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# The Alternative Investment Fund Managers Directive

European Regulation  
of Alternative Investment Funds

Dirk Zetsche (ed.)



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Law & Business

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# Summary of Contents

<b>Preface</b>	v
<b>List of Contributors</b>	xliii
<b>List of Abbreviations</b>	liii
PART I: INTRODUCTION	
Chapter 1	
<b>Introduction: Overview, Regulatory History and Technique, Transition</b>	<b>1</b>
<i>Dirk A. Zetzsche</i>	
PART II: GENERAL ASPECTS	
Chapter 2	
<b>AIFMD, Systemic Risk and the Financial Crisis</b>	<b>21</b>
<i>Rüdiger Wilhelmi &amp; Moritz Bassler</i>	
Chapter 3	
<b>Scope of the AIFMD</b>	<b>39</b>
<i>Dirk A. Zetzsche</i>	
Chapter 4	
<b>Challenges from the Supervisor's Perspective</b>	<b>71</b>
<i>Marcel Lötscher &amp; Patrick Bont</i>	
Chapter 5	
<b>Interplay between the AIFMD and the UCITSD</b>	<b>77</b>
<i>Ulf Klebeck</i>	

Chapter 6	
<b>AIFMD vs. MiFID: Similarities and Differences</b>	<b>97</b>
<i>Markus Wagner, Verena Schlömer &amp; Dirk A. Zetzsche</i>	
Chapter 7	
<b>White Collar Crime, Money Laundering and Taxation: The AIFMD and Hedge Funds – An International and Irish Perspective</b>	<b>109</b>
<i>Shelley Horan</i>	
Chapter 8	
<b>CSR and the AIFMD</b>	<b>137</b>
<i>Dirk A. Zetzsche &amp; Christina D. Preiner</i>	
PART III: THE AIFM	
Chapter 9	
<b>Appointment, Authorization and Organization of the AIFM</b>	<b>159</b>
<i>Dirk A. Zetzsche</i>	
Chapter 10	
<b>The Liability Insurance of the AIFM</b>	<b>199</b>
<i>Gregory Walker</i>	
Chapter 11	
<b>Delegation</b>	<b>217</b>
<i>Thibaut Partsch &amp; Jérôme Mullmaier</i>	
Chapter 12	
<b>The AIFM's Governance and Remuneration Committees</b>	<b>237</b>
<i>Paulo Câmara</i>	
Chapter 13	
<b>Liquidity Management and Side Pockets</b>	<b>253</b>
<i>Ulf Klebeck</i>	
Chapter 14	
<b>Risk Management</b>	<b>265</b>
<i>Dirk A. Zetzsche &amp; David Eckner</i>	
Chapter 15	
<b>Investor Information, Disclosure and Transparency</b>	<b>333</b>
<i>Dirk A. Zetzsche &amp; David Eckner</i>	
Chapter 16	
<b>The AIFMD's Cross-Border Dimension and Third Country Rules – A Systematic Perspective</b>	<b>367</b>
<i>Dirk A. Zetzsche &amp; Daniel Litwin</i>	

PART IV: THE DEPOSITARY AND THE PRIME BROKER	
Chapter 17	
<b>Depository Regulation</b>	<b>409</b>
<i>Sebastiaan Hooghiemstra</i>	
Chapter 18	
<b>The AIF Depository’s Liability for Lost Assets</b>	<b>447</b>
<i>Christophe Clerc &amp; Jacques Deege</i>	
Chapter 19	
<b>Depository Liability – A Fine Mess and How to Get Out of It</b>	<b>455</b>
<i>John Siena</i>	
Chapter 20	
<b>(Prime) Brokerage</b>	<b>489</b>
<i>Dirk A. Zetzsche</i>	
PART V: INVESTMENT STRATEGIES	
Chapter 21	
<b>Securizations</b>	<b>527</b>
<i>Dirk A. Zetzsche &amp; David Eckner</i>	
Chapter 22	
<b>Hedge Funds and Systemic Risk Reporting</b>	<b>557</b>
<i>Frank Dornseifer</i>	
Chapter 23	
<b>The AIFM’s Duties upon the Acquisition of Non-listed Firms</b>	<b>575</b>
<i>Christophe Clerc</i>	
Chapter 24	
<b>The European Venture Capital Cycle in the Post-AIFMD Era</b>	<b>593</b>
<i>Erik P.M. Vermeulen &amp; Diogo Pereira Dias Nunes</i>	
Chapter 25	
<b>The AIFMD’s Impact on Real Estate Funds (and its Dutch Implementation)</b>	<b>611</b>
<i>J.H. Bennebroek Gravenhorst &amp; C.C. Destrée</i>	
Chapter 26	
<b>Impact of AIFMD on the Private Equity Industry</b>	<b>623</b>
<i>Mark van Dam &amp; Jérôme Mullmaier</i>	
PART VI: COUNTRY REPORTS	
Chapter 27	
<b>Italy</b>	<b>635</b>
<i>Giovanni Stefanin &amp; Francesco della Scala</i>	

Chapter 28 <b>Switzerland</b> <i>Guenther Dobrauz-Saldapenna</i>	645
Chapter 29 <b>Luxembourg</b> <i>Thibaut Partsch &amp; Ezéchiél Havrenne</i>	653
Chapter 30 <b>The Netherlands</b> <i>Sebastiaan Hooghiemstra</i>	661
Chapter 31 <b>Austria</b> <i>Julia Nicolussi</i>	673
Chapter 32 <b>Liechtenstein</b> <i>Guenther Dobrauz-Saldapenna &amp; Claudio Tettamanti</i>	685
Chapter 33 <b>United Kingdom</b> <i>James Greig</i>	697
Chapter 34 <b>Germany</b> <i>Sascha Staat</i>	711
Chapter 35 <b>France</b> <i>Christophe Clerc &amp; Jacques Deege</i>	723
Chapter 36 <b>Ireland (with Focus on HF Industry)</b> <i>Shelley Horan</i>	735
PART VII: CONCLUSION	
Chapter 37 <b>The AIFMD and the Joint Principles of European Asset Management Law</b> <i>Dirk A. Zetzsche</i>	747
<b>Bibliography</b>	755
<b>List of Legal Texts (EU/EEA)</b>	789
<b>Index</b>	797

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# Chapter 4

## Challenges from the Supervisor's Perspective

*Marcel Lötscher & Patrick Bont*

### 1. INTRODUCTION

The dictum '*Gouverner, c'est prévoir*' is attributed to the French politician Emile de Girardin (1806–1881). It continues to hold even in the 21st century. The financial markets are undergoing an unprecedented upheaval. The globalization and internationalization of markets and businesses is being accompanied by a fundamental reform and expansion of supervision and regulation across national borders. This is associated with a considerable increase in the scope and complexity of regulation in the financial industry. This also entails considerable risks, as the world has painfully experienced over the past few years. The desire for more control and protection is understandable, but influencing this complex system may also have undesirable effects. These effects should be avoided and the right balance of rules and freedom should be found. Looking ahead and acting prudently have not become easier since Emile de Girardin, but are all the more important.

### 2. EXPLORING THE SUPERVISORY CHALLENGES

The predominant role of supervisory authorities is to safeguard the stability of financial markets, to protect investors and customers, prevent market abuse, as well as to implement and comply with recognized international and European standards.<sup>1</sup>

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1. For a pan-European supervisory authority, see for instance Art. 1(5) Regulation (EU) No. 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory

The government as legislator and, for instance, the *Finanzmarktaufsicht Liechtenstein* (hereinafter referred to as ‘FMA’) as the supervisory authority must deal with a conflict of goals. ‘On the one hand, there is the [intermediary] with an understandable need for clearly and easily implementable regulatory requirements. On the other hand, any attempt to offer the [intermediary] and other practitioners schematic instructions on how to supplement indeterminate legal terms or make use of leeway in interpreting the law necessarily runs counter to the legislative goal of replacing the formalistic approaches taken by [intermediaries] with an autonomous, flexible, and risk-based assessment of individual cases.’<sup>2</sup>

Resolving this conflict of goals is not, however, a precondition for risk-based supervision as such. Rather, the dialogue necessitated by this conflict should help ensure coherent implementation of the supervisory requirements. The suggestions made by supervisors should furthermore enable application and implementation of the relevant laws and regulations to be legally secure.<sup>3</sup> The conflict of goals inherent in the system is supplemented by the information asymmetry prevalent especially in the fund industry.<sup>4</sup>

From July 2009 onwards, the regulatory landscape of collective investment undertakings was subject to significant change.<sup>5</sup> One of the core rationales was to create harmonized regulatory standards for management companies and the funds they manage, such as AIF and UCITS. Moreover, transparency vis-à-vis investors and supervisors was about to be improved. In any of these cases, the subject matter to be governed was and will be mostly interdisciplinary, i.e. the regulation of banking and financial markets is to be legitimated and shaped by an economic understanding.<sup>6</sup> This rising importance of economic rationales influencing financial regulation bears predominantly a twofold challenge for supervisors.

On the one hand, the challenge for the supervisor is now the conflict between the legislative goal of a formalistic approach and the goal of an autonomous, flexible, and risk-based assessment of the individual case. This will be particularly aligned with the transparency required to dissolve the information asymmetry and not lead to information overload. The principle of investor protection inherent in both points must be ensured.

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Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15 December 2010, 84; for instance, on EU/EEA Member State level, see for Liechtenstein Art. 4 FMA Act (Finanzmarktaufsichtsgesetz, LGBl. Nr. 175, 18. August 2004); for Germany, sec. 4 BaFin Act (Finanzdienstleistungsaufsichtsgesetz, BGBl. I S. 1310, 22. April 2002); for the UK, see sec. 2 of the Financial Services and Markets Act 2000.

2. Translated by the authors from A. Ogbamichael, *Das neue deutsche Geldwäschereirecht* 51 (De Gruyter 2011).

3. A. Ogbamichael, *Das neue deutsche Geldwäschereirecht* 52 (De Gruyter 2011).

4. See the seminal G. Akerlof, *The Market for Lemons*, 84(3) *Quarterly Journal of Economics* 488 et seq. (1970); M. Jensen & W. Meckling *Theory of the Firm*, 3(4) *Journal of Financial Economics* 305 et seq. (1976); J.E. Stiglitz, *The Contributions of the Economics of Information to Twentieth Century Economics*, 115(4) *The Quarterly Journal of Economics* 1441 et seq. (2000); see also F.S. Mishkin, *Prudential Supervision: Why Is It Important and What Are the Issues?*, in *Prudential Supervision: What Works and What Doesn't?* 1 et seq. (F.S. Mishkin ed., UCP 2001).

5. For further details, see D. Zetzsche, *Introduction: Overview, Regulatory History and Technique, Transition*, ch. 1.

6. Seminally addressed by D. Llewellyn, *The Economic Rationale for Financial Regulation*, Financial Services Authority Occasional Paper Series No. 1, 5 et seq. (FSA, April 1999); revisited by R. Herring & R.H. Schmidt, *The Economic Rationale for Financial Regulation*, Reconsidered, House of Finance Policy Platform White Paper No. 05 (HOF 2012); see also S. Kilgus, *Effektivität im Finanzmarktrecht* point 24 with additional references (Dike 2007).

Another focal point in the supervisory challenge will be to preserve and strengthen the accountability of the respective financial centre as such. On the other hand, the quality burden on supervisory authorities will be raised significantly. As economic approaches become more important and are, most notably, subject to frequent change, supervision will become more costly due to a higher demand for education and training.

### 3. RESOLVING THE SUPERVISORY CHALLENGES

Given that financial market regulations increase and become more complex for national supervisory authorities as well as the European System of Financial Supervision (hereinafter referred to 'ESFS'),<sup>7</sup> appropriate resolutions have to be found. Aligned with international and European rulemaking, these resolutions encompass a variety of different settings. A brief overview of certain aspects is given in the following by specifically highlighting the AIFMD transposition process in the perspective of the FMA.

#### 3.1. MARKET ANALYSIS

The FMA follows a dualistic system of supervision in Liechtenstein. This means that, in addition to the work of the supervisory authority as such, certified auditors act as the extended arm thereof. The supervisory authority and the auditors, thus, constitute a two-stage approach to safeguarding financial market stability and reputation.

A market analysis forms the basis for the supervisor's contributions to the legislative process and its active exchange of views with intermediaries and the relevant business associations. The market analysis also forms the basis for transforming intermediaries and products under the new legislation. On the basis of the auditors' reports, the FMA initiates official proceedings where necessary. Moreover, it also selects the financial institutions for detailed on-site inspection. Instead of the common 'know your customer' philosophy, the approach applicable to the persons and entities supervised by the FMA is referred to as 'know your supervisor'.

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7. The ESFS consists of the ESRB and the supervisory authorities EBA, EIOPA, and ESMA; see Regulation (EU) No. 1092/2010 on European macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB), OJ L 331, 15 December 2010, 1; Regulation (EU) No. 1093/2010 establishing the European Banking Authority (EBA), OJ L 331, 15 December 2010, 12; Regulation (EU) No. 1094/2010 establishing the European Insurance and Occupational Pensions Authority (EIOPA), OJ L 331, 15 December 2010, 48; Regulation (EU) No. 1095/2010 establishing the European Securities and Markets Authority (ESMA), OJ L 331, 15 December 2010, 84; Council Regulation (EU) No. 1096/2010 conferring specific tasks upon ECB concerning the functioning of the ESRB, OJ L 331, 15 December 2010, 162; Directive 2010/78/EU amending the legal framework in respect of the new powers, OJ L 331, 15 December 2010, 120.

3.2. REGULATORY PROJECT MANAGEMENT: THE AIFMD IN LIECHTENSTEIN

As an EEA member,<sup>8</sup> Liechtenstein is required to implement and apply a body of European directives and regulations.<sup>9</sup> The government and authorities are, therefore, constantly planning and executing relevant projects in a wide range of areas. The resources of a small state like Liechtenstein are, of course, limited. Hence, it is of the utmost importance to define priorities and to target the use of the available specialists.

Liechtenstein followed the discussions and preparations at the European level with regard to the introduction of a comprehensive and harmonized regulation of AIFMs. Shortly after adoption of the AIFMD, the government commissioned experts from its own staff and the FMA to plan the implementation of the AIFMD and to assess the consequences, opportunities, and risks for the financial centre. It was recognized that the implementation of the AIFMD is of extraordinary importance to the financial centre. The fund business, both UCITS and AIFs, but in particular AIFs, have traditionally been a very significant pillar of the Liechtenstein financial centre. Implementing the AIFMD should, therefore, on the one hand be consistent with the government's financial centre strategy, and at the same time ensure that the European requirements are implemented correctly and completely. The government was therefore requested to approve a project to that effect.

The AIFM project was headed by the Office for International Financial Affairs. The FMA served as the project office and made experts available for project management. The project team included representatives of the National Public Administration, the FMA, the Fiscal Authority, the University of Liechtenstein, and the business associations of the financial centre.

The project was divided into four streams, each of which was the responsibility of one project group. These streams were coordinated as follows:

- (1) The first stream dealt with implementation of the AIFMD in national law. This included preparing the draft law and ordinance as well as accompanying and initiating the entire political legislative process.
- (2) The second stream considered market orientation, marketing and communication. A particular issue was which business models would be possible and desirable within the framework of the AIFMD and how changes should be communicated.
- (3) The third stream considered taxation-related topics of AIFMs. The question of the fiscal impact of the AIFMD's provisions was examined in particular by experts from the Fiscal Authority.
- (4) The fourth stream dealt with qualification and training. As previously mentioned, this stream was and still is of importance as the AIFMD imposes new and, should adequate training fail, costly measures on AIFMs. Accordingly, the professional qualifications of AIFMs were particularly stressed. The working group developed concepts to ensure that the necessary opportunities for basic

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8. The Principality of Liechtenstein, the Kingdom of Norway and Iceland are EEA Member States, see Agreement on the European Economic Area (EEA), OJ L 1, 3 January 1994, p. 3 (hereinafter 'Treaty of Porto').

9. See particularly Art. 7 of the Treaty of Porto and its annexes IX (financial services), XII (free movement of capital) as well as XXII (company law).

and continued training are available and that the requirements on managers are specified in detail.

In conclusion, the basis for a proper transposition was a structured and well-organized project with an interdisciplinary project team that brings experts and stakeholders to the same table. By pooling these interests, competencies and ideas, acceptance was created on the part of both, the authorities and the market.

### 3.3. IMPLEMENTATION WITHIN THE FMA

As a supervisory authority, the FMA's actions must be guided by the principle of legality.<sup>10</sup> Therefore, every new regulation and every new law affecting the financial market also have an impact on the work of the FMA. In general, the density of regulation is steadily increasing, both nationally and internationally, and the European financial market regulations expanding in terms of scope and complexity. For a comprehensive change of law as triggered by the AIFMD, major adjustments within financial market supervision are unavoidable and must be tackled early on. In particular, the following three areas are affected: organization and processes, expertise, and infrastructure.

The implementation of the AIFMD in national law has an impact on approval processes and on-going supervision. The internal organization of the national supervisory authority must be adjusted in a range of aspects. Competences, workflows, deadlines and so on, must be redefined. Furthermore, responsibilities must be assigned and communicated externally.

Efficient supervision and short approval processes are only possible if the FMA staff have the necessary expertise. Hence, it is of the utmost importance to train FMA staff intensively and/or to cooperate with external professional service providers.

The adjustment of processes and organizational structures has also a direct impact on infrastructure. Specifically, IT hardware and software, archiving systems and similar operating conditions must be redesigned and supplemented.

This requires an early planning procedure, numerous internal projects, and the inclusion of and coordination with experts from the National Public Administration and external providers. In addition, ongoing supervision must be ensured. The efficient allocation of the limited human and financial resources in such a situation is therefore a special challenge for the FMA. At the same time, however, it is a precondition for being ready when the new provisions enter into force.

## 4. OUTLOOK

The implementation of the AIFMD in national law is only the first, albeit the most important step in an extended process. The FMA will have to incorporate these measures into its internal processes. This will entail additional work and again have an impact on internal

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10. For an analysis of the interaction of legality and financial supervision, see T. Duijkersloot, *The Principle of Legality and the 'Soft Law' Regulation and Supervision of Financial Markets*, in *The Eclipse of the Legality Principle in the European Union* 169 et seq. (L.F.M. Besselink, F. Pennings & S. Prechal eds, Kluwer Law International 2010).

organization and resources. The same is true of the numerous technical guidelines expected to be issued by ESMA. A review of the AIFMD regime by the EC is planned for 2017. Depending on the experiences of ESMA at the European level and by the supervisory authorities in the individual states, this may entail another major revision of the AIFMD.