds - as any other collective investment scheme - but taking into account the additional risks, may impose tighter rules on the organisation of the fund and insure adequate disclosure to investors. This is the scheme followed in Australia for the Managed Investment Scheme, where apart from organisational rules, a Product Disclosure Statement, comparable to a prospectus has to be issued. In Canada, hedge funds can be offered through a prospectus

[20] Most regulations define the conditions according to which hedge funds would not be regulated. Even today, no jurisdictions address hedge funds as such.
[21] Reference is to be made to the provisions of the Investment Company Act in the US and the Investment advisers Act, and the UCITS legislation in the EU.
[22] See e.g. Switzerland, Belgium.

offering, where additional requirements apply to the dealers who sell the securities. The Brazilian regime does not distinguish hedge funds from other funds: it only imposes some stricter requirements to the former, e.g. on disclosure – initial and continuous – on risk control and conflicts of interest.

-b- Express prohibition to create or to offer hedge funds

There are few if any jurisdictions that have adopted an outright prohibition to create or offer hedge funds. Most systems allow acquisition of hedge funds by institutional, professional or sophisticated investors, and funds can be freely created outside the regulated zone. Also if these funds would be offered to the public, the regulation of the public offering of securities would apply. This the regime applicable to foreign hedge funds, offered in Belgium: according to the directive no prospectus is required for offers for individual amounts above € 50.000[23].

-c- Exempting hedge funds

The most widely used technique for dealing with hedge funds has been the private offering exemption, allowing funds, that in principle would be subject to the investment fund regulation to be exempted provided that they are not offered to the public at large. There are several ways to define the private character: usually a number of investors is mentioned, or the minimum entry investment establishes a floor. In several states, "qualified" or professional investors may be solicited. In others the number of investors per fund is limited.

A brief overview will give an insight in the diversity.

In the US, the involvement of less than 100 investors[24] was followed, later extended to "qualified purchasers", being individuals or institutionals owning a substantial amount of money[25]. In Canada, offerings without prospectus can only be made to accredited investors who meet a net income or financial assets test, or make a minimum initial purchase for Can $ 150.000. In the UK, individual investors can only access through a "qualified investor scheme". In Spain, the individual investment had to be at least € 50.000, and limited to qualified or professional investors; minimum 25 persons should be involved[26]. The French system is also linked to the minimum investment ($125.000) and to the wealth of the investor[27]. In Italy, a minimum initial investment of € 500.000 is followed[28]. The German system relies on the intermediary bank: private placements – whether to individual or professionals investors – are exempted but only banks are allowed to offer these. Finally Switzerland and Japan relies on the intervention of authorised intermediaries, in Switzerland with a check on the prospectus for completeness and consistency by the supervisor.

-d- Funds of Hedge Funds

The restrictive attitude towards offering hedge funds to the public is relaxed for the offering of Funds of Hedge Funds, as these insure a wide risk spreading.

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[23] Another exception relating to the sale of hedge funds in private portfolios managed on a discretionary basis.
[24] The calculation basis excludes foreign investors, and non-resident alien investors.
[25] In the US, different regimes apply under the Investment Company Act and the Securities Exchange Act. The former follows a cap on the number of investors involved (100 or less), the second uses the private placement exception, standing here for individuals with a minimal income of $ 200.000 or $ 1 million net worth; of 5 million assets for institutionals. In these cases a prospectus has to be published.
[26] See Machuca and Menendez, in: Astleford & Frase, nt. 5, 12-166.
[27] See French Report.
[28] And there may not be more than 200 investors per fund

In the jurisdictions where FoHF may be offered to the public, these criteria are relaxed, whether by allowing free access- Germany, Spain -[29], or as is the case in France, down to a minimum investment of €10.000[30]. The same is planned in Italy. In Spain, FoHF can be offered provided the investor – other than qualified investors- [31], acknowledges that he is aware of the risks in investing in the FoHF. In the UK, FoHF are accessible through the listing regime. In Belgium, the requirement of a full capital guarantee effectively prevents these funds to be distributed.

-e- Indirect regulation

The distribution or activity of hedge funds is often regulated indirectly, by addressing their financiers – the so-called prime brokers, viewed under banking regulations – their distributors, or more importantly their portfolio managers. In most jurisdictions, acting as a portfolio manager for any type of portfolio is subject to licensing and hence more or less strict regulation and ongoing supervision applies[32]. This is especially useful as the managers often act for funds legally located abroad.[33] Often these requirements are stricter than for managers of investment funds in general, due to the additional risks in their portfolio: this may seem paradoxical, as the investors in these funds would normally be able to fend for themselves, better than the common fund investor. Financial stability objectives may justify supervision in these cases.

-f- Professional or industry regulation

The hedge fund industry has also taken some initiatives to develop voluntary codes relating to the activities of the fund managers. Several initiatives and statements have to be mentioned, such as the Hedge Funds Standards Board (UK) that produced Hedge Fund Standards[34] dealing with a wide range of organisational issues. The President's Working Group Private-Sector Committees released on April 15, 2008, Best Practices for Hedge Fund Participants[35], while the Alternative Investment management Association has adopted a Guide to Sound Practices for Hedge Fund Administrators. The Managed Fund Association (MFA) has also been active in this field. Most of these voluntary instrument contain interesting ideas and have been used in formulating i.a. IOSCO's position.

-g- Contractual regulation

That most hedge fund are not regulated does not mean that no rules are applicable. In the absence of state regulation, parties to the fund will have developed elaborate rules on information, remuneration, organisation, risk management, valuation, etc: these are governed by the contract between the investor and fund manager. Up to now, financial regulation does

[29] See in Germany, at least for domestic FoHF; for foreign FoHF, a notification to Bafin and a cooperation agreement with the home supervisor is needed. A full prospectus is required.
[30] For whether wealthy investors or investors with experience in the financial sector.
[31] According to a specific regulatory regime, see Machuca and Menendez, in: Astleford & Frase, nt. 5, 12-166.
[32] See for Switzerland, where managers are subject to licensing and qualification conditions, and have to present a prospectus to the supervisor.
[33] See the UK where the asset manager regime applies, however with a close follow-up of about 40 major hedge fund managers. Most of the funds managed out of the UK are located in tax friendly jurisdictions.
[34] www.hfsb.org/?page=10915; comp. the rules of the Swiss Funds Association: https://www.sfa.ch/self-regulation/selbstregulierungmusterdok. Danish funds may also subscribe to the Danish Venture Capital Association.
[35] http://www.ustreas.gov/press/releases/hp927.htm

not intervene[36]. The information provided to their participants, whether in the form of – voluntary - prospectuses or other documents would be protected in some jurisdictions under the rules prohibiting deceptive, misleading or fraudulent information[37]. In addition, most managers are registered as "asset managers" or "investment advisers", and under that heading subject to more or less elaborate rules e.g. the MiFID rules in the EU, the Investment Advisors Act in the US. In the UK, where many asset managers of off shore hedge funds are located, they have to be registered with the FSA[38]. Moreover in some jurisdictions, asset managers have subject themselves to a voluntary code, and investment contracts will sometimes make reference to these standards or codes[39].

Some national reports mention that general company law rules may impose certain provisions on hedge funds; however, most of the time these are not applicable to the limited partnerships. The absence of last-mentioned legal form has been mentioned as a handicap[40]. If hedge fund shares are traded on a regulated market, the disclosure, accounting, criteria for admission and so on would then become applicable.

To be mentioned is the regime for combating money laundering: this usually is applicable to funds and managers. In Switzerland, a licence on the basis of AML-CTF is needed for resident managers of foreign funds.

-h- alternative approaches

In some states, funds similar tot hedge funds or private equity funds have been organised by the law. This is the case in Denmark and in Belgium. They are subject to rules similar as those applied to regular investment funds, but have some more freedom in their investment and risk objectives. In the Belgian case, an "institutional" fund, aimed exclusively at institutional investors can be created under a non-UCITS status, with free investment policies, no mandatory prospectus disclosure, nor publication of the net asset value. Also the securities supervisor does not exercise supervision.

Recently, a certain number of hedge fund strategies have been proposed under the form of exchange-traded funds (ETFs), opening up their distribution to all investors acquiring the funds on the open market. However, asset managers that are registered and overseen by the market supervisors will manage these funds.

-i- "Linked" or "substitute "products

In some states, investments in hedge funds may not be directly offered to the public, but the practice has developed to offer them indirectly, through other products that are financially equivalent, but legally different, and whether not or differently regulated and may therefore not offer the same guarantees in terms of investor protection[41]. This is the case with "notes"

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[36] To be mentioned however is the Swiss proposal according to which the new provisions on remuneration in financial institutions would have been applicable: the scope of the final regulation was considerably reduced, excluding thereby the hedge fund managers: see Finam Circular 2010/1: Minimum standards for remuneration schemes of financial institutions http://www.finma.ch/f/regulierung/Documents/finma-rs-2010-01-f.pdf

[37] E.g. in the US were rule 10B-5 would apply.

[38] See D. Frase, Hedge funds in the UK, nt. 5, at 12-004.

[39] See in the UK, the Hedge funds Standards Board Code, to which 57 funds have now signed up, has reportedly been referred to in whether the statement of some hedge funds, or the contracts with investors. See HFSB, www.hfsb.org/?section=11400. The IOSCO report, nt.2 raised the question of effectiveness: § 17.

[40] See Taiwan report.

[41] In Belgium, Canada, Germany, Denmark, e.g. See the EU Commission's statement on the Packaged Retail Investment Products, or "prips": for the latest update, see: ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20091215_prips_en.pdf

or "certificates", debt instruments outside the scope of the general public offering laws, the capital of which is often "guaranteed" but the return linked to the return of a hedge fund or a portfolio of hedge funds. In some states, hedge funds have been offered under the formula of unit linked insurance products, or similar financial instruments, for which the rules on disclosure and distribution are considerably different from those applied in the investment fund sector[42]. Other techniques like regrouping small investors to reach the minimum floor of e.g. € 50.000 was mentioned in the Spanish report. In the EU, the Commission intends to investigate this subject, i.a. on the basis of a report to be submitted by the three financial supervisory committees[43]

-j- Tax regulation

The hedge fund activity is deeply connected to the applicable tax regime, both at the portfolio and at the manager's level. Tax neutrality for the fund is pursued by domiciling funds in tax neutral jurisdictions e.g. in the Caribbean Islands Cayman, Virgin and Bermuda. The fund participants will then be taxed according to the regime applicable to them: exchange of information among tax authorities is here of the essence. At the level of the asset managers, a favourable tax regime helps to explain their localisation in cities like London. Changes in that regime may trigger delocalisation of the managers. In the US, the report illustrates the complexity of the issues involved and mentions that managers changed to partnerships formula, avoiding double taxation by direct taxation of the partners.

In the Belgian case, double taxation prevents funds to be created outside the regulated area, i.e. as UCITS or as "institutional funds

-k- Specialist funds

In some states, regulation has been developed aimed at creating specialist funds with a view of contributing to the financing of local industry or commerce, often of the SME type. Examples of these are found in Belgium, Denmark, or Taiwan. Germany knows an important number of specialist funds, addressed to institutional investors and enjoying a lighter regime.

4. Objectives of the regulation of hedge funds

Hedge funds have remained unregulated for a long time, as due to the composition of their membership, it was generally considered that there was no need for any regulation[44]. However, even before the recent financial crisis, the attention has been drawn to the possible systemic consequences of the collapse of a major hedge fund: the rescue of Long Term Capital Management, in 1998[45]. Although refused for a long time by US regulators, it is now

[42] Especially on suitability and conflicts of interest, including fee disclosure.
[43] Communication from the Commission on Packaged Retail Investment Products, COM(2009) 204 final, 30.4.2009, ec.europa.eu/internal_market/finservices-retail/docs/investment_products/29042009_communication_en.pdf
[44] This position was repeatedly voiced by several representatives of the Wharton School. This was still the case in February 2007, in a report of President's Working Group on Financial Markets, chaired by Treasury. Secretary Henry M. Paulson, urged vigilance but concluded that new regulations are not needed (www.nytimes.com/2007/02/23/business/23hedge.html?_r=1&pagewanted=2). The Securities and Exchange Commission in 2004 tried to require them to register with the agency and make limited disclosures about their activities. But a federal appeals court ruled last June that the Commission did not have that authority: Ph. Goldstein v. SEC, 23 June 2006.
[45] See on this case: the US report.

accepted that direct oversight of the hedge fund managers for financial stability is needed[46]. Before, prudential supervisors relied on the information obtained from the prime brokers, but this does not allow aggregating the data from several prime brokers. Both in the US and in Europe, regulation is being developed to take account of this objective, especially by requesting hedge fund managers – and not individual hedge funds - to report to the supervisors about the positions they have taken. Whether this approach applies to all hedge funds managers – see the European regulation – or only to the most significant ones – more so in the UK and in the US approach – is a matter of difference of opinion. This concern exceeds however the mere systemic issues: hedge funds should be well organised, respect integrity rules especially on business conduct and conflicts of interest, offer adequate guarantees in terms of management and organisation, while the contagion effect should be minimised by requiring appropriate risk management systems allowing for monitoring counterparty risk. All these instruments serve both systemic risk detection and avoidance and financial stability.

The second objective for which hedge funds may need to be regulated concerns the offer or distribution of their securities or rights to the public at large and is a negative form of investor protection. Most jurisdictions have up to now restricted the distribution of hedge funds, especially for retail risk reasons, to the more sophisticated and institutional investors; at the same time they did not hold the existing rules relating to investment funds or investment management applicable. In several states, there was an outright prohibition on offering hedge funds to retail investors. In other jurisdictions, hedge funds are lawfully offered to the public, and with more regulation becoming applicable it seems likely that investments in hedge funds will become accessible to a wider audience, provided certain conditions are met. One also sees some hedge funds adopting the legal form of UCITS, thereby availing themselves of the flexibility offered by the 3rd Ucits directive allowing for the use of derivatives in their portfolios: these funds are beneficiaries of the European passport, according to which the fund can be distributed all over Europe without any additional requirement (they are colloquially referred to as "newcits"). As mentioned, investor protection through distribution requirements becomes even more ineffective through the use of listed hedge funds, under the form of managed exchange traded funds.

Moreover several jurisdictions allow the distribution of Fund of Hedge Funds (FoHF), even to the public at large. Some hedge fund investments come wrapped under other forms such as assurance products, or bank issued certificates. The applicable rules are then considerably different, raising the question whether investors can be protected differently depending on the legal wrapper under which the investment is presented.[47]

Outside the realm of domestic regulation is the activity of investors acquiring hedge funds abroad, or where the fund is acquired locally but without solicitation of or offering to the investor. But this exemption for the "act of investing" is not necessarily extended to asset management services: asset managers may be subject to regulation and supervision in their jurisdiction of establishment with respect to the management of funds established outside their home jurisdictions[48].

The registration of hedge funds will also become necessary from a market integrity point of view. Recent cases have alleged that insider trading has been going on within insider rings

[46] See e.g. statement by Lord Myners, .UK. Must Fix Hedge-Fund Oversight, Nov 10,2009, online.wsj.com/article/SB125778995639339045.html. In the US, initiatives came mainly from Congress (Paul Kanjorski, Barney Frank)

[47] This subject is mentioned in several reports, and is sometimes referred to as relating to "substitute products", or "prips", (prepackaged retain investment products). See nt. 38.

[48] This is the case in the UK, but not in France.

constituted by hedge fund managers. Market manipulation cases are likely to have occurred[49]. Although these objectives can efficiently be pursued on the basis of the existing rules on market abuse, covering both insider trading and market manipulation, it would be helpful that the funds and their managers and staff would be readily identifiable, and could appropriately be sanctioned in case of violation.

In some jurisdictions hedge funds have been heavily criticised for their role as activist investors. Some high profile cases have lead to public outcry as some funds have triggered – or attempted to trigger - major changes in listed companies, leading some to claim that their "excessive" conduct has to be curbed [50]. Sometimes there has been some confusion with the role of private equity funds, which after having invested in companies have massively increased the latter's leverage, threatening sometimes their survival. The now adopted EU AIFM directive contains some provisions in this respect.

5. Private law aspects

Hedge funds are organised in different ways: frequently they are legal persons set up in a jurisdiction with minimum formalities and little or no taxation. The fund is managed out of jurisdictions with advanced financial markets such as the US or the UK. Also depositaries and support functions will be located or managed out of the latter jurisdictions. Originally many funds were constituted as limited partnerships with the managers as active partners[51], while investors as limited partners will limit their risk to their contribution. This organisational type is mentioned in some jurisdictions, e.g. in Switzerland[52]. These funds may whether organise the management of the portfolio within the fund, often a company, where the board of directors will be directly in charge of the management, usually with a professional manager as an advisor, or outsource the management and the administration to a third party, a professional asset manager. As mentioned above, "open ended companies" or "sicavs" are also used.

Purely contractual funds are frequently used especially for their tax neutrality. In the regulation they remain usually unmentioned, except from the angle of the obligations of the asset manager. In France, this type of fund is subject to more severe requirements if it wants to address itself to "outside" investors[53]. The trust form should also be mentioned as used in the UK and other countries whose laws have adopted the use of the trust for business purposes.

The relationship between the fund and the members are essentially of a contractual nature. This means that relations are the result of individual negotiations, and often present considerable individual differences. To be mentioned are the clauses relating to the information to members, the valuation rules, to the fee due to managers, but also the conditions relating to repayment, especially the lock up rules, side pockets, the reimbursement in kind, the duration of the fund that is often limited to a certain number of years, etc.

[49] See the Galleon case in the US, involving an insider ring. On 20 January the SEC charged two hedge funds with violations of the short selling rules. See for other cases: E. Allen, Hedge funds and related entities as defendants, in Astleford & D. Frase (eds) nt. 5, 7-041 e.s.

[50] Among these one can mention the dismantling of ABN Amro Bank, the attempts to urge Deutsche Börse to adapt its business plan. The opposition has been expressly virulent in Germany – see the speech by Müntefering, referring to "the swarms of locusts": see P. Gumpel, The day of the Locust, Time, May 15, 2005, www.time.com/time/magazine/article/0,9171,1061439,00.html and the French report.

[51] Held to unlimited liability, although this partner is often a limited liability entity.

[52] Where the Kommanditgesellschaft would constitute an adequate vehicle for a fund with only a few members.

[53] The minimum initial contribution to a contractual fund would be € 250.000, indicating that this type of fund is only addressed to professional, or institutional investors.

Generally these are left to the parties' negotiations[54], except that the law may impose disclosure duties to ensure parties are well informed and if needed warned[55]. Disclosure acts as a surrogate to substantive regulation: parties have to determine for themselves to what obligations they want to be bound. Interesting is the French technique according to which the investor, along with receiving the prospectus, has to state in writing that he is informed that the investment is only addressed to certain, more sophisticated investors. This warning also applies to the due diligence investors are expected to undertake before entering into a fund. This especially applies to larger investors, but constitutes a handicap for smaller members, such as some pension fund, or foundations, that are unable to engage in expensive investigations. Hence hedge fund activity may affect investor confidence.

The regulation on hedge funds may also be applied to so-called private pools of capital, irrespective of their legal structure. This may extend to undivided assets, whether or not held in segregated accounts. The designation of applicable regulation would then mainly be based on the location of the managers and apply to all asset management activities.

6. Regulation of hedge funds or of hedge funds managers

There are several techniques to approach hedge funds. Several national jurisdictions regulate the funds as such, in the same way as they regulate other investment funds[56]. This is the most effective approach in terms of investor protection and will be found in those states that allow funds to be publicly distributed, directly or as FoHF. Indeed in some jurisdictions the funds are a variety of the traditional investment funds, with however some derogatory rules. In some states, this has been refined by creating special fund types, related to the basic investment fund type: this is e.g. the case in France, in which case specific types have been developed for dealing with Funds of Hedge Funds[57], where the common UCITS type constitutes the basic pattern amended to take account of the additional investor protection needs. The situation in Spain is similar, but more elaborate.

The other approach is primarily not to deal with the funds, individually, but with the managers of the funds, what allows the regulation to make abstraction of the different legal structures in which the portfolios are managed, including the managed accounts that do not correspond to the notion of a fund. Indeed, it is necessary to look at the aggregate position of all portfolios managed by the same managers, if one want to have information about the systemic risk involved, or the possibility of contagion to other financial institutions. It is therefore no surprise that the UK and the US, and the new regulations in the EU follow this aggregate approach, as these are more oriented towards the systemic issues. A certain number of provisions formulated as applicable to the manager will however affect the individual funds: risk management requirements, valuation rules or provisions on depositaries have "third-party effect".

Another indirect approach that has been followed for some time and that was considered sufficient for dealing with hedge funds, is some form of indirect supervision, through their prime brokers: as these are subject to banking regulation, the prudential supervisors have addressed these banks not only to inform them about the position and evolution of risks within their clients, the hedge funds, but also looking at the same time at their relations with the funds and the latter's' risk assessment, e.g. for dealing with collateral. Indirectly these

[54] Spain is stricter in regulating these relations, dealing i.a. with organisation and risk control measures, the relations with prime brokers; and the collateralisation rules.
[55] This is the case in France, and in support of the regulatory obligations in Spain as well.
[56] This is the case in Spain, France, Denmark, Taiwan.
[57] So-called ARIA; see also the FCIMT, that trade positions in the marché à terme.

requirements will have affected the funds' functioning. However, this approach does not allow aggregating the information per manager, as there may be several prime brokers active for the same management firm.

7. The future regulation of hedge funds

The general absence of regulation is likely to be modified after the crisis. The crisis has considerably awakened the politicians, the public authorities and the media to the role of hedge funds in their economies[58]. Although it is recognised that hedge funds have not constituted a significant systemic risk[59], it was considered regulation is needed to take account of their potential impact on systemic developments, both from the angle of their financing through the banking system, as with respect to the effect of their trading activity on the markets[60]. Financial stability institutions[61] have stepped into the debate asking for more and timely information[62]. Therefore states will require hedge funds to report to the financial supervisors and according to some proposals, to restrict their leverage, to restrict their managers' remuneration, require a minimum capital, and so on. The oversight of hedge funds was expressly mentioned in the G 20 April[63] statements [64] and is included in the mandate of the European systemic risk board[65]. This presupposes registration, whether on a fund's basis, or more likely on the basis of the fund manager's basis[66].

Technical scrutiny of hedge funds was started by IOSCO several years ago[67]. In November 2007, a report was published dealing with issues surrounding the valuation of hedge fund

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[58] See above on the objectives of regulation

[59] See IOSCO report, nt. 2: "However, the activities of hedge funds may have amplified the consequences of the crisis. This occurred, for instance, because of the need for hedge funds (along with many other market participants) to quickly unwind positions because of liquidity restrictions in meeting margin calls or significant requests for redemption by investors."

[60] See art. 2(a) of the proposed regulation on the ESRB defining" financial institution" as " any undertaking whose main business is to take deposits, grant credits, provide insurance services or other financial services to its clients or members or engage in financial investment or trading activities on its own account."

[61] The Central banks, and in Europe the future European Systemic Risk Board. For the proposal, see ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_499_en.pdf

[62] See Hedge Funds and Their Implications for Financial Stability by T. Garbaravicius and F. Dierick, ECB, Occasional paper Series, nr. 34, August 2005.

[63] ―"hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management. We ask the FSB [Financial Stability Board] to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager.

[64] The G-20 Action Plan states: "Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.‖ See Declaration Summit on Financial Markets and the World Economy, Action Plan to Implement Principles of Reform, G-20, 15 November 2008, available at http://www.g20.org/Documents/g20_summit_declaration.pdf.

[65] ESRB, see nt. 58.

[66] The latter would allow aggregation of data relating to all funds managed by the same firm; however it excludes self managed funds.

[67] See IOSCO Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds — Final Report, Report of the Technical Committee of IOSCO, February 2003, p.4, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf, and The Regulatory Environment For Hedge Funds, A Survey And Comparison — Final Report, Report of the Technical Committee of IOSCO,

portfolios[68]. In June 2009, IOSCO published its report on Hedge Fund Oversight, formulated six high level principles on the regulation and supervision of hedge funds. These principles will be mentioned in the appropriate sections of this report.

Over time the regulation in the European Union' member states has developed from a total exclusion of hedge funds or private equity funds from the benefit of the UCITS directive, essentially by restricting the mutual recognition or "passporting" regime to funds organised in conformity with the UCITS directive, to a more liberal attitude allowing UCITS to engage in a wide range of activities that are normally undertaken by hedge funds – especially in the derivative sector - and even private equity funds. As a consequence one sees more and more previously excluded funds taking on the legal form of a UCITS and benefiting from the passporting regime, allowing the funds even to be offered to retail investors: they are sometimes called "newcits"[69]. In some respects the UCITS regime does not give full freedom: borrowing is not allowed for UCITS[70], investments must be made in "transferable securities" but with the use of derivatives as allowed by the directive[71], the restrictions for other assets is easily circumvented, provided the assets are liquid. The limitation to 10% OTC securities may also be a handicap, e.g in the private equity sphere. Redemption is obligatory for UCITS and must be offered within 14 days. These, and some other differences will avoid these funds being entirely absorbed by the UCITS regime. Some fear that this evolution may endanger the reputation of the "UCITS brand".

7.1. The international initiatives

As a consequence of the financial crisis, several proposals have been discussed and some adopted, to introduce comprehensive regulation addressed to whether "hedge funds", "highly leveraged institutions", "private pools of capital" or comparable forms of collective investment. These proposals have first been formulated at the international level by the "Financial Stability Forum", now Financial Stability Board, and by IOSCO. Support of the G 20 has been important. They have received further regulatory support in the EU directive on Alternative Investment Fund Management (AIFM), or in the Dodd Frank Act after its adoption by the US Congress.

Technical attention to hedge funds was started by IOSCO several years ago[72]. The FSF published in 2002 a Report on Highly Leveraged institutions[73]. In November 2007 an IOSCO report was published dealing with issues relating to the valuation of hedge fund portfolios[74]. In June 2009, IOSCO published its Final Report on "Hedge Fund Oversight", in which it formulated six high level principles on the regulation and supervision of hedge funds. These will constitute the international standard to be applied in all IOSCO member jurisdictions, in practice worldwide. The statement aims at dealing with both systemic issues and investor protection matters. For some matters, it refers to the cross sectional aspects, referring to the Basel Committee. It draws attention to the global dimension of the hedge fund activity, the

November 2006, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

[68] See IOSCO Principles for the valuation of hedge fund portfolios, November 2007

[69] See PWC, Future Newcits Regulation? www.pwc.com/gx/en/asset-management/assets/newcits-regulation-0310.pd

[70] Leverage

[71] Directive art. 50(1)(9) of the Ucits directive, 17 July 2009, 2009/65 OJ. L. 302/66 of 17 November 2009 allows UCITS to invest in derivatives but the amount should be less than the total net value of the portfolio.

[72] See nt. 64.

[73] Report of the Working Group on Highly Leveraged Institutions, see for the text Annex II of the IOSCO Documents PD288.pdf.

[74] See IOSCO Principles for the valuation of hedge fund portfolios, November 2007.

hedge fund industry being very mobile. It may suffice to reprint here the said six high level principles that are likely to be guiding the future national or regulation regulations.

1. Hedge funds and/or hedge fund managers/advisers should be subject to mandatory registration.
2. Hedge fund managers / advisers which are required to register should also be subject to appropriate ongoing regulatory requirements relating to:
    a. Organisational and operational standards; i.a. stress testing, protection of client's interest by segregation, designation of independent custodian and depositories and offering protection to client's assets
    b. Conflicts of interest and other conduct of business rules; strong independent compliance function
    c. Disclosure to investors; and
    d. Prudential regulation.
3. Prime Brokers and banks which provide funding to hedge funds should be subject to mandatory registration/regulation and supervision. They should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds.
4. Hedge fund managers/advisers and prime brokers should provide to the relevant regulator information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).
5. Regulators should encourage and take account of the development, implementation and convergence of industry good practices, where appropriate.
6. Regulators should have the authority to co-operate and share information, where appropriate, with each other, in order to facilitate efficient and effective oversight of globally active managers/advisers and/or funds and to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders. Recently IOSCO has published "Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practice[75]".

7.2. The regional or national initiative

Under this heading the recent European and American measures dealing with hedge funds will be briefly described.

7.2.1. The European AIFM directive

In the EU, a directive on Alternative Investment Fund Management has been adopted: the final vote was cast by the EU parliament on the 22nd of September 2010. The final text is expected early 2011, and therefore the present analysis will be based on the agreement between Parliament and Council of Ministers. It contains a comprehensive and elaborate regime dealing with the managers of hedge funds, of private equity funds, and of other types

[75] IOSCO, nt. 2.

of collective investment. The directive deals essentially with the management companies of these funds, and only indirectly with the funds themselves. To the extent that it introduces considerable substantive provisions for both the fund manager and indirectly the fund, the European approach is likely to be more interventionist than the comparable US regulation, raising issues of regulatory competition and arbitrage.

(a) Objectives

The directive aims at mastering risk, both at systemic level, and at the level of the groups of funds under management. This explains why the directive addresses the fund managers, and imposes obligations on the basis of all funds managed. The directive contains also several provisions that are likely to reduce risk taking that may be systemic in outcome, such as the rules on leverage and remuneration while other provisions will contribute to financial stability by strengthening the organisation of the funds or allowing for a more in depth supervision. Several provisions are directly aimed at protecting the investors in these funds, while others attempt to protect investee companies and employees of these.

The main features of the directive can be summarised as follows:

- it deals with alternative investment schemes (AIF), i.e. all collective investment schemes other than investment funds or UCITS, being “Undertakings for Collective Investment in Transferable Securities”, that are governed by a directive of 1986, as repeatedly amended
- Although AIFs can be self managed, special attention goes to the externally managed type: the management company (AIFM), mandatory for all these types of AIFs, must be authorised by the securities supervisor before starting business. AIFs managed by authorised AIFM enjoy the European passport.
- Investment, or units in AIF may only be offered to professional investors, and not to retail investors. However, individual member states may and do allow AIF units to be offered to retail investors, but that is a state-by-state decision. The state can impose additional requirements in the context of marketing of the funds (gold plating)
- The directive essentially introduces rules on authorisation of AIFM, on their structure (need for a depository, valuer, leverage, etc.) and conduct of business rules (conflicts of interest, compensation of the manager)

(b) The scope of the directive

The directive applies to all managers of collective investment schemes, irrespective of the type of assets in which they invest[76]. This approach avoids to define what is a hedge fund, and to draw distinctions according to the type of investment, or to the investment strategy.

The Alternative Investment Fund (AIF) is widely defined as “any collective investment undertaking …, which raises capital from a number of investors, with a view of investing it in accordance with a defined investment policy for the benefit of those investors”, other than a UCITS. On many points the UCITS and the AIFM scheme deal with the same issues, although in different terms, oddly enough sometimes in more protective terms in the AIFM. It would be advisable in a later stage to harmonise the two schemes, probably with a common stem of provisions, and differentiation according to the subfield to which they apply. This

[76] The IOSCO Report, nt. 2 considered the choice between addressing the management company of the fund a matter to be decided at national level, depending on local conditions and the structure of the local industry: § 25.

approach would allow the regulation to deal with the so-called "Newcits", being AIF organised according to the rules of the UCITS and entitled to take advantage of all the privileges of the latter, including the European passport.

The AIF undertaking can take the form of an investment company, this is a legal entity - usually a company - or of a contractual scheme, in that case a common or contractual fund, or a trust. This means, practically spoken, that the directive will cover all collective investment schemes, and that no such schemes may be organised except under the AIFM regime. But the AIF itself remain outside the scope, and will therefore continue to be regulated and supervised at the national level[77]. Privately organised investment schemes would in principle trigger the application of the AIFM rules, except for some exemptions to be mentioned later.

In practice this would mean that the directive applies to all hedge funds, to private equity funds, or other non-regulated collective investments, to real estate funds, closed-end funds, institutional funds. This wide definition raises some questions about e.g. private holding companies, (managed) exchange traded funds, but also private or "family" offices with several participants, family foundations, and even Sovereign Wealth Funds with several investors. The directive contains some clarifications on these points: "holding companies"[78] and family offices, where the own capital of the members are at stake, are exempted. So are the Pension fund (IORP) managers[79] who are subject to their own directives[80], employee participation or savings benefit schemes[81], managers of securitisation SPVs, supranational organisations, central banks, local authorities for their social security systems. Group internal asset managers would probably be exempted, under the condition that only group companies, other than an AIF are the only investors[82].

Credit institutions and investment firms and insurance companies are not exempted, as far as their management function for individual AIFs[83] is concerned. They should however not apply for an authorisation as they have already been entitled to offer these services as asset managers in their principal capacity. But the products they offer must conform to the directive distribution rules. The latter rule has been stated only for investment firms, not for banks and is questionable absent any justification. As to insurance undertakings, according to the preamble, insurance contracts – in fact their marketing - would fall outside the scope, along with joint ventures[84]. It is unclear to what extent asset management activities of insurers are included in the scope of the directive.

As to the types of assets invested or as to investment strategies, the absence of any criterion means that all types assets and all asset management strategies would be included: securities, commodities, precious metals, real estate, art collections, antiques, woodland, and so on. For some of these asset classes the provisions will have to be read in a "constructive" way.

As has been discussed in several member states, the discussion from what moment an investment scheme with several investors becomes "collective" will flare up in this context. The definition of AIF refers to a collective undertaking "raising capital from a number of

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[77] See Preamble nr 8.
[78] Defined on the basis of the trading on a regulated market, or are not managed with a view of divestment of subsidiaries or branches (art 4.r)
[79] See for the IORP or "Institutions for occupational retirement provisions", see Directive 2003/41/EC of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ L 235, 23 September 2003, p. 10-21.
[80] IORP directive
[81] This would relate both to the management relation and the offering of the scheme to beneficiaries.
[82] On the basis of art. 3.1, where the issues is translated in terms of AIFMs.
[83] Art 6.8.
[84] See preamble, pt 6.

investors", so that the mere fact that several investors are involved without any collective interest would fall outside that definition. Accounts that are individually managed would therefore not be viewed.

The said definition does not require active investment activity: although that will normally be the case, the definition does not clearly exclude passive investment vehicles, such as index funds, or real estate funds investing in one single project, although the definition of "managing AIF"[85] referring to investment management services being "portfolio management" and "risk management" are not necessarily be restricted to active management.

A certain number of managers of collectively managed portfolios are expressly excluded: these are the managers exclusively managing UCITS, as said portfolios are not qualified as AIFs,[86], but investment funds that do not qualify as UCITS would trigger the obligations under the AIFMD.

(c) The small fund relief

Certain smaller funds are not subject to the full thrust of the AIFMD:

AIFM managing less than € 100m, in one or several funds

AIFM managing less than € 500m, that are not leveraged and with no redemption rights within the first 5 years.

They must be registered, not authorised, and further keep the supervisors informed about some limited points such as their investment strategy and their principal exposures. For these AIFM, national law would determine their legal status[87] and may therefore impose additional or different obligations, creating some form of competition within the directive's regulatory framework. But the relief comes with some sorrow: they can only distribute in their home state, unless they opt into the directive's full regime[88].

(d) the authorisation regime

Basically AIFM must be authorised in the state in which it has its registered office, which is also the place where the head office should be located[89]. The conditions for obtaining the authorisation and the authorisation procedure have been detailed in the directive. In that process the national supervisor may restrict the scope of the authorisation and forbid the AIFM to develop certain investment strategies[90]. If an AIFM is part of a wider group, e.g. a subsidiary of an AIFM from another member state, or of a Ucits management company, the supervisor of that other firm will have to be consulted. The authorisation must be granted within three months, once renewable, after the application has been considered complete.

ESMA will be in charge of developing Regulatory Binding Standards aimed at insuring the "consistent harmonisation" of the application procedure and information.

The authorisation is valid for all member states. It will be publicly announced in the central register that will be kept by ESMA mentioning the AIF for which that AIFM may act, where they are located and their competent supervisor. This database will also mention the cases where the AIFM has been removed from the list. This electronic tool will enable market participants and supervisors to check whether a specific fund is duly authorised.

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[85] Art 4.
[86] See art 4(1)(b); for the UCITS directive, Directive 2009/65 of 13 July 2009.
[87] Preamble 38
[88] Art.4 (4)
[89] art 8 1(e)
[90] Art 8.4

(e)- Substantive authorisation requirements

The directive lists a certain number of conditions that have to be fulfilled before the AIFM can start to operate

Directors and manager have to be found "fit and proper" while shareholders must be suitable to ensure sound and prudent management.

The directive imposes minimum capital rules: these essentially aim to support the operating costs of the AIFM

- initial capital: € 300.000 for internally managed AIF
- € 125.000 for AIFM that act as external manager of AIF
- additional own funds:
  - if assets under management in AIF exceed 250 m: 0,02% of assets above € 250 m additional capital with a total maximum of € 10 m. The own funds must remain invested in liquid assets.
  - The own funds shall never be less to one quarter of their preceding year's fixed overhead[91]

Own funds shall be invested in liquid assets, or equivalent readily convertible assets.

Liability insurance must be subscribed by the AIFM covering professional negligence of the fund. This may be replaced by additional own funds. It may covers personal liability of managers or directors, but that would be a separate line in the insurance policy. More details will be worked out in Level 2 measures.

Ucits management companies are bound by their own funds rules, and hence are exempted under the AIFM regime: however the rules on professional liability insurance would apply. Also the obligation to invest own funds in liquid assets applies[92].

(f)- Operating conditions

Under that heading the directive introduces a number of very substantial requirements of which only the most controversial ones will be discussed here.

Under general principles the directives states some general obligations for the AIFMs conduct: they should e.g. act honestly, with due skill, care and diligence and fairly towards AIF investors. The question will arise to what extent these obligations will have a direct effect in the AIFM relations to the AIFs and their participants. The question cannot be analysed from the standpoint of a European directive, as this has to be implemented in national law.

Apart from these general obligations the main operating requirements relate to

- Remuneration
- Conflicts of interest
- Risk management
- Liquidity management
- Valuation

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[91] art 9(5) referring to art 21 of directive 2006/49 of 14 June 2006.

[92] No similar obligations applied according to the UCITS directive

- Delegation or Outsourcing
- Depositary
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Many of these provisions have to be worked out in greater detail in secondary legislation, some of it to be adopted by the Commission on the proposal from ESMA. The most prominent and most controversial ones are the provisions on remuneration – largely comparable to the rules applicable to banks – and the rules on the depository and its strict liability for restitution of the assets it had itself received for safekeeping.

(g) The third country regime

A very complex system of rules relates to AIFM engaging in activities with an element of non-EU law, being whether EU funds managed or distributed by non-EU management companies, and vice-versa. For these, the manager – EU or not – should conform to the directive, and will then be authorised. For non EU-managers, the same applies, although in case of incompatible requirements in the domestic legal order of that manager, an equivalence test would apply. The non-EU managers that only distribute EU or non-EU funds have to be authorised by the national supervisor where the centre of their European activity is located, i.e. where the funds are registered, or most of the sales take place. The directive would be entirely applicable. Complex rules allow the competent national supervisor to be determined. Once registration has been obtained, these managers may distribute the funds on the basis of a European passport, without additional obligations.

(h) Application of the new regime

There remains considerable insecurity as to the legal regime currently applicable: the directive will enter into force 21 days after its publication, but national regulators have to implement it within two years. During this period numerous secondary legislative and regulatory acts will have to be adopted the content of which is largely undetermined. For non EU-AIFM, the legal regime will only be determined after the Commission has adopted a certain number of secondary acts[93] what should normally intervene before the 2 year period has come to an end. This relatively long delay may insight non-EU operators to adopt an EU status, and enjoy the privileges of the directive for their AIF that have been constituted according to EU law.

7.2.2. The US debate

In the US, the 2010 Dodd Frank Wall Street Reform and Consumer Protection Act has modified a limited number of provisions relating to hedge funds, mainly approaching the matter from the angle of the Registered Investment Advisers. The requirement to register with the SEC has been extended to advisors with more than $ 100 m. under management, whereby the smaller advisors – between $ 25 and $100 m - can register with the state in which they are located. All large funds would therefore be held to register, opening the SEC's right to examine the books or make inspections. Interesting is their obligation to appoint a compliance officer and develop a code of ethics. Very large funds that may create systemic risks will be held to additional reporting obligations.

93 Art 63 (1) 3rd para.

Important are the exemptions to the registration rule: venture capital funds, small business investment companies, private equity fund advisers (less than 150m in the US[94]) family offices, do not have to register with the SEC but some obligations e.g. on record keeping will apply. Also the SEC can inspect private funds. Future work will be undertaken to define these notions, like family offices.

Non-US advisors also have to register with the SEC unless they have no place of business in the US, manage less than $ 25 m. for US clients, have fewer than 15 US clients and do not hold themselves out as investment advisors in the US.

If trading in the OTC derivative market, the question will arise about their qualification as a "major swap participant", and their obligation to clear through a CCP.

It seems striking that the US approach mainly deals with changing the perimeter of the regulation, by subjecting a larger population to the already existing requirements, but does not fundamentally change the obligations imposed to hedge funds and their managers. These may however result from other parts of the regulatory system, such as the rules relating to OTC derivative trading. Further work has been planned about the custody rules, securities lending, short selling an arbitrage. It will take several months if not years before more clarity about the applicable regulatory regime will have been attained.

Part 2. Private equity funds

To a certain extent, the issues flowing from the activity of private equity funds overlap those relating to hedge funds, especially in their relation to investee or portfolio companies, but the structure of private equity funds, their modus operandi and their transactions are usually substantially different.

1. Typology and structure

As is the case for hedge funds, there is no standard definition of private equity funds, except that these normally are pools of non-public capital, aimed at financing investee companies by acquiring considerable stakes in these companies, often at the 100% level of ownership[95] and with a view of turning them around during a limited period of time after which the investees will be returned to the market, or sold in a private transaction. Most funds are not accessible to the public, even less publicly listed, and the investees are usually privately held firms, or publicly traded firms that have been taken private. The funding of these funds may have originated from wealthy individuals, but today mostly from institutional investors, pension funds i.a. and more exceptionally even from the public markets. Most private equity funds however are privately held, based on individual contractual arrangements and therefore not subject to the disclosure and other rules applicable to publicly traded companies. Legal issues usually concern the way these funds are financed, their internal structure and their interaction with the investee companies. The funds usually are structured in the legal form of a limited partnership, whereby the investors are limited partners, and the private equity firms the

[94] The definition of "accredited investor" with $ 100 m assets has been strengthened by excluding his primary residence from the calculation.

[95] Thereby putting an end to the disclosure obligations: see the Danish report for the case of a failed 100% takeover whereby the disclosure duties to the market were maintained.

general partner. Private equity firms as such usually are not the subject of extensive regulation, except if they engage in regulated activity e.g. under the MiFID regime. The supervisory regime applicable to these firms is described in the UK as "light touch", based on a proportional application of the MiFID rules. In Italy managers should register with the Banca d'Italia, that has to be regularly informed of the portfolio. But Swiss and other laws do not contain any registration procedure. In France too, private equity is not regulated unless it is distributed to the public by way of e.g. a fund of funds, or another regulated form. In other jurisdictions there are specialised forms of funds that may be used for purposes close to these of private equity funds: this would be the case in Belgium[96], Denmark[97], and in Croatia[98].

Usually one distinguishes several classes of PEF, starting with venture capital funds, specialising in start up investees, growth capital and buyout funds, that usually aim at acquiring full control. But this classification is not a legal one and mixed forms are frequent.

2. Regulating private equity funds

There has been an intense debate about the need for regulating private equity funds, sometimes confounding private equity with hedge funds[99]. Arguments are based on their opaqueness, both in structure and in operations. They are accused of being destructive of the long-term perspectives of the firms in which they invest. The high level of leverage and of remuneration of the funds and their managers are mentioned as creating too heavy burdens, weakening their investees and leading eventually to the latter's demise.

Private equity funds may create considerable risk in the financial system, making use of considerable leverage to finance their investments with a view of maximising their return from the investee firms. However, in case of a market squeeze and reduced ability to find adequate market financing, private equity funds have been obliged to offload some of their portfolios (in so-called "crowded trades"), at the same time straining the financial institutions that had promised the leverage or subscribed their bonds (relations to the banking system, whether as financier as or underwriter of debt securities). As both aspects might result in triggering systemic developments, this explains why recent European proposals include funds engaging in private equity in the mandate of the authorities in charge of monitoring financial stability. An April 2007 study by the ECB concluded that the exposure of the banks to the private equity sector in relation to the banks own funds buffer was at that time relatively mild in relation to the banks' own funds, however drawing attention to the rapidly increasing leverage, resulting in large LBO debt concentrations, with a caveat for the underwriting risks of banks for the unsold stock of private equity debt, and for the secondary market for LBO debt trading[100]. Some of these fears have materialised in the subsequent financial crisis. But it also showed that private equity funds, as hedge funds as well, are important sources of financing in the economy.

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[96] See the Belgian Report on the public and private pricaf.
[97] See the Danish Report.
[98] See the Croatian Report.
[99] See, by way of example, the Rasmussen and Lehne reports in the European parliament: Rasmussen Report, European Parliament 2007/2238(INI) of 18.4.2008 and Parliaments' motion: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0338+0+DOC+PDF+V0//EN) and Lehne report (www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0296+0+DOC+PDF+V0//EN) and the motion adopted.
[100] Large banks and private equity sponsored leveraged buyouts in the EU, April 2007 www.ecb.eu/pub/pdf/other/largebanksandprivateequity200704en.pdf

Most of the legal aspects in the national reports relate to the action of the private equity funds in connection with their investee companies. Some of these issues – e.g. their action as activist investors - are common with the hedge funds, but different in the sense that private equity investors usually strive for fully acquiring the investees and remain invested at least on the medium term. Moreover, they usually play an active role in the management of their investees, aiming at repayment of their investment with a view of reimbursing the leverage needed for financing the investment. This financing scheme has raised eyebrows in some jurisdictions as, depending on its conditions, it may be analysed as "financial assistance" that before 2006 was strictly prohibited under the Second company directive[101]. Conflicts of interest between the investee, its directors and the private equity funds should also be mentioned, as these may be detrimental to the public investors at the moment of going private.

Another series of company law issues are related to the activist policy pursued by some of these funds. Some national reports refer to the danger of destabilizing the management by allowing investors' activism[102]. Apart from the general rules dealing with takeover bids - such as the mandatory bid rules, introduced by the takeover bid directive[103]-, several company law provisions play an important role, such as the right to call a general meeting (often at 5%, in some cases at 1%) the right of the AGM to dismiss directors "ad nutum", by a simple majority vote of the shareholders present. In several jurisdictions, the board of directors cannot independently from any shareholder vote, dispose of substantial assets of the company[104]. The law contains a certain number of protections for the companies and their management against involuntary takeovers, among which one can mention the right to know their shareholders[105], disproportional or double voting rights[106], and several other takeover protections.

Private equity funds and hedge funds have been accused of destroying the firms in which they invest, by overloading them with debt, extract the net value, lay off personnel, sell assets or divisions, and ultimately sell the remainder of the firm to another equity investor, or to the market. This is the caricature of the debate that has been carried on in the European media, and in some political statements. It is know under the reference to the "locusts", an expression used by a German politician, or to "predatory capitalism"[107]. Additional concerns relate to issues like foreign dominance, referring to the debate about the sovereign wealth funds. The debate was picked up in the European Parliament, i.a. in the Rasmussen Report, where the following ideas were put forward, many of which were later introduced in the AIFM proposed directive.

- Mandatory capital requirements for all financial institutions;

[101] Art. 23 of the 2nd Company Law directive forbade any form of financial assistance. It has been changed in 2006, allowing financial assistance under certain conditions. See Wymeersch, Article 23 of the second company law directive: the prohibition on financial assistance to acquire shares of the company, Festschrift für U. Drobnig, Mohr Siebeck, Tübingen, 1998, 725-748.
[102] See the French report.
[103] Art. 5, Takeover Directive, of 21 April 2004, OJ L 142, 30.4.2004, 12-23.
[104] Comp. the German Holzmüller case BGH – Federal Court of Justice February 25, 1982, (BGH – Federal Court of Justice, BGHZ 83, 122 ("Holzmüller") and the decisions of the Dutch Hoge Raad of 13 July 2007 (" La Salle") whereby the first decided that it was legally required to submit significant disposals of assets to the decision of the general meeting, and the second decided this to be in the remit of the board.
[105] See the French system of the "titres au porteur identifiables".
[106] See about these the Control enhancing mechanisms, see Report on "Proportionality between ownership and control in EU listed companies, ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf
see the French system whereby shareholders can form an association to protect their interest.
[107] Expression used i.a. by Frans Timmermans, Dutch junior minister.

- Aligning reward packages with longer term outcomes, to reflect losses as well as profits;
- Full transparency of high level executives and senior managers' remuneration systems;
- Disclosure of leverage/debt exposure, source and amount of funds raised, and identification of shareholders (above a certain level) for all investment products (and therefore including hedge funds and private equity) to investors and public authorities;
- Extending the Directive obliging employees to be informed and consulted during takeovers to include leveraged buy-outs;
- Measures to "avoid unreasonable asset stripping in target companies";
- Action to avoid excessive debt caused by leveraged buy-outs, so that "the level of leverage is sustainable both for the private equity fund/firm and for the target company";
- Employees or staff representatives of pension funds must be informed on how their pensions are invested and the associated risks.

From the national reports it appears that while this debate is quite active in some jurisdictions, it is inexistent in most others[108]. So e.g. do the Danish and to a lesser extent the Swiss and French reports refer to the – largely past – negative political discussion[109], but refer to subsequent reports especially dealing with the consequences on employment that allow to modify the first negative impressions. For their contribution to innovation and improving financial results of the investees, private equity funds have been considered positively. In the Netherlands the activist attitude of some of these funds – but also of other investors – have caused great concern[110]. Several of the national reports draw attention to the effects of the activity of these funds on the legal position of the investee companies.

The national reports frequently mention the need for the investee to know exactly who its shareholders are, and what are their intentions with the acquisition of a block of shares[111]. Several reports draw attention to the weakness of the rules on disclosure of significant holdings, as laid down in the Transparency directive, especially with respect to the cases of hidden ownership due to the use of derivatives, such as contracts for difference, or equity swaps. The general rules on declaration of significant holdings do not yield a sufficient granular picture of the ownership of the target company, are not always fully respected, do not always yield the identity of the beneficial owner, and have raised difficult questions about "concert action"[112]. Serious often highly publicised conflicts and surprise manoeuvring by funds, along with fears of foreign takeovers have put both hedge funds and private equity funds in a negative daylight. It would seem however that private equity funds adopt less of a conflicting or "activist" strategy, as they usually will have to rely on the management to develop a longer term relationship, than hedge funds that are usually adopting a more "short term" approach.

3. The AIFM directive

The AIFM directive is fully applicable to private equity funds although these are not separately addressed. Certain provisions are however more clearly relating to the activity of

[108] So also in Spanish and Italian Reports.
[109] See the Danish report referring to "Danish discussion" and the Rasmussen report Hedge Fund and private Equity, nt. 93. This report also refers to voluntary codes such as a Guide for responsible ownership and good corporate governance .
[110] However, there may be confusion as to whether they were due to the activity of hedge funds, rather than of private equity investors.
[111] The latter point is especially mentioned in the French report, although the obligation exists in similar terms in the takeover regulation of other jurisdictions. See also the Spanish report referring to the regulation. (p. 16).
[112] See about these points the Swiss report.

private equity funds[113]. That means that the funds' management company has to be authorised and will become subject to supervision according to the general rules applicable to all AIFM. Apart from the prudential requirements (essentially minimum capital, leverage ratio), the widely framed provisions on conflicts of interest and on conduct of business call for special attention. The rules on remuneration also apply even to fully privately owned funds. Risk management calls for special attention: it includes i.a. provisions on holding or on securitising investee securities or liabilities[114]. The rules on valuation and on the depositary are also applicable, what may lead to specific issues as these provisions may not well fit the case of holdings in non-listed entities[115].

Only a few provisions of the directive deal more specifically with private equity funds: these are the provisions that deal with the notification disclosure of the holdings in non-listed entities, other than SMEs will especially affect private equity funds[116]. In case of acquisitions of listed companies, the general financial disclosure obligations will apply (on the basis of the Transparency directive for substantial holdings). If applicable – i.e. on crossing the 30% or 1/3 threshold - the rules on mandatory bids will also come into play. On acquisition of control, more specific special disclosures will become mandatory, especially with regard to the intentions of the AIFM as to the future business of the investee and the repercussions on employment.

Upon the acquisition of control in privately held companies – at the more than 50% level[117] – the AIFM will notify the investee, its shareholders and its employee representatives about the control acquisition, the level of control, its policy on managing conflicts of interest, its communication policy towards employees and the intentions of the AIFM as to the future business of the investee and the repercussions on employment. The supervisors and the shareholders of the AIF will also have to be informed, especially viewing the effects on the debt ratio. Finally the AIF annual report will contain an overview of the different businesses it has invested in. Information on the investee policies has been dropped. It is expected that these disclosures would allow supervisors and stakeholders to monitor the situation of the AIFM's activities.

Under the heading" asset stripping", the directive prohibits certain distributions by the investee for the first 2 years after acquisition: it relates to any form of distribution; whether under the form of dividends, share buy-backs, capital reduction, or the like. While reacquisition profits or reserves are viewed, current profits can be distributed or used otherwise.

The proposed directive was strongly opposed by the venture capital sector[118]: especially the provisions on the depositary[119] and the valuator[120]were the most strongly rejected.[121] They have been maintained in the final text.

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[113] Indirectly, art.26 to 30 focus more clearly on PEF, by addressing AIFM acquiring control of non-listed companies and assets.
[114] Including the retention by the originator of at least 5%: art 17. The rule will apply to all AIFM. The rules have to be further detailed in Commission secondary legislation.
[115] See for criticism: European venture capital association, or Alternative Investment Management Association.
[116] Art 26, also excluding SPVs for holding real estate.
[117] At the 50% + level: art 26(5).
[118] www.evca.eu/uploadedFiles/News1/News_Items/LPsurveyAIFMDventure_15_03_10.pdf
[119] www.evca.eu/BTF/300909_Depositary_FINAL.pdf
[120] www.evca.eu/BTF/Independent_Valuator_300909.pdf
[121] See Gauzès Report, nt. 4.

Part 3. Sovereign Wealth Funds (SWFs)

Although the subject of the SWFs is substantially different from the two previously analysed types of collective investment, there are a number of common points that deserve to be dealt with. The organisation of the SWF, their investment practices and the procedures for investment in other jurisdictions will not be analysed. The report will focus on the recently developed guidelines for SWF, and on the politically most active issues, that of the restrictions to investment in mostly Western economies.

SWFs[122] play a considerable role in the financial system, with total assets of about 3,7 trillion, invested whether in significant stakes in their home area, or mostly minority stakes in foreign companies. During the crisis they intervened in some of the bank rescue operations, e.g. in UBS (Singapore Fund). Due to the crisis, they also become important investors in government bonds issued by states that had to come to the rescue of their banks. According to recent information, about 20% of their assets consist of government bonds, likely to increase significantly as a consequence of the financing needs of states (for an annual gross amount of $ 15 trillion, as far as OECD states are concerned)

3.1. Definition and code of conduct for SWF

The definition of foreign wealth funds has been widely discussed. It is now well defined in an international agreement, adopted in 2008 with the assistance of the IMF, "the Generally Accepted Principles and Practices (GAPP)", formulated by the International Working Group on Sovereign Wealth Funds[123].

This agreement, the so-called "Santiago principles" define a SWF:

> "Sovereign wealth funds (SWFs) are special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. SWFs have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities".

The Santiago principles were formulated after initial concern about the action of some SWF and government related companies had been formulated. They aim at improving understanding of the action of the SWF by creating transparency about their structure, providing for sound governance and adequate controls, risk management and accountability. They also call for members to ensure that investments will be made on the basis of economic and financial returns and return-related consideration, implicitly rejecting political investments. Finally they state that the maintenance of the free flow of capital, and of an open and stable investment climate will be strived at. Recipient countries from their side should

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[122] The main SWF are the funds from the UAE (Abu Dhabi), Norway, Saudi-Arabia, China (2 investment funds) Singapore, Kuwait, Russia, China (social security funds), and Hong Kong: D. Oakley and Gillian Tett, Sovereign Wealth Funds, courted in debt sales, FT, 25 March 2010.

[123] The members of which are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States.

maintain clear and non-discriminatory policies towards SWF.

In 2009 an International Forum of Sovereign Wealth Funds was established. It will i.a. look in to the application of the Principles, the investment and risk management practices of the SWF and the developments in the investment environment and the recipient country relationships.

These initiatives have resulted in a more objective debate about the role of the SWF. However implementation of the principles remains voluntary, compliance may be the crucial test.

Several national reporters have mentioned the creation or existence of a SWF in their jurisdiction[124].

3.2. The protective measures

In the past the role of the SWF has mainly received attention form the point of view of supervision of their investment in activities that were considered strategic or essential in the host states. The attitude of the states towards this issue is however very diverse.

Some states have not adopted any rules in this respect.

This is also the case with the European Union: the issue has been debated without resulting in any legislative or other initiative. Rather, Commissioner McCreevy underlined in a December 2007 speech[125] that Europe has no interest in erecting barriers to investment and that the investment of the SWF should be seen as a financial opportunity. He further referred to the Treaty according to which measures for national security could be taken, while in the financial sector, capital movement may be restricted – by a unanimous vote however and that the "fit and proper" test, applicable to financial institutions, may be used for a similar purpose. The Commission formulated its official position in 2008 based on transparency and governance[126]. Also, the rules on freedom of capital transfers, the merger control regulation[127] but also the limits traced by the ECJ in the field of "golden shares"[128] allow Member states to take appropriate measures to protect legitimate interests other then competition or merger control interests. Public security, plurality of the media and prudential rules are considered "legitimate interests".

Some other jurisdictions had some limited restrictions on investments: these were sometimes dealt with under the heading of competition law, e.g. in the UK, where golden shares may be linked to ownership restrictions for other parties.

Provisions with respect to the investment activities of SWF have been introduced in several states and most of the time they are not explicitly addressed to SWF.

[124] see the Greek report, the Taiwan report

[125] Speech 4 December 2007, europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/787&format=HTML&aged=0&language=EN&guiLanguage=en

[126] A common European approach to Sovereign Wealth Funds, 27.2.2008 COM(2008) 115 final.

[127] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation).

[128] In the golden shares ECJ cases of 4 June 2002, the court took a restrictive attitude as to he compatibility of "golden shares" with the freedom of capital movement that can only be allowed for " an overriding reasons of general interest", see ECJ, 4 June 2002, C.367/98 (Portugal: general financial interest is not an adequate justification); C 483/99 (France: general right of refusal for direct and indirect investment is not compatible) but C. 503/99 (golden shares acceptable for safeguarding energy supply); more recent cases (e.g. Netherlands, 28 Sept. 06 C 282/04 and C 283/04 restrictions extending beyond the needs of maintaining postal service) (C 463/04 Federconsumatori) have maintained this line. See also the Volkswagen case (C 112-05 Germany no showing of protection of minority shareholders as a legitimate interest).

Several approaches should be mentioned:

- many jurisdictions have no regulation at all: this is the case in Belgium, Switzerland, Denmark;
- some jurisdictions have introduced a procedure, requiring all foreign direct investment to be notified: Italy and France;
- in Italy, SWF may qualify as "investment companies" and hence will be subject to general or specific disclosure obligations;
- other states have listed the sectors where foreign investment is subject to a government decisions for considerations relating to public order, national security, but also more widely
    - o Taiwan requires an approval for all foreign investment, and prohibits certain categories on the basis of concerns of public order, national security and good customs and practices.
    - o France requires an authorisation for investments in certain industry sectors involving public order, public authority, national defence, and research, production of trade of armament, munitions, and explosives.
    - o The US has a complex regime limiting or restricting foreign investment, or imposing specific disclosures: this applies to wide range of activities such as banking, communications, transportation, natural resources, energy, agriculture and defence[129]. In general all investment exceeding the 10% threshold may trigger scrutiny. Formal authorisation procedures apply to transportation, communications, and natural resources and energy. The implications of foreign investment on national security are analysed by the CFIUS, the "Committee for Foreign Investment in the US". The American report indicates that while a limited number of requests have been refused, many were voluntarily withdrawn. Financial investments exceeding 10% of total ownership are subject to scrutiny, and conditions may be imposed resulting in reducing the foreign investor's influence on the functioning of the investee company.
    - o Some other jurisdictions practice some limited restrictions on investments: these were sometimes dealt with under the heading of competition law, e.g. in the UK, where golden shares may be linked to ownership restrictions for other parties.
    - o Reference should also be made to the private law techniques although these are not specifically addressed to foreign investors. The use of private law is also mentioned in the Swiss report.
    - o Informal mechanisms have been used, consisting e.g. in political pressure, formulation of a counterbid by national firms, mobilising local especially institutional shareholders.

[129] See for a detailed overview, Government Accountability Office (GAO), Sovereign Wealth Fund Laws Limiting Foreign Investment Affect Certain U.S. Assets, May 2009/www.gao.gov/new.items/d09608.pdf

B. Conclusion

The regulation of the three types of investment vehicles reveals a wealth of issues and questions. They differ depending on the type of fund considered. The common denominator seems to be the effect of these investment funds on the investee companies. This issue is translated in different terms: for hedge funds it is more prominently their role as activist investors that comes to the forefront, while for private equity funds, it is their continuous relationship to the investee and the development, or non development of the latter that receives most attention. In legal terms, the first item belongs to the overall field of company law and corporate governance, the second relates to corporate finance, conflicts of interest and social relations. The sovereign wealth funds raise mainly political issues of sovereignty and possible abuse of economic influence: answers have been formulated at the political level, in an international conduct of business code, and in public interventions monitoring foreign investment.

The subjects of hedge funds and private equity funds have been the subjects of a significant regulatory effort, the implementation of which is still going on at the moment of writing. Some of the general features of these reforms have been mentioned. They will also affect the national reports. It will be interesting to verify in a couple of year how much has been changed, and whether these new regulations have effectively strengthened our financial system. .

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