

CHAPTER 4

Challenges from the Supervisor's Perspective

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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 twenty-first 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. The considerable increase in the scope and complexity of regulation in the financial industry associated with reform and expansion of regulation 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 CHALLENGE

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.¹

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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

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.²

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.³ The conflict of goals inherent in the system is supplemented by the information asymmetry prevalent especially in the fund industry.⁴

From July 2009 onwards, the regulatory landscape of collective investment undertakings was subject to significant change.⁵ 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 were 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.⁶

a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, 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, s. 4 BaFin Act (Finanzdienstleistungsaufsichtsgesetz, BGBl. I S. 1310, 22. April 2002); for the UK, see s. 2 of the Financial Services and Markets Act 2000.

2. A. Ogbamichael, *Das neue deutsche Geldwäschereirecht*, 51 (De Gruyter 2011).

3. *Ibid.*, supra n. 2, at 52.

4. See the seminal work by 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); 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*, 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).

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. 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'),⁷ 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

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 331/1; Regulation (EU) No. 1093/2010 establishing the European Banking Authority (EBA), OJ L 331/12; Regulation (EU) No. 1094/2010 establishing the European Insurance and Occupational Pensions Authority (EIOPA), OJ L 331/48; Regulation (EU) No. 1095/2010 establishing the European Securities and Markets Authority (ESMA), OJ L 331/84; Council Regulation (EU) No. 1096/2010 conferring specific tasks upon ECB concerning the functioning of the ESRB, OJ L 331/162; Directive 2010/78/EU amending the legal framework in respect of the new powers, OJ L 331/120.

common 'know your customer' philosophy, the approach applicable to the persons and entities supervised by the FMA is referred to as 'know your supervisor'.

3.2 Regulatory Project Management: The AIFMD in Liechtenstein

As an EEA member,⁸ Liechtenstein is required to implement and apply a body of European directives and regulations.⁹ 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.

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

- (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 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.¹⁰ 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 were unavoidable and had to be tackled early on. In particular, the following three areas were affected: organization and processes, expertise, and infrastructure.

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

Efficient supervision and short approval processes are only possible if the FMA staff have the necessary expertise. Hence, it was 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 had also a direct impact on infrastructure. Specifically, IT hardware and software, archiving systems and similar operating conditions had to 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, on-going supervision had to be ensured. The efficient allocation of the limited human and financial resources in such a situation provided a special challenge for the FMA. At the same time, however, it was a precondition for being ready when the new provisions entered into force.

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*, 169 et seq. (L. Besselink, F. Pennings & S. Prechal eds, Kluwer Law International 2010).

4 IMPLEMENTATION OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD) INTO THE EUROPEAN ECONOMIC AREA (EEA): ACQUIS

The parliament of Liechtenstein adopted the law on Alternative Investment Fund Managers (AIFMG) on 19 December 2012.¹¹ It entered into force on 22 July 2013. Condition, therefore, was the timely implementation of the AIFMD into the EEA-Acquis. The AIFMD relates in several cases to the ESMA which was established by Ordinance (EU) No. 1095/2010 (ESMA-Ordinance) and took up its work on 1 January 2011.¹² The AIFMD refers new duties and responsibilities to the ESMA, *inter alia* coordinating responsibilities, on-site visits in the Member States and mediation responsibilities in case of disputes between national supervisory authorities in relation to cross-border activities. In this respect the ESMA is authorized to issue binding decisions. In case the national authorities will not proceed accordingly, the ESMA may issue resolutions which are directly addressed to the market participants. The ESMA-Ordinance has not been implemented into the EEA-Acquis as to the time of writing (June 2015). For this reason the AIFMD and its accompanying legal instruments has not been implemented into the EEA-Acquis.

Following the delay of this implementation process of the AIFMD it was necessary to amend the AIFMG for purposes of maintenance of transparency and legal certainty on the one hand and for constitutional purposes on the other hand.¹³ These amendments were effected in such way, that the provisions relating to the AIFMD, especially those relating to cross-border activities and provisions with respect to the coordination until the entry into force of the resolution of the Joint Committee of the EEA with respect to the implementation of the AIFMD were abolished. As a consequence, the AIFMG which was formally drawn up as transposing law and referred to all European legal instruments turned temporarily (until the AIFMD's transposition in the EEA treaty) into a law based on national autonomy.

Insofar as the equal and unhindered market access of the Liechtenstein financial intermediaries is concerned, the transposing resolution is indispensable. Otherwise there will be no binding effect for the other EEA/EU Member States and the Liechtenstein financial intermediaries will have to apply for a licence according to the law of the relevant Member State. As a consequence, AIFMs established in the three EEA states Norway, Iceland and Liechtenstein do not benefit from the European passports for cross-border marketing or management of alternative investment funds (AIF).¹⁴

Despite the lack of transposition and as a sign for its EEA commitment, the FMA grants unhindered access of EEA-AIF to be marketed in Liechtenstein

11. Gesetz vom 19 Dezember 2012 über die Verwalter alternativer Investmentfonds, LGBL 2013, no. 49. (AIFMG).

12. Verordnung (EU) Nr. 1092/2010 des europäischen Parlaments und des Rates vom 24. November 2010, über die Finanzaufsicht der Europäischen Union auf Makroebene und zur Errichtung eines Europäischen Ausschusses für Systemrisiken, ABL 2010, Nr. 331.

13. Bericht und Antrag der Regierung an den Landtag des Fürstentum Liechtenstein betreffend die Abänderung des Gesetzes über die Verwalter alternativer Investmentfonds und anderes Gesetze, Bericht und Antrag 2013, Nr. 24.

14. For the mechanics of the AIFMD's European passport see D. Zetzsche & D. Eckner, *Appointment, Authorization and Organization of the AIFM*, Ch. 9.

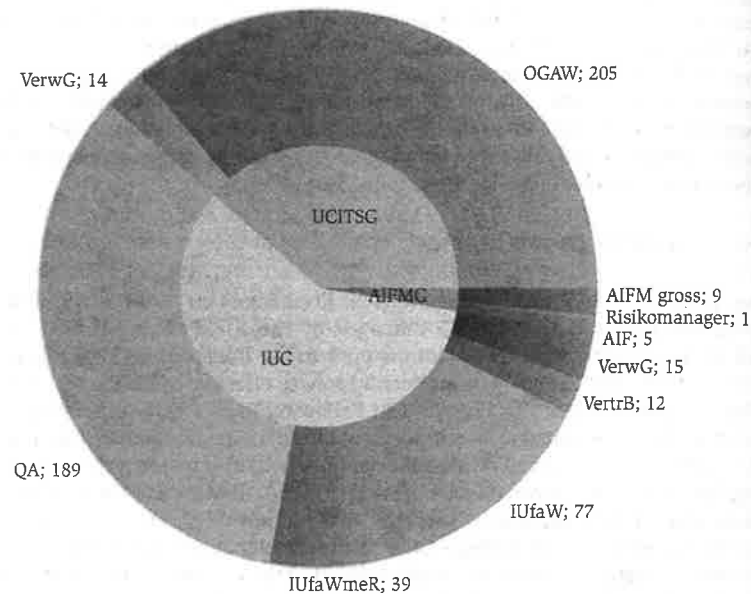
for accommodation purposes. The FMA will accept the marketing of EEA-AIF to professional and retail investors in Liechtenstein on the basis of authorization in accordance with Articles 42 and 43 of the AIFMD. The proceeding will be governed by Articles 150, 151 AIFMG and Article 200 AIFMV. The application shall be submitted to the FMA. As a further consequence, the AIFM has to appoint a paying agent in Liechtenstein if the AIF will be marketed to retail investors. Moreover, until the transposition of the AIFMD in the EEA-Acquis the FMA cooperates in the relevant ESMA committees and initiatives for implementing the European Single Rule Book to the extent possible under Liechtenstein constitutional law.

5 EFFECTS TO THE MARKET

Based on Article 189 AIFMG applications for licencing of an AIFM or authorization respectively registration of an AIF managed by the AIFM could be filed since 1 April 2013, i.e., more than three months prior to the transposition deadline for EU Member States. The licencing or authorization was effective at the earliest with the AIFMG's entry into force (22 July 2013). Following to this early possibility to file an application, Liechtenstein was in focus of international market participants. The FMA had many conversations with financial intermediaries which were interested in being licenced in Liechtenstein. Due the delays in the AIFMD's transposition into the EEA-Acquis yet notwithstanding Liechtenstein's intensive efforts, the international requests decreased slowly. However, nationally the Liechtenstein fund management companies managing non-UCITS funds submitted themselves to the AIFM-Regime. This seems to be based on the situation that the fund managers want to be prepared by the time the AIFMD will be implemented in the EWR-Acquis. Up-to-date (June 2015) eight so-called big AIFM were licenced. Furthermore, the FMA granted a license to a risk manager based on the AIFMG's authorization scheme for risk managers. The first AIF was authorized by the end of March 2014.

A special challenge was the introduction and transposition of the provisions of the AIFMD as manager regulation. First, this implied a rethinking that as from thereon the fund manager will be regulated rather than the product. Second, new duties were accrued such as, but not limited to the responsibility to implement a remuneration-policy with respect to all employees which is to prevent to take too high risks, the functional and hierarchical separation of the risk- and portfolio management as well as the obligation of the AIFM to do at least the risk- or portfolio management itself, the distinguished requirements with regard to risk management and further substance requirements for the AIFM, the reporting requirements and the independent calculation. All those requirements implied new challenges for the AIFM. Therefore, the FMA as well must live up to the challenge to assess in each case if the applying AIFM is sufficient qualified and organized to manage the future AIF with its personnel and duly fulfil the imposed responsibilities. As such, each filed application is to be assessed on a case-by-case basis which requires an administrative discretionary decision. To conduct the licencing process best, the FMA assists each application proactively. Accordingly, conversations between the intermediary and the FMA may take place ahead of and during the authorization process. Finally and before issuing the licence, there will be an onsite-visit. This way it can be ensured, that the licence can be issued based on a sufficient general picture.

Figure 4.1 Licences pursuant to the IUG, UCITSG and the AIFMG



Data as of 9 June 2015; source: FMA

Figure 4.1 reflects the licenced intermediaries and related products according to the IUG, UCITSG and AIFMG. This includes: management companies (VerwG) pursuant to IUG and UCITSG, distributors (VertrB) according to the IUG, qualified funds (QA), investment undertakings for other assets (IUfaW), investment undertakings for other assets with higher risk (IUfaWmeR), undertakings for collective investments in transferable securities (UCITS), AIFM, AIF and risk managers.

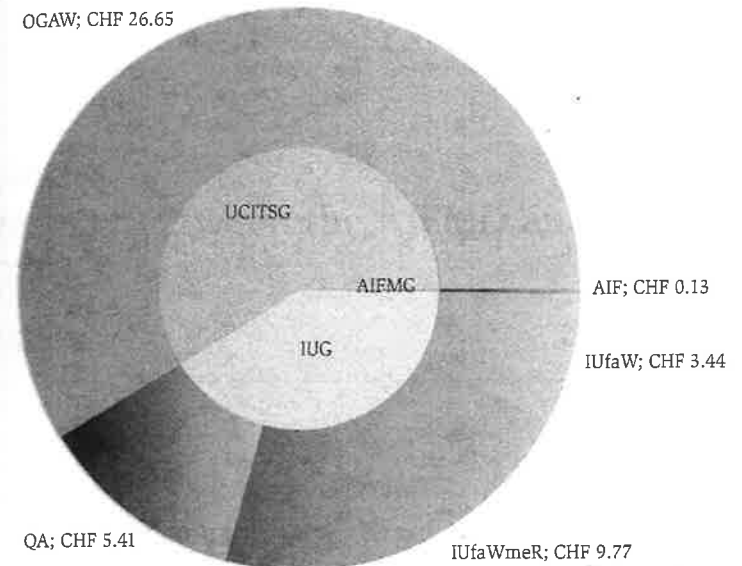
Figure 4.2 illustrates this by showing the related volumes concerning the IUG, UCITSG and AIFMG.

6 OUTLOOK

The transposition of the AIFMD did not lead to a one-size-fits-all solution, neither for the fund business nor for the supervisory authorities. The envisaged uniform European distribution passport lead to substantial changes in business models as well as the supervisory practice.

From a Liechtenstein perspective, it will be interesting to see, in which direction the funds that are currently licensed under the IUG will be directed. While we first observed a trend towards the stricter UCITS regulation (which was likely due to the yet-lacking AIFMD passport), we estimate that of the remaining funds approximately

Figure 4.2 Volume of Funds



Volume in Brd; data as of 9 June 2015; source: FMA

two-thirds belong in their current form to the AIF domain. Furthermore, the Liechtenstein legislator contemplates to implement a third fund regime for collective investment schemes that neither meets the UCITS nor the AIF definition. Finally, the next generation of European financial regulation, including MiFID II, the PRIIPSR and the ELTIFR signal further changes on the side of the industry and regulators.

All in all, we will be able to draw conclusions as to the attraction and effects of the AIFMD, as well as the true challenges for supervisors only after a certain time after effective implementation of the AIFMD and aforementioned legislation that impact on AIFMs into the EEA-Acquis.

Regardless of the rapid change in the regulatory environment and the complexities of European multi-level legislation, the FMA is committed to maintain a pragmatic (but not a tailored to suit the market need) approach with proportionality within the limits of the legal and regulatory environment provided by the AIFMD and European financial law to ensure the stability of the financial market, investor protection, to prevent market abuses as well as to ensure the transposition and implementation of the acknowledged international standards.

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