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ARTICLE

A FAILED ATTEMPT TO PROTECT HEDGE FUND INVESTORS? AN INQUIRY INTO THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

Mariia Domina Repiquet†

ABSTRACT

Historically, hedge funds operated in a 'legislative vacuum', i.e., they were structured in such a way so as to avoid falling within the scope of any regulatory perimeter. Hedge funds were designed as an exception to the rules, usually applicable to retail investment funds. This was achieved by offering their units to professional investors only, who were deemed to possess necessary skills and investment experience to protect their own interests, without the need for any additional legislative interference. The last financial crisis, in 2007-08, has shown the weaknesses of this approach.

The Alternative Investment Fund Managers Directive of 2011 is the first pan-European attempt to regulate the hedge fund industry. It aims to create an internal market for hedge fund managers, prevent systemic risks and protect fund investors.

This paper discusses the duties of a hedge fund manager—conduct of business rules—set forth in the Directive as a mechanism to protect investors. These duties form part of the regulatory law, i.e., they establish a relationship between a hedge fund manager and a national regulatory authority. The breach of hedge fund manager's duties does not give a private right of action, meaning neither a fund nor its investors can bring a claim directly against a hedge fund manager. These breaches are actionable by a national regulatory authority and lead to administrative sanctions.

This paper analyzes the interrelationship between regulatory law and private law related to hedge fund manager's duties in the United Kingdom, France, and Luxembourg. It argues that the mechanisms of private law—agency and contract law—are better suited to protect interests of hedge fund

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investors, by allowing either a fund or its investors to bring a claim in either contract, tort, or both, for the breach of hedge fund manager's duties. The Directive thus fails to a create an appropriate mechanism for the protection of investors, as compared to the concepts of private law.

I. INTRODUCTION

The history of hedge funds dates back to the mid-1960s.[1] The first hedge fund was established by Alfred Jones, who used a combination of short-selling and leveraging to significantly outperform existing mutual funds.[2] Despite the wide prominence of hedge funds, there is no agreed statutory definition of this term. This is explained by the fact that, historically, they operated outside of the regulatory perimeter. These funds were often defined by what they are not, rather than by what they are.[3]

In essence, a hedge fund seeks to generate profits in all market conditions.[4] Traditional retail funds aspire to be as profitable as a benchmark index (e.g., S&P 500). Conversely, hedge funds look for absolute profits, for example, non-correlated with an overall market volatility. In order to achieve this objective, they employ sophisticated investment strategies with a heavy use of leverage and short-selling.

Hedge funds are often accused of endangering the financial system.[5] They account for a significant portion of trading activity in financial markets and thus represent an important counterparty risk to other market participants, e.g., banks, brokers and clearing houses. In addition, the hedge fund scandals (Lehman Brothers insolvency and Madoff affair) have led the EU legislators to argue that hedge fund investors require stronger regulatory protection.[6]

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1. The term 'hedge fund' first appeared in *The Jones Nobody Keeps Up With*, by Carol Loomis. *See* Carol J. Loomis, *The Jones Nobody Keeps Up With,* FORTUNE (2015).

2. Over the previous ten years, Jones' hedge fund had outperformed mutual funds by 87%. *Id.*

3. Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

4. DICK FRASE & PETER ASTLEFORD, HEDGE FUNDS AND THE LAW 2 (2d ed. 2016).

5. *See generally* Tomas Garbaravicius & Frank Dierick, *Hedge Funds and Their Implication for Financial Stability*, EUR. CENTRAL BANK OCCASIONAL PAPER SERIES 34 (2005).

6. Suggested protection includes particularly the need to introduce a depositary requirement for each hedge fund. *See*, *e.g.*, Petty Hollinger, et al., *Luxembourg Decries French Madoff Claims*, FINANCIAL TIMES, Jan. 13, 2009, https://www.ft.com/content/111d2388-e1ab-11dd-afa0-0000779fd2ac (last visited March 3, 2018); *Consultation Paper on Hedge Funds*, COM (DG Internal Market), http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/ consultation_paper_en.pdf; *Consultation Paper on the UCITS Depositary Function and on the UCITS Managers' Remuneration*, COM (DG Internal Market and

In order to protect the investors and financial markets from the perceived threats hedge funds may pose to them, the EU has adopted the Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers OJ L174/1 (hereinafter 'AIFMD'). This paper discusses one of the objectives of this Directive – a protection of investors. In doing so, this Article will study the conduct of business rules to which the hedge fund managers must adhere under the Directive. It is suggested that the AIFMD has largely failed in establishing an effective mechanism for the protection of investor's interests. Regulatory law does nothing to ensure that either investors or a hedge fund itself can bring an action against a hedge fund manager. The mechanisms available in private law prior to the AIFMD are much more effective in protecting the investors, since they provide for a private right of action in tort and for breach of contract.

II. ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

Prior to the 2007-08 financial crisis, hedge funds and their managers were not subject to any specific European regulatory law. The AIFMD was thus the very first European attempt to harmonize the alternative investment industry. It has three objectives: (1) establishment of a single market for alternative investment industry within the EU; (2) prevention of systemic risk; and (3) protection of investors.[7] José Manuel Barroso, the President of the European Commission at the time of the adoption of the AIFMD, has stated as follows:

> The adoption of the directive means that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system.[8]

The AIFMD regulates the alternative investment fund managers (hereinafter 'AIFM') and not the alternative investment funds (hereinafter 'AIF') *per se*. This regulatory choice is mainly explained by two reasons: (1)

Services) (2010), http://ec.europa.eu/finance/consultations/2010/ucits/docs/consultation_paper_en.pdf.

7. Directive 2011/61, of the European Parliament and of the Council of June 8, 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, 2011 O.J. (L 174) 1 [hereinafter AIFMD].

8. European Commission Press Release MEMO 10/573, Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity (November 11, 2010, MEMO/10/573).

the array of legal forms that investment funds can take is very diverse across the Member States and is rather difficult to harmonise;[9] and (2) the legislators are slow to catch up with the developments in financial products and instead they should focus on the service provider who is responsible for managing and marketing these products.[10]

In order to understand the significance and the nature of the AIFMD, a short inquiry into the concept of the EU law is very helpful.

A. *The Directive as EU Law*

One of the objectives of the EU Law is to establish a single European market.[11] In order to achieve this goal, EU Law is based on a set of principles that include, *inter alia*, the primacy of the EU Law, proportionality, "full effectiveness, legal certainty, and effective judicial protection."[12]

The primacy of EU Law is an overriding principle that underpins all of the primary and secondary legislation in the Union, as well as the case law of the European Court of Justice (hereinafter ECJ). This principle has been established in *Costa v ENEL*.[13] It implies that the EU Law (whether a Treaty, a Directive or a Regulation, amongst others) has an absolute and unconditional precedence over the national law. As such, conflicting national law provisions should be set aside. For the purposes of this Article's analysis, two instruments of the EU Law—a Regulation and a Directive—will be discussed.

The EU Regulation does not require implementation into national law and, as such, it is directly binding in all the EU Member States.[14] It unifies the law of the EU Member States. The use of regulations ensures that a particular legal relationship is identical in all Member States, thus leaving no room for any legislative discretion (unless directly allowed by the Regulation).

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9. AIFMD, *supra* note 7, at 2.

10. THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE 120 (Dirk A. Zetzsche ed., 2015). The author discusses this approach with regards to the individual portfolio management. The same conclusion can be reached with regards to the AIFs.

11. Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1, 24.

12. SACHA PRECHAL, DIRECTIVES IN EC LAW 81 (2d ed. 2005).

13. Costa v. ENEL, Case 6/64, 1964 E.C.R. 587, 593-95.

14. Consolidated Version of the Treaty on the Functioning of the European Union, art. 288, 2012 O.J. (C 326) 47, 171.

The EU Directive harmonizes national laws in a particular area of legal relationships.[15] A directive is not directly binding and requires an implementation/transposition into the national law. It prescribes the objectives and results to be achieved but allows the Member States to decide how to achieve them.

One of the objectives of the Union is to establish a single EU market. A single market enables the exercise of the three fundamental freedoms: freedom to provide services, freedom of establishment and free movement of capital. The objectives of the AIFMD are "[to] establish[] common requirements governing the authorization and supervision of AIFMs"[16] and "to provide for an internal market for AIFMs and a harmonized and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs."[17] It grants an EU passport to hedge fund managers to provide their services within the Union (freedom to provide services), establish their branches in any Member State (freedom of establishment) and invest in the assets across the Union (free movement of capital).[18]

After the 2007-08 financial crisis, there has been a gradual shift from the Directives to the Regulations. This is mainly explained by the fact that the Regulations are directly binding upon the Member States and thus bring more legal certainty. For example, the AIFMD is supplemented by the "Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 . . . with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision."[19] It follows that the operating conditions of hedge fund managers – a scope of this paper – are unified across all the Union.

The Directives are often divided into the minimum or maximum harmonization legal instruments. Veil defines the two concepts as follows:

> Maximum harmonization describes the concept under which the legislative order of a provision is exclusive, i.e. allowing no deviations from its content in the Member States' national laws . . . . Minimum harmonization may be assumed in cases in which

15. EUROPEAN CAPITAL MARKETS LAW 36 (Rüdiger Veil ed., 2017).

16. AIFMD, *supra* note 7, at 1.

17. *Id.*

18. *Id.* at 2, 34, 54.

19. *See* Commission Delegated Regulation (EU) 231/2013 of Dec. 19, 2012, 2013 O.J. (L 83) 1.

> the provision only contains minimum requirements that must be met by the Member States and may be exceeded.[20]

In order to determine the overall spirit of the Directive, due regard should be paid to the Recitals that often describe the legislator's objective to combat regulatory arbitrage and to create a single market. These objectives signify a maximum harmonization. It follows from the Recitals of the AIFMD that it is a maximum harmonization legal instrument.

Rather often than not, a maximum harmonization Directive may contain minimum harmonization provisions. For example, the Article 15(3)(a) AIFMD provides that "AIFMs shall at least . . . implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF."[21] The use of "at least" implies that the Member States may impose stricter conditions on AIFMs with regards to risk management.

B. Duties of Hedge Fund Managers Under the Directive

In order to provide the safeguards for the investor's interests, the Directive imposes a set of the duties on hedge fund managers. They can be classified under the following headings: (i) authorization requirements; (ii) operational requirements; (iii) organization requirements, (iv) delegation; and (v) transparency obligations. This paper analyses the operational requirements represented by the conduct of business rules as transposed into the national regulatory law. Conduct of business rules lay down the standard of the behaviour to which a hedge fund manager must adhere. These rules are deemed to represent the most important safeguard of investor's interests under the Directive.

Conduct of business rules are listed in the Article 12 AIFMD and include an obligation to "act honestly, with due skill, care and diligence and fairly . . . act in the best interests of the AIFs or the investors of the AIFs . . . avoid conflicts of interests and . . . treat all AIF investors fairly."[22] For the sake of legal certainty, these duties may be referred to as "a duty of care and skill." According to the AIFMD, the Commission Delegated Regulation shall specify which conditions should be taken into account to assess whether an AIFM acts with due care and skill.[23]

Article 21 of the Commission Delegated Regulation details these obligations in the following manner:

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20. EUROPEAN CAPITAL MARKETS, *supra* note 15, at 54.

21. AIFMD, *supra* note 7, at 25.

22. *Id.* at 23.

23. *Id.* at 25.

> In order to establish whether an AIFM conducts its activities honestly, fairly and with due skills, competent authorities shall assess, at least, whether the following conditions are met:
>
> (a) the governing body of the AIFM possesses adequate collective knowledge, skills and experience to be able to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the AIF is invested;
>
> (b) the members of the governing body commit sufficient time to properly perform their functions in the AIFM.
>
> (c) each member of the governing body acts with honesty, integrity and independence of mind;
>
> (d) the AIFM devotes adequate resources to the induction and training of members of the governing body.[24]

Let us recall that the Regulation has a direct binding force and as such, it is directly applicable in all Member States. The use of "at least" signifies that the Member States are allowed to impose stricter conduct of business rules on the AIFMs authorized in their jurisdiction.

This Article will assess the components of the conduct of business rules under the Directive below. The purpose of this analysis is to dissect the standard of behaviour that hedge fund managers should adhere to in order to benefit from an EU passport to manage and market hedge funds to the EU investors.

1. The Duty to Act Honestly, with Due Skill, Care and Diligence and Fairly in Conducting Their Activities

This requirement has a rather abstract meaning, which calls for some additional precision as to what it practically entails. Acting honestly should be understood both as not seeking after a hidden benefit or a profit, whether material or immaterial, and as not withholding any important information from the fund and its investors. Acting with due skill, care and diligence should mean acting as a "reasonable AIFM." In order to determine what this criterion particularly believes, particular attention should be given to the best-practice codes used within the AIF industry: the

24. Commission Delegated Regulation (EU) 231/2013 of Dec. 19, 2012, art. 21, 2013 O.J. (L 83) 1, 26.

Association of Alternative Investment Management. It is important to note that in the UK and Luxembourg, a standard of care used to establish negligence in tort has no influence on the standard of care applied for regulatory purposes. As such, the case law of these two jurisdictions gives no indication for the statutory content of the duty of care. Acting fairly should mean to refrain from jeopardizing the interests of the fund and its investors, to treat each investor equally, and to avoid any preferential treatment.

2. The Duty to Act in the Best Interests of the AIFs or the Investors of the AIFs they Manage and the Integrity of the Market.

Recital (12) AIFMD states that the best interests of investors refers to their status as investors of the fund, and not to their "individual interests."[25] The interests of investors should be understood as the interests of their totality, not as separate investors. The Implementing Regulation provides that the AIFMs must ensure the prevention of malpractice, like "market timing or late trading," and to avoid applying "undue costs" to investors.[26] More generally, acting in the best interests of investors implies pursuing the interest of the investors of the fund, and not those of the fund manager. The reference to the interests of the AIFs or the investors of the AIFs is applicable to situations where a fund does not have a separate legal personality. For example, in Luxembourg, a hedge fund constituted as a common fund (*fonds commun de placement*) does not have a separate legal personality. It may be structured without any governing body and as such, it is represented by an ensemble of investors. Luxembourg law directly allows the investors to bring a claim against a hedge fund manager on behalf of the fund that is structured as a common fund.

3. The Duty to Prevent and Disclose the Conflicts of Interests

The Article 14(1) AIFMD requires that the AIFM takes necessary measures to identify, manage, disclose and avoid conflicts of interests between the fund manager and the investors of the fund. This requirement is not new since the UK hedge fund managers were subject to the same requirement before the introduction of the Directive.

In Luxembourg, any preferential treatment is prohibited by law. This is so because investment management is based on the equal treatment of

25. AIFMD, *supra* note 7, at 3.

26. Commission Delegated Regulation (EU) 231/2013 of Dec. 19, 2012, 2013 O.J. (L 83) 1, 5-6.

investors (of the same type/category). [27] The use of side letters is a common practice to accord similar or additional rights to the investors. This is especially the case for hedge funds, where the investors with the highest capital stakes may require additional rights, like more frequent disclosure. In order to comply with the principle of equal treatment, the side letter should be written in a manner that preserves the similar rights of the same category of investors. For example, in the case of investors with comparable stakes, they should be treated equally and be afforded similar rights amongst themselves. However, their rights may differ from the smaller investors, who are a different category of shareholders. A most-favoured-nation clause is also frequently employed, which stipulates that the forthcoming investors of the fund will have the same rights as existing investors. It is submitted, therefore, that the management of the conflicts of interests is already well regulated on the level of national law.[28]

4. The Duty to Treat Investors Fairly

An AIFM should ensure that its organizational framework and decision-making procedures provide a fair treatment of investors. It is a prerequisite that any preferential treatment given to one investor is disclosed to a totality of the other investors in the fund. This may result in the most-favoured-nation clause. Non-preferential treatment means the equal treatment of investors; however, some investors may be treated differently than others. The prerogative rights may include, among other things, more frequent reporting. Once properly disclosed to the rest of AIF's investors, this will not constitute preferential treatment.

In addition, the AIFM must comply with the provisions listed in Article 24 of the Implementing Regulation, as to how an inducement can potentially impair the degree of due skill, care, and diligence required from an AIFM. It states that the hedge fund manager should not accept any inducement from a third party that may lead to the undermining of the investor's interests.[29]

To conclude, the conduct of business rules under the AIFMD are rather general and vague, which were already adhered to by the hedge fund managers before the Directive.

27. LODEWIJK VAN SETTEN & DANNY BUSCH, ALTERNATIVE INVESTMENT FUNDS IN EUROPE: LAW AND PRACTICE 154 (2014).

28. *Id.*

29. Commission Delegated Regulation (EU) 231/2013 of Dec. 19, 2012, art. 24, 2013 O.J. (L 83) 1, 27.

C. Sanctions for the Breach of the Duties under Directive

No duty is effective if there is no sanction for its breach. The transposition of the EU Directive includes not only modifying the national substantial law but also creating procedural conditions for their enforcement. The AIFMD provides that "Member States should lay down rules on penalties applicable to infringements of this Directive and ensure that they are implemented. The penalties should be effective, proportionate and dissuasive."[30] In addition, following the reasoning of the European Court of Justice in *Von Colson*, the penalties should ensure effective judicial protection and have a deterrent effect.[31]

Interestingly, the sanction regime under the AIFMD differs from the other EU Directives in financial markets law. For example, Directive 2014/65/EU of 15 May 2014 and Directive 2014/91/EU of 23 July 2014 detail administrative penalties and criteria for imposing additional criminal sanctions under national law for breach of their rules.[32] This regulatory choice is based on the Article 83(2) TFEU, which allows introducing criminal sanctions in the areas harmonized by the EU legislation.[33] While the AIFMD requires the remedies to be effective, proportionate and dissuasive, it offers no further guidance on how to achieve such remedies.[34] Effective sanctions should remedy any faulty behaviour, so as to achieve a sense of overall order desired by EU Law. In the case of the AIFMD, this should mean that any breach of conduct of business rules by hedge fund managers should be penalized in such a manner to restore the desired level of investors' protection. In addition, the remedies should guarantee effective judicial protection, which means that the procedural aspects for bringing a claim under the EU law (as transposed into national law) should not be less favourable than the ones for breaches of the national law. The

30. AIFMD, *supra* note 7, at 11.

31. *See* Von Colson and Kamann v. Land Nordrhein-Westfalen, Case 14/83, 1984 E.C.R. 1891.

32. Directive 2014/65/EU, of the European Parliament and of the Council of 15 May 2014 on Markets In Financial Instruments and Amending Directive 2002/92/EC and Directive 2011/61/EU, art. 70, 2014 O.J. (L 173) 349, 455-460; Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 Amending Directive 2009/65/EC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) as Regards Depository Functions, Remuneration Policies and Sanctions, art. 1, 2014 O.J. (L 257) 186, 205-207.

33. Consolidated Version of the Treaty on the Functioning of the European Union art. 83, May 9, 2008, 2008 O.J. (C 115) 80-81 [hereinafter TFEU].

34. *See generally* AIFMD, *supra* note 7, at 40.

remedies should be proportionate to the offense committed and specify, where possible, the lower and the upper limits of the sanctions to be imposed. [35] Furthermore, the remedies should be dissuasive, preventing further breaches of the EU law. This objective can be achieved by public shaming—making public the administrative decisions taken against fund managers—which deters other market players from committing the same breaches.

III. INTERPLAY BETWEEN REGULATORY AND PRIVATE LAW

The previous part of this Paper has discussed the underlying objective of the AIFMD, which is creating a single EU market for hedge fund managers in order to protect investors' interests. This objective is mainly achieved by the introduction of conduct of business rules that hedge fund managers should obey. The AIFMD is a regulatory law, which regulates the relationship of the AIFM with a national regulatory authority.[36] Thus, it is not primarily concerned with regulating the relationship between a fund manager and investors. Regulatory rules do not allow either a fund or a fund investor to bring a claim against the hedge fund manager. The question then arises as to how investors can protect their interests when hedge fund managers breach regulatory rules. In other words, what is the interplay between regulatory law and private law liability? This paper will answer these questions based on the approach of English law. The date of Brexit – exit of the UK from the EU – is currently fixed on 29 March 2019. As such, before its exit from the Union, the UK remains one of the most business-friendly EU jurisdictions. It is thus both theoretically and practically interesting to assess under English Law how hedge fund investors can protect their interests if a hedge fund manager fails to perform his duties with due care and skill.

A. *English Law Approach*

In the UK, the AIFMD has been transposed by the Alternative Investment Fund Managers Regulations of 2013. Its provisions form part of the FCA Handbook rules, which represent national regulatory law in the area of financial services. According to the English law, a breach of financial services regulatory rules may give rise to a claim for damages only when the

35. PRECHAL, *supra* note 12, at 91.

36. BUSCH, *supra* note 27, at 13.

statute directly allows.[37] The breaches of the FCA rules are dealt with in the Financial Services and Markets Act 2000; the only ground for bringing a claim for the breach of the FCA rules is under section 138D of FSMA. It states the following:

> (1) A rule made by the PRA (the Prudential Regulation Authority) may provide that contravention of the rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.
>
> (2) A contravention by an authorised person of a rule made by the FCA [Financial Conduct Authority] is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.
>
> (3) If rules made by the FCA so provide, subsection (2) does not apply to a contravention of a specified provision of the rules.
>
> (4) In prescribed cases, a contravention of a rule which by virtue of subsection (1) or (2) would be actionable at the suit of a private person is actionable at the suit of a person which is not a private person, subject to the defences and other incidents applying to actions for breach of statutory duty.
>
> (5) In subsections (1), (2) and (3) "rule" does not include . . . (a) Part 6 rules; . . . (b) rules under section 137O (threshold condition code); . . . (c) rules under section 192J (provision of information by parent undertakings); . . . (d) a rule requiring an authorised person to have or maintain financial resources.
>
> (6) "Private person" has such meaning as may be prescribed.[38]

"Private person" is then defined in the regulation 3 of the FSMA Regulations 2001 as "any individual, unless he suffers the loss in question in the course of carrying on . . . any regulated activity . . . or . . . any person who is not an individual, unless he suffers the loss in question in the course

37. GERARD MCMEEL & JOHN VIRGO, MCMEEL AND VIRGO ON FINANCIAL ADVICE AND FINANCIAL PRODUCTS 414 (2014).

38. Amendments of Financial Services and Markets Act 2000, cl. 2, § 138D, sch. 6 (Eng.)

of carrying on business of any kind."[39] "Carrying on a regulated activity" implies acting as a professional in financial markets. The AIFMD, aimed at regulating alternative investment funds that are designed for professional investors, does not give rise to any private right of action under English law for the breach of conduct of business rules.

Furthermore, at the first sight, this definition of "private person" makes it clear that any individual not carrying on a regulated activity has a private right of action. In *Sivagnanam v. Barclays Bank Plc*, a claim was brought under section 138D by a sole shareholder and director, Mr. Sivagnanam, for his loss from mis-selling of interest rate hedging products to his company.[40] Cooke, J., held that the shareholder did not fall within the category of persons, whose interests the UK legislator intended to protect, as a matter of interpretation. Even though the shareholder was considered to be a "private person," his interests were not intended to be protected by the Statute. The alleged breaches of the COB rules were pleaded with reference to the loss of the company only; there was no claim that the bank breached its duty of care owed personally to a shareholder. As such, the personal interests of Mr. Sivagnanam were not intended to be protected by the statute in this situation.[41] It follows that even when a claimant falls within the category of a "private person," a case-by-case assessment is necessary to determine whether his particular interests were intended to be protected by the Parliament.

Sivagnanam case raised another issue related to a reflective loss. The principle of reflective loss, established in *Johnson v. Gore Wood*,[42] states that a shareholder cannot sue for damages for that shareholder's loss which is reflective of the loss of the company, if a company can itself claim damages for that loss.

Therefore, since hedge fund investors are professional investors, they do not fall within the category of "private persons." In addition, a doctrine of reflective loss will prevent a hedge fund investor from suing a hedge fund manager for the losses of the fund. But, Section 138D does not seem to allow a fund to initiate proceedings against the fund manager. To add to the complexities of the situation, a standard of care required to prove the negligence of the hedge fund manager in tort does not take into account the

39. Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, SI 2001/2256, ¶ 3.

40. Sivagnanam v. Barclays Bank Plc [2015] EWHC 3985 (Comm).

41. *Id.*

42. *See generally,* Gardner v. Parker [2004] EWCA (Civ) 781 (discussing the findings in *Johnson v. Gore Wood & Co. [2002] A.C. 1, 19).*

standard of care established by the regulatory rules. As such, under UK law, the possibility for investors (or even a hedge fund itself) to make effective use of the conduct of business rules under the AIFMD is non-existent. However, the breach of regulatory rules could lead to a revocation or suspension of the hedge fund manager authorization by the Financial Conduct Authority.

B. Leeway Under the AIFMD to Impose Stricter Duties

It has been mentioned above that one of the objective of the AIFMD is to create a single EU market for AIFMs. This implies that hedge fund managers should be held to the same conduct of behaviour across all EU Member States. Nevertheless, a careful analysis of the AIFMD and the Commission Delegated Regulation proves the contrary. Both the Directive and the Regulation allow the national legislator to apply a stricter standard of the duty of care to the hedge fund managers. A frequent use of the wording "at least" in the Directive and Regulation provides a legislative leeway for the national discretion.

Further possibilities to introduce stricter requirements relate to the retail hedge funds. The AIFMD is centered on those who manage the funds that are offered to professional investors. The Member States are allowed to impose stricter conditions on those fund managers that offer hedge fund units to retail clients. This is because retail clients do not possess the necessary knowledge and experience to assess the investment risks of hedge funds, and thus require a higher standard of a regulatory protection. The UK did not introduce stricter rules for the hedge funds aimed at retail clients. In contrast, the French legislature has imposed the same level of the conduct of business rules on hedge fund managers offering their securities to retail clients as is imposed on all French investment funds offered to the general public.[43]

This regulatory choice raises several questions. The ECJ decision in *Von Colson* [44] highlighted the fact that national courts are required to interpret and apply national rules, adopted under the Directive, in accordance with its spirit. This is referred to as a principle of consistent and uniform interpretation. In the situations involving AIFMs, national courts will be obliged to interpret and apply relevant national law provisions in the spirit

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43. Procedure de Commerecialisation de FIA en France, art. L214-24-1 *et. seq.*, https://www.legifrance.gouv.fr/affichCode.do?idArticle=LEGIARTI000028441432&idSectionTA=LEGISCTA000027763990&cidTexte=LEGITEXT000006072026&dateTexte=20180320.

44. *See* Von Colson and Kamann v. Land Nordrhein-Westfalen, Case 14/83, 1984 E.C.R. 1891.

of the AIFMD, which is aimed toward the creation of a single European market for AIFMs. Furthermore, this principle is not only relevant for the courts, but also for all regulatory authorities, as a more general obligation of the national legislator. By exercising discretion under the Directive to impose additional duties on the AIFM where allowed, legislators in each Member State should adhere to the objectives of the Directive. It is indeed not only the exact wording of the Directive that should be considered but also its general purpose; the interpretation should be purposive.[45] Any national rule that is based on the AIFMD should be purposively interpreted in terms of achieving a single market and efficient supervision of AIFMs. A single market objective requires an establishment of comparable, but not identical, conditions for the authorization and operation of AIFMs across the Union. In this case, imposing stricter rules on AIFMs in one Member State will undermine that objective.

Furthermore, the application of stricter requirements on hedge fund managers that manage retail hedge funds undermines the single market rationale when a hedge fund manager simultaneously manages several funds. For example, in case of a hedge fund structured as an "umbrella fund," each sub-fund has a different client base. However, these sub-funds are managed by the same manager and constitute the same fund structure. In this case, imposing different requirements on the same person and the same fund structure can lead to a regulatory arbitrage, by structuring operations in another jurisdiction with more lenient regulatory requirements or adopting another fund design to avoid regulatory constraints.

What happens if an AIFM is established in a Member State (the AIFM's home State) with less stringent requirements, but it operates in another jurisdiction (the AIFM's host State) that has a stricter approach? For example, the host State may prohibit the creation of side pockets, which are segregated accounts where risky assets are placed and which keep investors from redeeming their shares in full until those assets are sold. However, side pockets may be allowed under the law of the home State. If an AIFM is duly authorized in its home State and has an EU passport to manage and market AIFs, the host State should not impose stricter requirements on it than those imposed in the States where the AIFM is authorized to operate. Even though the theoretical answer seems straightforward, this may still pose practical problems as to the determination of the precise regulatory perimeter to which an AIFM should adhere.

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45. PRECHAL, *supra* note 11, at 184.

It follows that the AIFMD has largely failed in its attempt to create a single market for the AIFMs and ensure the protection of investors. The subsequent part of this Article will show that the existing mechanisms under national law, even prior to the Directive, have already provided sufficient mechanisms for the investor's protection.

IV. PRIVATE LAW SAFEGUARDS OF INVESTOR'S INTERESTS

This part analyzes two legal concepts that apply to a hedge fund under private law: agency law and contractual freedom. In my view, they provide sufficient safeguards for hedge fund investors and explain the limited success of the AIFMD.

A. Hedge Fund Manager as an Agent of the Fund

In an agency relationship, an agent has a power to create a legal relationship for his principal vis-à-vis third parties. While an agency relationship may arise as a matter of law, it usually arises in a contractual relationship.[46] Lord Browne-Wilkinson observes, "agency is a contract made between principal and agent . . . like every other contract, the rights and duties of the principal and agent are dependent upon the terms of the contract between them, whether express or implied."[47]

It follows that an agent has duties and responsibilities towards his principal and not the third parties, due to the principle of the privity of the contract. Thus, a hedge fund manager has duties towards a hedge fund and not its investors. This is consistent with the approach of the AIFMD as transposed into the national regulatory law. What duties does an agent have towards its principal? According to *Bowstead and Reynolds on Agency*, "the agent owes to the principal . . . a duty to use due diligence, or, if appropriate, his best endeavours to achieve the result required. . . . [T]his is . . . a feature of a contract for services . . . ."[48]

This duty is an overriding feature of any agency relationship and is very much consistent with the duty of care as established under the AIFMD. All other duties of an agent follow from his obligation to use his best endeavours to achieve the results required by his principal. This Article will

46. Scott v. Davis, [2000] 204 C.L.R. 333, 367 (Austl.) (citing *Int'l Harvester Co. of Australia Pty Ltd. v Carrigan's Hazeldene Pastoral Co.* [1958] 100 C.L.R. 644, 652).

47. Kelly v. Cooper, [1993] A.C. 205 (P.C.) (appeal taken from Bermuda).

48. PETER WATTS & F.M.B. REYNOLDS, BOWSTEAD & REYNOLDS ON AGENCY 8 (20th ed. 2014).

analyze these duties in the light of their resemblance to the requirements set forth in the AIFMD.

First, there is a duty to act according to the contract between an agent and a principal. In an agency relationship between an AIFM and AIF, an AIFM is obliged to act within the scope of his authority as established under the service agreement. For example, if a fund is structured as a hedge fund, an AIFM does not have the right to invest the AIF's assets into the illiquid assets, which are usually in the scope of private equity funds. This is explained by the fact that the majority of hedge funds are structured as open-ended funds, such that investors should be able to redeem their shares at a short notice. An investment into illiquid assets may prevent the investors from exercising their redemption rights. Nevertheless, the fund's foundational documents may contain a restriction on redemption. In this case, a hedge fund manager should carefully assess the terms of a service agreement in order to act within his authority.

Second, there is a duty to comply with the further instructions of the principal. The principal has a control over the agent's authority, in that the principal can grant, limit or revoke that authority. Consequently, an agent is under an obligation to comply with the further instructions of his principal to maintain his authority.

Third, an agent owes a duty of care to its principal in exercising its duties. He is under an obligation:

> [T]o exercise such skill, care, and diligence in the performance of his undertaking as is usual or necessary in or for the ordinary or proper conduct of the profession or business in which he is employed, or is reasonably necessary for the proper performance of the duties undertaken by him.[49]

This is almost identical to the conduct of business requirements laid down in the Article 12 of the AIFMD. However, while there is no right of action for breach of the regulatory law, a breach of an agency obligation creates two possible grounds for action. The principal can claim damages for the breach of contract, and if there is a negligence involved, he can also claim damages in tort.

Bowstead and Reynolds on Agency[50] notes that the claim in tort may be more advantageous in terms of the limitation period. In contract, the period for bringing up an action starts from the moment of the breach. In tort, such period starts from the moment when damage was suffered. Suppose

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49. *Id.*

50. *Id.* at ¶ 6-018.

that the contractual duty of care was breached by an agent but did not lead to an immediate damage. In this case, at least from the perspective of procedural law, it would be more advantageous for a claimant to exercise his action in tort, where the time period runs from the moment of the damage suffered.[51]

Fourth, an agent owes both a duty of good faith towards its principal and a duty to avoid conflicts of interests. The breach of these duties will involve either a claim for damages or equitable compensation.[52] This structure is similar to the provisions of the AIFMD, but it has an advantage of providing a claimant with a private right of action.

Fifth, a hedge fund manager should not profit from his position as an agent, unless a principal gives his consent to such conduct. This corresponds to the prohibition of inducements under the AIFMD. The agent should not obtain a personal benefit from using his principal's assets or some confidential information (a secret profit). An AIFM should not accept secret commissions from a third party if this will put his principal (AIF) in a disadvantageous position. For example, if an AIFM is being proposed a reward for investing the AIF's assets in the shares of a particular company, an AIFM should act only in the best interests of the AIF and its investors and not because he will receive any secret profit from such a dealing. In such circumstances, an agent will be liable to his principal jointly and severally with the third party from whom he received a secret profit. The causes of action are generally either in contract or in tort for the loss suffered by the principal as a result of these dealings.[53]

By analyzing the agency relationship inherent in any dealings between a hedge fund manager and the fund, we conclude that the duties are similar to the regulatory law provisions under the AIFMD. However, the advantage of agency law is that the breach of an agent's duty provides two causes for action—in contract and in tort—whereas, under the regulatory law those causes of action are non-existent.

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51. For an example of a case where a principal had the right to claim damages simultaneously in contract and in tort, *see, e.g.*, Henderson v. Merrett Syndicates, Ltd. (1995) 2 A.C. 145 (H.L. Eng.).

52. *See generally* Trimble v. Goldberg [1906] A.C. 494 (H.L.); Rama v. Miller [1996] 1 N.Z.L.R. 257 (P.C.); Finlayson v. Turnbull (No. 1) 1997 S.L.R. 613 (O.H.); and Imperial Group Pension Trust Ltd. v. Imperial Tobacco Ltd. [1991] 1 W.L.R. 589.

53. Mahesan v. Malaysia Gov't Officers' Coop. Hous. Soc'y Ltd. [1979] A.C. 374, 374 (P.C. 1977).

B. Contractual Freedom

The particularity of hedge funds lies, among other things, in the ability of professional investors to tailor-make their investment agreements. The most commonly used legal form for structuring hedge funds is a limited partnership. It presents hedge fund investors with a double benefit of contractual flexibility and tax transparency.

A limited partnership is characterized as a contractual relationship based on the partnership agreement between general and limited partners.[54] General partners manage a hedge fund and may also act as an AIFM if allowed under a national law. Limited partners are investors that commit their money to the fund without taking on any management roles.

A partnership agreement gives a high degree of contractual liberty to the contracting parties, save for the rules relating to third parties and the public interest or duty. Many sections of the Partnership Act 1890 and the Limited Partnership Act 1907 use the following wording: "[s]ubject to any agreement between the partners,"[55] "[s]ubject to any agreement to the contrary among the partners,"[56] and "[s]ubject to any agreement expressed or implied between the partners."[57] This highlights the high degree of contractual liberty that partners are given.

Spangler observes that the contractual flexibility of the partnership refers to the degree of flexibility that partners have in determining the precise terms of the partnership agreement.[58] As such, investors can negotiate both the level of protection they require and the standard of care a hedge fund manager must exercise in fulfilling his duties. Wymeersch highlights the fact that the contractual nature of the partnership implies that almost every term in a partnership agreement is the result of individual negotiations.[59] Different partners have different standards regarding the reporting requirements and the investment strategy of the fund, which is important for institutional investors who may be bound by their trustee status to invest only in certain funds. In addition, provisions related to management fees, lock-up, gates, and side letters are of primordial importance for the partners. A limited partnership structure allows investors to negotiate not

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54. That agreement between general and limited partners is based on the principle that "[a] partnership can only arise by a voluntary contract of the parties." H.T. Hackney Co. v. Robert E. Lee Hotel, 300 S.W. 1, 3 (Tenn. 1927).

55. English Partnership Act 1890, 53 & 54 Vict., §§ 32-33(1).

56. Limited Partnerships Act 1907, 7 Edw. 7 c. 24, § 4(3).

57. *Id*. at § 6(5).

58. TIMOTHY SPANGLER, THE LAW OF PRIVATE INVESTMENT FUNDS 130 (2d ed. 2012).

59. ALTERNATIVE INVESTMENT FUND REGULATION 17 (Eddy Wymeersch ed., 2012).

only the duties that the fund manager should owe to the fund but also the mechanisms of their enforcement. If a manager breaches his duties, he will be liable for breach of the contractual terms.

National private law provides for a comparable standard of a hedge fund manager's duty of care to that imposed under the Directive. The advantage of relying on national law is having the ability to bring an action against a hedge fund manager either in tort or for breach of contract. Such a possibility does not exist under the regulatory law. Therefore, the conduct of business rules as set forth in the AIFMD is a law in word only, with very little application in practice.

V. CONCLUSION

This paper has critically assessed the conduct of business rules under the AIFMD. One of the objectives of the Directive is to protect the interests of hedge fund investors. The analysis in this paper proves that this attempt has largely failed. The conduct of business rules that form a part of the regulatory law have no effect on the relationship between a hedge fund manager and the fund, and the rules have even less of an impact on a fund's investors. While breach of the regulatory rules may lead to the revocation or suspension of a hedge fund manager's authorization license, there is no mechanism to allow a hedge fund or its investors to bring a claim against the manager.

The private law mechanisms—agency law and contractual freedom—provide investors with a much better solution. If the fund manager breaches his duties as an agent of the fund or the terms of a service agreement, either the fund or investors can sue him in tort or for breach of contract.

In addition, the AIFMD does not fulfil its promise of fostering a single EU market. It allows the EU Member States to impose a higher standard of a duty of care on hedge fund managers, which leads to a disjointed application of the regulation in the Union. An example is a French approach that differs significantly in terms of the hedge fund manager's duties, as compared to the UK. As such, in terms of achieving an investor protection objective, the AIFMD is rather a law in word only, with very little application in practice.