Hedge Fund Regulation: Prospects of the Alternative Investment Fund Directive in the Netherlands

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Foreword

During the course of my IBL master, I had little insight into the activities of hedge funds and the role they played in the events of the financial crisis. As regulatory deficiencies were analyzed during various subjects of the master, the contribution of hedge funds to the impact of the financial crisis and consequently the extent to which the deficiencies in the regulation of these funds had contributed to the main problems the financial systems faced, were not emphasized. With the insight of my supervisor E.P.M. Vermeulen, my attention was drawn to this particular segment of the financial sector and to the conflicting activities that influenced the impact of the financial crisis. In consequence, this dissertation gave me the opportunity to take a closer look at the structure and activities of hedge funds and to understand how more stringent regulation on the activities of hedge funds can contribute to a constructive recovery of the financial markets in the EU and more specific in the Netherlands. Although the financial crisis occurred in 2008, the impact of the events is still noticeable in the financial markets across the world. In this context, the aim of this dissertation is to contribute to the continuing debate on effective regulation of financial actors and their activities in the financial markets of the Netherlands. The writing of this dissertation has been an educational process on diverse levels and I trust that this instructive experience will be perceived through this paper.

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Table of Contents

FIGURES

1. Introduction

The events of the financial crisis have brought to light the extent to which the risky investment strategies and the inadequate transparency on the trading strategies of the managers of many hitherto unregulated hedge funds, can pose risks to market participants and contribute to the destabilization of (global) financial markets.[1] In this regard, the G20 leaders concluded during the G20 summit in April 2009 that it was crucial for hedge funds and their managers to be registered and supervised more efficiently.[2] Moreover, the EC pointed out that the activities of the managers of alternative investment funds[3] such as hedge funds, who generally are the ones that determine the investment policy, the investment strategies and the assets in which is invested, have significantly contributed to the amplification and the diffusion of risks in the financial markets and accordingly have led to the financial systems in the world to crumble.[4] As a consequence, in the wake of the events of the global financial crisis, concerns were expressed regarding the deficiencies in EU's regulatory and supervisory frameworks in the field of alternative investment funds and their managers.

On 30 April 2009 the European Commission (EC) published a proposal for consultation for a directive on alternative investment managers, the AIFMD, which was drafted by the European Parliament (EP) and the European Council.[5] After a broad debate, the European Parliament approved the draft of the AIFMD, which after publication in the Official Journal of the European Union on 1 July 2011, came into effect on 21 July 2011. On many elements of the AIFMD, the European Commission is asked to give a further elaboration of the Directive through the establishment of implementing measures. The EC has in that light consulted the European Securities Markets Authority (ESMA), which is the authority for financial regulation and supervision in the EU, to give technical advice on specific aspects of the AIFMD in order to determine the scope of the Directive and to implement the Directive in the Member States more efficiently. The ESMA published its technical advice on 16

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[1] See *'Commission calls on EU leaders to stay united against the crisis, move vast on financial market reform and show global leadership at G20'*, 4 March 2009, IP/09/351.
[2] The Declaration of the G20 Working Group, *'Enhancing sound regulation and strengthening transparency'* of 2 April 2009. Available at: www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_1615_final.pdf
[3] Hedge funds are part of the 'alternative investment' industry. In this segment of the financial sector, the funds make investments in financial products that are not only part of the traditional asset classes such as stocks, bonds and cash, but also in more sophisticated and relatively illiquid assets. Alternative investments include derivatives, real estate, commodities, managed futures and investments in tangible assets such as wine, art and antiques.
[4] Working Document of the Commission Services (DG Internal Market) Consultation Paper on Hedge Funds. Available at: http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf
[5] COM(200) 207 final. 2009/0064 (COD) Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC {SEC(2009)576}{SEC(2009)577}. Brussels, 30.4.2009. Available at: http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf

November 2011.[6] Based on the ESMA's advice the Commission will adopt implementing measures, through delegated acts, on specific rules of different subjects of the Directive. In the legislative process of the AIFMD, the final agreement on the framework of the AIFMD are referred to as the Level 1 Directive, the implementing measures of the EC is referred to as the Level 2 Measures and the regulatory technical standards of the ESMA are referred to as Level 3.[7] Thus, the three levels will apply in the Netherlands.

The Directive introduces rules regarding licensing, organizational, reporting, transparency and quality requirements to managers of alternative investment funds in the EU. Consequently, the aim of the AIFMD is to specifically regulate the managers of alternative investment funds (AIFMs) and to make the activities of the managers more transparent to regulators and market participants in order to create an effective and harmonized regulatory and supervisory framework for AIFMs in the EU. Moreover, the AIFMD provides tools to supervisors of the Member States for timely intervention in cases where the activities of alternative investment funds can contribute to systemic risks in the financial markets. The AIMFD is thus part of the set of measures of the EC to combat the financial crisis and to reinforce the financial stability in the EU. At the moment, the Member States have until 22 July 2013 to implement the Level 1 Directive and the Level 2 Measures into their national regulatory frameworks.

The implementation of the AIFMD into the Dutch Act on Financial Supervision, Wet op het financieel toezicht (Wft), will lead to significant alternations in the supervisory and regulatory regime of hedge funds in the Netherlands. Although it is no longer possible to influence the contents of the Directive, this paper will enhance to provide a contribution to the ongoing reflections on the final scope of the implementation of the AIFMD in the Wft and on the impact of this implementation to the Dutch hedge fund industry. The analysis and related recommendations will serve to further incite a wider debate on the developments of an efficient regulatory framework relating to hedge funds, and to draw the attention to areas for improvements in order to bridge the interest of the financial market and investors on one side and the interest of Dutch hedge funds on the other. Consequently, the research question of this paper reads as follows:

To what extent will the legal and practical implications of the AIFMD to Dutch hedge funds managers, contribute to a constructive recovery of the financial system in the Netherlands?

[6] ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, 16 November 2011. Available at: http://www.esma.europa.eu/system/files/2011_379.pdf
[7] See: http://www.aima.org/en/regulation/asset-management-regulation/eu-asset-management-regulation/aifmd/index.cfm

Firstly, this question is elaborated by taking a closer look into the background of the hedge fund industry and the main characteristics of hedge funds, in order to understand the notion of hedge funds and to provide a comprehensible insight on the structure of hedge funds. Subsequently, the role that hedge funds have played during the events of the financial crisis and the controversies that arose from these events are discussed. Furthermore, the regulatory framework of the AIFMD and the Wft are elaborated in order to provide the EU and Dutch legal perspective on hedge funds and their conflicting activities. In the context of the implementing procedure of the AIFMD into the Wft, the access to the Dutch market for Dutch hedge fund managers is consequently analyzed. In conclusion, an assessment of the previous chapters is made in order to provide recommendations for an effective supervision of the Dutch hedge fund industry on the one hand, and constructive incentives for the activities of hedge funds in the Netherlands on the other hand.

2. An introduction to hedge funds

An official and universal accepted definition of what a hedge fund is, is not available due to the fact that the specific details of the characteristics of hedge funds vary from jurisdiction to jurisdiction.[8] Nonetheless, in order to understand the notion of hedge funds, this chapter will briefly introduce the specific characteristics of hedge funds and discuss the emergence of the hedge fund industry as seen in the past six decades.

2.1. Hedging defined

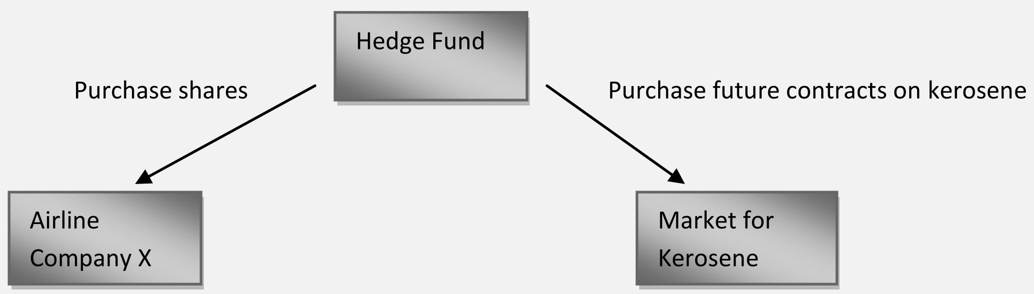
In order to define hedge funds, it is foremost crucial to provide an insight into the original definition of the term hedging. The term hedging in finance is designed for any strategy whereby financial risks (losses) in an investment such as commodities, currencies or securities are reduced or controlled by taking a defensive or inverted position on related financial products through for instance derivative[9] contracts.[10] The purpose of hedging is to limit or reduce the risks that are associated with price changes of the underlying assets. Hence, managers of hedge funds employ the hedging-technique in order to diminish risks as much as possible against unexpected fluctuations of the securities in the portfolio and to generate absolute returns for their investors. For instance, a hedge fund manager

[8] In a survey of IOSCO it was noted that there is not a regulatory body in the world that employs a comprehensive description of hedge funds. IOSCO, *The Regulatory Environment for Hedge Funds: A Survey and Comparison,* November 2006, p.3. Available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf
[9] A derivative is a security whose value is determined by fluctuations in prices of one or more underlying assets such as bonds, stocks, commodities, currencies, interest rates, market indexes and so on. The derivative itself is a contract between two or more parties in which the terms such as the payments conditions, are specified. Based on this contract, the parties will act upon their expectations in which they determine whether the underlying assets will rise or drop in price. Examples of derivative contracts are options, futures and credit default swaps contracts.
[10] Clifford Asness, Robert Krail and John Liew, *Do Hedge Funds Hedge?*, Journal of Portfolio Management, Fall 2001; 28, 1; Accounting & Tax Periodicals.

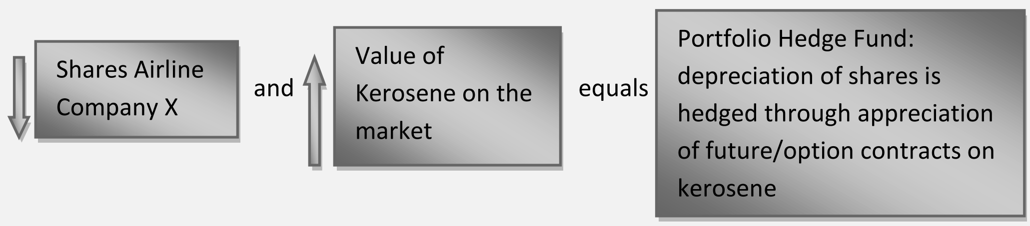
can purchase shares of an airline company and concurrently buy options or futures on kerosene or diesel in order to offset the risks in both assets. A future or an option is a financial derivative based on a contractual agreement that provides the possibility to purchase or sell a specific asset at a pre-determined price within a pre-determined time frame on a specific date, in order to reduce the price volatility of the underlying asset. The main difference between an option and a future contract is that with the latter the holder of the contract has the obligation to purchase or sell the specific assets on a specific date, while the holder of an options contract has the right to purchase or sell the specific assets on a specific date.[11] Consequently, if the fuel prices rise the negatively affected shares of the airline company are hedged through the positively affected option or future contracts on fuel and vice versa. In such a way, a return is made on the difference in value of the two assets whether markets are rising or falling and the portfolio is hedged against any price changes in the market in order to create a risk free portfolio (see figure 1).

<u>Figure 1. Hedging defined</u>

Scenario 1: Portfolio of the hedge fund



Scenario 2: Portfolio of the hedge fund after appreciation of kerosene



2.2. Definition of a hedge fund

A hedge fund is generally defined as a private actively managed investment vehicle run by professionals, in which the access is restricted to a group of specific investors and whose capital is

[11] Chuck Kowalski, *Future Options – The Basics, Buying a Call Option – Futures Call Option Strategy, Buying a Put Option, Options Trading – Description of Options Market and Contracts, Put Option on Futures Contracts in Trading Commodities*. Available at: http://commodities.about.com/od/futuresoptions/a/option_basics.htm

pooled in the vehicle in order to invest in various asset classes, and in which the performance is measured by making a consistent positive return in all market conditions, without the consideration of a particular benchmark.[12] The significant characteristics of hedge funds are clarified in the following subparagraph through a comparison of the main elements of hedge funds and mutual funds.

2.2.1. Hedge funds vs. mutual funds

Mutual funds and hedge funds are both actively managed portfolios, whereby a (group of) manager(s) picks promising securities and groups them into a single portfolio in order to invest for their investors.[13] The investors can thus get instant diversification and professional management of their capital. The main difference between traditional investment funds and hedge funds, lies in the investment objectives and the flexible investment strategies. Hedge funds are set up to create a consistent positive return in all market conditions and generally do not measure the performance of the investments against a stock exchange-based benchmark such as the S&P 500 or the Dow Jones Industrial Average.[14] Mutual funds on the other hand, mark their performance against a relevant benchmark which they attempt to outperform. Moreover, the investment strategies of hedge funds are more flexible in the sense that they can invest in a vast variety of strategies (such as long/short, arbitrage and the short selling strategy) and a vast variety of assets including derivatives, real estate, equity, currencies, commodities, art and also other investment vehicles. Consequently, hedge funds are managed more aggressively and take (highly) leveraged and riskier positions in order to invest in (risky) assets. Mutual funds on the other hand, due to regulatory constraints and disclosure requirements, are generally limited to more traditional assets classes such as cash, stocks and bonds, and typically take safer and limited leveraged positions in these assets.[15] Another remarkable characteristic of hedge funds is that the portfolio of hedge funds compared to the portfolio of mutual funds, shows a low correlation to stock markets and traditional asset classes. This low correlation enables hedge fund managers to constantly achieve absolute returns that are often superior to the returns that are based on set benchmarks.[16] With regard to the investor base, hedge funds face a higher restriction then mutual funds. Due to the fact that hedge funds are private placed investment vehicles, they are usually not permitted to market and distribute the fund to public and retail investors. As a result, the investor base of hedge funds is usually composed of high net worth retail

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[12] Gregory Connor and Mason Woo, *An Introduction to Hedge Funds*, Discussion paper from The London of Economics and Political Science Research Online, 2004. Available at: http://eprints.lse.ac.uk/24675/1/dp477.pdf
[13] Manuel Ammann, Otto Huber and Markus Schmid, *Hedge Fund Characteristics and Performance Persistence*, August 2010. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1650232
[14] See: http://www.sec.gov/investor/pubs/inwsmf.htm
[15] See note 14.
[16] Andrea Burashi, Robert Kosowski and Fabio Trojani, *When There is No Place to Hide: Correlation Risk and the Cross-Section of Hedge Fund Returns*, 9 March 2012. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1639984

investors and institutional investors.[17] In this context the investors are usually required to fulfill a high minimum of investment capital. Mutual funds, on the other hand, are open to the public and allow a wide range of investors to participate in the investments of the fund. Finally, the hedge fund manager usually invests a specific amount of his own equity in the fund and employs a performance fee in order to align his incentives with the interest of the investors. Thus, once the hedge fund manager faces negative performance returns, it is reflected in the performance fee and the manager's own equity. In mutual funds however, the manager's capital is not at risk and they do not employ performance fees. Managers are remunerated according to the quantity of assets managed, in spite of the returns made.[18]

2.3. The pioneer of the modern hedge fund industry: A.W. Jones

The origin of the hedge fund industry started in 1948, when Alfred Winslow Jones, a sociologist, author and financial journalist, while working as a freelance journalist, got inspired to create an own, unique investment vehicle. This unique investment vehicle could achieve higher returns than traditional funds by implementing hedging in the investment strategy.[19] At that moment he was writing an article[20], commissioned by Fortune Magazine, on current trends in investment strategies and market forecasting. Captivated by the subject, he quit journalism and launched in 1949 a vehicle that he called a 'hedged fund' bearing the name A.W. Jones & Co. The fund was an investment partnership of four friends, with Jones as the managing partner. From the $100.000 he had raised (in which he contributed $40.000 of his own capital in order to align his interest with those of his investors), he hedged market risk through a specific selection of securities and a combination of long positions in undervalued stocks with short positions in overvalued shares. This strategy enabled him to limit the risks of overall market movement and to enhance portfolio returns. For the long positions Jones made use of a healthy dose of leverage in order to purchase stocks and to enhance the potential returns of the investments. A long position on the market entails taking a position in tradable financial products, whereby one purchases financial products with the expectation that they could be sold in the future for a higher price. The opposite is taking a short position whereby one speculates on a depreciation of securities. In case of stocks, taking a short position will lead to a trader to borrow stocks from a broker house or to open a margin account in order to borrow money to buy stocks, while the assets of the fund are used as a collateral. The short position is made in

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[17] Institutional investors are financially sophisticated institutions such as banks, (life) insurance companies, pension funds, hedge funds or mutual funds, that often hold extremely large portfolio of investments. In contrast to retail investors, who are individual investors who buy and sell securities for their personal account.
[18] See http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/what-is-a-hedge-fund.html
[19] Alan Rappeport, *A Short History of Hedge Funds*, 7 March 2007. Available at: http://www.cfo.com/article.cfm/8914091
[20] See http://www.awjones.com/images/Fortune_-_Fashions_in_Forcasting.pdf The title of the original article reads *'Fashions in Forcasting'* by A.W.Jones.

order to sell the stocks and repurchase them back at a lower price than the price the trader paid for. The trader will hence profit from the difference in value of the shares at the two specific moments. Subsequently, the borrowed shares are returned to the broker house before or at a specific date and in addition the trader pays the broker fees and dividend from the borrowed stocks.[21] This method is referred to as short selling. The combination of long and short positions in stocks that A.W. Jones employed, lays the fundament of what is referred nowadays as the classic long/short equities model.

The fund A.W. Jones had set up, was a true hedge fund in the sense that the short stock positions in the portfolio were used as a hedge mechanism against the market risk of the long stock positions. The combination of these positions gave a certain level of insurance against failing markets, which led to successful performances of the fund throughout the years. Subsequently, in order to implement the long/short strategy and to benefit from a high level of freedom regarding the use of investment strategies, Jones made some changes to the structure of his investment company and converted his investment vehicle in 1952, from a general investment partnership to a limited partnership. The choice of the structure of the fund was based on the fact that existing registered investment companies on the market, were not allowed to make use of techniques such as short selling and leverage, as is the case nowadays. Accordingly, the introduction of a limited partnership exempted A.W. Jones's fund from registration at the stock exchange as an investment company under the U.S. Investment Companies Act of 1940. Furthermore, A. Jones could request a high minimum investment capital from his investors and could charge a performance fee of 20% in order to align his incentives with those of his investors. This incentive structure made it possible for managers to earn 10 to 20 times as much in compensation compared to established funds, and remains nowadays characteristic to hedge funds.

The achievements of the fund of Jones remained unnoticed till in 1966 the Fortune Magazine published a groundbreaking article written by journalist Carol Loomis entitled *"The Jones' That Nobody Can Keep Up With",* referring to his strategy as a 'hedged fund'. This article not only described in details Jones' unique investment strategy, but also revealed how this 'obscure' investment vehicle had outperformed the best performing mutual funds that year by 44% and the major mutual funds by more than 85% net of fees during the period from 1962 to 1966.[22] Alfred W. Jones was considered to be an innovative investor in a time when most investment techniques were based on long-only positions. The publication aroused the interest of high net worth individuals seeking better investment returns and many top investment managers (including the trader Michael Steinhardt who opened a small vehicle in 1967 and the philosopher-financier George Soros who

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[21] Joshua Kennon, *The Basics of Shorting Stock*. Available at: http://beginnersinvest.about.com/cs/newinvestors/a/022703a.htm
[22] See note 12.

started a fund similar to Jones's in 1969) were drawn to hedge funds due to their unique fee structure. This public attention resulted in subsequent years to the introduction of dozens of funds with similar strategies and a similar legal structure as the fund of Jones, and thus the birth of the hedge fund industry. In 1968, the Securities and Exchange Commission (SEC) counted that between 1966 and 1968 nearly 140 new investment partnerships that should be considered as hedge funds, had made their entrance on the market.[23]

As the first investment manager to combine short selling, the use of leverage and a compensation system based on performance in a partnership, Jones earned the title of the originator of the modern hedge fund in investing history. Consequently, although the strategies that similar private funds employed showed an increasing diversity, the fund of Jones and other similar private funds were the 30 subsequent years synonymous with the term hedge fund.[24]

In the 70's however, many hedge fund managers started to turn away from Jones' strategy which focused on specific stock picking and the use of hedging in order to maximize returns. Hedge fund managers changed their approach and began to engage in riskier strategies based on long and over-leveraged positions and less on short ones. As a result, they exposed their portfolios highly to the stock markets. During the recession of 1969-70, the use of a leveraged, long-only strategy led to heavy losses in which some hedge funds dropped in value by more than 70% within two years, followed by a number of hedge fund closures during the stock market crash of 1973-74. Many were liquidated and the total value of the remaining hedge funds at that time was $300 million.[25]

After the disastrous events of the early 70s, the hedge fund industry was relatively quiet till in 1986 an article in *Institutional Investor* described the double-digit performance of Julian Robertson's Tiger Fund[26]. This article led to a hype around hedge funds. The success of several other funds profiled in the media during the late 1980s/early 1990s, such as Michael Steinhart's fund[27] and George Soros's Quantum Fund[28], where the managers attracted capital, beat the markets, used high-

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[23] See note 12.
[24] Sebastian Mallaby, *Learning to love Hedge Funds,* June 2010. Available at: http://online.wsj.com/article/SB10001424052748703302604575294983666012928.html
[25] See note 12.
[26] Julian Robertson established Tiger Management Corporation which was one of the first hedge funds. The fund had in 1980 $8 million assets under management and peaked to $22 billion by 1998. The largest group of assets of the fund at that time were future contracts based on stocks of the U.S. Airways.
[27] Along with the investors Horward Berkowitz and Jerrold Fine, Michael Steinhardt established a hedge fund called Steinhardt, Fine, Berkowitz & Co. This fund accomplished average annual returns that exceeded the S&P 500 by at least 50% by using several investment instruments.
[28] By shorting the British Pound in advance of the United Kingdom's withdrawal from the European Exchange Rate Mechanism (ERM) and consequently making a profit of $1 billion during the 1992 Black Wednesday Currency crisis, George Soros earned the name of *'The Man Who Broke the Bank of England'*. Basically, Soros had bet against the UK government to be able to keep the British Pound within the ERM. Until his remarkable performance, most professionals on Wall Street were unaware of the possibility to realize a nine or ten figure paycheck.

return instruments and unregistered funds in order to make massif profits, not only attracted global publicity to the hedge fund industry but also restored the credibility of the industry. Consequently, high-worth individuals got more encouraged to invest in hedge funds and many investment managers of traditional investment vehicles converted into hedge funds due to the potentially higher fees and the greater flexibility to use diverse financial products. By this time, the industry had evolved into hundreds of active funds on the markets. Simultaneously, an increasing array of exotic financial products emerged and traders started using more sophisticated investment methods then the traditional long-short and leverage model of A.W. Jones. The sophisticated financial products included currencies, interest rates and derivatives such as options, swaps and futures. By the early 1990s there were over 500 hedge funds worldwide with assets under management of circa $38 billion.[29] The growth of the hedge fund industry had now emerged, and from 1994 to 1999 the great bull market pushed returns of hedge funds to high records.

Unfortunately history repeated itself in the late 1990s and into the early 2000s when the dotcom bubble burst and various high profile hedge funds failed in a spectacular way. Particular incidents, such as the headline-making collapse of Long Term Capital Management (LTCM)[30] in 1998, the meltdown of the Tiger Funds in March of 2000 and the reorganization of the Quantum Fund in April of 2000, drew negative attention to the hedge fund industry. Despite these incidents, the industry grew significantly in the late 1990s and into the early 2000s from $38.9 billion worth of assets under management in 1990 to $536.9 billion in 2001.[31] During this period hedged equity and other alternative strategies performed better than 'long only' strategies. This success brought a large number of institutional investors, both in the U.S. and abroad, to take a closer look at 'hedged' investment strategies. Moreover, an increasing variety of strategies was noticeable such as a mix of long-short, credit arbitrage, event-driven, quantitative and multi-strategy among others, and the interest in emerging markets and funds of funds evolved. These hedge fund strategies will be elaborated in chapter 3 of the dissertation.

During the 2008 credit crunch however, the outflow from hedge funds rose again due to their lack of liquidity and excessive leverage leading to many investors and managers to lose a great deal of money. The events of the financial crisis also high-lighted other negative elements of hedge

[29] Tomas Garavicius and Frank Dierick, *Hedge Funds and their implications for financial stability,* Occasional Paper Series No. 34, August 2005.
[30] LTCM was a large hedge fund established in 1993 by the prominent Salomon Brothers bond trader, John Meriwether. By 1998, the fund had assets under management worth $ 1 trillion. However, due to the risky arbitrage trading strategies the managers of LTCM employed, the default of Russian government bonds and the high level of leverage, the fund made huge losses. As a consequence, the hedge fund failed dramatically and nearly created a global financial meltdown in 1998. Thus, the size of the trades of the hedge fund and the huge amounts of capital borrowed in order to finance its trades, forced the Federal Reserve to bail out LTCM in order to prevent a global financial crisis. The collapse of LTCM shocked the financial world because it disclosed the extent to which financial markets were exposed to the activities of hedge funds.
[31] Committee on Capital Markets Regulation, *The global financial crisis, A plan for regulatory reform*, May 2009. Available at: http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf

funds, such as the low levels of transparency and poor qualities of due diligence standards which will be elaborated in chapter 4. After the financial crisis, the hedge fund industry nevertheless reestablished itself and many ex-hedge fund managers took their investment strategies into new hedge funds in order to raise funds again.[32]

In conclusion, although the hedge fund industry experienced difficult periods from 1970 to 2008 such as the stock market crash, the Asian financial crisis[33], the collapse of LTCM, the bursting of the dotcom bubble, the Madoff scandal[34] and the collapse of the credit markets, hedge funds have throughout the years succeeded in generating consistent positive returns. The strategies employed by hedge fund managers exposed a low correlation to equity markets, the ability to preserve capital and the ability to maintain a low volatility of the portfolio regardless the direction of overall markets.

2.4. The hedge fund industry nowadays

At the present time, more than 60 years after the father of the hedge fund industry Alfred Winslow Jones started the first fund, hedge funds have evolved tremendously. From 300 hedge funds in the 1990s to nearly 10.000 hedge funds nowadays, managing a sum of approximately $2 trillion in assets as opposed to the $100.000 it started with.[35] Nearly the half of today's hedge funds are registered in offshore locations, with The Cayman Islands as the most popular registration location. On the other hand, hedge funds are predominantly managed from onshore locations, with the US as the global leading location (70%), followed by Europe (21%).[36] As A.W. Jones once did, managers of hedge funds nowadays still employ the performance fee in order to align their interest with the ones of the investors and generate absolute return despite market volatility. However, while Jones never

[32] HedgeFundFacts.org, *Hedge Funds. How They Serve Investors in U.S. and Global Markets*, August 2009. Available at: http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[33] The Asian financial crisis was caused by a sequence of currency devaluations and other incidents that stretched out to several Asian markets in the midst of 1997. The crisis in the currency markets started in Thailand when the Thai government decided to detach the local currency from the US dollar. Soon after, currency declines extended quickly throughout South Asia leading to reduced import income streams and declines in stock markets. The Malaysian government more specifically accused hedge fund managers of intentionally short selling the Malaysian currency which led to a further decline of the currency. The downfall of the Asian economies was felt in other parts of the world such as Russia, Europe and the US. Eventually, the International Monetary Fund (IMF) and the World Bank intervened in order to restore the stability in global financial markets. The events of the Asian financial crisis revealed the extent to which short selling activities of hedge funds can damage economies in the world.
[34] Bernard Madoff was a prominent investment manager on Wall Street whose business was based on an elaborated fraudulent investment scheme. He sold unregistered securities and made returns that derived from the capital of his investors or the capital of subsequent investors. This fraudulent investment scheme is referred to as a ponzi scheme. The fraudulent investment activities of Madoff were also done through his hedge fund Ascot Partners, which was considered to be one of the largest hedge funds in the world with $1.8 billion worth of assets under management. Moreover, many hedge funds had passed their clients' capital to Madoff's fund contributing to the huge value of assets managed by Madoff. These hedge funds were called 'feeder funds'. After the revelation of the scandal, the activities of Bernard Madoff brought to light the lack of due diligence and inadequate transparency on trading strategies certain hedge funds dealt with, and the scandal affected the image of the hedge fund industry negatively.
[35] Report of TheCityUK, Financial Markets Series, Hedge Funds, March 2012. Available at: www.thecityuk.com
[36] See note 35.

charged his investors management fees unless the fund made profits, most of today's managers charge their investors a management fee of typically 1-2%. Furthermore, the investment portfolio has changed tremendously and is more sophisticated and diverse including investments in currencies, foreign exchange, commodities, bonds, real estate, derivatives and so on, and not all of them follow the conventional long/short strategy of A.W. Jones.

The use of complex strategies in order to adapt to the new complexities of the financial markets, the ambition to outperform traditional asset classes while maintaining low levels of volatility even in difficult economic times, the global trend towards market liberalization and the rapid development of the financial technology, are the main reasons why the industry has grown to represent one of the largest segments of the investment management industry. Consequently, in the tradition of A.W. Jones, hedge funds in this day and age, not only continue to successfully outperform traditional investment institutions, but they also have contributed to the expansion of capital markets and the modern financial industry.

2.4.1. The Dutch hedge fund industry nowadays

The hedge funds managed from onshore locations in Europe is 21% of the total assets under management in the world. In this regard, the Netherlands accounts for approximately 3% of the European based hedge funds market, with nearly 100 funds in the second quarter of 2012 managing a total of €19.8 billion worth of assets.[37] The investor base of Dutch hedge funds are institutional investors such as banks and pension funds, and retail investors that usually are high net worth individuals. The Dutch hedge funds often have a high minimum subscription that can start from €10.000. One of the reasons for the small representation of the Dutch hedge fund industry in the global hedge fund industry is due to the fact that large institutional investors such as pension funds are unwilling to invest in small funds due to their size, and/or unwilling to invest in large hedge funds due to their preferences for foreign funds.[38] Moreover, the relatively un-transparent nature of large hedge funds results in the reluctant behavior of pension funds.[39] On the other hand, pension funds more often create hedge funds that are set up as funds for joint account (Fonds voor Gemene Rekening, FGR) in order to transfer specific risky investments from their balance sheets to FGRs. The FGR is a type of pooled investment vehicle which is created through a contract between the manager, the depositary and the participants and that has no legal personality.[40] Furthermore, institutional investors also invest strongly in funds of hedge funds that are set up by pension fund

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[37] See: http://www.dnb.nl/en/news/news-and-archive/statistisch-nieuws-2012/dnb277179.jsp
[38] Koos Henning, *Meer Mogelijkheden, Minder Toezicht*, 11 June 2011. Available at: http://www.saemor.com/LinkClick.aspx?fileticket=yGq1-iribpM%3D&tabid=341
[39] http://www.pensioenbestuurders.nl/wp-content/uploads/2011/12/Presentatie-Ruud-Hendriks-PDF.pdf
[40] See: http://www.hollandfinancialcentre.com/publications//HFC-Pocket-AlternativeInv4-SA_310512%20definitief.pdf

managers.[41] These funds do not employ an investment strategy of their own, but invest in other hedge funds based on best track records. At the GAIM conference[42] it was concluded that although the financial markets are currently facing difficulties, hedge funds are more likely to maintain a better risk-return ratio compared to other investment vehicles. In this context, institutional investors are facing a greater pressure to provide returns and therefore invest more often in alternative investments.[43] This is a significant reason for pension funds in the Netherlands to engage in alternative investments through FGRs and funds of hedge funds. The size of the Dutch hedge funds excluding FGRs and fund of hedge funds amount to €3.2 billion at the end of the second quarter of 2012.[44] Consequently, the participation of pension funds in the Dutch hedge fund industry is significant. In conclusion, although the Dutch hedge fund industry is relatively small, the Netherlands is nonetheless perceived as an attractive location for investment managers in the EU and currently is amongst the top 5 major hedge fund countries in Europe.[45] According to the Holland Finance Center[46], one of the reasons why the Netherlands has a strong reputation as a location for alternative investment managers is due to the favorable legal, fiscal and regulatory framework for alternative investments, the large Dutch pension fund industry that manages €800 billion worth of assets, and the relatively low cost of doing business in the Netherlands.[47]

2.5. The need for a stricter regulated hedge fund industry

Alfred Jones once succeeded in avoiding regulation by marketing its fund by word of mouth. As the hedge fund industry has grown however, hedge funds are nowadays less successful in dodging national regulation and awake more often national regulator's suspicion around the world. In the wake of the global financial crisis, the role of hedge funds in the financial markets and the lack of transparency in their investment strategies have caused controversies around the industry. Regulators raise concerns for potential market abuse and amplification of systemic risk due to their influence and magnified effects on market prices. On the other hand, the role of hedge funds in global financial markets is highly esteemed by some financial professionals, where their positive impact on financial stability, portfolio diversification, price discovery, shareholder value and the liquidity supply on the financial markets are mentioned.

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[41] See note 37.
[42] GAIM international is an annual global meeting point and networking forum for investors and managers of alternative investment funds. The GAIM conference itself is the largest and longest-running hedge fund event in Europe and was held in 2012 in Monaco.
[43] See: http://www.fondsnieuws.nl/nieuws/headlines/artikelen/13350-nederland-in-race-voor-hedgefondsen-.html
[44] See note 37.
[45] See: http://www.hollandfinancialcentre.nl/newsletter_item.php?id=2271&language=NL
[46] The Holland Financial Centre is a semi public organization created by financial institutions, the Dutch government and professionals from the science and the legal practice.
[47] Publication from the Holland Financial Centre, *The Netherlands: The best alternative*, 2012. Available at: http://www.hollandfinancialcentre.nl/publications//HFC-Pocket-AlternativeInv4-SA_310512%20definitief.pdf

In chapter 4 the above mentioned economic benefits and controversies of the activities of hedge funds will be elaborated. In chapter 5, the controversies will be discussed in the regulatory context of the AIFMD and the Wft.

3. The frame of hedge funds

This chapter outlines the characteristics of hedge funds in order to clarify its features and to provide a comprehensible insight on the structure of hedge funds.

3.1. Providers of services

I. The investment manager

The portfolio of a hedge fund is managed by an investment manager who is also the general partner of the fund. The manager is usually accountable for the investment strategy, makes operational decisions with regard to the allocation of capital in investments and is in charge of the recruitment of new clients. Depending on the jurisdiction where the hedge fund has its registered office, certain administrative functions of the manager can be delegated to other service providers such as a prime broker(s) (or asset custodian), an administrator, auditors , distributor/placement agents (they market and distribute the fund's shares to potential investors), a custodian and legal advisers. Although the extent to which hedge fund managers outsource administrative functions varies from jurisdiction, the events of the financial crisis have led to the requirement from supervisors and regulators in the US and the EU, to employ well-established independent third party administrators in order to satisfy investor's demand for independent reporting and transparency.

II. The administrator

The administrator usually deals with time-consuming, day-to-day operational activities such as accounting and reporting services, subscriptions and withdrawals of investors, advice on regulatory compliance, independent valuation of a fund's portfolio and other administrative functions that support the trade in the financial products.[48] In particularly the US, the functions of an administrator are often executed by the investment manager.

III. The custodian

A custodian, which is also referred to as a depositary, is a specialized financial entity that is responsible for the safe-keeping of the assets of the hedge fund and the investors on their behalf. The activities of the custodian include the process of clearance and settlement of all trades, which is a process that entails all activities made in order to settle the transaction related to securities, such

[48] See: http://www.hedgefundlawblog.com/hedge-fund-administrator-%E2%80%93-what-is-a-hedge-fund-administrator.html

as risk handling, tax handling and monitoring, and which ensures that the trades are made in accordance with the market rules. The settlement of securities is a process that derives from the contractual obligation of the securities trade contracts, whereby the transaction of the securities has to take place according to the specified terms of the contract. Other activities of the custodian include the supervision of corporate activities such as dividend payments and interest payments, and to control whether the securities that are traded are registered in order to enable a legal transaction of the securities.[49]

IV. The prime broker

Prime brokers usually provide operational support facilities and particular niche services. The activities include capital introduction, risk management services, providing securities in order to facilitate short selling, the supervision of cash lending transactions in order to support leveraged trade executions, clearing and settlement of trades and so on. In certain cases, the services of prime brokers are provided in addition to the custodial services.[50]

3.2. Hedge fund marketing

Hedge funds are private placed investment vehicles that are often not registered with competent authorities. Due to the fact that they are not registered, they are usually restricted from any form of direct communication to potential investors for public marketing purposes. Consequently, specific detailed information on the investment strategies and performance statistics are not allowed to be made available on websites and other marketing materials, leading to leaflets and other marketing materials to be prevented from any distribution to the public. Nonetheless, hedge fund managers find various ways to distribute and market their funds to potential investors. Hedge fund managers can choose to market the fund through third parties such as brokers, investment firms or third party marketers who market the hedge fund to institutional and high net worth investors in return for fees.[51] Furthermore, by employing unique investment strategies, hedge fund managers can attract the interest of investors. The internet and the media can be used as instruments of distribution of general hedge fund information or to acquire media exposure. Hedge funds can for instance get listed on major hedge fund databases and post performance returns or acquire media exposure through blogs, books, press releases of articles or researches on major market trends.

[49] HedgeFundFacts.org, *Hedge Funds. How They Serve Investors in U.S. and Global Markets*, August 2009. Available at: http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[50] See note 47.
[51] See note 47.

3.3. Open-end structure vs. closed-end structure

Most hedge funds in the US are structured as open-end funds. An open-end structure is a collective investment scheme where at regular specified intervals (monthly, quarterly or semi-annually), the fund can accept further subscriptions from investors and allow them to withdraw part or all of their capital from the fund. The latter is referred to as a redemption. Usually it is stated in the subscription agreement what the specific fees, dates and the total amount for redemption are. The value of a participation right or share in a open-end hedge fund is based on the net asset value (NAV) of the underlying assets. The net asset value is a form of accounting and recordkeeping activity, designed to describe the value of an entity's assets through the calculation of the assets subtracted with the value of the liabilities. Since the value of the units of the investors is based on the NAV, the depreciation and the appreciation of the value of the fund's assets is immediately reflected in the amount an investor can withdraw at a later specific moment. Moreover, in case an investor intends to redeem its units from the fund, he is usually free from restrictions on the transferability thereof to other investors on the market and is able to trade the units on an established trading market.[52]

A closed-end structure is a collective investment scheme whereby the units are not continuously issued and redeemed to the public. The investment manager merely invests the capital that was acquired during the initial public offering (IPO) and is unable, unlike in the open-end structure, to create new units for the benefit of the investors. The price of the participation rights, which may be higher or lower than the NAV of the underlying assets, is determined by supply and demand and can be traded amongst specific investors in for instance secondary markets. An investment is generally less liquid in a closed-end structure, due to the fact that investments are locked-in for a longer period and investors are unable to withdraw their investments from the fund at any given time.[53]

3.4. Fees

Hedge fund managers are remunerated by two types of fees: management fees and performance fees. The management fee is usually based on the fund's NAV and typically ranges between 1%-2%, while the performance fee is based on the profitability of hedge fund's investments and is typically around 20%.[54] In the Netherlands the performance fee usually range between 15 and 20%.[55] Hedge fund managers also often employ a minimum level of performance rate through high watermarks

[52] Jeremy C. Stein, *Why Are Most Funds Open-End? Competition and Limits of Arbitrage*, Harvard University and NBER, September 2003.
[53] See: http://www.sec.gov/answers/mfclose.htm
[54] Gregory Connor and Mason Woo, *An Introduction to Hedge Funds*, The London of Economics and Political Science. Available at: http://eprints.lse.ac.uk/24675/1/dp477.pdf
[55] Koos Henning, *Meer Mogelijkheden, Minder Toezicht*, 11 June 2011. Available at: http://www.saemor.com/LinkClick.aspx?fileticket=yGq1-iribpM%3D&tabid=341

and hurdle rates in order to ensure that the profits are distributed fairly to investors.[56] A water mark is an absolute minimum level rate of performance based on accumulated performances obtain in a year that the manager must attain before incentive fees are paid. Consequently, performance fees only apply to net profits and thus paid after cumulative performance recovers any past underperformance. A hurdle rate is a minimum rate of return on an investment that a manager must surpass before he can receive an incentive fee. For instance, if the manager sets a hurdle rate at 5% and the fund returns 15%, incentive fees would only apply to the 10% above the hurdle rate.

3.5. Domicile and management locations

The domicile and type of legal entity used for a specific hedge fund is normally determined by regulatory considerations and the tax environment in which the investors are located. Due to the beneficial tax and regulatory regimes, hedge funds are often registered in small, low-tax jurisdictions or countries that specialize in providing commercial and corporate services to onshore companies. These locations are referred to as offshore financial centers (OFCs). Examples of offshore financial centers for hedge funds are the Cayman Islands which is the leading offshore location for hedge funds (34%), the British Virgin Islands (6%), Ireland (7%) and Luxembourg (10%). Although the fund will usually be established offshore, investment managers are for the most part located onshore in order to be in the proximity of clients, local expertise and hedge fund service providers. The leading location globally for hedge fund managers is in this regard the US East Coast (70%). In Europe, with a total of $395 billion worth of assets under management the leading location is the UK (69%).[57]

3.6. Categories of investment strategies

Due to the continuous availability of investment opportunities, investment strategies are constantly modified by hedge fund managers. Hence, there is not a consensus on a formal classification of hedge fund strategies. The categories made in this paper are based on a research made by the Hedge Fund Research Inc. (HFR), one of the main hedge fund databases that employs 33 different strategies divided within four categories; equity hedge, event driven, macro and relative value.[58] For the sake of the length of this paper, the more common strategies will be elaborated. Each category has its own investment style and its corresponding risk and return characteristics. Remarkable in the use of these investment strategies is that the long/short investment strategy is by far the most employed strategy by hedge funds in the world, including in the Netherlands.[59] Before the strategies are looked at in

[56] See note 52.
[57] Report of TheCityUK, Financial Markets Series, Hedge Funds, March 2012. Available at: www.thecityuk.com
[58] See: http://www.hedgefundresearch.com/index.php?fuse=indices-str
[59] See note 50.

details, the following significant supporting strategies that hedge fund managers employ are highlighted; the discretionary and systematic investment approach, the market directional and market neutral investment strategy, the trend and the counter-trend approach and the quantitative and fundamental analysis.

In the systematic investment approach, mathematical and statistical models are used through complex computer programs. The human involvement is hereby minimal in determining the portfolio positioning. The discretionary investment approach on the other hand, is actively carried out by hedge fund managers. The fund manager employs his own sophisticated analysis in order to determine the portfolio positioning. Generally, the strategy employed by hedge fund managers fall between these two extreme investment approaches.[60]

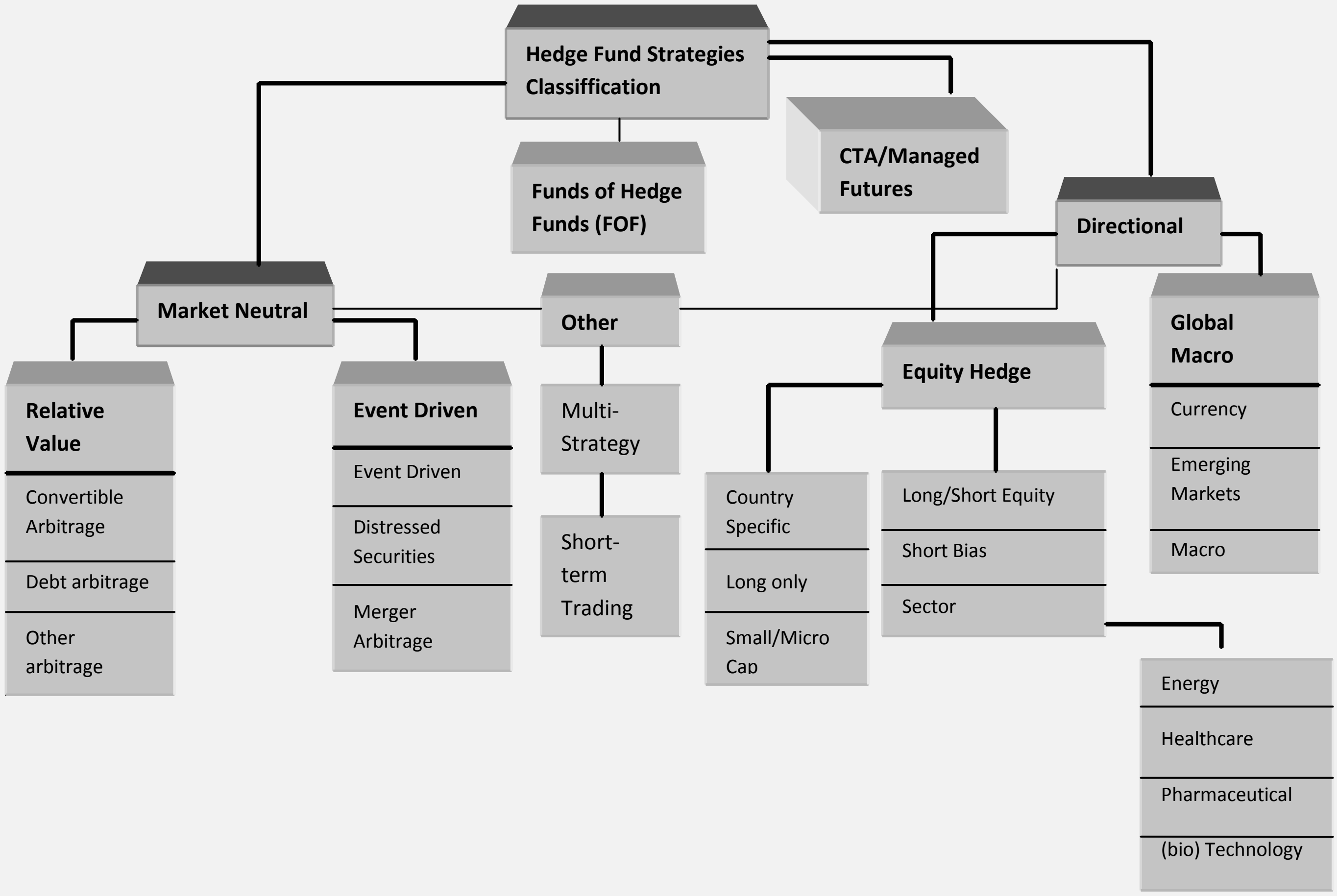
As seen in the figure bellow, hedge fund strategies are mainly based on whether they are market directional or market neutral orientated. The absolute returns in directional orientated strategies have a strong correlation with and a greater exposure to the fluctuations of the overall market. The great exposure to the markets is due to the fact that the investments are based on the (global) market movements and trends. Market neutral orientated strategies on the other hand have a neutral exposure and a low correlation to the overall market risks and returns.

In the trend approach, the manager enhances profits based on (anticipated) trends while in the counter-trend approach the profits are based on (anticipated) setbacks in trends. Examples of these approaches are respectively the event-driven and the distressed securities strategy.

A fundamental analysis is based on financial fundamentals such as cash flow, earnings per share, liabilities, assets, expenses and so on in order to evaluate and predict the security's value or changes in this value. The fundamental analysis is made through an quantitative analysis which is a financial analysis method in which statistical and mathematical models are employed.[61]

[60] Gregory Connor and Teo Lasarte, *An Introduction to Hedge Fund Strategies*, The London School of Economics and Political Science. Available at: http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund-Strategies.pdf
[61] See note 58.

Figure 2. Strategies Classification



3.6.1. Equity hedge strategy

The equity hedge manager is primarily focused on market trends and movements, which leads to the investment portfolio in this strategy to have a greater exposure to the fluctuations of the overall market. Concurrently, both long and short positions are maintained in equities, commodities, real estate, currencies, derivatives and other financial products in order to hedge the risks involved in the different positions. The challenge in this strategy lays in the fact that the portfolio manager has to be able to correctly predict the relative performance of two related equity in order to determine its position. Equity hedge managers will thus attempt to reduce the volatility in the underlying assets by either hedging the positions against potential market risks or by diversifying in different asset classes. Equity hedge managers are distinguished by the geographic market they operate in, the investment style they employ (going long, short or a combination), the sector and the market capitalization in which they invest. The market capitalization, which is often referred to as 'market cap', is the grouping of companies by size determined by the total market value of all of the tradable shares of a publicly traded company. It is calculated by multiplying the current share price (excluding preferred shares) by the number of shares outstanding. The stocks of small, medium and large companies are referred to as small-cap, mid-cap, and large-cap respectively.[62]

I. Long/Short Equity

The long/short equity strategy derives from the original structure of A.W. Jones's 'hedged fund'. The fund manager hereby maintains a combination of long-short positions within the same capitalization, industry, sector, region or country in order to exploit price discrepancies between related securities. The manager purchases undervalued equity through a long position, while overvalued equity is sold through a short position on the market in order to hedge risks and make profit regardless the volatility of the underlying assets. The positions that are made, are determined by a process of stock picking based on a sophisticated analysis of future price movement that has not been accurately reflected in the current security prices. Depending on whether the manager identifies attractive opportunities in companies that experience or expect a high level of growth in sales, earning or profitability in comparison with the price movements in the equity market, the manager will either take a long or short position. [63]

II. Short Bias

Within this hedge fund strategy the focus lies on a consistent exposure of the portfolio to short positions rather to long positions in order to enhance profits in declining equity markets. Thus, in case of a company's misrepresentation on the markets, managers that employ this strategy can contribute to market informational efficiency. On the other hand, in case of a prolonged bull market this investment strategy can be extremely risky.

3.6.2. Event Driven Strategy

The event-driven manager attempts to make profit from changing equity prices in response of corporate activities such as acquisitions, mergers, stock buybacks, dividend issuance, corporate restructuring, liquidations and other atypical events. Once a company has given one of these signals to the market, the event-driven manager will analyze the potential event and determine the likelihood of the occurrence of this event. Once the manager predicts correctly the effect of the

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[62] Morningstar Methodology Paper, *The Morningstar Category Classifications for Hedge Funds,* 30 April 2012. Available at: http://corporate.morningstar.com/it/documents/MethodologyDocuments/MethodologyPapers/MorningstarHedgeFundCategories_Methodology.pdf
[63] See note 60.

anticipated event and take positions accordingly, he will consequently benefit from the corporate event. [64]

I. Distressed securities

Investing in distressed securities comprise investing in corporate bonds, stocks, bank debts, warrants, and other assets of financially troubled companies that may face distressed equity sales, financial reorganizations, corporate restructurings and bankruptcies. When a company is unable to meet its financial obligations and faces a bankruptcy, the shareholders often react by selling those securities at a reduced price. Hedge fund managers in distressed securities consequently purchase these securities at a price that is below their intrinsic or market value, while expecting that the company, unlike the market believes, will eventually not file for bankruptcy. Another scenario is that the company in question may enter a bankruptcy procedure, but nonetheless have enough capital upon liquidation to pay its debt holders or is able to successfully reorganize.[65] In these two scenario's, the value of the company's distressed securities may increase, leading to the distressed securities manager to profit once he has sold the securities to the market at a higher price. In certain cases the manager will actively get involved in the management of these distressed companies by buying a considerable amount of securities and attempt to influence the restructuring process of the company. This is called shareholder activism and can lead to problems with other shareholders of the company since the interest of hedge fund managers sometimes differ from those of the shareholders. Hedge fund managers are usually focused on the achievement of short-term profits rather than long-term profitability, which can be at the expense of the long-term vision of the shareholders.[66] The risk within this strategy is that if the company eventually ends up filing for bankruptcy, the manager will face worthless distressed securities. The manager therefore must have sophisticated knowledge and skills to accurately assess whether the company in distress can improve its performances and effectively reorganize. Due to the fact that the event-driven investment strategy and the distressed investment strategy are complementary, these strategies are often used in combination. The event-driven strategy tends to work best when the economy is performing well, while distressed investing tends to work well when the economy is performing poorly.

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[64] Gregory Connor and Mason Woo, *An Introduction to Hedge Funds*, The London of Economics and Political Science. Available at: http://eprints.lse.ac.uk/24675/1/dp477.pdf

[65] See: http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-event-driven.html

[66] Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 2007. Scholarship at Penn Law. Paper 99.

II. Merger Arbitrage

The merger arbitrage strategy entails the acquisition of securities of the acquiring and target company involved in mergers, acquisitions and other similar corporate events. Before entering into the details of the merger arbitrage strategy, the investment strategy arbitrage will be elaborated.

Arbitrage is a short-term trading strategy in which substantial identical or similar financial products are simultaneously purchased and sold at two different prices in two different markets in order to profit from the price difference between the two assets and to reduce the risks of the assets. Since the price differences are often small, an arbitrageur will leverage in order to buy securities in huge volumes at a low price, and within a few seconds for instance re-sell them to a buyer at a higher price in another market. The other way around is also possible. The manager sells higher priced securities at a certain time in a certain market and concurrently purchase similar securities once the value has dropped in the same or another market. The strategy however, can rebound if unexpectedly interest rates, prices, currency exchange rates or other influential factors move in ways the trader did not anticipate. When hedge funds apply arbitrage on the other hand, rather than exploiting price differences between similar financial products, the trader simultaneously purchases and sells two similar securities whose prices are not in sync with their true value in order to offset significant price differences between the two assets. If for instance, in the opinion of the manager, an asset is overvalued and the manager assumes that prices will return to their true value over time, the manager will short the overpriced securities and purchase the underpriced securities in order to profit from the price differences. Since markets are inefficient, this investment strategy contributes to relatively stable prices on the markets and prevents financial products to diverge substantially from their real value for long periods of time.

In case of a merger, the shares of a target company will usually trade below the purchase price, prior to the closing of a merger deal due to the uncertainty of the transaction. Before the manager chooses to purchase the shares of the target company, he will look at different important elements of a merger transaction such as the terms of a merger, the financial risks, the probability of an approval of the merger by the shareholders, the time needed to close the deal, any regulatory issues that may obstruct the occurrence of the merger and other risk factors. Once the transaction is completed the value of the shares of the target company will normally rise. The merger arbitrage manager will as a result sell the shares at a higher price and profit from the price discrepancy.[67] This situation is usually the case in the cash mergers. A cash merger is when the acquirer purchases the shares of the target company by paying each shareholder a specified amount for each share. In a

[67]See: http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-merger-arbitrage.html

stock-for-stock merger the acquisition is financed through an exchange of stocks of the target company with the shares of the acquiring company. During this merger the fund manager will in the expectation that the stocks of the target company will increase, take a long position on the stocks of the target company while simultaneously short the shares of the acquiring company. The manager takes a short position on the shares of the acquiring company due to the uncertainty of the completion of the merger transaction. Once the transaction is completed and the stocks of the target company are converted into the stocks of the acquiring company, the manager will employ the converted stocks to hedge his short position.[68] The risk in this strategy is for instance that the merger does not go through or that the ratio at which the stocks of the target company is exchanged for the acquiring company's stocks, fluctuates. As seen with the distressed securities strategy, merger arbitrage fund managers can act as shareholder activist by acquiring large amounts of shares in order to influence the merger negotiations and its outcome for their benefits.

3.6.3. Global macro strategy

The global macro strategy is based on broad macroeconomic events and trends in equities, bonds, currencies, derivatives, indexes and commodities markets in global economies. While long/short equity managers will focus on the movements and fundamental characteristics of micro events within a company or an industry such as the quality of the management, market shares, profits, P/E ratios and so on, macro events focus on changes in global markets. Macro events are usually created by alterations in government related events which have an influence on interest rates for instance and which subsequently affects the value of financial instruments. Within this strategy the investment opportunities are specifically found by anticipating on changes in government policies, political changes (including inter-government relations), interest rates, inflation and market trends, that can have an influence on the exposed portfolio.[69] Due to the fact that events in certain countries or regions can affect markets across the world, global macro managers are less limited than other types of hedge fund managers in their choice of a market and investment instruments. Hence, they usually efficiently succeed to allocate capital to global diversified and lucrative asset classes, sectors and regions. In this strategy however, the financial instruments that are traded are relatively illiquid, leading to the returns to be more volatile than in other types of hedge fund strategies.

[68] See note 58.
[69] See: http://www.hedgefundresearch.com/index.php?fuse=indices-str

I. Currency

An active currency management portfolio entails the prediction of inefficiencies on currency markets in order for hedge fund managers to profit from fluctuating values of currencies.[70] When currencies are exchanged for other currencies at a specific exchange rate, they float against each other on the foreign exchange market, the Forex market. Consequently, once a foreign exchange rate transitions at the time of the currency transaction, the currencies are exposed to the Forex market risk. In order to alleviate the currency risk, the hedge fund manager employs the currency strategy in combination with a fundamental analysis in order to determine the relative currency valuations. The manager hereby looks at the relative strength of one (home) currency based on the strength of its economy, versus the relative strength of another foreign currency in order to hedge the exposure of the home currency. This is referred to as a currency pairs. Global monetary and economic policies, inflation rates and domestic interest rates are hereby tracked in order to predict whether currencies will appreciate or depreciate.[71] Based on this analysis the manager decides whether to purchase or sell a particular currency. A common technique to hedge against currency risk is through a Forex option. An option is a derivative contract which is sold by one party, an option writer, for a premium to another party, an option holder. The option grants the buyer the right, not the obligation, to buy or to sell a specific asset for a specified amount (the strike price) through respectively a call or put option, during a specific period at a predetermined date (exercise date). Thus, ounce a trader takes a long or a short position in calls or puts, the trader buys call or put option contracts from an options writer and speculate on a future appreciation or depreciation of the value of the underlying asset by the time that payment is due.[72] A Forex option is a currency option where a foreign exchange derivative contract, which is based on the exchange rate between two currencies, is used in order to grand the holder the exercise right to buy or sell a specified amount of currencies at a given price by a certain delivery date. If this option is exercised at some point of time in the future, a future contract can be used. However, since it is impossible to predict with certainty a future movement of a specific exchange rate this technique carries substantial risk of loss that can be amplified by the use of leverage .

3.6.4. Relative value strategy

In this investment strategy the manager seeks to profit from relative discrepancies of related securities by concurrently buying and selling similar securities. Through the use of this strategy, the

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[70] Arun Muralidhar, FXConcepts, *Currencies As A Perfect Long-Short Alternative Investment Strategy*, AIMA Newsletter, April 2002.
[71] Marc Levinson, *Guide to Financial Markets (The Economist)*, John Wiley & Sons, Inc, 1 December 2009, p. 14.
[72] Marc Levinson, *Guide to Financial Markets (The Economist)*, John Wiley & Sons, Inc, 1 December 2009, p. 201.

portfolio exposure to price movements of underlying securities and risks associated with fluctuating interest rates and broad market price movements are hedged. When a security appears to be underpriced the manager will take a long position and concurrently take a short position in the security that seems to be overvalued. This position will be hold until the price difference disappears. Since the discrepancy in price is usually short lived, these types of funds often are highly leveraged in order to increase the size of the possible gains. Due to the fact that this strategy has a low market exposure, it is also referred to as the market neutral strategy.[73]

I. Convertible arbitrage

This market neutral investment strategy involves a synchronized long position in convertible securities and a short position in the same company's common stock in order to increase returns in difficult market conditions. A convertible security is a security that can be converted into another security within a certain time frame and for a specific price. The most common convertible securities are convertible bonds or convertible preferred stocks which can be converted into equity or common stocks once the price of the convertible security appreciates to a certain price level. In case of a convertible security, a periodic fixed amount (for convertible bonds) or a preferred dividend (for convertible preferred shares) and a specified price rate at which it can be converted into a common stock, is paid. In the convertible arbitrage strategy, arbitrage is employed in order to profit from the discrepancy of an inefficient pricing of company's convertible bonds compared to the company's stock. For instance, a hedge fund manager will buy company's convertible bonds while simultaneously sell the company's stock. Whenever there is a decline in the stock price the manager will profit from its short position. On the other hand, if the stock price rises the manager can benefit from its long position on the convertible bonds and compensate the losses on its short position by converting its bonds into stocks and sell those stocks at market value.[74] However, managers of convertible arbitrage will have to carefully evaluate and determine in advance whether market conditions will match the time frame in which conversion is allowed.

3.6.5. Managed future fund

Managed futures are part of the alternative investment strategies in which predominately futures contracts are part of the investment portfolio. Managed future funds are usually managed by commodity trading advisors (CTA's). Commodity trading advisors are professional financial investors and advisors on commodities, options, futures, derivatives, foreign currencies and managed futures

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[73] Gregory Connor and Teo Lasarte, *An Introduction to Hedge Fund Strategies*, The London School of Economics and Political Science. Available at: http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund-Strategies.pdf
[74] http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-convertible-arbitrage.html

accounts. Although managed future funds are often managed by CTA's, they are also managed by hedge fund managers. Due to the increased use of future contracts and the need for greater diversification in portfolios, hedge fund managers and other investment management professionals have been encouraged to use managed futures. Futures fund managers employ sophisticated computer-driven trading programs and the fundamental analysis in order to evaluate the value of underlying assets in global future markets. Concurrently, the manager determine his position in which he decides to sell or purchase the assets. An advantage of managed futures is that future contracts are very flexible and can be used for different asset classes. Managed futures can thus be used to diversify across global markets and to diminish the portfolio risk of underlying assets. Simultaneously, the manager can profit from changes in equity, commodities and currency markets and maintain a low correlation between and to the asset classes in these markets. The low correlation reduces portfolio volatility and risks attached to the assets without affecting the returns negatively. Another benefit of the use of futures in managed futures funds is that they offer an opportunity to profit in both increasing or decreasing market environments, due to their ability to go long on futures positions in anticipation of rising markets or to go short in anticipation of falling markets.[75]

3.6.6. Multi strategy

In this strategy the manager employs multiple hedge fund investment strategies within multiple asset classes in order to reduce the risks associated with the assets, to diversify the portfolio and to reduce the volatility of the portfolio. The multi strategy can be used within the four main investment strategy categories mentioned above. A single strategy fund will usually have one management team that focuses on one particular investment strategy, while multi-strategy funds represents multiple investment teams that employ multiple investment strategies.[76]

3.7. Fund of hedge funds

A fund of hedge funds is a hedge fund whose portfolio consists of participation rights in one or several other hedge funds in order to diversify the risks that are usually associated with investing in a regular hedge fund. This is referred to as multi-management investment. Thus, the fund does not directly invest in financial products but invest through the portfolio of another fund or other funds. The fund of hedge funds will try to select hedge funds with the best track record based on past performance statistics and other relevant factors. An advantage of this fund is that they are actively

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[75] See: http://www.attaincapital.com/alternative-investment-education/managed-futures
[76] Morningstar Methodology Paper, *The Morningstar Category Classifications for Hedge Funds,* 30 April 2012. Available at: http://corporate.morningstar.com/it/documents/MethodologyDocuments/MethodologyPapers/MorningstarHedgeFundCategories_Methodology.pdf

involved in the management of the hedge fund they invest in, hence contributing to supplementary expertise and skills. Another advantage is that the manager of the fund of fund can have access to the best hedge funds and allocate the capital of the investors to these hedge funds. Consequently, investors not only benefit from diversification of investments but also from a relatively lower initial investment capital compared to regular hedge funds. The diversification of the portfolio also contributes to a decreased level of volatility of the investment portfolio while the returns are maintained or increased. The disadvantage is that the management and performance fees are usually higher than in a regular hedge fund due to the fact that the investor pays fees for both the fund of hedge fund and for the underlying hedge fund. Overall, funds of hedge funds have the same characteristics as regular hedge funds.[77]

4. The impact of the activities of hedge funds on financial markets

In June 2007 the American bank Bear Stearns announced that two of its managed hedge funds, the Bear Stearns High-Grade Structured Credit Fund and the Bearn Stearns High-Grade Structured Credit Enhanced Leveraged Fund, were in serious financial problems. The hedge funds invested in tradable financial instruments backed by pools of debts. These are called collateralized debt obligations (CDOs). The CDOs were market to model[78] which was higher than the valuations in the market, referred to as marking to market[79]. Consequently, assets turned out to be inaccurate and the losses that had to be written off on the balance sheets were such that Bearn Stearns was compelled to bail the hedge funds out.[80] Although the events were not directly associated with the occurrence of the financial crisis rather than with the subprime mortgage meltdown at the beginning of 2007, the problem these hedge funds faced were characteristic for problems certain hedge funds dealt with during the credit crisis.

This chapter will discuss the role of the hedge funds in the events of the financial crisis and the controversies that arose from these events.

[77] See: http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-fund-of-funds.html
[78] The mark-to-model is a pricing strategy that calculates the price of a specific asset based on financial models and the expertise of the trader. Due to the fact that the valuation is open for interpretation, risks are created for investors. These risks were highlighted during the subprime mortgage meltdown.
[79] The mark-to-market (MTM) model is an accounting calculation that tracks the NAV of a fund, based on an unbiased and rational estimation of the current market price of the assets or similar assets.
[80] Kate Kelly, *Lost Opportunities Haunt Final Days of Bearn Stearns*, The Wall Street Journal, 27 May 2008.

4.1. The role of hedge funds to the occurrence of the credit crunch

4.1.1. The creation of the structured financed bubble

The credit crunch started when the dot com bubble of 2000 and the 9/11 attacks caused a risk of recession on American financial markets as share prices on stock exchanges plummeted. The Central American Bank decided in order to circumvent panic on the financial markets, which could lead to a reduction of economic activities on the financial markets, that the Federal Reserve had to respond to these events by cutting the interest rates to an extremely low level of 1%. This measure would help avoid a deep recession in 2000-2001. Simultaneously, on the other side of the world, the growth of the economy in China and oil producing countries in the Middle East caused a greater availability of capital on Western capital markets. Consequently, the combination of an availability of cheap capital and an abundance of capital led to a climate of lax lending in the period 2002-2006. These events led to the birth of a boom and bust in the mortgage sector.[81] Banks and investment banks sought ways to capitalize on the climate of lax lending by investing in risky financial products such as securitized sub-prime mortgages. A subprime mortgage is a type of mortgage for borrowers with low credit ratings and who under normal circumstances will not obtain the loans due to their larger-than-average risk of defaulting. In a normal situation, in order to compensate the higher risk of default, the lending institution will charge interest on subprime mortgages at a higher rate than a normal mortgage. However, the system that many subprime-lenders employed was to introduce a low interest rate in the introductory period of 1-2 years, which would lure homebuyers, and increase the interest rate in the course of time. These subprime mortgages were eventually transformed into tradable financial instruments referred to as securitized sub-prime mortgages. Moreover, the financial institutions leveraged highly in order to finance securitized sub-prime mortgages and to boost the potential returns made with these structured financial products.[82]

The securitized sub-prime mortgages are referred to as mortgage backed securities (MBS).[83] A MBS is a type of asset-backed security (ABS) which is a tradable financial instrument backed by underlying collateralized assets such as credit card debts, car loans, student loans and so on in order to diversify the risks of investing in the underlying asset and to sell the ABSs to investors. A MBS is thus a financial security backed by a mortgage or collection of mortgages.[84]

Ounce American citizens saw the value of real estate appreciate partially due to the MBS

[81] See: http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm
[82] Adam B. Ashcraft and Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Federal Reserve Bank of New York Staff Reports, Staff Report no. 318, March 2008, p. 13-29.
[83] MBS securities were rated by accredited credit rating agencies and were required to fall within the group of the top two ratings A (medium low risk) and BBB (medium risk) in order to be traded. The latter rating is according the system of Standard & Poor. Moreover, the securities could only be issued by regulated and authorized financial institutions.
[84] See note 79

trading, more families took on new loans to buy houses. The popular demand of mortgages contributed to the increase of property prices and led mortgage companies to relax their lending criteria even more.[85] In the course of these events, investment banks decided to introduce a number of bold financial products such as collateralized debt obligations (CDOs) in which the purpose was to shift the risks of these financial products from one party, the investment bank, to another party, investors such as hedge funds. At the same time the CDO sellers endeavored to maintain profits made with these products. CDOs are in essence the same as ABSs. The difference is that CDOs are only backed by MBSs and other types of debts. As a result, investment banks leveraged highly in order to buy subprime mortgages and loans for the creation of CDOs. Subsequently, the debts of consumers were sold to a special purpose vehicle (SPV). The SPV is an entity created by the bank or another financial institution (originator) for a specific financial purpose and which has a legal personality and an asset/liability structure. The trustee is entrusted with the management of the assets that are brought under the SPV for the benefit of the beneficiary, which is the originator, and the trustee oversees all the transactions related to the assets. Subsequently, the different types of debts of the originator were bundled into packages and transformed into CDOs. Thereafter, the CDOs were sliced up into tranches and sold to other financial institutions who in return acquire the principal and interest payments of the underlying assets from the SPV.[86] The SPV thus enables the originator to transfer the credit risk of risky assets to another financial institution, to remove the value of the underlying assets from its balance sheet, to liquidate the assets once the CDOs are sold and to generate more capital for its investments. Consequently, when the originator goes bankrupt, the creditors of the bank are legally unable to claim the assets within the SPV. Thus, the SPV is said to be bankruptcy remote.[87] An additional benefit of the SPV is that the credit rating of the CDOs were based on the assets and liabilities of the SPV rather than the assets and liabilities of the originator that also bears other risks associated with other assets it holds. As a result, the rating was often higher which in turn was reflected on the interest rates of the CDOs. The risk and interest rate of each particular tranche of the CDO, based on the quality of debts contained within the bundle, was determined by renown accredited rating agencies such as Moody's and Filch. The rating agencies received fees from the creator of the securities which affected an unbiased assessment of the risks of the assets. Consequently, the risks were underestimated by the rating agencies and thus lead to overvalued CDOs.[88] As a consequence, in due course it became difficult to value the financial health

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[85] See note 79

[86] Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response,* Cleveland State Law Review, Vol. 56, pp. 271-318, 2008.

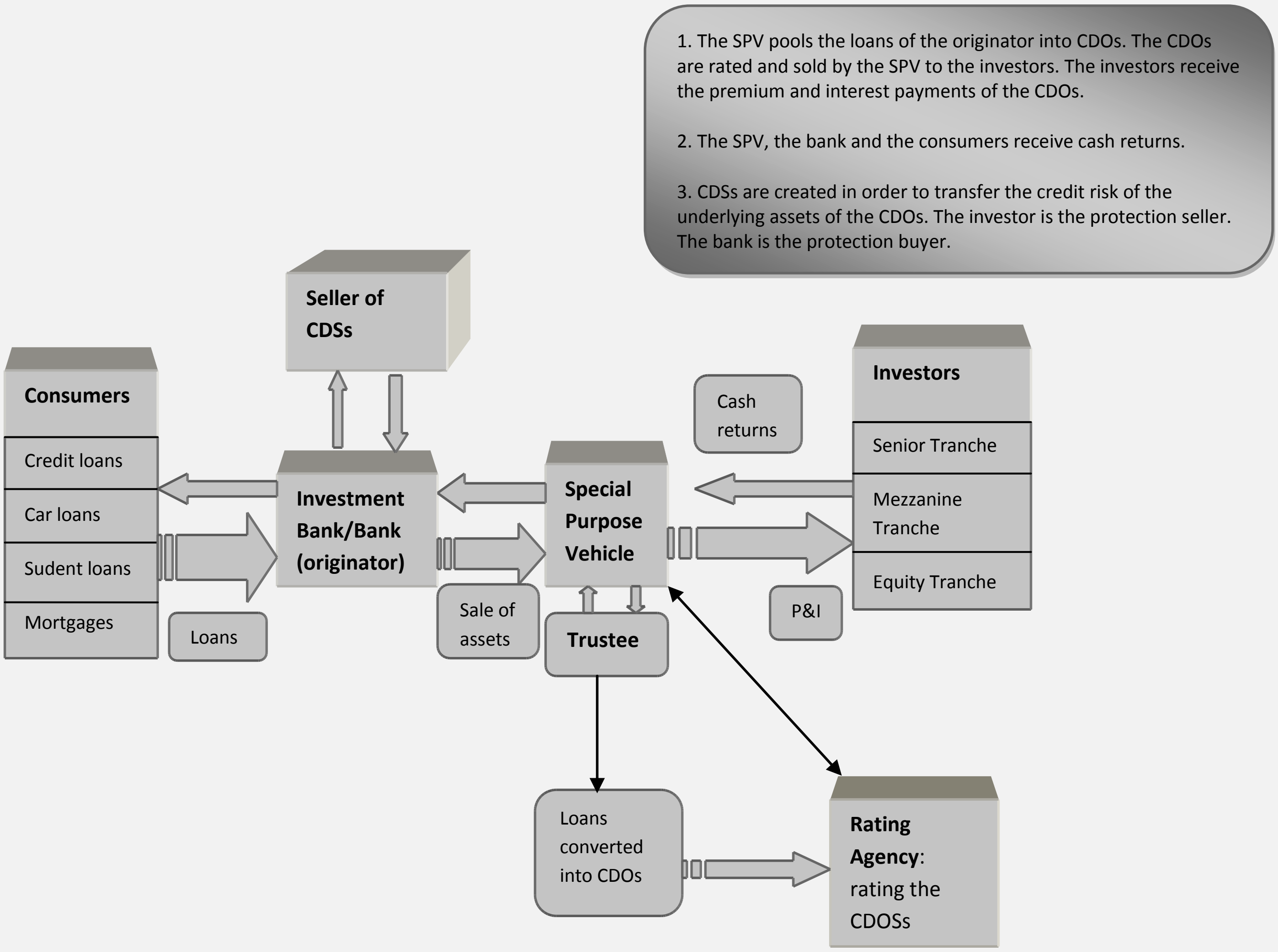
[87] Kenneth Kapner, *Introduction to Collateralized Debt Obligations,* Global Financial Markets Institute. Available at: http://www.gfmi.com/GFMI_0610.pdf

[88] Adam B. Ashcraft and Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Federal Reserve Bank of New York Staff Reports, Staff Report no. 318, March 2008, p. 36-40.

of financial institutions who traded massively in CDOs. After the SPV creates the CDOs, the CDOs are sold to the investors who can choose from the different tranches according to the credit quality and the rate of return of these financial products. The first tranche of the sliced up CDOs primary goes to the investor who want to run the least risk, such as pension funds. This tranche is in effect risk free but carries a low interest rate. Once the bank receives the debt payments from the borrowers, through the SPV the cash flows will first go to the top-tier investors. The subordinated tranche is for the investors such as the investment banks, who are willing to take on more risks. Once the first debt payments are made, the remaining will go to the second group of investors. The residual equity tranche transfers the highest risk of default, but at the same time provides the highest interest. This tranche attracts investors who are high risk-seekers such as hedge funds. Thus, once the first and the second debt payments are made, the remaining will go to the residual equity tranche.[89]
Concurrently, the banks insured against the risk of default on payments of the CDOs through credit default swaps (CDSs) in order to transfer the risk of default to another financial institution, usually another (investment) bank, an insurance company or a hedge fund. A CDS is a security based on a contract designed to swap the risk of credit default of an underlying asset to another party, in order to acquire credit protection from the seller of the CDS. Subsequently, the protection buyer pays a fee to the protection seller of the swap until the maturity date of the contract. In case of default of the underlying debt, the seller of the swap guarantees the credit worthiness of the security by reimbursing the debt of the third party to the buyer of the CDS.[90]

[89] Adam B. Ashcraft and Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Federal Reserve Bank of New York Staff Reports, Staff Report no. 318, March 2008, p. 29.
[90] See: http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_default_swaps/index.html

Figure 3. CDO structure



In due time however, it became clear that the financial innovations (CDOs and CDSs) gave financial institutions a false sense of security and an incentive to give loans to companies and individuals who due to their low credit ratings were not appropriate for them. Thus, once the Federal Reserve increased the interest rates in 2006 to 4% due to inflationary pressure in the United States, the increased rates were reflected in the mortgage rates. On top of that, the interest rates of the mortgages rose after the introductory period ended. Hence, the mortgage payments got unaffordable to subprime mortgage borrowers and defaults on subprime mortgage rose sharply. As mortgage defaults increased, the US housing boom came to an end and house prices started falling. As a result, investment banks increasingly faced empty houses which they tried to sell as quickly as possible, leading to an increasing supply of houses and a further decline of houses prices. Accordingly, the value of mortgage backed securities depreciated severely. Moreover, the toxic assets of investment banks and other financial institutions, which are risky assets based on subprime mortgages such as MBSs, CDOs and related CDSs, were massively absorbed into global capital markets. Financial institutions that had based most of their activities on financial products related to subprime mortgages, faced negative equity and the losses on US subprime mortgages amounted to billions of dollars. All around the world, financial institutions had to write off large losses and saw a decline in their reserves. The reduced reserves was also caused by the fact that many investors and consumers had lost confidence in the financial institutions and gradually started to withdraw their capital from the institutions. A number of big financial institutions consequently faced liquidity problems, which led to a trust crisis in the financial system since it was not clear which institutions were affected by the toxic assets. Consequently, the costs of interbank lending increased significantly and it became very difficult to borrow money, leading to a liquidity crisis on the credit markets.[91]

Since several banks in the US and in Europe had lost capital, they could not afford to lend to other financial institutions. Even if they were able, many were reluctant to lend capital due to the trust crisis and the counterparty risks. The counterparty risk is the risk involved in a transaction where one party is unable to fulfill its commitment to the other party. The reticence of financial institutions was reflected in the rising interest rates, leading to the scarce lending activities to be more expensive. Consequently, many financial institutions faced a shortage of liquidity, the capital markets in the US and Europe dried up and governments and Central banks were compelled to bail out big institutions which due to their sizes and their level of integration in global financial markets, were too big to fail. Nevertheless, a financial meltdown followed as bankruptcies took place all around the world and major economies in the world faced a recession.

4.1.2. The Magnetar-case

The use of structured financed products such as CDOs, MBSs and CDSs by financial institutions, highlights the crucial role some hedge funds played during the events of the crisis. The use of structured finance products as instruments of speculation by certain hedge funds contributed considerably to the instability of financial markets and amplified its effects. A good example of this situation is the case of hedge fund firm Magnetar Capital LLC that sponsored and created several synthetic CDOs in order to bet on the default of CDOs it held in its portfolio. Before entering into details on the Magnetar-case the structure of synthetic CDOs will first be explained.

Synthetic CDOs are a form of credit derivatives where the SPV, often created by the originator, holds a portfolio of CDSs that covers the credit exposure of the underlying assets of the originator. In a synthetic CDO merely the credit risk of the underlying assets of the originator, which are referred to as the reference portfolio, is transferred from the originator to a SPV through the use of credit

[91] Austin Murphy, *An analysis of the financial crisis of 2008: Causes and Solutions.* Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1295344

default swaps. The difference with a regular CDO structure, which is also referred to as a cash CDO, is that in the transfer of the assets from the originator to the SPV, the SPV does not physically nor legally owns the assets. Hence, the originator keeps the assets on its balance sheet and is the legal owner of the assets. Due to the fact that merely the credit risks of the originator's assets are transferred out of the originator's balance sheet through the purchase of credit derivatives rather than a true sale of the assets to the SPV, this structure is referred to as naked CDS. As a result, the SPV is compelled to make payments in case of defaults of the underlying assets of the originator and in return the SPV receives a swap premium from the originator. Subsequently, the premium is deposited with the trustee and contributes to the high quality assets such as bonds of the SPV, which the SPV owns in order to finance its activities and which is used as a collateral for the CDSs. On the other hand, the SPV issues various tranches of securities to investors according to the risk of default of the reference portfolio of the originator. Consequently, in the synthetic CDO structure, the originator holds a short position in the reference portfolio and bets that the underlying assets will default, and the investors hold a long position in the reference portfolio and bet that the underlying assets of the originator will not default. The SPV receives cash returns from the investors and concurrently make the principal and interest payments to the investors. The cash returns are consequently deposited with the trustee and contributes to the high quality assets of the SPV. Thus, the similarities between a regular CDO structure and a synthetic CDO structure are the relationship between the SPV and the investors, the cash flow payments between the SPV and the investors and the transfer of risk of assets from one party to another. However, once the underlying assets of the originator defaults, instead of the investor of the senior tranche to receive the first payments, it is the originator who receives payments from the SPV prior to the payments made to the investors. The recovery payments are made with the cash flow of interest and principal that normally would have gone to the investors.[92] In sum, the investors collectively are the ones who purchase the credit risk on the reference portfolio of the originator through the SPV and thus are exposed to the default risks of the underlying assets of the originator. The protection sellers in this case are the investors who take a long position in the CDS trade because they expect that the referenced securities will perform well. On the other hand the protection buyer, that is in this case the hedge fund, takes a short position since it expects that the referenced securities will default. Due to the fact that the investors are synthetically exposed to the credit risk of the underlying assets of the originator, the structure is referred to as synthetic CDO.[93] See figure 4 for a view of the synthetic CDO structure. In the synthetic CDO structure, a difference can be made between a fully funded and a partially funded

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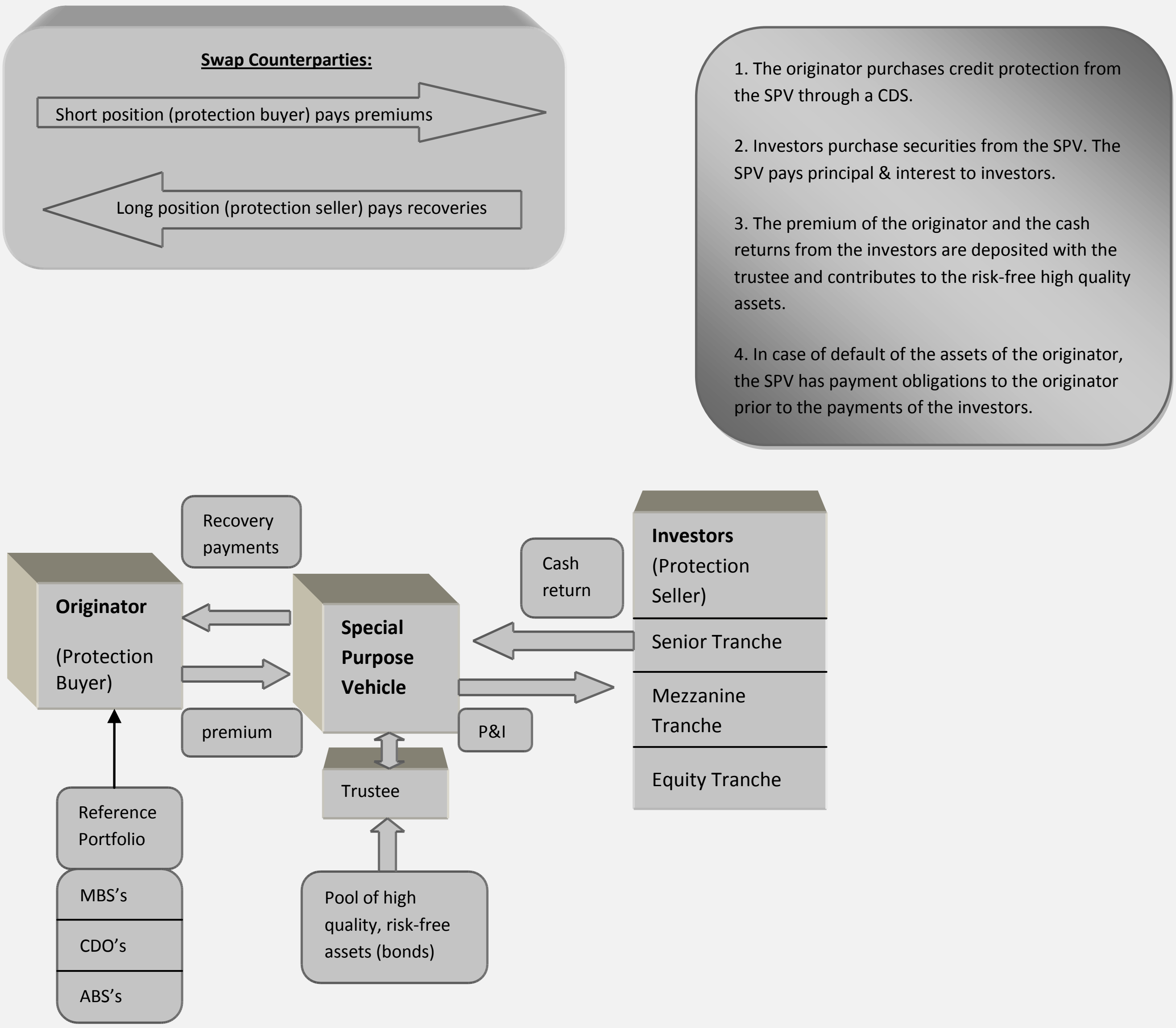
[92] See: http://www.vinodkothari.com/Nomura_cdo_plainenglish.pdf
[93] Michael S. Gibson, *Understanding the Risk of Synthetic CDOs*, July 2004. Available at: http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf

synthetic CDO. A fully funded synthetic CDO is a synthetic CDO structure where the credit risk of the entire reference portfolio of the originator is transferred to the SPV through the use of CDSs. The securities that are issued to the investors are such, that the capital that is raised by the SPV from the investors is in an amount sufficient enough to fully cover the potential defaults of the underlying reference assets of the originator. In a partially funded synthetic CDO, merely the credit risk of the riskiest segment of the underlying assets of the originator is transferred to the SPV and is covered by the cash returns of the investors. An extra CDS contract is employed by the originator and established with another financial institution in order to transfer the risk of the relatively safer remaining underlying assets.[94]

Figure 4. Synthetic CDO structure



[94] Moorad Choudhry and Aaron Nematnejad, *An Introduction to Collateralised Debt Obligations*. Available at: http://www.yieldcurve.com/Mktresearch/files/IntroCDOs.pdf

During the period of 2006 till mid 2007, when the housing market was already facing difficulties after the Federal Reserve had raised interest rates, Magnetar employed synthetic CDOs heavily in order to profit from the falling markets.[95] Magnetar more specifically created and invested in CDOs in order to bet on the default of the underlying assets through the use of synthetic CDOs.[96] On the one hand, the hedge fund could increase its income by increasing its assets under management and benefit from the spread between the interest rates of the CDOs it created and invested in. On the other hand, the use of synthetic CDOs ensured the hedge fund of income streams in falling markets. The long/short and arbitrage investment strategy were employed by Magnetar in order to support the speculation activities on the CDOs. The managers of Magnetar were thus able to offset positions in different tranches of a CDO security. For instance, the managers went long on the first tranche of their own CDO tranche and went short on the riskiest tranche of their CDOs and those of other financial institutions through the use of synthetic CDOs in order to enhance the returns. Consequently, regardless the situation in the housing market Magnetar would make profits. The managers even intentionally bought the riskiest tranche of the CDOs in order to resell them and insisted in including riskier assets, therefore making the tranche more susceptible for failure. Subsequently, instead of profiting from the riskiest tranches, the manager placed bets on these tranches through synthetic CDOs with the expectation that the underlying assets would default. When the mortgages in the CDOs started to default and interest payments dried up, many CDOs collapsed and several financial institutions made enormous losses while Magnetar made huge profits.[97] The profits were acquired from the recovery payments of the CDS contracts. The problem embedded was that many investors were not aware of the high credit risk of the underlying toxic assets of Magnetar nor did the hedge fund disclose the high credit risk of the assets. As a result, the investors assumed that the investments were safe. Moreover, due to the fact that Magnetar was holding short positions in risky CDO tranches through the use of synthetic CDOs, the hedge fund did not have the incentive to examine the credit risk of the underlying assets. As a result, the credit exposure of the assets was amplified and aggravated by the use of leverage. This lead to a conflict of interest with the investors of Magnetar. Concurrently, several large banks such as Merrill Lynch, Citigroup, UBS and JP Morgan Chase, in the run-up to the sub-prime mortgage crash ended up doing one of the riskiest and most profitable deals with Magnetar. Magnetar sold highly risky CDOs to the financial institutions and concurrently invested in their riskiest tiers. Consequently, when the real estate market finally crashed, practically all the securities worth of an estimated $40 billion became worthless. Magnetar

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[95] Jesse Eisinger and Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, ProPublica, 9 April 2010. Available at: http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going
[96] See note 93.
[97] See: http://www.propublica.org/special/the-anatomy-of-the-magnetar-trade#http://propublica.org/projects/hedge_fund/graphics/slideshow/finalslides_040910-01.png

and the banks that had marketed the Magnetar CDOs then faced difficulties to sell them. Due to the riskiness of the Magnetar CDOs, they blew up faster compared to similar CDOs that were not sponsored by Magnetar. While taking short positions through arbitrage for instance, is beneficial for financial markets and can lead to price convergence, in the case of Magnetar Capital it had an opposite effect. Since it was used as an instrument for speculation, it led to price distortions in the CDO and the housing market. The method used by Magnetar stimulated the creation of deals that were designed to fail especially in late 2005 when the booming US housing market was falling, thus aggravating the impact of the downfall of the financial system.

Thus, the size of the deals, the failure of the investment strategies employed by Magnetar and the greed of exploiting toxic assets they created and bet against through synthetic CDOs, the activities of Magnetar influenced the proportion of the credit crisis and the bust of the subprime market significantly.[98] Magnetar's activities influenced the prices of houses in the US, increased the demand of CDOs and amplified the size of total exposures of toxic assets to the financial markets, leading to the housing bubble to swell to massive proportions in 2006-2007 and to burst severely. Magnetar's trade was also copied by other hedge funds and traders, thus further increasing the systemic risk on the financial markets. Weren't for these type of trading strategies of hedge funds such as Magnetar, the subprime bubble would have ended earlier and would have been less damaging. Yves Smith, a financial expert, writes in her book '*ECONNED: How unenlightened self interest undermined democracy and corrupted capitalism'* that: *"Magnetar went into business of creating subprime CDO's on an unheard of scale. If the world had been spared their cunning, the insanity of 2006-2007 would have been less extreme and the unwinding milder."*[99]

4.2. Economic benefits

In order to understand the motives behind the need for stricter regulation regarding the activities of hedge funds, it is primary crucial to acknowledge the economic utility of hedge funds. As seen before hedge funds take in their investment strategies positions in risky or illiquid assets, which they price through extensive and accurate research and according to their actual value. Especially during bull markets, the strategies based on long and short positions and arbitrage can be a voice of reason and give financial actors a reality check regarding the actual value of financial assets. Through the hedging mechanism in the investment strategies, hedge funds give signals to the market with regard to securities which they believe to be overvalued or undervalued compared to what the market believes. Moreover, by buying undervalued securities and selling overvalued securities, (small)

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[98] Thomas Mahlmann, *Hedge Funds, CDO's and the Financial crisis: an empirical investigation of the Magnetar trade*, July 2011.
[99] See note 93.

discrepancies in prices of securities are reduced and shifted till the discrepancy disappears. This behavior not only leads to corrected market prices that reflects the fundamental value of financial assets, but it also contributes to price efficient markets, a reduced volatility of market prices and a better allocation of the capital that circulates in the capital markets.[100] With regard to the positions in risky assets, hedge funds contribute to the distribution and the transfer of risks on financial markets. Due to the fact that hedge funds are risk seekers, risky financial products which other financial institutions such as banks are unwilling or unable to invest in, can be absorbed through the activities of hedge funds and can thus be better diversified in the financial markets. Thus, the risk-seeking nature of hedge funds leads to an efficient allocation of capital on the capital markets.[101] Moreover, hedge funds provide extra liquidity to markets through the enormous volume of trades they make. Hedge fund managers have the possibility to employ financial instruments such as options, futures and swaps that mutual funds are unable to use, in order to hedge the risks of the assets they invest in. Mutual funds traditionally invest in stocks, bonds or cash and the returns are often generated only when the markets are performing well. Thus, the hedging mechanism that hedge fund managers employ, the various asset classes in which they invest and the ambition to obtain absolute returns regardless the direction of the markets, enables the managers in general to generate profits and capital appreciation under all market circumstances.[102] In specifically distressed market conditions, through the use of for instance the event-driven strategy, by buying securities that are distressed and are less attractive to others financial institutions, hedge funds generate extra liquidity on the markets. In particular in the context of the financial crisis, as banks face stricter liquidity requirements, hedge funds contribute to the enhancement of global liquidity and the creation of numerous sub-debt markets. Consequently, under normal market conditions and especially during periods of distress, hedge funds are able to provide a significant level of liquidity to financial markets which is a key role in ensuring financial stability.[103] Furthermore, in contrast to managers of mutual funds, hedge fund managers have the flexibility to invest in different asset classes and markets simultaneously in order to outperform the market. This freedom in investment activities (through diverse strategies and asset classes) leads to a continuous search of lucrative opportunities and improved investment strategies which leads to possibilities to create innovative financial products, strategies and services. These innovations can in turn be beneficial to investors, since their capital is

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[100] Jon Danielsson, Ashley Taylor and Jean-Pierre Zigrand, *Highwaymen or Heroes: Should Hedge Funds be Regulated*, September 2005.

[101] Rene M. Stulz, *Hedge Funds: Past, Present, and Future*, Journal of Economic Perspectives-Volume 21, Number 2-Spring 2007-pages 175-194.

[102] *Best Practices for the Hedge Fund Industry*, Report of the Asset Managers' Committee to the President's Working Group on Financial Markets, 15 January 2009. Available at: http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf

[103] KPMG, *The value of the hedge fund industry to investors, markets and the broader economy*, 2012. Available at: https://www.kpmg.com/KY/en/Documents/the-value-of-the-hedge-fund-industry-part-1.pdf

allocated more efficiently which in addition augments market participation.[104] Furthermore, through the various investment strategies in which hedge funds attempt to lower the correlation of the assets with the overall movements of the market, the managers are able to provide their investors low portfolio volatility and diversification benefits.[105] From a view of corporate governance and shareholder activism hedge funds play a critical role. As active shareholders, especially in the event-driven strategy, they are intensively involved in the corporate governance of a company in order to enhance transactions that will increase shareholder value. Through their partial ownership of a company, the hedge fund managers can actively interfere with the management of a company and make requirements for improvement in the business and the management strategies. Hedge fund managers can also make requirements relating to the capital structure, the liquidity structure and the executive compensation, and influence the negotiations regarding mergers and acquisitions transactions. Thus, as active shareholders hedge fund managers can improve the performance of the companies in which they operate in numerous ways.[106]

In conclusion, the role of hedge funds in global financial markets is significant. The activities of hedge funds show a positive impact on portfolio diversification, price discovery, shareholder value and liquidity supply on the market which in turn have contributed to the expansion of capital markets and the modern financial industry.[107]

4.3. Hedge funds controversies

There are several controversies relating to the activities of hedge funds including corporate governance issues, the speculative short selling practices and the use of high fees and remunerations. However, for the purpose of this paper merely the issues of systemic risk and transparency are highlighted due to their relevance for the assessment of the Wft and the AIFMD in subsequent chapters.

4.3.1. Systemic risk

The events of the financial crisis have exposed the interdependency between financial market actors and demonstrated how risks in a particular sector or country can affect the global financial system. A risk caused by a series of correlated defaults among financial institutions or a specific entity, triggered by destabilizing events, that occur over a short period of time and that has an impact on an

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[104] HedgeFundFacts.org, *Hedge Funds. How They Serve Investors in U.S. and Global Markets*, August 2009. Available at: http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[105] See note 99.
[106] Marcel Kahan and Edward B.Rock, *Hedge funds in corporate governance and corporate control*, 5 January 2007. Scholarship at Penn Law. Paper 99.
[107] See: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf

entire market or a market segment and which cannot be circumvented through diversification, is called 'market risk' or 'systemic risk'.[108]

As seen in the Magnetar case, hedge funds can contribute to systemic risk once their failures are so large, they negatively affect the liquidity position of other financial institutions or cause economic distress which affects the financial stability. In the case of the CDO-market during the financial crisis, hedge funds who had highly invested in financial products related to subprime mortgages aggravated the outcome of the financial crisis by adding volatility to the market prices of CDOs and the underlying assets and by spreading highly risky assets into the financial system. Through the use of the long/short strategy and the use of derivatives as instruments of speculation, certain hedge funds leveraged highly in order to purchase CDOs and to enhance the profits made with these investments. Due to the excessive use of leverage hedge fund managers could purchase CDOs and other risky assets in a ratio greater than the liquidity of the hedge fund. This is referred to as over-leveraging. The use of leverage not only amplified the demand and volatility of CDOs and the underlying assets, but it also increased the exposure of the financial markets to risky assets such as CDO's and aggravated the losses made with these assets once the assets depreciated in value.[109] Consequently, hedge funds can cause systemic risk through the credit channel, which is related to credit counterparties' exposure and the possibility that failures of hedge funds affect the liquidity in the banking sector, and the market channel, which is related to hedge funds' aggressive and high volume trading strategies.[110] Once hedge fund failures activates the decline of the value of its relatively illiquid investments, the managers will attempt to sell the assets as quickly as possible in order to raise capital. When the investors pick up a repeatedly underperformance of a hedge fund, investor's confidence is affected leading to the investors to withdraw their capital from the fund. The behavior of the investors will lead to a further decline of the liquidity of the hedge fund and thus to more forced asset sales and eventually a further decline of the value of the remaining assets. Ultimately, the liquidity position of the fund and financially interrelated institutions is affected, which in turn affects creditors liquidity position. Thus, when a hedge fund is interconnected with numerous (large) financial institutions and has little capital reserve compared to the risks it is exposed to, the failure, which is amplified by leverage, will cause a domino effect in the liquidity position of the institutions that do business with the hedge fund. As a result, the ability of the hedge fund and the interrelated

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[108] Nicolas Chany, Mila Getmansky, Shane M. Haas and Andrew W. Lo, *Systemic Risk and Hedge Funds*, MIT Sloan School of Management, Working Paper 4535-05, February 2005. Available at: https://secure.brightworkinc.net/~andrewlo/documents/Chan_Getmansky_Haas_Lo_2005_-_Systemic_Risk_and_Hedge_Funds.pdf

[109] David Ruder, *Suggestions for Regulation of Hedge Funds following the financial crisis of 2008*, 13 November 2008. Available at: http://oversight.house.gov/documents/20081113101847.pdf

[110] Eilis Ferran, *The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis*, University of Cambridge and ECGI, Law Working Paper Nr. 176/2011, February 2011.

institutions to provide capital to the financial markets is affected. This affects other market participants and the capital market as a whole and causes market instability and significant damage to the economy. In consequence, systemic risk can be caused by a large hedge fund, but also be created by a group of hedge funds that fail in similar investment strategies and/or similar risk management systems, which leads to disturbance of the liquidity supply and the normal operation of supply and demand of liquidity on the markets.[111]

Overall, due to the size of assets under management of hedge funds, the use of leverage and speculation in risky assets, a highly leveraged hedge fund or a group of hedge funds can expose market participants to systemic risk through the credit and market channel. However, it has not yet been proven that the activities of hedge funds in general expose a whole economic system or specific sector to serious danger once they fail.[112]

4.3.2. Transparency

Regulation relating to investor protection is designed to establish minimal requirements of public and private disclosure and minimal requirements of conduct of a financial institution in order to increase confidence in capital markets. Public disclosure provides information to consumers and encourages market discipline while private disclosure supplies information to supervisors by which they can measure the financial health and stability of the institution in question.[113] With these requirements in place investors are able to make investment decisions and allocate their capital more efficiently, which augments investor's confidence. As a result, although transaction costs are increased in the short term, in the long run investment activities and liquidity are increased in the capital markets which boosts market participation and positively benefits the economy.[114] The problem enclosed is that the regulatory requirements for disclosure are not compulsive to the private, lightly regulated hedge funds and they are often not compelled to fulfill prospectus requirements. Moreover, due to the fact that hedge funds are usually restricted from public offerings and advertisement to investors, they are unable to freely market the fund to investors and are therefore not required to report their performance to an authority. This restriction often leads to fund managers to be reluctant or to refuse to disclose confidential trading positions and related risks or performance information to the public, forcing investors to carry out a greater due diligence. However, through the investment consultant of the fund or an external investment adviser that acts

[111] John Kambhu, Til Schuermann and Kevin J. Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, FRBNY Economic Policy Review, December 2007. Available at: http://www.newyorkfed.org/research/epr/07v13n3/0712kamb.pdf
[112] Adair Turner, *The Financial Crisis and the Future of Financial Regulation*, The Economist's Inaugural City Lecture, 21 January 2009. Available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml
[113] Jon Danielsson, Ashley Taylor and Jean-Pierre Zigrand, *Highwaymen or Heroes: Should Hedge Funds be Regulated*, September 2005, p. 20.
[114] See: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf

as an intermediary in the investment decision process, the investor can acquire in some hedge funds a high level of disclosure of internal information on for instance, the portfolio, the investment strategies, the fund's risk characteristics and major positions. Nevertheless, this information is usually not disclosed to the public, forcing public investors to do their own due diligence which increases the costs to participate in a hedge fund.[115] Moreover, the deficient supervisory and regulatory frameworks relating to hedge funds, grants managers the possibility to engage in harmful behavior such as excessive risk taking. The decreased private disclosure leaves room for misrepresentation of the performance of the fund or creates incentives for fraudulent behavior. As a result, the supervisors and regulators are unable to efficiently identify potential sources of systemic risk that hedge funds may pose, either individually or collectively.[116] In conclusion, the low level of transparency of hedge funds contributes to a weaker position of the investors and to an inefficient supervision of activities of hedge funds that can contribute to the occurrence of systemic risk.

5. Legal Framework

During nearly 20 years the hedge fund industry has grown out to become one of the fastest and one of the most innovative evolving areas within the financial industry. This development however has come along with concerns regarding the potential risks the activities of managers of alternative investment vehicles such as hedge funds pose to participants of the financial markets and the impact these activities have on the stability of the entire financial system. Consequently, in the light of the events of the financial crisis, supervisory and regulatory authorities of financial markets in the EU and the Member States have pressed for more stringent regulation with regard to the lightly regulated hedge fund industry. The aim of this chapter is to introduce the existing legal framework in the EU and the Netherlands with regard to hedge funds, and to analyze the structure of hedge funds from the European and Dutch legal perspective.

5.1. EU Legislation

5.1.1. UCITS funds vs. non-UCITS funds

In order to provide a better understanding of the legal structures available to hedge funds in Europe, the distinction between UCITS funds and non-UCITS funds is firstly specified.

In the European Union funds are primarily categorized as UCITS or non-UCITS. A UCITS stands for an Undertakings for Collective Investment in Transferable Securities. According to art. 2 of the

[115] HedgeFundFacts.org, *Hedge Funds. How They Serve Investors in U.S. and Global Markets*, August 2009. Available at: http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[116] Technical Committee of the International Organization of Securities Commissions, Hedge Funds Oversight Final Report, June 2009, p. 14. Available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf

UCITS Directive, an UCITS is: *"an undertaking (i) with the sole objective of collective investment in transferable securities or in other liquid financial assets (…) and which operate on the principle of risk-spreading; and (ii) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets."*[117] According to art.2 (1)(n), transferable securities are: *"(i) shares in companies and other securities equivalent to shares in companies; (ii) bonds and other forms of securitized debt; (iii) any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange"*. The UCITS Directives[118] are adopted in order to create a single regulatory regime for mainly open-ended funds and funds that do not fall within the scope of article 3 of the Directive and that invest in transferable securities across the EU. Through a so-called 'European passport' UCITS-compliant funds are able to freely operate and market transferable securities across the EU with no further regulatory obligations imposed on the fund, once it complies with the authorization requirements of the home Member State. All EU based investment funds had to convert to the UCITS III rules by mid-February 2007. The UCITS III rules were amended in the UCITS IV Directive[119], which was implemented in the Netherlands on 22 July 2011. The UCITS IV Directive creates a greater harmonization of the European collective management fund sector, in which the supervisory authorities of the Member States cooperate closely in order to boost cross-border investment activities in Europe. It is expected that the harmonization process will in turn increase market efficiency and increase investor protection.

The alternative investment funds (AIFs) that do not adhere to the restrictions and requirements contained in the UCITS Directive, are referred to as non-UCITS.[120] Alternative investment funds are thus non-UCITS collective investment funds that raise capital from a number of investors which is primarily invested in illiquid assets such as real estate, derivatives and commodities. The AIF-sector includes hedge funds, private equity, real estate, commodity funds and other alternative investment funds. Contrary to an UCITS fund, non-UCITS funds are currently subjected and established pursuant to relevant domestic laws rather than EU law.[121] In this perspective it is crucial to refer to the Alternative Investment Fund Manager Directive (AIFMD).

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[117] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).
[118] Directive 2001/107/EC, Directive 2001/108/EC and Directive 2009/65/EC.
[119] Proposal for a Directive 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) {SEC(2008) 2263} {SEC (2008) 2264}/* COM/2008/0458 final – COD 2008/0153 */
[120] Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating for collective investment in transferable securities (UCITS) (85/611/EEC).
[121] Heleen Rietdijk, *AIFMD logische vereisten met veel impact*, B&E Juli/Augustus 2011.

5.1.2. The AIFMD

The AIFMD[122] seeks to establish a harmonized regulatory and supervisory framework for the management and marketing activities of the managers of AIFs (AIFMs). In this context, the crucial aspect of the AIFMD is that the managers are the principal addressee of the Directive and consequently bear the responsibility to ensure that one or several AIF(s) comply with the requirements set in the Directive. Thus, the manager is accountable for any deficiency in that compliance. The AIFMD does not regulate the AIF itself due to the extensive different types of AIFs that exist in the EU and that fall within the broad scope of the AIFMD. Consequently, the regulation and supervision of AIFs will continue to be carried out on a national level. Another remarkable aspect of the Directive is that the Directive specifically aims to regulate the marketing activities relating to professional investors. Within the context of the AIFMD a professional investor involves "*any investor which is considered to be a professional client or may be treated as a professional client on request within the meaning of Annex II of MiFID*".[123] According to the MiFID[124], a professional client is considered to *"possess the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs".*[125]

The AIFMD in combination with the ESMA Final Report[126], which is the Regulatory Technical Standards of the ESMA, will form the basis of the analysis of the relevant provisions of the AIFMD in this paragraph. For the sake of the length of this dissertation paper the outline of the Directive will be limited to a few significant provisions of the Directive in order to understand the European legal aspects of the structure of hedge funds mentioned in chapter 3.

1. Definition of AIF

Article 4(1)(a) of the AIFMD defines an alternative investment fund as the following: *"AIFs' means collective investment undertakings, including investment compartments thereof, which (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) which does not require authorization pursuant to Article 5 of the UCITS Directive."* Although the term 'collective investment undertaking' is

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[122] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF
[123] See art. 4(1) (ag) AIFMD.
[124] The MiFID is a Directive relating to investment services in the EU and stands for 'Markets in Financial Instruments Directive' (2004/39/EC).
[125] See art. 4(1)(11) MIFID.
[126] ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, ESMA/2011/379, 16 November 2011. Available at: http://www.esma.europa.eu/system/files/2011_379.pdf

not defined in the AIFMD, it is expected that not only collective investment schemes will fall under the scope of this term. Article 2 specifies that AIFs can be both open or closed-ended vehicles, can take any legal structure, can be constituted under the law of contracts, under trust law, under statute or have any other legal form, thus have a legal personality or not, and can be admitted to trading on a regulated market or not be listed on a regulated market. The definition does not limit AIFs in the types of assets they can invest in. As a result the permitted assets of AIFs are subjected to national regulation.

The term 'raising capital' is related to business activities that are made for commercial purposes with the prospect of investment returns or profits. The business activities should cover a relationship between the entity seeking capital or a person acting on behalf of this entity and the prospective investors, and should result in the transfer of investors' cash or other assets to the AIF.[127]

The investment policy that is defined by the AIFM, entails a contractual relationship between the AIF and the investor and is binding for the entity. The investment policy contains a document that includes a description of the investment instruments, the investment strategies, the concentration of the managed AIFs and the main exposures of the assets. The investment policy is likely to be set out in a document which is incorporated or is referenced in the constitutional documents of the AIF. Any alternation to the investment policy should be disclosed to the investors and in some cases investors can provide their consent to the changes.[128]

Article 2(3) of the Directive describes a series of entities that fall outside the scope of the Directive. In accordance with article 2(3) these entities include holding companies[129]; institutions for occupational retirement provision (as covered by Directive 2003/41/EC); employee participation or saving schemes; supranational institutions such as the International Monetary Fund and the World Bank; national central banks, national, regional and local government bodies or institutions that manage funds supporting social security and pension systems; and securitization special purpose entities. Moreover, article 3(1) stipulates that AIFMs that manage one or more AIFs whose only investors are AIFs, the AIFM or the parent undertakings or subsidiaries of the AIFM or other subsidiaries of those parent undertakings shall be exempted from the scope of the Directive. Furthermore, recital 7 of the AIFMD states that investment undertakings, such as family office vehicles which invest the private wealth of investors without raising external capital, should not be

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[127] ESMA Discussion paper, p. 9.
[128] ESMA Discussion paper, p. 10-11.
[129] According to the discussion paper of the ESMA, holding companies are companies with shareholdings in one or more companies and which the commercial purpose is to carry out a business strategy or strategies through subsidiaries and which the commercial purpose is to carry out a business strategy or strategies through subsidiaries, associated companies or participations, in order to contribute to their long-term value. The company can either (i) operate on its own account and whose shares are admitted to trading on a regulated market in the EU; or (ii) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents.

considered to be AIFs. Finally, recital 8 excludes insurance contracts and joint ventures.

2. Definition of AIFM

An alternative investment fund manager (AIFM) is defined in article 4(1)(b) as: *"any natural or legal person whose regular business activities relates to the management of one or more AIFs."* The scope of the AIFMD covers EU AIFM that manage EU and non-EU AIFs, non-EU AIFM that manage EU AIFs, and non-EU AIFM that market EU and non-EU AIFs in the EU. In article 4(1)(w) 'managing AIF' is defined as performing at least the investment management functions referred to in part 2(a) or (b) of Annex I of the Directive for one or more AIFs. These investment management functions are the portfolio management and the risk management. The risk management specifically include the implementation of a sound risk management system by the AIFM in order to measure and control all risks that are associated with the investment strategies. Article 6(5)(d) requires an AIFM to be capable of providing and take responsibility for the portfolio management and risk management functions in order to obtain an AIFM authorization. If the legal form of the AIF facilitate internal management, then the AIF itself is considered to be the manager of the AIF. If the legal form of the AIF does not facilitates internal management, then according to article 20 of the Directive these management functions can be delegated to an external manager, which is a legal person appointed by the AIF or on behalf of the AIF and who is responsible for the management of the AIF. However, the delegation of the management function should not be outsourced to the extent where the sub-delegation leads to a letter-box entity of the AIFM. The ESMA considers two situation under which an AIFM should be considered as a letter-box entity. First, when the AIFM is no longer able to supervise the delegated tasks and to manage the risks associated with the delegation effectively. The second case arises when the AIFM no longer has the power to take decisions in key areas that fall under the responsibility of the senior management or to perform senior management functions.[130] The prevention of a letter-box entity is to ensure that the delegation arrangements do not obstruct an effective supervision of the AIFM and to enhance the AIFM to behave in the best interest of its investors and the AIF. Moreover, the (sub-) delegation arrangements to other service providers should be justified by the AIFM with objective reasons and should be noticed to the competent home authority prior to the (sub-) delegation comes into effect. According to the ESMA Discussion Paper the AIFM has to evaluate whether the third party complies with the criteria of 'sufficient resources, sufficiently good repute and sufficient experience'. Thus, once the management tasks are sub-delegated to other service providers, the authorization of the competent authority of the home Member State of the AIFM is required beforehand. As a result, whether the AIFM is appointed

[130] ESMA Discussion paper, p. 7.

externally or internally, the AIF(s) is subjected to the supervision of the competent authorities of the home Member State of the AIF, and the AIFM has the responsibility to ensure that the AIF(s) comply with the requirements set in the Directive.[131]

2a. The *de minimis* exemption

The *de minimis* exemption set in art. 3 of the Directive provides an exemption for managers whose assets under management in total do not exceed €100 million or € 500 million. In the case of the second threshold the *de minimis* exemption is only applicable if the portolio(s) under management are not financed through leverage and if the investors are not able to exercise their redemption rights during the first five years after the initial investment of each AIF. Consequently, the authorities of the home Member State are required to subject the vehicles that fall under *de minimis* exemption to registration requirements and reporting requirements of national regulation. The national regulations are allowed to be stricter than the requirements under the Directive. In consequence, through these requirements the national competent regulators are able to measure the possibility of systemic risks and the effects for the financial stability that can arise from the activities of exempted AIFs. However, it is expected that managers that fulfill the *de minimis* exemption, will have a prospect to make use of the passport-rights of the AIFMD which will grant them the possibility to manage and market the AIF freely across the EU once they comply with the other requirements set in the Directive. This is referred to as the opt-in to the Directive.[132] The competent authorities of the Member States are required to stipulate the opt-in procedure.

3. Authorization requirements

An AIFM that manages and markets one or more AIFs is required to obtain a license from the competent authorities of the home Member State. The AIFMD provides a registered AIFM the possibility to have an EU marketing passport in order to offer units to professional investors and an EU management services passport in order to manage one or several AIFs in the EU. According to art. 7 AIFMD the authorization granted to the AIFM with regard to the management services passport is provided by the competent authority in the Member State where the AIFM has its registered office, this is referred to as the home Member State. If the AIF does not have an external manager, the AIF itself has to apply for a license in the Member State in which the AIF is authorized or registered under applicable national law or in which the AIF has its registered and/or head office. Before the AIFM acquires the management passport, the manager must notify and provide specific information set in

[131] See art. 20 (1) AIFMD.
[132] See art. 3(4) AIFMD.

art. 7(2) (3)[133] with regard to the AIFM, to the competent authority of the home Member State. Subsequently, the authority of the home Member State notifies the AIFM's request and provides the complete notification file within 20 working days to each host Member State authority in which the AIF is supposed to be managed. Whether the request has been approved or disapproved, the AIFM receives a notification in writing from the home Member State authority within 3 months of the submission of a complete application. According to art. 8(1) AIFMD the competent authorities of the home Member State of the AIFM must ensure that;

- the AIFM will be able to meet the conditions of the Directive;
- the AIFM has sufficient initial capital and own funds in accordance with art. 9;
- the persons who effectively conduct the business of the AIFM are of sufficiently good repute and are sufficiently experienced (…);
- the shareholders or members of the AIFM that have qualifying holdings[134] are suitable in order to ensure a sound and prudent management of the AIFM;
- the head office and registered office of the AIFM are located in the same Member State.

Any material changes to the specific information provided in the initial authorization procedure, should be reported in written notice to the authority one month before the changes can come into effect. If the material changes that occur are due to unpredictable events, they should be reported instantly. The competent authorities of the home Member State of the AIFM may according to art. 8(4) restrict the scope of the authorization, in particular with regard to the investment strategies that the AIFM is allowed to employ.

The marketing notification procedure is similar to the management notification procedure. If an AIFM wishes to market units of one or several AIFs it manages in the home Member State, according to art. 31 and 32 of the AIFMD the AIFM has to notify the competent authority of the home Member State prior to its marketing activities of one or several AIFs. In case the AIFM intends to market the units of one or several AIFs in Member States other than the home Member State, the AIFM should submit a notification file to the authorities of the home Member State in respect of

[133] The specific information with regard to the AIFM entails information concerning the persons who effectively conduct the activities of the AIFM; information on the identities of AIFM's shareholders who have 10 % or more of the capital or voting rights in the AIF; the amounts the shareholders have in the AIF; information on the investment policy; a document that sets out the organizational structure of the AIFM including information on how the AIFM intends to comply with its obligations under Chapters II, III, IV and where applicable Chapters V, VI, VII and VIII; information on risk management and liquidity management; information on the policy on effective control of conflict of interest; a description and motivations on the delegation and sub-delegation arrangements to third-parties of functions as referred to in article 20; information on the remuneration policies and practices pursuant art.13 of the Directive; valuation and organizational requirements and so on.
[134] According to the Directive 'qualifying holding' means a direct or indirect holding in an AIFM which represents 10% or more of the capital or of the voting rights, in accordance with Articles 9 and 10 of Directive 2004/109/EC, taking into account the conditions regarding aggregation of the holding laid down in Article 12(4) and (5) thereof, or which makes it possible to exercise a significant influence over the management of the AIFM in which that holding subsists.

each AIF that it intends to market. In the course of the notification procedure the AIFM should provide specific information[135] to the home Member State authority with regard to the AIF(s) it intends to market. The specific information must also be disclosed to investors before the marketing activities are made. Subsequently, if the AIFM intends to market units of one or several AIF(s) in other Member States, the competent authority of the home Member State is required to transmit within 20 working days after receipt of the complete notification file and attached documents, the complete file to the authorities of the host Member State(s). In this regard, the authority of the home Member State must also notify the authorities of the host Member State(s) that the AIFM is authorized to manage AIFs in which particular investment strategies are employed. The AIFM must be informed immediately by the authority of the home Member State of the transmission and may consequently start its marketing activities in the host Member State(s). The home regulator may prevent the marketing activities if the information in the notification reflects inconsistencies with the one or more provisions of the AIFMD.

The home supervisor is allowed to grant approval to the AIFM to market an AIF to retail investors in their territory based on supplementary or more stringent requirements then the marketing requirements applicable to professional investors. In this context, the Member States are required to notify the EC and the ESMA of the AIF's the AIFM intends to market to retail investors in their territory and of the supplementary requirements applicable to the AIFM.[136]

4. Capital requirements

In order to qualify for authorization the AIFM must maintain sufficient initial capital and own funds and must invest the funds of the AIFM in liquid assets or assets readily convertible to cash in the short term.[137] The latter restriction is to prevent the AIFM from using its own funds as working capital and to create a form of buffer capital in case of fraudulent activities that affects the capital of investors. Furthermore both internally and externally managed AIFMs are required to maintain a specific compensation structure through for instance a professional indemnity insurance or additional own funds to cover potential liability risks arising from professional negligence that results from activities of the AIFM.[138]

According to art. 9 of the Directive the competent authorities of the Member States must ensure that an external AIFM maintains an initial capital of at least €125.000 and an internally

[135] The specific information with regard to the AIF entails information concerning the risk profiles of the AIF, the use of leverage, the investment strategies of each fund, information about the Member State(s) or third countries in which it is established or expected to be established and to be market, the AIF rules of incorporation, information on the depositary and so on.
[136] See art. 43 AIFMD.
[137] See art. 9(1) and (8) AIFMD.
[138] See art. 9(7) AIFMD.

managed AIF an initial capital of at least €300.000. Where the value of the portfolios of the AIFs managed by the AIFM exceeds €250 million, the AIFM must provide an additional amount of own funds. That additional amount of the own funds must be equal to 0.02% of the amount by which the total value of portfolios of the AIFM exceeds € 250 million but the required total of the initial capital and the additional amount shall not exceed € 10 million. The Directive further states that the AIFM should invest with a view to short-term availability and he is not allowed to invest in speculative positions. With regard to the liquidity management, the AIFM is required in art. 16 to employ an appropriate liquidity management system for each AIF it manages (provided that the AIF is not an unleveraged closed-end AIF), to adopt a procedure that enables an efficient control of the liquidity risks of the AIF and to ensure that the liquidity profile of the investments complies with the obligations of the AIF. Moreover, the AIFM must regularly conduct several stress tests that enables to assess and monitor the liquidity risk of the AIF(s).

5. Leverage

The use of leverage is defined in the Directive as *"any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash securities, or leverage embedded in derivative positions or by any other means".* In order for home regulators to determine whether the use of leverage by the AIFM can contribute to the buildup of systemic risk in the financial system or disorderly markets, the home regulator has to ensure that the AIFM that employ leverage on a systemic basis provides information on the following:

- leverage embedded in financial derivatives;
- the five largest sources of borrowed cash or securities and the amounts of leverage received;
- the extent to which assets have been re-used under leveraging arrangements;
- the level of leverage employed by the AIF;
- a distinction between leverage used from borrowing of cash and securities;
- other information required by the home regulator that contributes to an effective control of systemic risk in the financial system or risks of disorderly markets.

Moreover, the home regulator has to ensure that the AIFM sets reasonable leverage limits with regard to the managed AIF(s) and has to ensure that the AIF continuously respects the leverage limits that the AIFM has set. The AIFM is also required to reveal the extent in which the leverage limits it has set for each AIF that it manages is reasonable. The home regulator may also impose supplementary requirements on the maximum leverage limits that the AIFM can employ.[139]

[139] See art. 25 AIFMD.

6. Transparency requirements

With regard to the transparency requirements, the AIFM is required to make specific information available to the investors as well as any material changes thereof for each of the EU AIFs that he manages and markets before the investors can invest in the AIF.[140] This information includes the following:

- an identification of the AIFM, the AIF's depositary, the auditor and other service providers, a description of their duties, a description and the identification of any delegated management function and of any function delegated by the depositary, the identification of any conflicts of interest that may arise from the delegation to service providers and a description of the investors' rights;
- a description of the investment strategy and objectives of the AIF, a description of the types of assets in which the AIF may invest, the techniques it may employ and all the associated risks with the investment strategies and assets, any applicable investment restrictions, the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage and the maximum level of leverage which the AIFM is allowed to employ on behalf of the AIF;
- a description of the procedures by which the AIF is allowed to change its investment strategy and/or policy;
- information of the most important legal implications of the contractual relationship with the investors;
- a description of the policy in how to cover professional liability risks, information with regard to the liquidity position, the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;
- a description of the AIF's pricing methodology and valuation procedure for valuing assets;
- a description of all fees, charges and expenses which are directly and indirectly borne by the investors;
- the latest annual report, the latest net asset value of the AIF and the historic performance information;
- the procedure with regard to the issuance and sale of units;
- information on the specific privileged treatment for individual investors and the type of investors that receive a privileged treatment.

[140] See art. 23(1) AIFMD.

On top of this information, information must be provided periodically by the AIFM to investors on any new arrangements for the management of the liquidity of the AIF. Moreover, supplementary information such as information on the principal markets and instruments in which the AIFM trades, the main categories of assets in which is invested and the percentage of AIF's assets which are subjected to specific arrangements arising from their illiquid nature must be reported by the AIFM to the competent authority of the home Member State. The AIFM is also required to provide an audited, by an EU auditor, annual report on request of the authorities of the home Member States of each managed and marketed AIF. [141] The annual report should be in accordance with the accounting standards of the home Member State of the AIF, no later than six months following the end of the financial year. [142]

7. Depositary

The Directive stipulates in art. 21(1) that a single depositary should be appointed by the AIFM for each AIF it manages in order to acquire an European passport. According to art. 21(3) the depositary shall be *"(i) a credit institution having its registered office in the Union and authorized in accordance with the UCITS Directive, (ii) an investment firm having its registered office in the Union (…) , or (iii) another category of institution that is subject to prudential regulation and ongoing supervision (…)."* Although the depositary is not required to register in the home Member State of the AIF, the depositary is required to be established in the same jurisdiction as the AIF and it is also subjected to approval requirements of the competent authority of the home Member State. According to the AIFMD the depositary has two primary functions; the safe-keeping of the AIF's assets and to oversee its compliance with the AIF's rules and instruments of incorporation and with applicable law and regulation. Moreover, the Directive requires the depositary to ensure that the AIF's cash flows are properly monitored.[143] It is further required that the depositary ensures the protection of investors in cases of losses made from fraudulent activities by the AIFM. In this context, when the depositary fails due to negligent or intentional behavior to ensure the protection of investors, the depositary is required to refund similar financial assets or reimburse a compensation fee to the AIF or the investors of the AIF. The depositary is however not liable for losses that arise from unpredictable events beyond its reasonable control. Consequently, the main purpose of a depositary is to ensure a separation of roles within a AIF and to ensure a proper management of conflict of interest.

[141] See art. 24 AIFMD.
[142] See art. 22(1) AIFMD.
[143] See art. 22(7) AIFMD.

8. Remuneration

The Directive stipulates that the AIFM should have a remuneration policy that enables the promotion of effective risk management and discourage risk taking activities which are not in line with the risk profile, the objectives and the rules of the AIF and that can raise conflict of interests with the fund(s)'s investors. With regard to significant AIFMs in terms of assets they manage or the size of the AIF, a special remuneration committee should be established in order to provide an independent valuation on the remuneration policies and practices for management risk. Furthermore, the remuneration policies and practices of the AIFM should meet the terms of a number of principles such as the proportionality principle which specifies that the remuneration policy should reflect the assets managed by the AIFM, the size of the AIF, the complexity and scope of the activities and the nature of the internal organization.[144]

5.2. Dutch Legislation

The AIFMD came into effect in the Netherlands on 21 July 2011 and as seen before the Member States have until 22 July 2013 to implement the Directive into national law. The Dutch Ministry of Finance submitted a proposal Bill (Bill) for implementation of the AIFMD into Dutch law on 19 April 2012. Through this Bill the AIFMD will bring about amendments to the Dutch Act on Financial Supervision, Wet op het financieel toezicht (Wft).[145] Debates on the final version of the Bill are currently still in process, thus it remains uncertain how the Directive and the implemented measures of the EC will exactly be implemented in the Netherlands. In this paragraph, the similar provisions that were elaborated in the paragraph with regard to the AIFMD are analyzed in order to understand the currently Dutch legal aspects of the structure of hedge funds mentioned in chapter 3.

5.2.1. The Wft before the implementation of the AIFMD

Before, the relevant provisions of the Wft are elaborated, it is primarily crucial to differentiate the authority that is responsible for the compliance of the provisions of the Wft and the competent authority that is responsible for the supervision of financial actors in the Netherlands. These authorities are the AFM and the DNB. The Authority for Financial Markets, Autoriteit Financiele Markten (AFM), supervises the way financial institutions interact with their customers and with each other on the financial markets. The purpose of the AFM is to enhance the confidence of consumers and businesses in the financial markets in order to stimulate market participation. The DNB, De Nederlandsche Bank, is the central bank of the Netherlands and is responsible for the stability of the financial system. The DNB is more specifically responsible for a sound payment system, a sound

[144] See art. 13 AIFMD.
[145] Available at: http://www.st-ab.nl/wetten/1064_Wet_op_het_financieel_toezicht_Wft.htm

monetary policy in order to enhance price stability and sound business operations of financial institutions. Thus, for a better understanding of the provisions detailed below, it is crucial to comprehend that the AFM is the principal supervisor of the investment institutions in the Netherlands and the DNB is responsible for the prudential supervision.[146]

1.The investment institutions

The main legal structure available for collective asset management under the Wft is through the establishment of an investment institution (beleggingsinstelling). Investment institutions are within the meaning of the Wft, legal entities or entities which do not have a legal personality that attract capital or goods from the public for the purpose of collective investment in order for the participants to share in the profits of the investments or for the realization of an intrinsic growth of the participation rights of the investors.[147] A collective investment is an investment portfolio that includes various investors who have joint ownership of that portfolio and are entitled to the benefits of the portfolio. The profits are generally allocated in proportion of the contributions of the investors.[148] Moreover, in order to determine whether an institution qualifies as an investment institution, the AFM makes the distinction between entrepreneurship and investing in the Policy enterprise or investing (Beleidsregel ondernemen of beleggen).[149] According to this policy, the way in which an entity creates value for its participants determine whether the activity qualifies as an investment or an enterprise. If an institution employs labor that directly or indirectly aims to increase the value of the assets that are acquired, this activity is considered to comprise an enterprise. A passive value enhancing activity entails investing. An example of this scenario is the case where the entity purchases a building. In case that the entity purchases a building in order to rent it en to resell it in due course time, then no value has been added to the asset by commitment of labor, leading to this activity to comprise an investment.[150] The distinction between an investment and an enterprise is thus crucial in order to understand the essence of an investment institution. Moreover, the structure of an investment institution can either be open-end or closed-end. The distinction between an open-end and a closed-end structure is important for the applicability of several rules of the Wft which will be elaborated in subsequent sub-paragraphs.

1a. Investment companies and investment funds

Investment institutions are subdivided in the category investment companies (beleggingsmaatschappijen) and the category investment funds (beleggingsfondsen). Hedge funds

[146] See: http://www.rijksoverheid.nl/onderwerpen/financieel-toezicht/toezicht-op-het-financiele-stelsel/toezichthouders-dnb-en-afm
[147] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 41.
[148] See note 144.
[149] Available at: http://wetten.overheid.nl/BWBR0027980/
[150] B. Bierman e.a., *Hoofdlijnen Wft, Recht en Praktijk Financieel Recht*, Kluwer, Deventer, 2011, 187.

are not clearly defined in the Wft, but they specifically fall under the category of investment funds.

According to art. 1:1 Wft, an investment company is *"a legal entity that requires or obtains financial funds or other goods from investors, in order to make collective investments and to share the profits of the investments with the investor."* The investment company is thus an entity with a legal personality and can be structured as a limited liability company or a public company. The investment company is both the legal and the economic owner of the investment portfolio.[151] Within an investment company the relationship between the investment company and the participants are governed by corporate law.[152] Moreover, investment companies are registered on approved regulated markets and the participation rights in the company are equal to shares that are traded on these regulated markets.[153]

According to art. 1:1 Wft, an investment fund is defined as *'an entity that is not an investment company, in which assets are pooled and financial funds or other goods are obtained or required, in order to make a collective investment and to share the profits from these investments with the investors'*. An investment fund does not possess a legal personality and can be structured as a partnership, a limited partnership, a general partnership or as a mutual agreement such as a FGR between the manager, the participants and in some cases a depositary.[154] Since investment funds do not possess a legal personality, the Wft stipulates that the depositary should obtain the legal ownership of the investment portfolio of the fund while the participants are the economic (beneficial) owners of the portfolio. Consequently, the main differences between investment companies and investment funds are the legal form, the fact that the relationship between the participants and the investment fund is governed by contract law and not by corporate law and the units are referred to as participation rights and not as shares.[155] The distinction between investment companies and investment funds is relevant for the applicability of specific licensing requirements and ongoing requirements which will be elaborated in subsequent sub-paragraphs.

2. Authorization requirements

According to art. 2:65 Wft, managers of investment institutions are required to obtain a license from the AFM in order to offer units to investors. Based on this license, the manager is allowed to market several investment institutions in the Netherlands. The manager is however required to register the new investment institutions with the AFM two weeks before he starts the marketing activities.[156] In case the investment institution is a legal person or does not have a separate management body, the

[151] See note 144 p. 185.
[152] Mr. J.W.P.M. van der Velden, *Beleggingsfondsen naar Burgerlijk Recht*, Kluwer, Deventer, 2008, p. 377-385.
[153] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 41,42.
[154] See note 149.
[155] See note 150.
[156] See art. 4:50 Wft.

investment institution itself is required to obtain a license under art. 2:65(1)(b) Wft. In order for the manager of an investment fund to obtain a license, the manager must according to art. 2:67(1) Wft comply with several requirements concerning management[157], sound business operations[158], the control structure[159], minimum capital[160], liquidity[161], investor's protection[162] and so on. In this regard, along with the application form the manager is required to submit the registration document of the investment institution, statutes of the manager, a description of the policy with respect to the sound conduct of business, a description of the control structure, a description of the activities of the manager and the depositary, a description of the persons who determine the daily policy and their duties, the agreement between the manager and the depositary, the statutory objective description and so on.[163] The AFM decides within thirteen weeks upon receipt of the submission of the application whether the manager should receive a license in order to issue units to investors. The AFM may impose additional requirements or restrictions before it grants the license.[164] The license is personal and the manager is not allowed to transfer it to another (legal) person.[165] Once the manager is authorized to market the investment institution, it is subjected to continuous supervision of the AFM and the manager should ensure that it complies with these requirements.

2a. Exception rules and exemptions

The exceptions to the applicability of the authorization requirements of art. 2:65 Wft are with regard to investment institutions that offer units to less than hundred investors that are non-qualified/ non-professional investors (art. 1:12(1)(a) Wft) and/or to investment institutions that only offer units to qualified investors (art. 1:12(1)(b)Wft). The rationale behind the exception relating to qualified investors is that qualified investors are considered to possess sufficient expertise and professional qualification to understand the nature of the units that are offered.[166] According to art 1:1 Wft a qualified investor includes the following:

- a legal person that is licensed or regulated in order to operate in the financial markets;
- a legal person that is not authorized nor regulated in order to operate in the financial markets and whose corporate purpose is to invest in securities;

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[157] See art. 4:9 and 4:10 Wft.
[158] See art. 4:11 Wft.
[159] See art. 4:13 Wft.
[160] See art. 3:53 Wft.
[161] See art. 3:63 Wft.
[162] See art. 4:42 Wft.
[163] See art. 35 of the Decree Market access of financial companies Wft (Besluit Markttoegang financiele ondernemingen Wft). Available at: http://wetten.overheid.nl/BWBR0020413/Hoofdstuk2/27/Artikel35/
[164] See art. 1:102 Wft.
[165] See art. 2:1 Wft.
[166] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 197.

- a national and regional government body, a central bank, an international or supranational organization or other similar financial international institution;
- a legal person that has its registered office in the Netherlands and is considered to be a small company according to art. 4 Decree definition provisions Wft (Besluit definitiebepalingen Wft), and at its own request wishes to be registered as a qualified investor by the AFM;
- an undertaking that is not considered as a small company, but by law is considered as a qualified investor. Given their size it is assumed that they do not need protection from the regulator;
- a natural person domiciled in the Netherlands that fulfills at least two of the three requirements set in art. 4(3) Decree definition provisions Wft and at his own request wishes to be registered as a qualifying investor by the AFM.

The Wft also provides two exemptions with regard to the authorization requirement. To the extent that the units can be acquired for a counterpart of at least €100.000 per participant (art. 4(1)(a) VrWft[167]) or to the extent that the units have a nominal value of at least €100.000 per unit (art. 4(1)(b) VrWft), the manager is exempted from the authorization requirement. These exemptions are based on the Prospectus Directive.[168] The rationale behind the exemptions is that a participant that purchases a unit or units of a value of €100.000 is assumed to possess sufficient professional expertise to understand the nature of the offered units.[169] In this context, according to the Dutch parliamentary history it is concluded that normally small investors are unable to pay such a large amount at once.[170] As a result, the aim of the Wft is to specifically regulate marketing activities relating to retail investors instead of professional investors.

2b. Selling restrictions

According to art. 1:12(5) Wft art. 4 VrWft, investors who wish to participate in an investment institution that falls under an exemption or a rule of exception, should be informed by the manager, prior to the issuance of the units, that it is not compelled to comply to the authorization requirements and that it is not under continuous supervision of the AFM. Thus, in order for the manager to benefit from the rules of exceptions or exemptions, the manager is required to include a

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[167] Exemption provisions Wft (Vrijstellingregeling Wft). Availabe at: http://wetten.overheid.nl/BWBR0020536/
[168] The limit of €100.000 was amended on 1 January 2012. Untill then the limit was set at €50.000. The limit is increased in order to prevent non-professional investors to invest in vehicles that are exempted from supervision. Due to the amendment of the VrWft, the issuer that issued units before 1 January 2012 for a value of at least €50.000 but less then €100.000 per participant, was required to obtain a license before 31 January 2012. From 1 January 2012 on, the managers of these investment institution fall under the scope of the Wft. See: http://www.debrauw.com/News/Publications/Documents/20111223%20wijziging%20Vrijstellingsregeling%20Wft.pdf
[169] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 198.
[170] *Kamerstukken TK* 2009/10, 32 545, nr. 1. Available at: https://zoek.officielebekendmakingen.nl/kst-32545-1.html

warning text in the listing materials and public advertisements.[171] This warning text is referred to as a selling restriction, legend or disclaimer. The warning text is not required for investment institutions that offer units to professional investors and for closed-end investment institutions that offer units to investors.[172]

3. Manager and Depositary

The appointment of a separate manager and/or depositary is not compulsive to all authorized investment institutions. Investment companies are not compelled to appoint a separate investment manager and/or depositary, because they are legal entities and therefore the legal owners of the rights and obligations of the assets in the vehicle. The Wft stipulates on the other hand that separate legal entities must be enforced for the management and the depositary activities in an investment fund, in which the depositary obtains the legal ownership of the assets of the fund.[173]

The Wft does not provide a definition of a manager. According to the Dutch parliamentary history a manager is defined as a *'legal entity that manages one or more investment institutions'*. It is further stated that the management functions include the management of the assets, the administration of the fund, the issuance of units, defining the investment policy according to the rules of the fund, the decision making process with regard to the purchase and selling of the assets and so on.[174] As a result, it is the manager who actually controls the investment fund, represents the fund in public, who is held accountable for the doings of the fund and therefore is the addressee of the authorization requirements. Pursuant to art. 1:13 (4) Wft, the seat of the fund should be established where the investment manager is located. Furthermore, the manager is according to art. 4:42 Wft required to take measures to ensure that the assets of the fund are obtained for the benefit of the participants by an independent depositary. According to art. 4:44 Wft only a legal person whose sole statutory objective is to safeguard the assets and to administer the assets of the fund on behalf of the beneficiary is considered as a depositary. These rules are designed to provide a separation between the assets of the manager and the fund, in order to prevent the risk that creditors of the manager attempt to recover from the assets of the fund for their claims.[175] In addition to the rule laid down in art. 4:42(a) Wft on the separation of assets of an investment fund, art. 4:45 Wft provides a ranking for claim settlements of creditors for the recovery on the assets of the fund as follow: (i) claims arising from debts related to the management and safeguarding of the assets; (ii) claims arising from rights of participation; and (iii)other claims. Another task of the depositary is to ensure

[171] See art. 1:12(5), (6) and art. 4(2) VrWft.
[172] See note 166.
[173] Art. 2:67(1)(g) (h) Wft, art. 4:42(a) Wft and art. 4:44(1) Wft.
[174] *Kamerstukken TK* 2005/06, 29 708, nr. 19. Available at: https://zoek.officielebekendmakingen.nl/kst-29708-19.html
[175] See art. 4:45 Wft.

that the manager acts in accordance with the rules or statutes of the investment fund.[176] The Wft states in this regard in art. 4:42(b) that the power to dispose of the assets of the investment fund, is shared by the manager and the depositary jointly in order to prevent the manager and the depositary to purchase assets at the expense of the capital of the participants. Moreover, the manager and the depositary are according to art. 4:43 Wft compelled to contractually agree on the conditions for management and custody of the assets.

In terms of operational requirements art. 4:9 and further of the Wft stipulates that the manager and the depositary must have sufficient expertise, should be sufficiently trustworthy and with respect to the integrity of the business, are compelled to counteract any conflict of interest. Furthermore, the manager, the depositary and the investment company are required according to art. 17 (5) BGfo[177] to ensure an independent monitoring of the application of policies, procedures and measures with regard to a sound conduct of business that cover potential risks of integrity.

3a. Delegation of functions

The manager, the depositary and the investment company are according to the rules of art 3:18 (1), (3) and art. 4:16 Wft allowed to delegate their functions to a third party. The general rule is that the entities have to ensure that in case of delegation, the applicable rules of Part 3 of the Wft, regarding the access of financial undertakings to the market, and Part 4 of the Wft, regarding the supervision of the behavior of financial undertakings, are complied with by the third party. However, according to art. 38(2) BGfo the manager is not allowed to outsource the decision power of determining the investment policy. Furthermore, the delegation by the manager or the depositary should be done in writing (art. 38 BGfo) and may not result in hindrance of an adequate supervision of the manager, the investment company or the depositary (art. 37 BGfo) by the AFM. Even if the functions of the entities are outsourced, the entities are still responsible for the outsourced business activities and therefore should monitor how the activities are performed by the external parties.

4. Capital requirements

The liquidity requirements only apply to the managers of open-end investment institutions and UCITS funds.[178] Liquidity in an open-end vehicle is of great importance due to the fact that the vehicle has to be able to have sufficient capital in order to purchase and sell units at the request of participants. Therefore, art. 3:63 Wft and art. 109 Bpr[179] states that open-end investment funds have to ensure that 10% of the assets under management should consist of liquid assets such as cash

[176] See note 171.
[177] Decree on the supervision of the conduct of financial enterprises (Besluit Gedragstoezicht financiele ondernemingen). Available at: http://wetten.overheid.nl/BWBR0020421/
[178] See art. 3:63 Wft.
[179] Decree Prudential Rules Wft (Besluit prudentiele regels Wft). Available at: http://mijnwetten.nl/besluit-prudentiele-regels-wft/hoofdstuk11

deposits on demand with licensed banks and debt securities in bearer form. Although the AFM is the licensing authority and therefore the main supervisor when it comes to investment institutions, the DNB is the authority that enforces the prudential regulation of the Wft and related rules. In this context, art. 48 Bpr provides the minimum equity requirements that managers located in the Netherlands have to comply with. The minimum amount of own equity range from €112.500 to €300.000. Pursuant to art. 3:53(5) and art. 3:63(3) Wft, the manager and the depositary are compelled to notify the DNB immediately when the minimum amount of equity or the liquidity position of the fund does or will not comply with the rules and related rules of the Wft.

5. Requirements of disclosure

The Wft and the related subordinate rules of the Wft contain detailed requirements regarding the information that investment institutions should provide to the AFM and investors before units can be issued to investors. These requirements can be divided into mandatory and non-mandatory information. The mandatory information is the information based on the requirements of the Wft. The non-mandatory information concerns the information that the manager or the investment institution provides voluntary, such as information for advertisement purposes.[180] The non-mandatory information should not affect the mandatory information that is provided to investors and it should be specified in the non-mandatory information that it is provided for commercial purposes.[181] The rules regarding mandatory disclosure can be divided into pre-contractual information requirements and ongoing disclosure requirements that apply after the conclusion of the issuance agreement with investors. An example of an ongoing disclosure requirement is that in case of changes in the conditions that apply between the investment institutions and the participants in the issuance documentation, the manager has the obligation to publish these changes in a Dutch newspaper or it should be addressed in a Dutch newspaper to each participants of the investment institution, as well as on the website of the manager.[182] According to art. 4:46 Wft, the manager is required to maintain a website. On this website, the information relating to the pre-contractual phase such as the registration document, the prospectus, the financial leaflet and a number of general information including monthly statements of the total value of the investments of the investment institutions (art. 50 BGfo) should be published. In addition, the manager, the investment institution and the depositary should provide and disclose specific annual financial information to the AFM.[183]

As mentioned before the manager is required to make a registration document available on

[180] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 214.
[181] See art. 4:19 Wft.
[182] See art. 4:47 Wft.
[183] See art. 4:51 and art. 4:52 Wft.

his website. According to art. 4:48 Wft, the information in the registration document should include information about the manager, the investment institutions it manages or intends to manage, information about the depositary and it must fulfill the disclosure requirements mentioned in Annex D of the BGfo (art. 117 BGfo). The addressee of the registration document are the manager and the depositary and it is not required that different registration documents are made for each managed investment institution. On the other hand, the manager should make a prospectus available for each managed investment institution. One of the main goals of the prospectus is to provide information to investors that enables them to form an opinion about the investment institution and the associated risks and costs. The legal basis of the prospectus requirement depends on the type of units issued. If the units qualify as securities as is the case in a closed-end investment institution, pursuant to art. 4:49 (6) Wft the prospectus has to be made in accordance with the rules for offering of securities in Part 4 of the Wft which derive from the Prospectus Directive[184]. If the units do not qualify as securities such as units in an open-end investment institution, the prospectus has to be made in accordance with art. 4:40 Wft, art. 118 en Annex E BGfo. Moreover, the financial leaflet should be made available on the website of the manager and sent free of charge at the request of the client. The financial leaflet with respect to issued units should include information on the costs and risks of the assets and, if available, the historical performance of the investment institution.[185] Besides the data listed in art. 66 BGfo, the financial leaflet should include the information set down in Chapter 3 Nrgfo.[186] According to the parliamentary history it is crucial that the information in the financial leaflet is provided in a standardized format in order to enable consumers to compare significant information between several investment institutions and to take an informed decision accordingly.[187] To ensure that potential clients are aware of the existence of a financial leaflet, the manager has to refer to this leaflet in its advertisements relating to the offering of units.[188]

6. Impact assessment of the AIFMD

On 19 April 2012, the Dutch Ministry of Finance submitted a proposal Bill (Bill) for implementation of the AIFMD to the Parliament.[189] As a result, a large number of currently exempted hedge fund

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[184] Directive 2003/71/EC of the European Paraliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.
[185] Dr. R.J. Schotsman, *Praktijkgids Wft, Financiele markten en ondernemingen onder toezicht*, NIBESVV, 2011, p. 216.
[186] The Nrgfo Wft stands for Nadere regeling gedragstoezicht financiele ondernemingen Wft (Further Regulation for the supervision of the conduct of financial undertakings Wft). The Nrgfo contains a set of guidelines with regard to the format of a financial leaflet. Available at: http://wetten.overheid.nl/BWBR0020540/
[187] *Stb. 2006*, 520, p. 222.
[188] See art. 52(4) BGfo.
[189] Voorstel van Wet: Wijziging van de Wet op het financieel toezicht, het Burgerlijk Wetboek, de Wet op de economische delicten en enige fiscale wetten ter implementatie van richtlijn nr. 2011/61/EU van het Europees Parlement en de Raad van de Europese Unie van 8 juni 2011 inzake beheerders van alternatieve beleggingsinstellingen (…). Available at: http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2012/04/19/voorstel-van-wet-aifm-richtlijn.html

managers will be regulated and monitored by the AFM and the DNB as of 22 July 2013. In addition to the Bill, important elements of the Directive including the Level 2 Measures still need to be elaborated in subordinated legislation of the Wft and will also apply to hedge funds. Since the set of laws and rules that will arise from the Directive is not yet complete, the Bill and the Explanatory Memorandum of the Bill[190] will form the basis of this chapter. Consequently, the aim of this chapter is to stress out the implications of the Bill for Dutch hedge fund managers with regard to the access to the Dutch market. In this regard, merely the aspects of the Bill that give an insight to the Dutch market in the near feature for Dutch hedge fund managers will be elaborated.

6.1. Investment institutions vs. UCITS-funds

The Bill divides collective investment vehicles into two categories: the collective investment funds that fall within the scope of the AIFMD and the collective investment funds that fall within the scope of the UCITS Directive. The collective investment funds that fall within the scope of the AIFMD are in the Bill referred to as 'investment institution' instead of 'AIF'. The legislator has opt to replace the term 'AIF' by the term 'investment institution' due to the fact that the word 'alternative' in 'AIF' can lead to confusions as to the type of investment institutions that should be considered as AIFs. The term can lead to the interpretation that merely hedge funds and private equity funds are covered, while the Dutch legislator expects that the majority of the current investment institutions will fall into this category.[191] Consequently once the Bill comes into effect, hedge funds will according to the Bill fall under the category investment institutions within the meaning of the AIFMD and will face the requirements that are set for investment institutions.

6.2. Managers of investment institutions

According to the Bill, a manager should be appointed for each investment institution it intends to manage and market.[192] In art. 1:1 of the Bill, a manager of an investment institution is described as *"the person in the exercise of a profession or business that manages one or more investment institutions"*.[193] This definition is slightly different from the definition of an AIFM in art. 4(1)(b) AIFMD as it reads "*any natural or legal person whose regular business activities relates to the management of one or more AIFs."* According to art. 4:37c (1) of the Bill, the manager has to be a legal person and art. 4:37c (2) states that the Dutch manager is required to have its registered office and headquarter

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[190] Memorie van Toelichting: Wijziging van de Wet op het financieel toezicht, het Burgerlijk Wetboek, de Wet op de economische delicten en enige fiscale wetten ter implementatie van richtlijn nr. 2011/61/EU van het Europees Parlement en de Raad van de Europese Unie van 8 juni 2011 inzake beheerders van alternatieve beleggingsinstellingen (…). Available at: http://www.rijksoverheid.nl/zoeken?zoeken-op=memorie+van+toelichting+aifm
[191] See p. 10, 46 and 50 of the Explanatory Memorandum of the Bill. In the following footnotes, the Explanatory Memorandum is indicated with the abbreviation MvT.
[192] See p. 13 of the MvT.
[193] See p. 46 of the MvT.

in the Netherlands in order to be considered as a manager of an investment institution. Moreover, according to art. 4:37c (3) the manager is required to have at least two individuals that determine the daily policy.[194] The definition of the Bill specifically differs from the definition of the AIFMD with regard to the type of business activities that a manager should perform at least in order to be defined as a manager of an investment institution. The Dutch legislator expands in the Bill the 'regular business activities' with the element '*the person in the exercise of a profession or business'* in order to include 'incidental' management activities.[195] However, the added element is not sufficiently defined and leaves room for interpretation with regard to the main activities that the manager should perform at least in order to fall within the scope of the Bill. This deficiency is somewhat compensated through the description of what the management functions of the manager should include, namely (i) activities regarding the portfolio management function and the risk management function, and (ii) activities regarding the administration of the managed investment institution(s).[196] Consequently, in order for a hedge fund manager to be defined as a manager under the Bill, the manager should perform in addition to the portfolio management and the risk management function, at least the administration of the managed hedge fund. The administration function includes the valuation and the pricing of the assets, the maintenance of an unit registry, the offering of units in the managed investment institution(s) and consultation services relating to the units of the investment institutions.[197] As a result once the Bill comes into effect, the manager of a hedge fund should be a legal person and should perform at least the above mentioned duties in order to manage a hedge fund in the Netherlands and across the EU.

My personal view in this regard is that, the definition which is provided by the Dutch legislator should be more in line with the definition of the AIFMD. Firstly, the definition accorded in art. 1:1 is not complete and is supplemented with other elements in art. 4:37c. From a technical viewpoint and for a better understanding of the term manager, it is preferable to replace *"the person in the exercise of a profession or business"* with *"the legal person"* since art. 4:37c (1) requires a manager of an investment institution to be a legal person. Consequently, misinterpretation is prevented as of the required legal status of the manager. Moreover, if a manager is required to be a legal person it implies that the manager exercises the management activities for commercial purposes and/or as a profession. Secondly, it is difficult to deduce from the definition of the Dutch legislator the extent in which the management function can be outsourced to third parties. Although the rules of delegation of art. 20 and 21 of the AIFMD will be implemented in art. 4:16 of the Wft and in the rules of the Bgfo en the Bpr, it seems that the definition of the AIFMD puts a greater

[194] See p. 78 of the MvT.
[195] See note 191.
[196] See p. 10 of the MvT.
[197] See note 194.

emphasize on the fact that the natural or legal person has to bear the responsibility for the management functions. The definition of the Wft however, implies that the management functions has to be performed by the manager himself. In this regard, the Wft seems to leave little room for the manager to determine the organization of the management functions compared to AIFMD. Moreover, the Wft over-regulates the management activities of Dutch hedge fund managers. Although, the administration activities that are included to the core activities of the Dutch hedge fund manager are in accordance with art. 6(4)(b) AIFMD[198], they are however too extensive. As art. 6(4) AIFMD reads, the valuation and the pricing of the assets, the maintenance of an unit registry and the consultation services relating to the units of the investment institution, should be part of the non-core services instead of the core activities that the manager should perform at least in order to be considered as a manager. According to art. 6(5) (b) AIFMD the non-core services shall not be authorized without also being authorized to provide the core services. Consequently, it seems more efficient to maintain a clear distinction between the core activities and the non-core activities in order to prevent a manager to perform an extensive list of activities before he is authorized to manage a hedge fund. In conclusion, the definition of a manager in the Wft should be more in line with art. 6 of the AIFMD, since this definition is more clear and leaves managers more room for the organization of their management activities.

6.3. Authorization requirements for investment institutions

6.3.1. Requirements for management and marketing activities in the Netherlands

In order to manage and market a hedge fund in the Netherlands, the manager will as of 22 July 2013 have to obtain a license from the AFM pursuant art. 2:65 Wft, which is based on the authorization requirements set in art. 2:67 and 2:68 Wft. A remarkable aspect of the authorization procedure is that in order to manage and market a hedge fund in the Netherlands, the manager does not have to acquire two separate licenses for the different activities. As mentioned before, the management functions of the manager include (i) activities regarding the portfolio management function and the risk management function, and (ii) activities regarding the administration of the managed investment institution. Due to the fact that the offering of units is part of the administration activities, the manager that acquires a license in order to manage a hedge fund can with this same license offer units to professional investors. On the other hand, if the manager does not acquire a license to manage a hedge fund that is established in the Netherlands, he accordingly does not acquire the right to offer units to investors in the Netherlands.[199] According to art. 2:67 Wft, the AFM is prior to

[198] It is stated in art. 6(4) AIFMD that the Member States are allowed to authorize an external AIFM to provide non-core services on top of the portfolio management function and the risk management function.
[199] See p. 58 of the MvT.

its approval of the activities of the manager required to ensure that the manager fulfills the following requirements; the manager and the depositary should be suitable, reliable and should maintain a sound conduct of business[200], a policy regarding sound business operations[201], the conduct of business should include a specific policy regarding the management and prevention of (potential) conflicts of interest arising with investors and the investment institution[202], the appointment of an independent depositary is mandatory[203], disclosure requirements[204] and so on. Furthermore, in order for the manager of a hedge fund to be able to issue units to professional investors he will have to fulfill requirements regarding leverage[205], capital[206] and risk management, valuation of the portfolio, a prudent remuneration policy and so on, which are largely based on the requirements of the AIFMD. Through the extensive requirements set in the Bill, the legislator ensures that the activities of hedge fund managers are performed in an sound and transparent way in order to strengthen investor's protection and to improve the supervision of the activities of hedge funds.

In my view, the Bill does not seem to clearly stipulate whether managers of hedge funds that employ a FGR structure, should obtain a license from the AFM pursuant art. 2:65 of the Wft. The FGR is a type of pooled investment vehicle which is created through a contract between the manager, the depositary and the participants and that has no legal personality. [207] The purpose of the FGR is to manage and invest the capital of the participants collectively in order to achieve economies of scale.[208] Hedge funds that are structured as FGRs are currently not bound by the rules of the Wft. The Dutch legislator indicates that due to the fact that there are different forms of pooling structures, it cannot be determined in advance which pooling structure will be covered by the requirements of the AIFMD. Hence, in case of doubt concerning the applicability of the AIFMD to a specific pooling structure, the AFM should be addressed. [209] Due to the significant contribution of FGRs to the hedge fund sector in the Netherlands, the Dutch legislator should in my view clearly stipulate the extent to which FGRs will be regulated in order to prevent legal uncertainty.

6.3.2. Requirements for activities in the EU

The requirements applicable with regard to the management services passport following art. 33 of the AIFMD are implemented in art. 2:121d of the Bill. This article is for a Dutch manager that has his

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[200] See resp. art. 4:9, 4:10, 4:11 of the Bill.
[201] See art. 4:13 of the Bill.
[202] See art. 4:37 e of the Bill.
[203] See art. 4:37f of the Bill.
[204] See art. 3:72 and 3:74 of the Bill.
[205] See art. 3:18b of the Bill.
[206] See art. 3:57 and 3:72 of the Bill.
[207] See: http://www.hollandfinancialcentre.com/publications//HFC-Pocket-AlternativeInv4-SA_310512%20definitief.pdf
[208] See: http://www.esma.europa.eu/system/files/pf_response_to_esma_discussion_paper_key_concepts_of_the_alternative_investment_fund_managers_directive_and_types_of_aifm.pdf
[209] See p. 11 of the MvT.

registered office in the Netherlands and that intends to manage an investment institution established in another Member State. The authorization procedure that is stipulated in art. 2:121d is in accordance with art. 33 of the AIFMD. A remarkable aspect of the authorization requirements regarding the management activities, is that a manager that has obtained a license to manage a hedge fund in the Netherlands is also allowed to manage that same hedge fund outside the Netherlands with that same license, provided that the AFM notifies the competent authorities of the host Member State in advance.[210] Another remarkable aspect is that once the manager has completed the procedure for the first time with regard to a hedge fund established in another Member State, provided that the license allows the management of other hedge funds in that same Member State, the manager is not required to go through the same authorization procedure for the other hedge funds. The requirements applicable with regard to the marketing services passport following art. 32 of the AIFMD are implemented in art. 2:121c of the Bill and are in accordance with the requirements of the AIFMD. As a result, in order for a Dutch hedge fund manager to obtain a management services passport and a marketing services passport, he has to go through two separate authorization procedures with the AFM.

6.4. The 'light regimes' under the Bill

6.4.1. The current rules of exception and exemptions

The current rules of exception and exemptions to the applicability of art. 2:65 Wft has as its consequence that currently several hedge funds are not required to fulfill the authorization requirements and thus do not have to obtain a license in order to manage a hedge fund or issue units to investors. The exceptions to the applicability of the authorization requirements are with regard to hedge funds that offer units to less than 100 investors that are non-qualified/non-professional investors and/or to hedge funds that only offer units to qualified investors.[211] The Wft also provides two exemptions with regard to the authorization requirement. To the extent that the units can be acquired for a counterpart of at least €100.000 per participant or to the extent that the units have a nominal value of at least €100.000 per unit, the manager is exempted from the authorization requirements.[212] However, hedge funds that intend to make use of one of the exception rules or exemptions are required through the so called selling restrictions to provide a warning text in the issuance documents. The manager is hereby required to explicitly inform the investors that the fund is not subjected to supervisory regulation of the AFM and the DNB. This requirement however is not mandatory for managers that issue units to qualified investors.

[210] See p. 69 of the MvT.
[211] See art. 1:12(1) (a)(b) Wft.
[212] See art. 4(1) (a)(b) VrWft.

The AIFMD introduces the *de minimis* exemptions in art. 3 in which it states that managers whose assets under management in total do not exceed €100 million or € 500 million are exempted from the authorization requirements of the AIFMD. In case of the second threshold the *de minimis* exemption is only applicable if the portolio(s) under management are not financed through leverage and if the investors are not able to exercise their redemption rights during the first five years after the initial investment of each AIF. Consequently, the authorities of the home Member State are required to subject the vehicles that fall under *de minimis* exemption to registration requirements and reporting requirements under national law. However, managers that fulfill the *de minimis* exemption have a prospect to make use of the passport-rights in order to manage and market the vehicle freely across the EU, provided that they comply with the other requirements set in the Directive. This is referred to as the opt-in under the Directive.[213]

6.4.2. The light regime under the Bill for 'small' managers

The *de minimis* exemption set in the AIFMD will partially be implemented in the Wft in art. 2:66(a) Wft. Consequently, article 2:66a Wft will read as follow; *"(1) Article 2:65 shall not apply to a Dutch manager of an investment institution that: (a) directly or through a company with which it is connected by joint management, joint control or a qualifying shareholding, manages investment portfolios in which the total value of the assets under management (i) does not exceed €100 million or (ii) does not exceed €500 million. In the latter case the exemption is only applicable if the portfolio(s) under management are not financed through leverage and if the investors are not able to exercise their redemption rights during the first five years after the initial investment of each managed institution. This period start on the date that the investment institution acquires units from investors for the first time; (b) (i) offers units to a maximum of 150 persons ; (ii) in which the value of the units are at least €100.000 or (iii) can be acquired for a value of at least €100.000; (2) section b is not applicable to managers that merely offer units to professional investors (…)."*

Merely the exemption under section (1)(a) applies to managers of relatively smaller hedge funds. The rationale behind this exemption is that due to the size of assets they have under management, it is very unlikely they can create or contribute to systemic risks.[214] As a result, managers of smaller hedge funds are, after the implementation of the AIFMD, not required to obtain a license in order to issue units to professional investors. However, according to art. 2:66a (3), managers that fulfill the requirements of (1)(a) are required to report this to the AFM and should provide the AFM the necessary information with regard to the manager and the managed institutions. Moreover, the manager has to provide information to the DNB periodically with regard

[213] See art. 3(4) AIFMD.
[214] See p.59 of the MvT.

to the main assets he invests in and the main trading position of the investment institution. The exemption set in art. 2:66a is referred to as the 'light regime' for the reason that managers of hedge funds amongst others, will still have to fulfill notification requirements before they can manage and market a fund in the Netherlands. In case that the manager no longer falls under the light regime, then according to art. 2:66a (4) of the Bill, the manager has to notify this to the AFM and should submit an application for authorization within 30 days. The 30-days period starts on the date that the manager knows or ought to know that he no longer can fulfill the provisions of art. 2:66a. Once the manager has reported to the AFM that it no longer falls under the light regime and has sent an application form for authorization, it may continue his activities until the day that the AFM has decided on his application. In conclusion, although the managers of small hedge funds that fall under the light regime are not required to obtain an authorization from the AFM, they are however required to notify their activities and provide specific information to the AFM and the DNB in order that the authorities acquire an overview of the activities of small hedge funds.

I. The opt-in procedure for 'small' managers

The AIFMD provides in art. 3(4) the possibility for managers that fall under the *de-minimis* exemption to start an opt-in procedure in order to benefit from the passport rights of the Directive. The opt-in procedure is implemented in art 2:66a(5) of the Bill and stipulates that managers that choose to obtain the passport rights of the AIFMD are not required to notify their activities to the AFM according to art. 2:66a(3) and (4) of the Bill. Consequently, the managers are required to obtain a license based on art. 2:65 and fulfill the requirements set in art. 2:67, 2:67a and 2:68 of the Bill. [215]

My personal view in this regard is that, it seems that the Bill does not provide an explicit opt-in procedure for small managers. The rule of art. 2:66a(5) reads as follow: *"The third and fourth paragraph shall not apply to the Dutch manager of an investment institution that fulfills the requirement set in art. 2:66a(1) and who on an voluntary basis has acquired a license as referred to in art. 2:65."* This rule is not sufficiently clear as to the possibility for managers to opt-in the Directive. Due to the fact that the opt-in possibility is a significant element of the AIFMD for small hedge fund managers, this rule should be formulated more adequately in order to provide a clear understanding on the opt-in procedure.

6.4.3. The light regime concerning retail investors

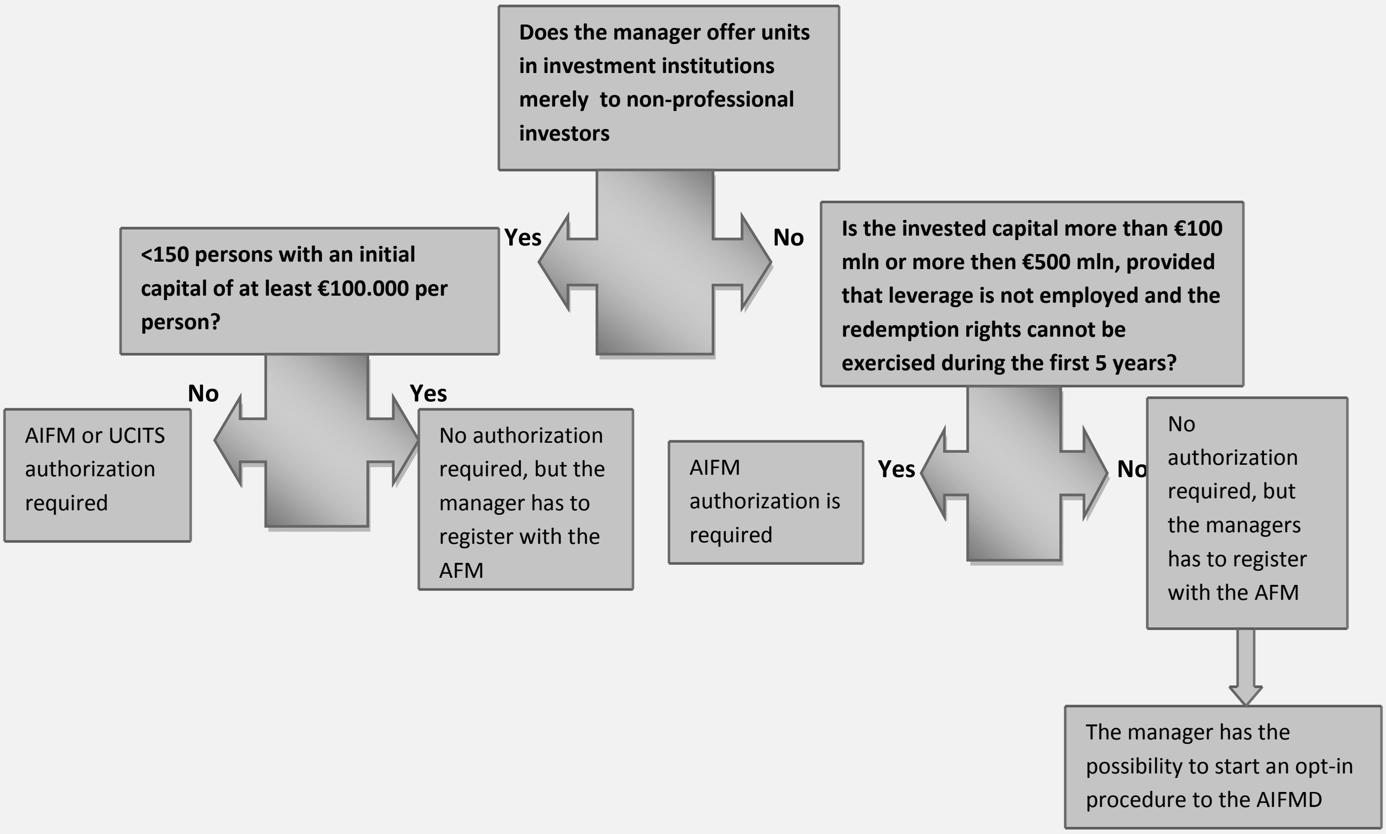
The AIFMD provides a level of maximum harmonization for managers of investment institutions that merely offer units to professional investors. Maximum harmonization relating to the AIFMD entails that the national rules should not deviate from the standards set in the Directive, thus expansions

[215] See p. 60 of the MvT.

and/or additions to the standards of the AIFMD are not allowed. On the other hand, the AIFMD provides a level of minimum harmonization for managers that offer units to retail investors.[216] Member States consequently are required to establish additional national rules for this particular group of investors.[217] In the consultation reactions on the proposal of the Bill, the legislator has decided that to the extent that investment institutions offer units to retail investors, the exemption of art. 2:66a Wft will apply.[218] Consequently, in case that units are offered to retail investors the hedge fund managers are required to fulfill the following conditions: (i) the units should be offered to a maximum of 150 persons; (ii) the value of the units should be at least €100.000; or (iii) the units can be acquired at a nominal value of at least €100.000. These conditions derive from the current exemptions under the Wft.[219] The only difference with the current situation is that in the new situation the exemptions are referred to as the 'light regime' due to the fact that the investment institutions that fall within these rules are not completely free from requirements. According to art. 2:66a (3) of the Bill, the manager that fulfills the conditions of art. 2:66a (1) and (2) is required to report this to the AFM. Moreover, the manager has to provide the necessary data which enables the AFM to identify the manager and the managed investment institutions and the manager should provide data on the investment strategies. The hedge fund manager should also provide the DNB information periodically on the financial instruments in which the manager trades, the risk exposures and the concentration of the managed investment institutions. The information that the DNB receives enables the DNB to monitor the extent in which the activities of the investment institutions can contribute to the occurrence of systemic risks.[220] In case that the manager does not fulfill the conditions that are set under the light regime, the manager is required to respect the authorization requirements that are applicable to manager that issue units to professional investors. Moreover, the manager has to comply with the requirements of art. 2:66a (4) of the Bill. According to art. 2:66(6), managers that offer units to retail investors are required to mention in the issuance documents that the manager is not subjected to ongoing supervision of the AFM and that the investment institution is unregulated. Thus, once a hedge fund manager offers units to retail investors, provided that he fulfills the requirements of the light regime, he is not required to obtain a license from the AFM. The manager however has to fulfill notification requirements and has to include a selling restriction in the issuance documents.

[216] See p. 7 of the MvT.
[217] See art. 43 AIFMD.
[218] See p. 31 of the MvT.
[219] See art. 1:12 (1)(a) and art. 2:74 (1)(a) and (b) Wft.
[220] See p. 60 of the MvT.

Figure 5. The 'light regimes' under the Bill



6.5. Effects of the authorization and notification requirements

One of the reasons for the small representation of the Dutch hedge fund industry in the global hedge fund industry is due to the fact that large investors such as pension funds are still reluctant to invest their capital in Dutch hedge funds. The relatively un-transparent nature of hedge funds and the fiduciary responsibilities of pension funds have as a result that these investors are naturally risk-adverse.[221] Consequently, the unregulated status of many hedge funds makes them inaccessible for institutional investors such as pension funds that prefer or are only allowed to invest in regulated funds. The mandatory authorization requirements for currently exempted hedge funds and the introduction of the light regimes can increase investor's confidence and provide incentives for reluctant investors to invest in hedge funds, which will stimulate the participation of investors in hedge funds and enhance the allocation of capital on the financial markets. Moreover, the authorization requirements ascertain that the quality of service providers is maintained, it ensures the protection of Dutch investors and other stakeholder and it provides tools for the AFM and the DNB to timely intervene in cases where the activities of hedge funds can contribute to systemic risk

[221] *Dutch hedge fund entrepreneurs struggle to be hard*. Available at: www.tradecapital.eu

on the financial markets.

On the other hand, the stricter supervision on the activities of hedge funds will lead to additional administration expenses and higher compliance costs for hedge fund managers. The extensive requirements that hedge fund managers will have to comply to, will oblige hedge fund managers to not only adapt their business operations in order to ensure that the requirements are met, but also to make additional cost that are related to the authorization or notification procedure. In this regard, the hedge fund manager will have to engage a compliance specialist, either internally through a compliance officer, or externally through a service provider, that will monitor whether the requirements of the Wft and the AIFMD are met.[222] Although the actual costs for hedge funds can only be determined accurately once the Level 2 Measures are definite and implemented in the Wft and subordinate rules, a rough estimation is available. According to the Explanatory Memorandum of the Bill, the cost associated with the authorization application amounts to €25.000 per hedge fund that is currently exempted. From that amount €5.000 is for the application procedure, €5.000 for the supervision of compliance by the AFM and €15.000 for legal services relating to the application. These costs are paid to the AFM, the DNB and the consultants involved in the authorization procedure. Hedge fund managers that are currently authorized and intend to continue their activities after 22 July 2014, will not need to obtain a new license after the Bill enters into force. The license will be converted into a license that fulfills the requirements of the Bill. However, if a currently authorized manager wants to obtain an European passport, then an application form should be submitted to the AFM before 22 July 2014 and the costs will amount to €10.000 per applicant. It is expected that the costs associated with the 'light regime' will merely amount to €5.000. The costs for the light regime include the costs concerning the notification requirements and the costs concerning the ongoing supervision. Furthermore, the EC still needs to elaborate further rules relating to the reporting requirements of art. 24 AIFMD that investment institutions have to comply with and rules relating to the requirements of the annual report. The outcome of this rules will influence the administrative costs of the hedge fund managers, and will more specifically lead to an increase of administrative costs for currently exempted hedge fund managers. Moreover, there are costs involved in order to adjust the business operations. These adjustments amount to €100.000 for a currently un-authorized manager, €50.000 for a currently authorized manager and €5.000 for a manager that will make use of one of the light regimes. In this context, the compliance cost will probably increase, especially for exempted hedge fund managers, since it is not clear how the managers will exactly have to fulfill the requirements relating to liquidity and risk management,

[222] See p. 28 of the MvT.

valuation of the assets, delegation, remuneration policy, capital, the depositary, leverage, disclosure requirements and the policy regarding conflict of interest.

Tabel A. The expected initial administration and compliance costs

Hedge Fund Manager	Administrative and compliance costs
Currently exempted hedge fund manager	€125.000
Currently authorized hedge fund manager	€60.000
Manager that fall under the light regime	€10.000

Moreover, after the manager is authorized he will face annual costs relating to the ongoing supervision of the compliance to the Bill. The extra costs relating to the ongoing supervision of the AFM and the DNB will amount to €9 million per year, which is a net increase of approximately €4 million. After the AIFMD is fully implemented in the Netherlands, the additional costs of ongoing supervision will be recharged to the investment institutions.[223] These expenses will eventually also be charged to investors and in consequence will lead to the participation in a hedge fund to be more expensive. In conclusion, although an accurate analysis of the costs and benefits that are associated with the supervision and the authorization requirements is not available, the additional costs related to the authorization and notification requirements may be disproportionate for especially start-up hedge funds compared to the benefits that can be obtained through the supervision.[224] In this regard, the Dutch legislator should provide financial incentives in order to reduce the transition costs and to stimulate their activities.

6.5. The depositary

The rules regarding the mandatory appointment of a depositary in art. 21 AIFMD are implemented in art. 4:37f of the Bill. According to art. 4:37f, *"A Dutch manager of an investment institution should ensure that the assets of the managed investment institution are kept with an independent depositary."* Moreover, according to art. 4:37h of the Bill the depositary shall be *"(i) a credit institution that has its registered office in the Union and is authorized according to the MIFID[225]; (ii)*

[223] See p. 27 t/m 30 of the MvT.
[224] See p. 31 of the MvT.
[225] The MiFID is a Directive relating to investment services in the EU and stands for 'Markets in Financial Instruments Directive' (2004/39/EC).

an investment firm that has its registered office in the Union and that (a) has a license that fulfills the requirements of art. 20(1) of Directive 2006/49/EC[226]*,(b) in which the ancillary services of safe-keeping and management of the financial instruments are for the benefit of clients (…), (c) the investment firm should have a minimum own equity in accordance with art. 9 of Directive 2006/49/EC; or (iii) another legal entity that meets the requirement set in the Wft with regard to the safe-keeping of assets of UCTIS-funds".* To avoid conflicts of interest, the Directive stipulates in art. 20(4)(a) that the manager cannot act as a depositary. According to art. 4:37f(1) of the Bill the Dutch legislator stipulates in this regard that the depositary should be independent, which includes that the manager may not also be a depositary. The rules relating to conflicts of interest are stipulated separately in the Bgfo pursuant art. 4:11 of the Wft. In this regard, the depositary is held liable to the (legal)persons for whom he keeps the assets, which are the participants and the investment institution. Hence, in the agreement between the manager and the depositary it should be stated that the contract is for the benefit of the investment institution and the participants.[227] As a result, if the depositary fails to fulfill his tasks, the investment institution and the participants can hold the depositary liable for breach of contract.[228] Furthermore, a significant aspect of the implementation of the AIFMD concerning the depositary is that according to art. 4:37j of the Bill the legal ownership of the assets of an investment fund will not be legally held by the depositary, but by an entity. This entity will solely hold the assets on behalf of the fund in case that, based on the investment policy of the fund, there is a real risk that the assets of the fund are insufficient to satisfy the claims of art. 4:37j(4) and the own equity of the vehicle will be insufficient for the fulfillment of such claims. According to art. 4:37j(4) the equity of the investment fund should solely be made available to pay the claims arising from (a) debts related to the management and the safe-keeping of the assets of the fund, and (b) participation rights. Article 4:37j is established to introduce a segregation of capital of the investment funds, which is in the current situation ensured through the appointment of a depositary. In conclusion, after the implementation of the AIFMD all regulated and registered hedge funds will be required to appoint a depositary for each managed hedge fund. The depositary is required to be an independent institution that is not related to the manager or the hedge fund. An exclusion in this regard is provided for a prime broker who acts as the counterparty of the hedge fund. In principle, the depositary functions are not allowed to be delegated to a prime broker, unless the independence of such a prime broker is secured through a functionally and hierarchically separation of the depositary functions and the tasks as primer broker, and if the potential conflicts of

[226] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006, on the capital adequacy of investment firms and credit institutions. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0201:EN:PDF
[227] This is referred to as the third clause under art. 6:253 of the Dutch Civil Code (DCC).
[228] See art. 6:74 of the DCC.

interest are properly identified, managed, monitored and communicated to the participants.[229] In contrast to the current situation, the depositary of the hedge fund should be one of the authorized institution stated in art. 4:37h and will not be the legal owner of the assets of the hedge fund. Furthermore, if the depositary fails to fulfill his tasks that are stipulated in the contract, the depositary can be held liable for breach of contract.

In my view, the description of art. 4:37f of the Bill should be more in line with the definition of art. 21 AIFMD which reads as follow; *"The manager shall ensure that for each managed investment institution a depositary is appointed".* In the Explanatory Memorandum it is stipulated that in addition to art. 4:37f, the manager has to ensure that for each investment institution a depositary is appointed.[230] This element is however not included in the current description of art. 4:37f. Thus, in order to prevent legal confusion, this specific requirement should be included in the description. Furthermore, in the description it is described that the depositary should hold the assets of the investment institution(s). It is however not specified in the Bill or in subordinated rules of the Wft including the Bgfo or the Bpr what the activities of the depositary after the implementation of the Directive will include. Thus, for an efficient implementation of the requirements relating to the function of the depositary, it is appropriate to provide a clarification in this regard. As a result, the description of art. 4:37f could read as follow;*"A Dutch manager of an investment institution should ensure that for each managed investment institution an independent depositary is appointed."*

7. Conclusion

There is much to say about the advantages that the hedge fund industry has for the financial markets in which they operate. The investment strategies that for the most part are based on hedging, long-short positions and arbitrage, not only leads to corrected market prices that reflects the fundamental value of financial assets, but it also contributes to a better allocation of the capital that circulates in the capital markets. Furthermore, the risk-seeking nature of hedge funds, in which they can take leveraged positions in order to invest in risky financial products which other financial institutions are unwilling or unable to invest in, leads to risky investment to be absorbed and better be diversified in the financial markets. Investors also benefit highly from the activities of hedge funds. The freedom hedge fund managers have to employ diverse investment strategies and asset classes not only leads to a continuous search of lucrative opportunities in order to create innovative financial products and strategies, but it also provides diversification benefits. As a result, the capital of investors is allocated efficiently which in addition stimulates market participation. These are just a few arguments why

[229] See p. 80 of the MvT. See in this regard also recital 43 of the AIFMD.
[230] See p. 80 of the MvT.

regulatory authorities should design policies that stimulate the activities of hedge funds.

However, there are two sides to every coin and so can the risk-seeking nature of hedge funds also expose financial markets and their participants to significant damage. The aim to obtain absolute returns regardless the market conditions can lead to high returns for investors, but it can also push hedge fund managers to take excessive risks in speculative investments which are not in line with the interest of investors. Moreover, the low level of transparency on the activities of hedge funds contributes to a weaker position of the investors and to an inefficient oversight of the activities that expose the financial markets to systemic risk. One can argue that as long as the volumes of trades are relatively small and that the capital that is invested derives from professional investors, then the involvement of the government should be minimal and the authorities should let the market regulate itself. Nonetheless, as the hedge fund industry expands across the national borders, and the interconnection of hedge funds with other financial institutions increases, so does the systemic threat calls for closer public assessment and an appropriate transnational approach.

A significant challenge in the creation of a regulatory and supervisory framework for the activities of hedge funds is to establish a balance between, giving hedge fund managers the freedom to provide their economical benefits to financial markets, while concurrently preventing any possibility of systemic risk that results from the failure of hedge funds. In this context, the AIFMD provides crucial tools in terms of activity and disclosure requirements in order to address the issues of investor protection and systemic risk. The question that arises however, is how successful the AIFMD and in this regard the Bill, can be in order to address these issues.

The most important implications of the AIFMD to the Dutch hedge fund industry is that as of 22 July 2013, the currently exempted managers will either have to obtain a license from the AFM and fulfill an extensive list of requirements in order to manage and market a hedge fund in the Netherlands, or have to register with the AFM and fulfill notification requirements in case they fall under one of the light regimes. Furthermore, after the implementation of the AIFMD all regulated hedge funds will be required to appoint an authorized depositary for each managed hedge fund and contrary to the current situation, the depositary will not be the legal owner of the assets of the hedge fund. Furthermore, the stricter supervision on the activities of hedge funds will lead to additional administration expenses and higher compliance costs for hedge fund managers. The extensive requirements that the managers will have to comply to, will oblige them to not only adapt their business operations in order to ensure that the requirements are met, but also to make additional cost that are related to the authorization or notification procedure. In this context, the compliance cost will probably increase, especially for the currently exempted hedge fund managers, since it is not clear how the managers will exactly have to fulfill the requirements relating to liquidity and risk management, valuation of the assets, delegation, remuneration policy, capital, the depositary, leverage, disclosure requirements and the policy regarding conflict of interest. Moreover, after the manager is authorized he will face annual costs relating to the ongoing supervision of the compliance to the Bill. All these expenses will eventually be recharged to investors and in consequence will lead to the participation in Dutch hedge funds to be more expensive.

In my view, the AIFMD is a significant measure in order to ensure a high level of transparency and quality of Dutch hedge fund managers and their activities. The mandatory authorization requirements for currently exempted hedge funds and the introduction of the light regimes can increase investor's confidence and provide incentives for reluctant investors to invest in hedge funds. This can stimulate the participation of investors in hedge funds and enhance the allocation of capital in the financial markets. Moreover, the authorization requirements provide tools for the AFM and the DNB to timely intervene in cases where the activities of hedge funds can contribute to systemic risk on the Dutch and European financial markets. Thus, the AIMFD can be an effective measure to reinforce the financial stability in the Netherlands. Nonetheless, the implementation of the AIFMD in the Bill still needs to be reviewed on specific elements in order to prevent legal confusion. The Dutch legislator should provide clarity on the activities of the manager and the depositary, and clarity on the opt-in procedure. Furthermore, the Dutch legislator should clearly stipulate the extent to which managers of hedge funds that employ a FGR structure, will be regulated and should obtain a license from the AFM. What is more, I doubt that the implementation of the Directive will enhance the activities of hedge funds in the Netherlands. Besides the extensive list of requirements Dutch hedge fund managers will have to comply to in order to manage and market a hedge fund in the Netherlands, the extensive additional costs might be disproportionate as to the benefits that will be acquired through the regulation. Smaller managers will face higher barriers for entry into the Dutch hedge fund market and the costs for participation in hedge funds will increase. In this regard, the Dutch legislator should provide financial incentives in order to reduce the transition costs and to stimulate the activities of hedge fund managers.

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