THE AIFM DIRECTIVE AND ITS REGULATION OF HEDGE FUNDS AND PRIVATE EQUITY

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I. INTRODUCTION AND GOAL OF THE DIRECTIVE

The situation for private equity companies has been improving again after the financial crisis, which led to the breakdown of M&A transactions. Low interest rates, potentially high growth of target companies and ringing cash tills attract new transactions. However, there are downsides: since attractive take-over targets are rare, high competition could lead to an increase in sales prices for potential target companies.[1] Also, regulatory insecurity is still high due to the Alternative Investment Fund Manager (AIFM) Directive,[2] which was passed in November 2010. The legislative procedure for this regulatory proposal is oriented by the Lamfalussy Procedure.[3] The first stage was completed with the coming into force of the AIFM directive, followed by implementing rules in the second stage. The ESMA (successor to the CESR) published these rules under authority of the EU Commission on July 13, 2011, in a comprehensive advisory document.[4] Numerous implementing rules are concretized in this document, and presented for discussion. The ESMA's final recommendations were provided on November 16, 2011. In the third stage, the ESMA passed recommendations and guidelines.[5] The requirements for private equity firms and hedge funds are only legally binding after the Directive's national implementing statutes come into force by July 22, 2013. Private equity firms should create a competitive advantage for themselves against

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1. Sebastian Jost, *Wird Deutschland zur "Kampfzone" für Firmenjäger?*, DIE WELT (Ger.), Feb. 5, 2011, http://www.welt.de/wirtschaft/article12457138/Wird-Deutschland-zur-Kampfzone-fuer-Firmenjaeger.html.

2. Directive 2011/61/EU of the European Parliament and of the Council v. 8 June 2011 on the manager of alternative investment funds and to amend Directive 2003/41/EC and 2009/65/EC and Regulation (EC) Nr. 1060/2009 and (EU) Nr. 1095/2010, Abl. 2011, Nr. L 174, 1 [hereinafter AIFM directive].

3. Martin Weber, *Die Entwicklung des Kapitalmarktrechts im Jahre 2010*, NEUE JURISTISCHE WOCHENSCHRIFT 273, 274 (2011) (Ger.). For the Lamfalussy Procedure, *see* Thomas M.J. Möllers, *Europäische Methoden- und Gesetzgebungslehre im Kapitalmarktrecht, Vollharmonisierung, Generalklauseln und soft law im Rahmen des Lamfalussy-Verfahrens als Mittel zur Etablierung von Standards*, ZEITSCHRIFT FUR EUROPAISCHES PRIVATRECHT 480 (2008) (Ger.); Klaus U. Schmolke, *Der Lamfalussy-Prozess im Europäischen Kapitalmarktrecht - eine Zwischenbilanz*, NEUE ZEITSCHRIFT FUR GESELLSCHAFTSRECHT 912 (2005) (Ger.).

4. ESMA, Consultation paper, ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/209 v. 13.7.2011, *available at*: http://www.esma.europa.eu/popup2.php?id=7625.

5. Thomas M.J. Möllers, *Sources of Law in European Securities Regulation—Effective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosiere*, 11 EUROPEAN BUS. ORGANIZATION L. REV. 385 (2010).

rival funds by an optimum implementation of necessary compliance measures even before the national statutes come into effect.[6]

Generally speaking, there are three starting points for the regulation of alternative investment funds: the financial product, the investors, and the managers. The AIFM directive starts with the managers of alternative investment funds. The directive's goal is both investor protection and functional protection of the capital market.[7] Balancing these two goals is a great challenge for the legislature, particularly due to the directive's great scope of application, which leads to many different persons concerned needing special rules. The legislature needs to consider to what extend investors in AIFs are in need of protection, since they mostly act professionally—which could mean that systemic protection of capital markets is generally more important.

This paper first explains who is affected by the AIFM directive (II.). It then introduces and evaluates the directive's regulating means (III.), focusing on those that are particularly relevant for private equity managers. After presenting the directive's legal consequences (IV.), the paper concludes with an outlook (V.).

II. Scope of Application of the AIFM Directive

1. Differentiation from the UCITS Directive

In many instances, the AIFM directive draws on already known rules from the UCITS directive, for example on the concept of a common European authorization,[8] a management company's minimum capital requirements[9] and

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6. *Id.* at 379, 402; Thomas M.J. Möllers, *Auf dem Weg zu einer neuen europäischen Finanzmarktaufsichtsstruktur—Ein systematischer Vergleich der Rating-VO (EG) Nr. 1060/2009 mit der geplanten ESMA-VO*, Neue Zeitschrift fur Gesellschaftsrecht 285, 288f (2010) (Ger.).

7 Ulf Klebeck, *Neue Richtlinie für Verwalter von alternativen Investmentfonds?*, Deutsches Steuerrecht 2154, 2154 (2009).

8. An authorization is valid in all member states, see directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Council Directive 2009/65/EC art. 5, para. 1, 2009 O.J. (L 302) 32, 45 [hereinafter UCITS] and Position of the European Parliament adopted at first reading on 11 November 2010 with a view to the adoption of Directive 2011/.../EU of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010 art. 6, para. 1.

9. The requirements concerning an administrative company's minimum capital according to UCITS, art. 7 para. 1 are identical with the ones according to AIFM directive 2011/61, art. 6, para. 2,

the introduction of a depository.[10] Like the UCITS directive, the AIFM directive generally covers all entities, which are set out for a common investment of gathered capital. UCITS entities gather their capital from a broad public and invest it in securities and solvent financial means in accordance with the principle of risk distribution. Alternative Investment Funds (AIFs), on the other hand, are defined more broadly in terms of investment and raising of capital: "A number of investors" is sufficient as financier, and a "defined investment policy" suffices for investing.[11] Contrary to the UCITS directive, an AIF is not required to allow anytime withdrawals or cashing of investors' capital contributions.

The directive's scope includes all AIF managers registered in the EU, regardless of whether the managed fund is headquartered in the EU as well.[12] The directive is applicable to funds that are managed from non-EU headquarters if the fund manages or markets AIFs registered in the EU.[13] This broad scope of application closes potential loopholes and lowers the risk of a regulatory arbitrage. The directive does not, however, differentiate between a public and non-public marketing, as does the German Investment Act.[14]

2. Factual Scope of Application

Not the fund itself, but its admission, on-going activities and management transparency are the objects of the regulatory efforts.[15] Only corporate bodies whose regular business it is to manage one or more AIFs are suitable as potential managers of alternative investment funds.[16]

The European legislature also included a *de minimis* rule. The directive's rules only partially apply to AIF managers if, due to leverage effects, the managed investments lie below 100 million euros.[17] If the funds administered by the AIF themselves are not leveraged, the threshold value is 500 million

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including the additional requirements for portfolios exceeding 250 million euros.

10. Both UCITS , art. 22 and AIFM directive, *supra* note 2, at art. 21, para. 8 require asset transferral to a depository.

11. AIFM directive, *supra* note 2, at art 4 § 1(a)(i), 2011 O.J. (L 174) 16 (EU).

12. *Id.* at art. 2 § 1(a)

13 *Id* at art 2 § 1(b)-(c).

14 Marketing, according to the German Investment Act, is "any measure by the provider of fund shares (or his employees) or by an independent sales agent to promote sales," see JOHANNES KONDGEN, INVESTMENTGESETZ INVESTMENTSTEUERGESETZ, § 2, margin no. 68 (Hanno Berger, Kai-Uwe Streck & Dieter Lübbehusen eds , 2010).

15. AIFM directive, *supra* note 2, at art. 1.

16. *Id* at art. 4 § 1(b).

17. *Id.* at art. 3 § 2(a).

euros.[18] As far as private equity funds are concerned, the 500 million euros threshold will generally apply, since the leverage financing of the fund itself and not the financing of the target company is relevant.[19]

Among others, holding companies are excluded by the directive. The same is true for entities already included in the Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision, for supranational institutions, family offices, central banks and governmental funds supporting social security and pension systems.[20] These exceptions should be appreciated. Family offices, for instance, do not invest investors' money but aim at private productive investments. Consequently, the MiFiD system of regulation applies.[21] There are no exceptions or simplifications included for professional investors, since the directive specifically assumes marketing to professional or institutional investors.[22] The directive's drafts were unclear about the application for closed funds;[23] however, the final version explicitly includes them.[24] Thus, a loop hole in protection is closed, concerning closed funds which operate mostly unregulated on the grey capital market. Before, closed funds were not included in the application scope of the German Securities Trading Act. In addition to the AIFM directive, the German legislator on February 16, 2011 published a discussion paper to amend the Investment Broker and Investment Act.[25] If amended, the new law would broaden the term "financial instrument" to include closed funds. Consequently, the Securities Trading Act and the Credit Services Act would apply to these funds as well. Thus, two new means of regulation will have to be considered for closed funds, and in order to avoid overlaps and over-regulation, a coordinated procedure is highly necessary.

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18. *Id.* at art. 3 § 2(b).

19. *Id.* at art. 3 § 2(b); *see also* ULF KLEBECK, NEUE RICHTLINIE FUR VERWALTER VON ALTERNATIVEN INVESTMENTFONDS?, 2154, 2156, 2160 (Deutsches Steuerrecht 2009).

20. *Id.* at art. 2 § 3.

21. CHRISTOPH KUMPAN, KAPITALMARKTRECHTS-KOMMENTAR, § 2, margin no. 93 (Eberhard Schwark & Daniel Zimmer eds., 2010); ANDREAS O. KÜHNE & MAXI EBERHARDT, ERLAUBNISPFLICHT EINES "FAMILY OFFICE" UNTER BERUCKSICHTIGUNG DES NEUEN FINANZDIENSTLEISTUNGSTATBESTANDES DER ANLAGEBERATUNG 133 (Zeitschrift für Bank- und Kapitalmarktrecht 2008).

22. *See* AIFM directive, *supra* note 2, at recital 15, 2011 O.J. (L 174) 3 (EU).

23. SEBASTIAN KIND & STEPHAN A. HAAG, DER BEGRIFF DES ALTERNATIVE INVESTMENT FUND NACH DER AIFM-RICHTLINIE—GESCHLOSSENE FONDS UND PRIVATE VERMOGENSANLAGEGESELLSCHAFTEN IM ANWENDUNGSBEREICH?, 1526, 1529 *et seq.* (Deutsches Steuerrecht 2010), criticizes the scope of application as too vague and broad.

24. AIFM directive, *supra* note 2, at art. 2 § 1a(a).

25. Entwurf eines Gesetzes zur Novellierung des Finanzanlagenvermittler- und Vermögensanlagenrechts v. 6.6.2011, BT-Drucks. 17/6051, *available at* http://www.kapitalmarktrecht-im-internet.de.

III. REGULATING INSTRUMENTS

1. Authorization of an AIFM

The AIFMs regulated by the directive may only manage alternative investment funds after prior authorization by the competent national regulatory agency.[26] The AIFM must apply for such authorization with the competent agency, for example the BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht or Federal Financial Supervisory Authority) in Germany.[27] In addition to some information concerning the management, the names of all shareholders with "qualifying holdings" must be published in order to show potential conflicts of interest.[28] According to the legislature, "qualifying holdings" are any direct or indirect share of at least 10% of an AIFM's capital or voting rights.[29] The authorization request is required to include information on the compensation policies and the organizational structure.[30] Furthermore, the AIFM needs to inform the national agency about the strategies pursued and potential use of leverage, as well as the risk profiles of such leverage.[31] The agency then examines whether the applicant is capable of fulfilling the conditions as set out in the directive, and whether the responsible person has sufficient experience concerning the strategies pursued, including a good reputation.[32] It remains to be seen whether this examination will be one of mere formality. According to Art. 8(1)(a) of the AIFM directive, the agencies must be persuaded that the AIFMs can fulfil certain material requirements. This argues in favor of a material examination. Even today, the BaFin examines professional qualification and knowledge when appointing a member for an administrative or supervising body according to the Credit Services Act.[33] Material scrutiny, however, is an

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26. AIFM directive, *supra* note 2, at art. 4(1).
27. *Id.* at art. 5(1).
28. *Id.* at art. 6(1).
29. *Id.* at art. 4(a)–(h).
30. *Id* at art. 5(2).
31. *Id.* at art. 5(3).
32. AIFM directive, *supra* note 2, at art. 4(1).
33. *Cf* § 24 Abs. 1 Nr. 1 Kreditwesengesetz [Credit Services Act] (Ger.); *see also* Ulrich Braun in *§ 24 in margin no. 51 et seq in* KREDITWESENGESETZ (Karl-Heinz Boos, Reinfrid Fischer & Hermann Schulte-Mattler eds., 3d ed. 2008); Rainer Sußmann, *§ 24 margin no. 8 in* KREDITWESENGESETZ (Andreas Schwennicke & Dirk Auerbach eds., 2009) (Personal reliability and professional competence are required for operating a bank, § 32 sec. 1 s. 2). On the requirement of professional competence, see Reinfrid Fischer, *§ 33 margin no. 39 in* KREDITWESENGESETZ KOMMENTAR ZU KWG UND AUSFUHRUNGSVORSCHRIFTEN

exception for the BaFin's measures and can easily overwhelm the particular agency's competences both in qualitative and temporal ways.[34] In order to be authorized, the AIFM must be equipped with sufficient starting capital, which is at least 300.000 Euros[35] for an internally administered AIF.[36] Also, an externally administered company can be appointed as manager, as opposed to AIFs with internal management.[37] Since the administration is separated from the AIF itself, the risk for conflicts of interest is lower. Consequently, externally administered AIFs have a lower minimum capital requirement of only 125.000 Euros.[38] If the administered fund's value exceeds 250 million Euros, the AIF has to supply additional equity capital of 0.02% of the additional fund volume, but no more than 10 million Euros.[39] A successful authorization will be valid in all EU member states.[40] The requirements for equity capital and the concept of a uniform European authorization already comply with the rules known from the UCITS directive.[41]

2. Guidelines for Conflicts of Interest and Compensation

The AIFM directive presents general guidelines to guarantee the necessary expertise and administrative accuracy. Along with the limitation on conflicts of interest,[42] an appropriate compensation for the management is important as well. The compensation policy is to be "consistent with an effective risk management" and should "not encourage risk-taking."[43] What

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(Karl-Heinz Boos, Reinfrid Fischer & Hermann Schulte-Mattler eds., 2008).

34. Wertpapierprospektgesetz [WpPG] [German Securities Prospectus Act], June 22, 2005, BUNDESGESTZBLATT [BGBL. I] at 1698, as amended by Artikel 4 des Gesetzes vom 22, § 13 (Ger.) (requiring only an audit of completeness, coherence and comprehensibility); *see also* Wertpapiererwerbs- und -übernahmegesetz [WpÜG] [German Securities Acquisition and Takeover Act], Jan. 1, 2002, ELEKTRONISCHER BUNDESANZEIGER [EBANZ.] at art 14 § 2 (Ger.); Corinna Ritz & Thorsten Voß, *in* WERTPAPIERPROSPEKTGESETZ UND EU-PROSPEKTVERORDNUNG: WPPG § 13 n.34 (Clemens Just, Thorsten Voß, Corinna Ritz & Michael E. Zeising eds., 2009); Eberhard Seydel, *in* KOLNER KOMMENTAR ZUM WPÜG § 14 n.37 (Heribert Hirte & Christoph von Bülow eds , 2010)

35. For an internally administered AIF, the AIF itself serves as AIFM. *See* AIFM directive, recital 101. AIFM directive, *supra* note 2, at recital 54.

36. *Id.* at art. 6(a)(1).

37. *See id.* at recital (10).

38. *Id.* at art. 6(a)(2). Note, however, that this article contains no further requirements

39. *Id* at art. 6(a)(3).

40. *Id* at art. 6(1).

41. An authorization is valid in all member states. See Council Directive 2009/65, *supra* note 6, at art. 6.

42. AIFM directive, *supra* note 2, at art. 10.

43. *Id.*

this means exactly remains to be determined by the ESMA. It may be that compensation needs to be oriented by long-term success as is the case in the German Act on the Appropriateness of Management Board Compensation.[44] A limitation of compensation by means of a horizontal sectorial comparison does not appear to be justified, as the characteristics differ greatly and are therefore not easily compared.[45] It is also unclear how to differentiate between various conflicts of interest and what administrative means can do to help avoid them.

Conflicts of interest can appear between the fund's administration (AIFM) and the fund (AIF), but also between the AIFM and the fund investors. The directive also foresees conflicts between the fund and its investors or in a horizontal relationship.[46] The Commission has not yet specified potential conflicts of interest;[47] however, the UCITS implementing directive, published in 2010, provides some clues.[48] In the directive, the Commission aims mainly at the relationship between portfolio management and UCITS, and accordingly, the administration is prohibited from gaining financial advantages and avoiding financial deficits burdening the UCITS.[49] Furthermore, no services shall be performed for other clients if they do not comply with the interests of the administered UCITS or are connected with opposing incentives, financial or otherwise.[50] Similar and further-reaching requirements are to be expected concerning the AIFM directive. The differentiation between the situations of conflict and the development of definite requirements to avoid them are welcomed in particular on the level of fund management. Potential misconduct can lead to significant financial losses, in particular in the AIFM's relationship to the AIF and its investors, since administrative decisions are of potential concern to most investors. The AIFM's necessary authorization and the periodical audits enable only a workable supervision and avoidance of conflicts of interest, especially

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44. For the Act on the Appropriateness of Management Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergutung; VorsAG), *see* Holger Fleischer, *Das Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)*, NEUE ZEITSCHRIFT FUR GESELLSCHAFTSRECHT, 2009, at 801, 802.

45. A vertical comparison does not make much sense for AIFMs due to the different levels of responsibility and decisional power

46. *Id.* at art. 10(1).

47. *See id* at art. 10(4)(a).

48. *See generally* Commission Directive 2010/43, implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, 2010 O.J. (L 176) 42 (EU).

49. *See id.* at art. 17(1)(a).

50. *See id.* at art 17(1)(b)-(c).

concerning fund administration. The differentiation between situations of conflict concerning the UCITS directive appears transferrable to the AIFM directive. It remains to be seen if the differentiation and naming of specific conflicts actually help to avoid them; this depends mostly on effective monitoring and implementation, which are to be addressed more in depth.

3. Organizational Requirements

The requirements concerning risk and liquidity management, from the outset, remain just as vague. Besides portfolio management, risk management is the main task for an AIF's administrator. Conflicts of interest can appear between these two tasks. Typically, portfolio management will apply yield pressure to risk management. To minimize this conflict from the start, the AIFM is required to functionally and hierarchically separate risk and portfolio management so as to ensure supervision that is as independent as possible.[51] Furthermore, an "appropriate" system of risk and liquidity management is to be installed. This includes carrying out of regular due diligence inspections, the goal of which is to determine and monitor the risks connected with investments. Additionally, stress tests are to reveal the administered funds' potential liquidity risks.[52] In practice, these measures can detect misappropriated funds earlier.[53] The detailed requirements for liquidity and risk management are yet to be determined by the Commission.[54]

The AIFM directive, therefore, primarily sets out only a frame of reference which needs to be filled by the ESMA and the Commission. It remains to be seen to what extent the specified measures fulfil the goal of a functioning capital market and investor protection. Already, however, it is clear that workloads are increasing and costs are rising as a result of the directive's provisions,[55] such as through the requirement that all assets

51. *See* AIFM directive, *supra* note 2, at art. 11(1).

52. *Id.* at art. 12(1).

53. Cases such as the Madoff scandal in the United States or that of Kiener in Germany would have been detected earlier or completely prevented. In the Kiener case, German hedge fund manager Helmut Kiener used investors' money to facilitate a Ponzi scheme. *See* Von Agnes Schonberger, *Der Fall Kiener: Gericht rollt Schneeballsystem auf*, FRANKFURTER ALLGEMEINE ZEITUNG, Mar. 2, 2011, *available at* http://faz.net/s/RubA5A53ED802AB47C6AFC5F33A9E1AA71F/Doc~ECF3C960D3D8847ED873477B47C02307E~ATpl~Ecommon~Scontent.html.

54. *See* AIFM directive, *supra* note 2, at arts 11(5), 12(3)

55. An increasing cost pressure was criticized from the beginning. *See* Klebeck, *supra* note 7, at 2154, 2160.

undergo independent periodical valuations.[56] These types of valuations take place at least once a year for closed funds, and can be undertaken either by an external evaluator or by the AIFM itself. An internal valuation must be performed by an authority independent of portfolio management and compensation policy.[57] An internal examination seems hardly attractive, however, because a redundant external valuation might be necessary if so requested by the appropriate agency.[58] It remains unclear why the valuation is measured by the fund's structure instead of the investment's volatility. The investment object itself is relevant for a necessary and useful periodical valuation, not the differentiation between closed and open funds. While a frequently renewed valuation may seem useful for volatile investments, its benefit is questionable in, for example, the acquisition of a medium-sized close corporation. A valuation that is independent of the assets is advisable instead. However, the resulting additional costs of periodic valuations will hardly be avoided.

4. Transparency Duties

a) Annual Report

The duty to create an annual report for the administered AIFs registered or distributed in the EU lies at the center of the new transparency requirements. This report is to be communicated to the national agency within six months, as well as to the investors as requested.[59] The agency needs to be informed not only about a verified closing balance and a list of gains and expenses, but also about "material changes" of the information originally distributed to the investors.[60] This includes, for example, the fund's investing strategy, its assessment procedure and increased fees. The AIFM's duties of disclosure toward the agency go far beyond the yearly report, though. For example, the national agency is to be informed frequently about the most important markets and instruments in which the managed funds are involved.[61] Mainly, the "greatest risks and risk concentrations" are to be addressed.[62]

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56. *See* Commission Directive 2010 art. 16
57. *Id* at art. 16(3)–(4).
58. *See id* at art 19(9).
59. *Id* at art. 22(1).
60 *Id* at art 22(2)
61. *Id.* at art 24(1).
62 AIFM directive, *supra* note 2. at art. 24.

Additionally, the AIFM has to report investments that are difficult to liquidate, the current risk profile, and the results of stress tests.[63] At the end of each quarter, the competent national agency receives a detailed list of all alternative investment funds managed by the AIFM.[64] Further information can be requested at any time "where necessary for the effective monitoring of systemic risks."[65] This information is very valuable. On the one hand, it is the basis for an early detection of risk concentration and systemic dangers by the regulatory authorities. On the other hand, the regulatory authorities can strengthen investor protection by revealing suspicious investment structures.[66]

b) Transparency Requirements for Acquisitions

The AIFM directive provides other transparency rules that affect private equity investors in particular. These are special rules for the acquisition of non-listed companies. As known from § 21 Securities Trading Act, the competent authority needs to be informed if certain threshold values are passed. If an AIF reaches a share of 10%, 20%, or 30% of voting rights, the agency is to be informed within 10 workdays.[67] A duty for publication, as the Securities Trading Act requires towards the investors, does not exist. It is unclear why investors of non-listed companies are regarded as less worthy of protection. One reason could be that the investors of a non-listed company are not subject to as big an information deficit as the small investors of listed companies.[68] The non-listed company and its shareholders only need to be informed after the fund has taken over.[69] The information thresholds provided in the Securities Trading Act serve both market functionality and investor protection, help to provide more transparency for take-over attempts and avoid creeping takeovers.[70] The Securities Trading Act's intention to protect cannot

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63 *Id* at art. 24(2).

64. *Id.* at art. 24(3)(b).

65 *Id.* at art. 24(5).

66. Regrouping of investors' money alone, for example, is considered a suspicious investment structure. In the Kiener case, the K1 Global Sub Trust invested in a hedge fund called Nauticus, which in turn, only invested in K1. Information about the main shareholders would have brought this circle to light. *See* Schönberger, *supra* note 53.

67. AIFM directive, *supra* note 2, at art. 27(1).

68. For information on this phenomenon, also known as the "prisoners' dilemma," *see* THOMAS M.J. MOLLERS, *in* KOLNER KOMMENTAR ZUM WPÜG, § 23, margin no. 2 (Heribert Hirte & Christoph von Bülow eds., 2010).

69. AIFM directive, *supra* note 2, at art. 27(2).

70. KLAUS-DIETER DEHLINGER & MARTIN ZIMMERMANN, *Vor §§ 21 bis 30, in* WERTPAPIERHANDELSGESETZ: WPHG, margin no. 21–22 (Andreas Fuchs ed., 2009); Holger Fleischer &

easily be transferred to the AIFM directive, as no market that is worthy of protection exists with non-listed companies. Attempts to take over listed companies usually lead to market distortion, which negatively affects investors' trust, and are therefore dangerous to the market's functionality. These distortions cannot happen where non-listed companies are concerned. The duties of disclosure connected to the information thresholds apply only in relation to the agency until the take-over has taken place. A direct protection of markets and investors is not intended. The directive does not provide which measures the agency can take. As long as the target company and its investors need only be informed after the fund's take-over, the creeping takeover of alternative investment funds cannot effectively be avoided. If the information remains accessible only to the agency, such monitoring can at the most meet systemic risks, which can hardly be determined from the threshold values alone. It is not clear how the thresholds provided in Art. 27 AIFM directive are to further functioning protection of markets or investor protection.

c) Duties of Disclosure When Acquiring Control

The transparency requirements are complemented by another duty of disclosure if the fund acquires control through a share of more than 50%. In this case, the AIFM has to inform the listed company, its shareholders and the competent agency about the situation resulting from voting rights, the conditions resulting in the take-over and the date of control acquisition.[71] Due to its timing, this duty of disclosure is of only an informative character for the investors. It is too late for potential attempts of resistance. Further information includes the name of the responsible AIFM, the strategy to avoid and channel conflicts of interest, as well as details about the intended external and internal communication policy concerning the company and its employees.[72] Furthermore, the fund's administration has to encourage the executive board to forward the information to the employees' representatives.[73]

Klaus U. Schmolke, *Das Anschleichen an eine börsennotierte Aktiengesellschaft Überlegungen zur Beteiligungstransparenz de lege lata und de lege ferenda*, NEUE ZEITSCHRIFT FUR GESELLSCHAFTSRECHT [NZG] 401, 409 (2009) (Ger.); HERIBERT HIRTE, § 21, *in* KOLNER KOMMENTAR ZUM WPHG, margin no. 4 (Heribert Hirte & Thomas M.J. Möllers eds., 2007) (Ger.).

71. AIFM directive, *supra* note 2, at art. 27(3).

72. *Id.* at art. 28(3).

73. *Id.* at art. 27(4). A duty of disclosure for the employees' representation is already known from Securities Acquisition and Takeover Act, § 10 sec. 5 and is meant to help involve employees in the tendering procedure at an early stage, *see* Marcel Grobys, *§ 10 in* WERTPAPIERERWERBS- UND

Only the company and its employees' representatives, not the agency, need to be informed about the intentions concerning business processing and the foreseen effects it has on the employees.[74] This appears justified, as the regulatory agency is not competent to oversee employees' rights. Not only the AIFM, but also companies taken over by alternative investment funds, are subject to additional transparency requirements. The company or the AIFM must give account at least about the "situation at the end of the time covered by the annual report" and "a fair review of the development of the company's business. . . ."[75] Furthermore, "any important events" taking place after the end of the business year need to be mentioned and the company's expected development shown.[76] These additional publication duties not only lead to increased costs, but also to potential competitive disadvantages for the companies taken over by the AIFM.

5. Asset Stripping[77]

As urged by the European Parliament, Art. 29a AIFM directive introduces a rule particularly applicable to private equity managers. Private equity has undisputed advantages, but the fact that the acquired company's management is oriented by short-term success also poses a problem.[78] This rule intends to prevent a company's asset stripping after a private equity investor takes over. The investor pulls assets out of the company without regard to its long-term success. In particular, the AIFM may neither encourage a capital reduction nor re-buy its own shares or encourage the shares' sale within twenty-four months after having acquired control of the target company. These measures aim to avoid take-over only for reasons of short-term profit maximization.

ÜBERNAHMEGESETZ (WPÜG) KOMMENTAR, margin no. 82 (Stephan Geibel & Rainer Süßmann eds., 2d ed. 2008) (Ger.).

74. AIFM directive, *supra* note 2, at art. 28(3).

75. *Id* at art. 29(2).

76. *Id* at art. 29(2)(a)–(b).

77. *See id* at art. 30. Asset "stripping" is a technical term. The German term "Ausschlachten" has a negative connotation. The neutral English term appears more appropriate and could have been translated differently.

78. MICHAEL MULLER, *Hedgefonds und Private Equity—Fluch oder Segen*, ZEITSCHRIFT FUR BANK- UND KAPITALMARKTRECHT 351, 352 (2008) (Ger.). According to Walter, the advantages of private equity are a positive effect on market liquidity, a decrease of volatility, the taking of risk positions, decrease of inefficiencies and, in particular in the beginning to an enterprise, the central financing source. These are met by the danger of market intransparency and large amount of outside capital which endanger the financial market's stability.

Negative experiences in the past (such as the take-over of Hugo Boss by Permira or ProSiebenSat1 by KKR)[79] shine a positive light on this rule.[80] If a company is acquired only to strip it of its assets, this is contrary to the other shareholders' interests. However, Art. 29a AIFM directive poses an immense intrusion into the main shareholder's property rights. There are situations in which this hinders an economically reasonable adjustment of capital structure.[81] On the one hand, this intrusion is limited to two years. On the other hand it is also limited factually and does not prohibit all capital measures, but only those going beyond certain threshold values defined in Art. 29a(2) AIFM directive. These limitations lessen the intensity of the intrusion.

6. Duties of the Custodian Bank

In order to avoid conflicts of interest between the safekeeping and management of the investors' assets, the AIFM directive finally introduces a mandatory safekeeping of all assets by an independent deposit facility, the custodian bank. An AIFM must appoint in writing a custodian for every AIF.[82] The bank's main task is to monitor the AIF's cashflows and post them accordingly.[83] To avoid conflicts of interest, the custodian may not serve the AIFM itself. Furthermore, the custodian must follow strict rules if it intends to delegate its tasks to others.[84] The AIFM directive also provides a comprehensive liability for the custodian. Similar to § 29 of the German Investment Act, Art. 18a(11) AIFM directive introduces an independent claim for reimbursement both for the AIF and its investors. Usually, investors' rights are exercised by the AIFM.[85] Since the burden of proof lies with the custodian and since the custodian is liable even for negligent breach of duty, this claim is very effective in terms of investor protection. However, the increased duties

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79. For example, the financial investor Permira cashed out 300 million euros shortly after taking control. *See* Susanne Preuss, *Permira Kam, sah und nahm*, FRANKFURTER ALLGEMEINE ZEITUNG, (Mar. 13, 2008), *available at* http://www.faz.net/s/Rub4D8A76D29ABA43699D9E59C0413A582C/Doc~E5CE163783C504CEFB0FF90E8F8A89E65~ATpl~Ecommon~Scontent.html.

80. For a detailed work on creditor protection for take-overs financed with outside capital, *see* FLORIAN HOLZNER, PRIVATE EQUITY, DER EINSATZ VON FREMDKAPITAL UND GLAUBIGERSCHUTZ, EINE UNTERSUCHUNG ZUR NOTWENDIGKEIT UND ZU DEN MOGLICHKEITEN EINER GESELLSCHAFTSRECHTLICHEN REGULIERUNG FREMDFINANZIERTER UNTERNEHMENSTRANSAKTIONEN (LEVERAGED BUY OUT/LEVERAGED RECAPITALIZATION) 29 (2009) (Ger.).

81. *See id* at 328 *et seq* , who favors a more flexible cashing out barrier.

82 AIFM directive, *supra* note 2, at art. 21(2).

83. *Id.* at art 21(6)

84 *Id.* at art. 21(4), 21(10)

85 *Id* at art. 21(15).

will also lead to an adjustment of business models and compensation structure in the custodian banks.[86] These costs will ultimately fall back on the AIF's investors.

IV. LAW ENFORCEMENT

1. Measures Undertaken by the ESMA

The directive's legislative procedure is parallel to that of the Lamfalussy Procedure introduced in 2002, which is intended to make the European legislative procedure faster and more efficient.[87] However, the additional levels of regulation introduced by the Lamfalussy Procedure also increase the complexity of capital market law. In total, six regulating levels are to be considered.[88] In addition to national laws, ordinances and the BaFin's secondary legal duties, three levels on the European side exist.[89] On a first level, the European Parliament enacts framework directives (level 1 measures). The AIFM directive, issued in June 2011, was such a framework directive. It does not provide definite sanctioning mechanisms for its breach. The directive only states: "[m]ember States should lay down rules on penalties applicable to infringements of this Directive and ensure that they are implemented. The penalties should be effective, proportionate and dissuasive."[90] Consequently, the next levels of regulation are immensely important. Many relevant issues of the framework directive are vaguely worded and refer to the so-called implementing rules. These are technical implementing measures introduced by the implementing directives (level 2 measures). They are enacted by the European Commission and the European

86. *See* Christoph Schmitt, *Die Rolle einer Verwahrstelle nach der AIFM-Richtlinie*, 64 ZEITSCHRIFT FUR DAS GESAMTE KREDITWESEN, 246, 250 (2011) (considers the liability rules exaggerated since they go beyond the UCITS rules).

87. *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, (Feb. 15, 2001), *available at* http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_de.pdf [hereinafter *Comm. of Wise Men*].

88. THOMAS M.J. MÖLLERS, *Auf dem Weg zu einer neuen europäischen Finanzmarktaufsichtsstruktur—Ein systematischer Vergleich der Rating-VO (EG) Nr. 1060/2009 mit der geplanten ESMA-VO*, 8 NEUE ZEITSCHRIFT FUR GESELLSCHAFTSRECHT, 285, 285 (2010) (Ger.).

89. THOMAS M.J. MÖLLERS, *Vollharmonisierung im Kapitalmarktrecht—Zur Regelungskompetenz nationaler Gerichte und Parlamente*, *in* VOLLHARMONISIERUNG IM PRIVATRECHT, DIE KONZEPTION DER RICHTLINIE AM SCHEIDEWEG? 253 (Beate Gsell & Carsten Herresthal eds., 2009) (Ger.); MOLLERS, *supra* note 88.

90. AIFM directive, *supra* note 2, at recital 75.

Parliament after hearing the respective panels.[91] On December 2, 2010, the European Commission sent an inquiry concerning the technical advice of the CESR/ESMA's implementing measures. Another inquiry concerning the AIFM directive is expected to be submitted by September 2, 2011.[92] Finally, on the third level, the ESMA, as the CESR's successor, issues recommendations and guidelines (level 3 measures) concerning the common regulatory tasks, and help to ensure a homogeneous implementation of the first two levels' provisions).[93]

These recommendations and guidelines are secondary sources of law, and are legally binding, although in a limited way.[94] National agencies must undertake all necessary efforts to follow the ESMA's recommendations and guidelines.[95] If agencies do not concern themselves with the rules, they must provide an explanation.[96] In certain cases, the ESMA also has decisional authority over the national agencies.[97] The AIFM directive transfers rules from the ESMA regulation and provides a clear decision authority connected to a shaming sanction for the national regulatory agency.[98] Finally, the ESMA's guidelines and recommendations are factually binding.[99] Since the directive is explained in detail only on the third level, the democratic legitimacy is questionable, as the European Parliament is bypassed.[100]

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91. Klaus U. Schmolke, *Die Einbeziehung des Komitologieverfahrens in den Lafalussy-Prozess Zur Forderung des Europäischen Parlaments nach mehr Entscheidungsteilhabe*, 41 EUROPARECHT, 432, 433 (2006) (Ger.).

92. Provisional Request to CESR for Technical Advice on Possible Level 2 Measures Concerning the Future Directive on Alternative Investment Fund Managers (EC), Ref. Ares (2010) 892960 (Dec. 2, 2010) 2.

93 MOLLERS, *supra* note 89, at 252.

94 For more on the duty to concern oneself, presumption effect and situations of trust for secondary sources of law, THOMAS M.J MOLLERS, *Sekundäre Rechtsquellen—Eine Skizze zur Vermutungswirkung und zum Vertrauensschutz bei Urteilen, Verwaltungsvorschriften und privater Normsetzung*, *in* FESTSCHRIFT FUR HERBERT BUCHNER ZUM 70. Geburtstag, 649 *et seq.* (Jobst-Hubertus Bauer, Michael Kort, Thomas M.J. Möllers & Bernd Sandmann eds., 2008) (Ger 2); THOMAS M.J. MOLLERS, GELTUNG UND FAKTIZITAT VON STANDARDS, 143 *et seq* (2009) (Ger.).

95. Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 Nov. 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC [hereinafter ESMA].

96. *Id.*

97. The directive power in case of differing option, ESMA regulation, *id* at art. 19, and in case of crisis, ESMA regulation, *id.* at art. 18, are most relevant.

98. AIFM directive, *supra* note 2, at arts. 38(5), 38(7)

99. MOLLERS, *supra* note 88, at 285 (mentioning also that neither the final report of the wise men for the Lamfalussy procedure and the CESR's self-image assume it to be legally binding).

100. *See also BVI*, Comments to the Draft EU Directive on Alternative Investment Fund Managers (AIFM) 2 (Aug. 28, 2009).

The AIFM directive's degree of harmonization is not defined completely.[101] Generally, the Lamfalussy Procedure ensures a homogenous legislation and application of law.[102] The fact that the AIFM rules are implemented in accordance with the Lamfalussy Procedure appears to speak in favor of a full harmonization. Indicators for a full harmonization can be found, for example, in the rules concerning starting capital.[103] Other sections, however, point toward minimum harmonization, according to which the member states can deviate from the top.[104] Most rules, however, do not leave much room for an implementation by member states. Therefore, the general rule is full harmonization. However, the question about the national legislature's competence to concretize remains open for individual cases.[105]

2. Sanctions

Since EU directives are not directly applicable (excluding vertical third-party application), the national implementing acts must still be awaited.[106] Only these will contain sanctions that are legally binding. Discussion papers can be expected at the end of 2012 since the directive must be implemented by July 22, 2013.[107] Since national rules need to be interpreted in conformity with European law, the AIFM directive's requirements are of immense practical relevance already. Capital market law knows sanctions from public, criminal and civil law.[108] The AIFM directive resorts to them. For example, Article 48 of the AIFM directive describes administrative sanctions. A breach

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101. For the basics of full harmonization, *see* MOLLERS, *supra* note 88, at 247 *et seq.*; MOLLERS, *supra* note 3, at 408; for the question of minimum or full harmonization at the transparency directive, see KLAUS U. SCHMOLKE & HOLGER FLEISCHER, *Die Reform der Transparenzrichtlinie: Mindest- oder Vollharmonisierung der kapitalmarktrechtlichen Beteiligungspublizität?*, NEUE ZEITSCHRIFT FUR GESELLSCHAFTSRECHT 1241 (2010) (Ger.).

102. *Comm. of Wise Men*, *supra* note 87, at 46.

103. AIFM directive, *supra* note 2, at art. 9 (according to which a deviation from no. 6 is only possible for no. 3).

104. E.g., *id.* art. 21(3) (the wording "[i]n addition, Member States may allow . . ." implies minimum harmonization); *see also id.* art. 22(3); *id.* art. 24(4) (contains discretionary provisions).

105. MOLLERS, *supra* note 88, at 271.

106. The ECJ interprets Art. 289 AEUV in a way that allows the court to apply directives directly if member states did not implement the directive orderly.

107. AIFM directive, *supra* note 2, at art. 66.

108. See THOMAS M.J. MOLLERS, *Anlegerschutz im System des Kapitalmarktrechts Rechtsgrundlagen und Ausblicke*, in FESTSCHRIFT FUR KLAUS J. HOPT ZUM 70. GEBURTSTAG AM 24. AUGUST 2010: UNTERNEHMEN, MARKT UND VERANTWORTUNG 2247, 2259 (Stefan v. Grundmann, Brigitte Haar & Hanno Merkt eds., 2009) (Ger.), on the problem of legal implementation in German capital markets law.

of national rules can be punished by taking back the AIF's authorization, with criminal proceedings and with administrative measures against the responsible persons. These measures are to be effective, proportionate and dissuasive.[109] As an additional deterring measure, the sanctions are to be published if this does not put the financial market's stability and investors' interests at too high a risk.[110] These rigorous sanctioning options are meant to meet a problem common to capital markets law. Mere financial sanctions are usually only a small incentive to change behavior. By comparison, the skimming of excess profits also appears to be a useful instrument.[111]

3. Actual Enforcement by the BaFin

Effective enforcement of the new requirements poses a great challenge. The large amount of transparency requirements makes effective supervision of systemic risks appear questionable. Suspicion of information overload, already criticized in capital markets law, is far more pressing.[112] The amount of information disclosed will pose more problems to the agency than its complexity. The BaFin already describes itself as "hopelessly understaffed."[113] It is therefore unclear how not only the authorization, but also its periodical control can be done effectively. The financial regulatory authorities need to be extended in order to fulfil the goal of an effective audit.[114]

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109 AIFM directive, *supra* note 2, at art. 48(1).

110. *Id* at art 48(3); see Thomas M.J. Möllers, *Effizienz als Maßstab des Kapitalmarktrechts, Die Verwendung empirischer und ökonomischer Argumente zur Begründung zivil-, straf- und öffentlich-rechtlicher Sanktionen*, 208 Archiv für die civilistische Praxis 1, 15 (2008), on the so-called Shaming.

111. MELANIE BINNINGER, GEWINNABSCHOPFUNG ALS KAPITALMARKTRECHTLICHE SANKTION, SYSTEMATIK UND KONZEPTION EINER GEWINNABSCHOPFUNG IM KAPITALMARKTRECHT, DARGESTELLT AM BEISPIEL DES DEUTSCHEN UND US-AMERIKANISCHEN INSIDERRECHTS 373 (2010) (Ger.).

112. Thomas M.J. Möllers & Eva Kernchen, *Information Overload am Kapitalmarkt - Plädoyer zur Einführung eines Kurzfinanzberichts auf empirischer, psychologischer und rechtsvergleichender Basis*, ZEITSCHRIFT FUR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, at 1, 26 (2011) (Ger.).

113. *See* Anne Seith, *Machtkampf ums Wühlen im Dreck*, SPIEGEL ONLINE (July 3, 2009), *available at* http://www.spiegel.de/wirtschaft/0,1518,633860,00.html; *BaFin warnt vor Überlastung durch HRE-Ausschuss*, SPIEGEL ONLINE (May 18, 2009), *available at* http://www.spiegel.de/wirtschaft/0,1518,625605,00.html. Lately, the number of additional employees has risen, but is still regarded as too low. See *Oberste Finanzaufseher bekommen Verstärkung*, SPIEGEL ONLINE (Nov. 23, 2010) (Ger.), *available at* http://www.spiegel.de/wirtschaft/0,1518,730679,00.html.

114. It is unclear who would bear these additional costs. AIFMs could become subject to fees: for example, when applying for authorization.

V. CONCLUSION AND ESTIMATION OF CONSEQUENCES

Hedge funds and private equity companies are not said to have triggered the financial crisis.[115] However, the sector faces many changes due to the much-discussed AIFM directive. The regulation's introduction of a uniform European regulation of alternative investment funds is to be welcomed as it prevents a race to the bottom. However, the balancing of investor protection and functionality protection is a great challenge asking a lot of the European legislator. After many changes were made, a directive is now in place which meets the "one size fits all" criticism with many detailed rules.[116] This directive, however, is very confusing, and its impact remains to be seen especially concerning the large number of vague legal terms and references to implementing measures.

Even now it can certainly be foreseen that the regulating instruments to be introduced will lead to high compliance costs.[117] Seen from an economical point of view, these costs lower the directive's benefits. A better protection of hedge fund investors[118] is met by higher costs, which will result in lower returns. Most professional investors will not welcome costs to this extent. The additional duties of disclosure connected to the directive increase the risk of information overload and competitive disadvantage. Additionally, a coordination of the MiFiD and the UCITS is desirable in order to avoid competitive disadvantages between banks, UCITS investment funds and alternative investment funds.[119] Finally, the authorization of alternative

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115. Thus is the result of a recent study by the British regulatory authority Financial Services Authority, ASSESSING POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS, (Feb. 2010), *available at* http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf., *see also* Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Das Erreichte nicht verspielen* 131 (2007/08) (Ger.).

116. The criticism of "one size fits all" addresses the problem of various funds (including hedge funds and closed funds) being covered by the same regulatory system. *See* Zentraler Kreditausschuss, Commentary, Proposal on a Directive on Alternative Investment Fund Managers, Sept. 25, 2009, *available at* http://www.zka-online.de/uploads/media/bzka_EU_Bassi_Proposal_for_a_Directive_on_Alternative_Investment_Fund_Managers.pdf, at 1, 2.

117. The EU Commission also sees these costs. *Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives*, at 8, SEC (2009) 577 (Sept. 30, 2009). *EU-Kommission*, Executive Summary on the Impact Assessment, Sept. 30, 2009, SEC 577, at 8 (2009).

118. The directive is a huge step for investor protection in hedge funds. A scandal like the *Kiener* one could probably have been prevented by audit duties as are now required for authorization. Schönberger, *supra* note 53.

119. *See also* Opinion of the European Central Bank, 2009 O.J (C 272) 1, 2.

investment funds will hopefully not lead to a race to the bottom within Europe.[120]

The AIFM directive must be implemented in national law by 2013. The ESMA, introduced as a regulatory agency in early 2011, is of special importance in this context. It will not only define the framework of the directive's exact provisions, but also monitor transparency requirements as data is registered.[121] In Germany, changes are necessary mainly in the Investment Act and the Securities Trading Act. Until then, private equity funds should have implemented AIFM standards in the best possible way in order to avoid competitive disadvantages. Existing AIFMs then need to apply for authorization within one year.[122]

Furthermore, the AIFM standards can be expected to prevail as a seal of quality in the market. After all, the AIFM directive's requirements are important as well for private equity funds to which the directive does not apply due to their size. They should orient themselves by the AIFM directive so as to avoid disadvantages in placement.

120. The member states have some discretionary power when authorizing AIFMs. AIFM directive, *supra* note 2, at art. 6(4) and at art. 8(4).

121. European Private Equity & Venture Capital Association, *AIFMD Essentials*, Dec. 2010, at 1, 16, http://www.avco.at/upload/medialibrary/FINAL_EVCA_AIFMD_Essentials_January_2011.pdf

122. AIFM directive, *supra* note 2, at art. 61(1).