Financial regulation and management of the legal risk.  
The case of alternative investment funds in the EU.¹

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Executive Summary
The last decade has witnessed a sharp increase of the regulatory requirements applicable to investment funds, in an attempt to ensure that their operations do not undermine financial stability but, on the contrary, might be beneficial to economic growth both in developing and developed countries. The increase of fund regulation, and of its complexity, has made it imperative for investment funds to develop appropriate systems and tools to properly manage legal risks.

The paper presents a methodology that may be used to identify, in the alternative fund management industry, which are the main legal risks arising in each phase of the fund lifecycle. Furthermore, the paper indicates how these legal risks could be properly detected and mitigated. The different phases of the fund lifecycle include: set up of the fund manager, of the fund and of the fund corporate structure, marketing of the fund to investors, selection and execution of investments, management of the invested assets, divestments. Each phase can be regarded as a separate component of the value chain of the investment fund business. Specific legal risks may arise in relation to any component of the value chain, and management of these risks may be used to prevent value destruction.

Legal risks result from the uncertain effect of the combination of the uncertainty of an event and the uncertainty of applicable rules. This same uncertainty that gives rise to a risk could also be transformed into an opportunity.

For each component of the value chain of the fund, the paper identifies which are the uncertain events that may occur and the rules that are applicable (together with their own degree of uncertainty). From the analysis of the interplay between these events and these rules, the paper identifies which are the legal risks that could arise in connection with each phase of the fund lifecycle. Based on an assessment of the likelihood and of the impact of any of these risks, it presents a comprehensive matrix describing which are the most relevant legal risks.

The proper management of legal risk also requires the set up and the maintenance of an organisational framework where there is functional separation and independence, but also constant feedbacks and collaboration, between business owners, (a notion including the legal department), standard setters (like the compliance department) and internal auditors. Outsourcing certain activities of the fund manager to external fund service providers or increasing the use of digitalisation, automatization and artificial intelligence may also help to reduce legal risk in specific cases.

Key Words
Legal risk, risk management, investment funds, AIFM, compliance, investments, financial regulation.
1. **Introduction, purpose and organisation of the research.**

Ensuring transparency, soundness and stability of the financial system is crucial to enhance economic growth in a sustainable way, both in developed and in developing countries. In the last decade, the increased regulation of the financial sector has represented a response to the challenges posed by the impact of the activities of financial institutions on the world economy. In other words, regulation may also be regarded as a tool to ensure that the financial sector might not affect economic and social development in an adverse way.

Furthermore, a complex and multi-faceted relation exists between foreign investments (including those made by investment funds) and economic development. In relation to this, new regulation has been adopted at international and national level, to ensure that foreign investments might not endanger the economy of the host State.  

As a result, investment funds, as they are key actor in the financial system and account for a relevant amount of international investments, have been increasingly regulated. The rise of the number of applicable rules, their complexity and the fact that their content may quickly change, represents a source of risk for investment funds. For this reason, developing a state of the art management of the legal risk has become crucial for investment funds.

The present paper aims at analysing the main legal risks in the alternative fund management industry and at suggesting appropriate measures to detect and mitigate them. It focuses on alternative investment funds in the European Union, i.e. funds whose managers are governed by the so called AIFM directive. However, as alternative fund operations are very similar across jurisdictions, the findings of this paper may be helpful also for non-EU alternative funds and non-EU alternative fund managers. Alternative investment funds are a broad category that includes in particular private equity (i.e. funds investing in non-listed companies), real estate (i.e. funds that invest in immovable properties, like lands and buildings) and hedge funds (i.e. funds trading in financial instruments which adopt a broad variety of strategies, including short selling and use of derivatives).

For the purposes of the present analysis, legal risk for a fund manager will be construed as the risk that the combination of (the uncertainty of) an event and of (the uncertainty of) a rule, may prevent the creation of value of a company in the business of the fund management. The findings of the paper may be useful mainly for executives, compliance officers and in-house counsels of fund managers to proactively manage the legal risks related to their business, to seize the opportunities that can be associated to said risks and to efficiently allocate efforts and available resources.

The paper will be organised as follows.

In chapter 2, I will provide an introduction of the functioning and organisation of alternative investment funds and a description of the activity of their managers (also referred to as management companies or “mancos”). I will identify the various phases of the lifecycle of the investment fund across which fund managers create value for the investors in the fund. To this purpose, the notion of value chain developed by Michael Porter will be applied. In chapter 2 I

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3 Developing an in-depth analysis of the relation between regulation of the financial sector, financial stability, regulation of foreign investments and economic development would go far beyond the scope of this paper. For an introduction on this topic see, for instance: UNCTAD (2015); IMF (2017); Sinha, A. (2011); Freckleton, M., Wright, A., Craigwell, R. (2012); de Serres, A., Kobayakawa, S., Slok, T., Vartia, L. (2006).

will also provide various references both to EU and to national legislations governing the structure and the operation of alternative investment funds.

In chapter 3 I will define and analyse the notion of legal risk. I will discuss the link between risk and opportunity and the fact that the key element of both is uncertainty. I will analyse the causes and the consequences of the uncertainty of the very broad and diversified array of rules that are applicable to alternative funds and to their managers. I will explain how legal risk results from the uncertain effect of the combination of the uncertainty of an event and the uncertainty of a rule. Several examples of rules relevant to the fund industry will be provided.

In chapter 4, I will discuss for each phase of the lifecycle of the fund, (1) which are the uncertain events that may occur and that may impact the fund’s ability to create value, (2) which are the rules that are most relevant (with their degree of uncertainty) and (3) the resulting legal risk. It must be stressed that the definition of all the possible legal risks already constitutes the first step in the management of these risks.

In chapter 5, I will further develop the analysis of the methods to manage the legal risks that were identified in chapter 4. This will include regrouping all legal risks in a coherent map, that would allow, among other things, to clarify which are the greatest legal risks and then to ensure proper prioritization. This will also include an explanation of the functioning of the so called “three lines of defence” and an introduction to the best practises to ensure that this organisational model can properly manage legal risks. Finally, a discussion will be made of the role of company culture in detecting and mitigating legal risks and also of the possibly beneficial contribution that external fund service providers and fintechs or regtechs may provide in ensuring proper management of legal risk in an increasingly regulated environment.

To write this paper, besides consulting relevant academic literature and sources of law, I also collected for more than 6 years valuable information by discussing with lawyers, consultants, heads of legal departments or other senior legal and compliance professionals from various companies, and I analysed several non-published, private memoranda, papers and documents prepared by these companies.

When in the paper I provide information and analysis based on the literature or the sources of law that I considered, a note is provided in the text and as a footnote respectively. When information and analysis are based on private communication or non-published documents of one of the companies and professional mentioned above, no specific reference to an individual company or person can be provided for clear confidentiality reasons.
2. The business of management companies of investment funds and its legal framework.

2.1 The value chain of the fund industry.

The present chapter will provide the essential elements for a proper understanding of the fund industry, of its operations and of the way it creates value for its customers (i.e. the investors in the fund).

The business of fund management consists in the collection of resources from a plurality of investors and the subsequent use of said resources to invest in a diversified portfolio of assets according to the principle of risk spreading (Anderson, B. J. 2016.). The business of fund management is performed by specially licensed companies that, in the present research, will be referred to as fund managers. When, in the remainder of the paper, reference is made to activities of the fund, they could include the activities and operations decided and implemented either by the management of the fund itself or of its fund manager.\(^5\)

The various phases in which the business of fund management is articulated can be listed (in a chronological order) as follows: set up of the fund manager, of the fund and of the fund corporate structure, marketing of the fund to investors, selection and execution of investments, management of the invested assets, divestments. Moreover, activities needed to maintain the fund manager, the fund and the fund corporate structure in good standing, together with those connected to various reporting obligations, need to be performed along all the phases mentioned above. Figure 1 (appendix 1), provides a summary of this.

They can be regarded as the different phases along which the fund manager creates value for its clients / investors in the fund and for the shareholders of the fund manager, (said shareholders could also own shares or units into the fund, thus becoming at the same time investors into the fund itself) (Hübner, M., Misra, S., ÖztÜrk, G.Samir, Urtheil, R. 2016). These different phases can also be construed as the different components of the value chain as developed by Michael Porter (Roquilly, C. ed.) (2011) (Collard, C., Roquilly, C. 2010). This famous economist, when he developed his theories in this area was focusing on manufacturers of goods; however even if the value chain of a manufacturer cannot be the same as the value chain of an investment fund, the notion of value chain itself remains valid and useful. Moreover, not only value can be created along these phases, but also destroyed in case, for instance, of legal risk materialising and not being properly managed. Management of legal risk should help first of all to prevent destruction of value across all the phases, but also, working with other business functions, to seize the opportunities which may be connected with legal risk.

In the remainder of the chapter, an analysis of each of them will be provided. In this discussion, some of these phases portrayed above may be aggregated in a single paragraph: this is done to avoid repetitions.

2.2 Set up and maintenance of the fund and the fund manager.

The first activity from which value for the investors of the fund is created consists in the set-up of the entity which will act as fund manager and then in the set-up of the fund. In principle, both the fund manager and the fund are regulated, and they must be authorised by the competent authority where they are domiciled before starting their activity (Athanassiou, P. and Bullman,

\(^5\) This also depends on whether the fund is internally or externally management respectively. For more details about this, see infra paragraph 2.2.
Moreover, they must make sure that they maintain their authorisations to do so. It is easy to imagine the damage that could be suffered by investors in a fund if the fund manager loses the authorisation to manage it as a result of some severe violations of applicable rules. Various elements should be carefully assessed and analysed when a new fund is set-up and launched. First of all, the fund manager should carefully analyse which class of assets it is going to invest in; this represents the key element of the fund’s investment strategy. For instance, a real estate fund manager should carefully evaluate whether setting up a fund investing in logistics rather than in commercial property may help to provide higher returns to investors, and then it should assess which is the geographic area to which it intends to restrict the eligible investments of the fund. Moreover, a fund manager should also choose which form of fund is more appropriate considering the envisaged investments and the expected investors as well as the target size of the fund. It should decide the service providers of the fund to be appointed, including the depositary bank, the transfer agent, the administrator, the tax and legal advisor, the prime broker, the investment advisor (Spangler, T. 2010). It should decide which functions it intends to internalise or externalise (Chirico, A. 2010) and in the case of delegated functions it must ensure that it is able to keep exercising surveillance in an effective way on the external service providers. All the features of the fund as mentioned above must be detailed out in the issuing document (sometimes also referred to as prospectus) of the fund itself. Both the fund manager and the fund must comply with the requirement provided under the law of the State(s) where they are established. They need to be authorised by the competent authority, which is different from country to country. For instance, in Ireland the authority entrusted with this task is the Central Bank. In Luxembourg, it is the “Commission de Surveillance du Secteur Financier” (CSSF), a public body independent from the Luxembourg central bank. The ability of the fund manager to create value at the moment of the set-up of the fund also depends on the legal form that it decides to adopt for the fund. For this reason, and also to ensure a full understanding of the analysis developed in the present paper, the remainder of this paragraph will provide a brief description of legal forms that are most used by funds in the European Union.

A fund can be incorporated as a company (most often with variable capital), which raises money from investors by issuing shares and uses the resources thus collected to undertake investments. This is the case of SICAV in France and Luxembourg (“société d’investissement à capital variable”) and in Italy (“Società d’investimento a capitale variabile”) or of the “investment company” in Ireland.

A fund may also be set up based on a contractual arrangement. In this case the fund is an unincorporated body where investors are “co-owners” of underlying assets which are held pro

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6 For an overview of the rules applicable in the European Union (subject to minor differences across jurisdictions) see: Directive 2011/61, art.6 seq.
7 The grounds for withdrawal of authorisation of a fund manager are partially harmonised at European Union level and provided in Directive 2011/61, art.11.
8 As a measure to protect the investors, it is key that the fund manager manages but not owns the assets under management, keeping them well separated from its own assets. (Bazzani, M. 2016).
10 Loi du 13 février 2007, art. 25 seq.
11 Decreto legislativo 24 febbraio 1998, n. 58, art. 38. For more information of alternative investment funds in Italy, see: Lener, R. (2014).
12 Companies Act 1990, Part XIII.
rata with their investment. The units issued by the fund and subscribed by investors are not to
be regarded as shares or equity claims. The fund does not have legal personality and it can be
construed as a pool of assets held by its investors although not managed by them. Examples of
funds established under contractual arrangements are the French and Luxembourg “fonds
commun de placement” (FCP)\textsuperscript{13} in Italy the “fondi comuni di investimento”\textsuperscript{14}, in Ireland the
“Common Contractual Fund” (CCF).
In common law jurisdictions a fund can be also set up as a Unit Trust. It consists in a contractual
fund structure constituted by a trust deed entered into between a trustee (which keeps the
ownership of the invested assets, in practise on behalf of the investors) and a management
company (manager). This structure is often used in Ireland.\textsuperscript{15}
The fund can be also set up as a limited partnership. This fund provides for two types of
partners: the general partner with unlimited liability that is also entitled to manage the
partnership, and the limited partners, whose liability is limited to the amount that they invested
in the partnership and which are excluded from the management of the partnership itself.
Usually, investors in a fund set up as a partnership are the limited partners. In many civil law
jurisdictions, the limited partnership or the partnership limited by shares is a company with its
own legal personality. It is therefore governed by the same provisions applicable to the funds
set up as companies (e.g. the provisions concerning the SICAV in Luxembourg law). In
common law jurisdictions, for instance in Ireland,\textsuperscript{16} the partnership on the contrary is not
regarded as a company with separate legal personality. However, these differences between
investment vehicles in common law and civil law jurisdictions are becoming increasingly
blurred. For instance, Luxembourg recently introduced into its legal system a new investment
vehicle\textsuperscript{17}: the special partnership without separate legal personality and whose objective is to
make Luxembourg fund industry more attractive for Anglo-Saxon private equity, real estate
and hedge fund houses that are more familiar with this legal form. (Repiquet, M. 2018).
Investment funds that are incorporated as companies and limited partnerships can be self-
managed (when the fund is also the fund manager of itself) or externally managed (when the
fund entrusts an external fund manager with the task, inter alia, of managing it). Funds set up
as contractual arrangements or unit trusts can only be externally managed and they need to
appoint a fund manager. Self-managed funds must fulfil both the condition of a fund and of a
fund manager to be authorised by competent authorities.

2.3 Set up and maintenance of the fund corporate structure.
Corporate and tax structuring create value by enabling tax optimisation, by ensuring ring
fencing of the invested assets, by allowing opportunities with co-investors, by enabling third
party financing, by ensuring correct and fast downstream and upstream of monetary resources
across the fund structure and avoidance of cash traps.
Alternative funds usually do not directly purchase the assets they invest in, but they rather set
up various intermediary companies which are used to buy the assets and to finance the
transaction. Therefore, the fund often acts as the parent company of a complex corporate
structure. In appendix 1, the simplified structure charts of two examples of alternative fund

\textsuperscript{13} Loi du 13 février 2007, art 4 seq.
\textsuperscript{14} Decreto legislativo 24 febbraio 1998, n. 58, art. 36.
\textsuperscript{15} Unit Trusts Act, 1990.
\textsuperscript{16} Investment Limited Partnership Act 1994.
\textsuperscript{17} Loi du 12 juillet 2013.
corporate structures are provided. In figure 2 (Appendix 1) it is represented a private equity fund, established in Luxembourg as a partnership and externally managed. In figure 3 (Appendix 1), it is represented a real estate fund, again domiciled in Luxembourg but in this case set up as a public investment company with variable capital (SICAV) and internally managed. Despite the diversities between the two funds, for instance in terms of legal form and investment strategy, there are relevant similarities in the underlying corporate structures. In both cases, the funds controls 100% of the share capital of a holding company, a fully taxable legal person domiciled in Luxembourg. The holding company owns either directly or indirectly (i.e. via sub holdings) the operational companies that are acquired, held and managed by the private equity fund (the Invested Companies or the Portfolio Companies). In the case of real estate structure, the holding company holds (again either directly or indirectly via sub holdings) the property companies, i.e. the companies whose sole object is to own immovable property and to receive rents from the tenants of said immovable properties.

The reasons for setting up these corporate structures can be grouped into three main categories.

The first category is related to the benefits of international tax planning. In many cases investment funds, as they are not fully taxable entities, cannot benefit from the provisions of the double tax treaties (Letizia, G., 2015) which would have allowed exemptions from, or reduction of, withholding taxes on dividends and interest payments received from companies in which funds hold a qualified participation. (Uckmar, V., Corasaniti, G., De’ Capitani di Vimercate P., 2009) (Brian, A. J., McIntyre, M. J., 2002). Likewise, investment funds domiciled in an EU country and directly holding companies established in another EU country, cannot benefit of the withholding tax exemptions that are granted under the parent subsidiary directive and the interests and royalties directive to those EU fully taxable companies that hold relevant participations in other fully taxable EU companies. This means that, should the fund directly hold the invested company without the interposition of a fully taxable holding company and with additional structuring, dividends and interests paid by the invested company to the fund would be subject to a withholding tax in the country of the invested company. Figure 4 (Appendix 1) clearly shows these tax leakages.

On the contrary, if interests and dividends are paid by the invested company to the fully taxable Luxembourg holding company, then no withholding tax may be levied at this level. In this case, the holding company may up-stream to the fund the proceeds received in this way as passive payments under hybrid financial instruments which are well developed in Luxembourg and agreed upon with tax authorities. Additional tax savings may be obtained if the fund downstreams the money collected from the investors down to the structure to purchase assets by financing the acquisition (and possibly also the acquired company itself) not only by equity, but also by maximizing intragroup debt, which is, at least to a certain extent, tax deductible. In this case, the invested companies and the property companies, when paying interests on intragroup debt, de facto transfer a part of their profits to the holding company, which in turn

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19 Directive 2003/49, art. 3
20 It should be noted that an increasing number of countries are renegotiating their double tax treaties in an attempt to include investment funds, at least those in a company form, as covered entities and then benefiting of the treaty provisions. See, for instance Samantha Schmitz-Merle Jean-Michel Chamonard, Luxembourg expands its treaty network, retrieved in June 2018 from https://www.atoz.lu/sites/default/files/atoz_pdf/tpa2420_ipes_pe_update_17_hi_res_v3.pdf
transfer them to the fund as passive payments under the hybrid financial instruments explained above. As a result, a relevant part of the taxable base is shifted from fully taxable companies established in high tax jurisdiction to a non-taxable investment fund. The tax optimisation described above clearly reduces the tax leakages and then it increases the final amount of the distributions that the fund may ensure to investors. However, the fund should make sure that this kind of tax planning is not regarded as illegal tax avoidance or as tax fraud as in this case public authorities may sanction it. Moreover, the complex and multi layered corporate structures may cause problems when distributing profits to investors. Practitioners usually call these issues “cash traps”. To explain this concept, it is possible to refer to our previous example of real estate fund represented in figure 3 (Appendix 1). Suppose that the Property Company based in Luxembourg and holding a building situated in Germany receives a huge amount of cash from the tenants of said building. This amount is supposed not to stay idle at the level of the Property Company, but to be up-streamed to the fund and then distributed to investors or to finance other acquisitions. However, suppose that the same Property Company based in Luxembourg has recently booked in its balance sheet an impairment connected to the loss of value of the property it holds. As the impairment is larger than the net rent, the company is in a loss position accounting-wise (at least provided it has no retained earnings from previous years) and then it cannot distribute dividends. It results that the property company holds cash, but this cash is “trapped” in it because of accounting reasons.

The second category of reasons why alternative investment funds tend to use various intermediary companies is referred to as “ring fencing”. The use of distinct companies to hold different assets prevents severe losses concerning one investment from impacting also the well performing investments. For instance, in case of a real estate fund, the losses that a poorly performing property is causing are “ring fenced” to the property company that holds it and then the impact on the fund as a whole is reduced.

The third category of reasons explaining the use of various intermediary companies is related to the possibility for co-investors to participate in the acquisitions of the fund not by investing in the fund but alongside the fund with different degrees of risk and return (Spangler, T. 2010). Moreover, it is related to the fact that banks may provide additional financing (third party financing) often in the form of senior or subordinated debt. Various corporate levels in the fund structure allows banks and co-investors to finance the investment activity of the fund with different levels of risks and returns. Figure 5 (Appendix 1) provides an example of the same fund portrayed in figure 2 (Appendix 1) but with participation of co-investors and banks. In detail, in the example, a co-investor participates in the acquisition of the Invested Company (Netherland) and it is not interesting in gaining exposure to the other investments of the fund. Therefore, a joint venture is incorporated, which is co-owned by a sub holding of the fund and by the co-investor. Moreover, in the example at issue, the investment fund decides to partially finance the acquisition of the Invested Company (Italy) using bank loans. To this purpose a sub-holding Italy is set up, which receives the bank loan and which pledges the shares of the Invested Company (Italy) in favour of the bank.
2.4 Marketing the fund to investors.
The marketing phase is key in adding (or destroying) value. A fund manager that timely obtains all the authorisations to market its funds, that is able to convince prospective investors to invest in the fund and that is able to properly handle the subscription and the capital call processes, is definitely creating value. It should be noted that a fund that raises more capital from investors than other funds is not necessarily creating more value. On the contrary, the capital arisen from investors should be in line with the capacity of the fund to source profitable investments. The event that the fund is actually unable to spend all the capital committed by the investors and then end up making unprofitable acquisitions is not as rare as it may seem.

The fund raises capital from investors either by selling them its shares (in the case of a fund incorporated as a company) or its partnership interests (if the fund is formed as a partnership) or its units (if it is set-up under a trust deed or a contractual arrangement).

In the European Union, since the implementation of the AIFM directive, it is possible to market a fund domiciled in one EU member State to investors resident in any EU member State with a particularly straightforward procedure. The fund manager submits a notification to the competent authority of the State where it is established (and not of where the fund is domiciled) indicating, inter alia, which are the EU member States where it intends to market the fund. It must be stressed that the authorisation to market the fund is not the same as the authorisation to set up (and as practitioners say “to launch”) the fund, which has been described in the previous paragraphs. Should the fund manager envisage to market several funds, it has to file a request for each of them. The directive provides a detailed list of the documents that must be attached to the application. The competent authority of the Member State where the fund manager is established assesses whether the fund complies with applicable national and EU rules and in this case it transmits the complete notification file to the competent authorities of the Member States where the fund is intended to be marketed and then notifies the fund manager of this transmission. The fund manager may start marketing the fund into the other EU jurisdictions as of the date of that notification, without having to apply to each competent authority of each State where it intends to market its fund. (Anderson, B. J. 2016).

Usually each investor enters into a subscription agreement with the fund (or with the fund manager) under which terms and conditions it commits to invest up to a certain amount into the fund. This amount, referred to as “total commitment” usually is not paid immediately in its entirety (this is different from what happens with open ended non-alternative funds, like those governed by the UCITS directive, where the amount committed is immediately paid to the fund and invested by it). On the contrary, the investor is required to pay various amounts of money (up to the amount of its total commitment), every time the fund asks it to do so (usually on the occasion of an investment) by sending a capital call notice or drawdown notice (Spangler, T. 2010). An example may help to explain how this mechanism functions. Let’s assume that the total commitments of all the investors in a fund amount to EUR 500 ml (which also corresponds to the size of the fund, provided it is not leveraged). Let’s also assume that investor

21 The directive also lays down a similar and quite straightforward procedure for EU alternative investment fund managers marketing in the EU funds that are not domiciled in the EU. This case will not be analysed further in the present paper. See: Directive 2011/61, art. 35.
22 Directive 2011/61 art. 32.
X total commitment according to the subscription agreement amounts to EUR 50 ml, i.e. 10% of the total commitments of the fund. At the moment of the conclusion of the subscription agreement, the investor is not required to pay anything. However, two months later, the fund decides to acquire an asset which costs EUR 20 ml. It issues drawdown notices to investors to collect the total amount of EUR 20 ml. Investor X receives a drawdown notice asking it to pay the amount of EUR 2 ml, i.e. 10% of EUR 20 ml.

2.5 Investments and divestments.
The investment and divestment phases are probably those which most contribute to create value. In fact, even the best structured fund, with state of the art procedures and governance, will be completely unsuccessful if it is not able to select the best assets and the most appropriate timing to buy and to sell them. Alternative funds use the money collected from investors to acquire and then sell a broad array of assets: non-listed companies in the case of private equity funds, immovable properties in case of real estate funds, or various financial instruments, both listed and over the counter in case of hedge funds. Investments and divestments are made within the investment restrictions which are stated both in the issuing document or prospectus of the fund and in applicable law (the latter ones mainly focusing on risk spreading and diversification).

The different phases of the investment activity for a private equity fund may be summarised as follows. The fund manager, usually supported by an investment bank, selects privately held companies that either are in a difficult financial situation or which are already performing well but that in any case have a potential to be much more profitable. After an initial contact with the shareholders of the target company, the prospective buyer (i.e. the private equity fund) and seller (the shareholder(s) of the target company), enter into a letter of intent and into a non-disclosure agreement based on which they undertake to negotiate the sale and purchase of the company and not to disclose to third parties any information they exchange in connection to the envisaged deal. Once parties exchange relevant information, the buyer performs an in-depth due diligence of the target company. This due diligence usually starts with an analysis of the financial documents of the target company but the results of this analysis are adjusted to take into accounts many items which are by their own nature not included in the financial documents. The due diligence process also includes a tax and legal due diligence, to assess if the company has tax or legal, actual or potential issues which might impair its value or its ability to continue to create value for its stakeholders in the future. The findings of the due diligence(s) serve as a basis for negotiating the purchase price and for any other undertaking that the buyer and the seller may enter into in connection to the sale. The acquisition of the target company is consummated upon signature of the closing documentation and the payment of the purchase price. For real estate funds the process is very similar to the one described above, with the following differences. Usually deal sourcing is done not (only) with the assistance of an investment bank but of a real estate broker. As to the technical due diligence, it requires engineers and architects as it focuses on the technical aspects of the building. For hedge fund the particularity of the investment process depends on the investment strategy of the fund itself. For funds using high frequency trading, for instance, the core of the investment activity is to select the securities to be traded and to define the algorithms that allow to gain from frequent and minor changes in price.
2.6 Management of the invested assets.
Differently from funds that invest in securities in a passive way, i.e. without aiming at controlling and influencing the company that issued the acquired securities, the funds that acquire real assets (i.e. private equity, real estate, infrastructure) have the opportunity to manage the invested assets in a way to increase their value. For instance, private equity funds and in some cases activist hedge funds (Brav, A., Jiang, W., Kim, H. 2012) usually work with the top management of the invested companies to reduce inefficiencies and to make said companies more profitable. Conversely, real estate funds may invest in renovations of the acquired buildings thus getting able to extract better rents (Manganelli, B. 2015). The day-to-day management of the invested assets requires the support of many experts also from the sector in which the invested company operates. Indirectly, the fund may be impacted by any relevant event affecting the invested assets.

2.7 Reporting, disclosure, transfer of information.
Even though reporting is not a core activity of investment funds, in the last years investment funds and their managers have been required to increasingly devote time and resources to it. This is the consequence of the growing regulation and supervision of the financial sector as a whole. Therefore, a proper management of all the reporting processes, in a way that maximises efficiency and rapidity while minimizing costs, is undeniably a way in which a fund manager may create value.

Fund managers provide regular reporting both to public authorities and to investors. This ensures that they, and the funds that they manage, are properly supervised, thus enhancing the soundness of the financial system. This also helps to improve the quantity and the quality of the information to the investors, thus fostering trust and allowing them to make more conscious investment decisions.

Certain reporting obligations to public authorities are provided in art. 3.3 and art 24 of the AIFM directive and more in detail in annex IV of the delegated regulation 231/2013. The fund manager must regularly provide the competent authority of the State where it is established with information on the investment strategies of the investment funds under its management, as well as on the main instruments in which said funds are trading and on the principal exposures and most important concentrations. It shall also report which is the percentage of the funds’ assets that are subject to special arrangements arising from their illiquid nature. The fund manager must also report on the risk profile of the fund and the risk management systems it employs. Additional obligations apply if the fund makes substantial use of financial leverage.

Reporting obligations apply also in relation to tax matters. First of all, investment funds and their management companies worldwide are impacted by the set of U.S. rules denoted as FATCA (which stands for Foreign Account Tax Compliance Act) that aim at tackling international tax evasion (Alexander, R.M., 2013). According to FATCA, and to the intergovernmental agreements (IGAs) which have been concluded on a bilateral basis between the U.S. and most countries to implement FATCA, the financial institutions (a notion that includes investment funds and their management companies) that are not based in the U.S. are required to identify their “accountholders” (which, in the case of investment funds, are the investors). Then, they have to assess which of them are U.S. specified persons (a very broad
notion which includes, but is not limited to, U.S. citizens and legal or physical persons resident in the U.S.) and to assess the amount of their “account”, which, with a certain degree of simplification, means the amount of their investment in the fund. Then, if the investment fund is established in a country which has concluded a so-called model 1 IGA, the fund or its fund manager will report, to the tax authority of the State where it is established, the details of the investors who are specified US persons and of their investments. That tax authority will then transfer the data to the IRS (Internal Revenues Service, the US tax authorities). (Barbieri 2015). If the investment fund is established in a country which has concluded a so-called model 2 IGA, then it will have to report the relevant information about their U.S. investors directly to the IRS, which is in practise very similar to what occurs to funds established in a State which had not entered into an IGA at all, and to which FATCA rules apply in any case due to their extraterritorial character. (M. Somare, M., WöhrerIssue, V. 2014). For the purposes of the present paper it is worth noting that all EU countries and then also the main EU jurisdictions for investment funds like Luxembourg and Ireland, have entered into a model 1 IGA.

A very similar reporting is the one that is made according to the so called Common Reporting Standards (CRS) which were developed within the framework of the OECD as an instrument of soft law. Its principles and proposed mechanisms to enhance international exchange of information in tax matters have been included in various legally binding instruments. (VV. AA., 2015). Among them, it is worth quoting the multilateral competent authority agreement signed in Berlin on 29 October 2014 by 61 countries and which has been implemented by all the main EU fund jurisdictions. Moreover, at the level of the European Union, it is important to mention directive 2014/107. The reporting obligations for a fund established in an EU country under these pieces of legislation can be summarised as follows. The fund (and/or its fund manager) must carry out an in-depth due diligence of all its investors and must address who are reportable persons, i.e. its investors that are residents in another EU member State or in another contracting party of the multilateral competent authority agreement. The fund (and/or its fund manager) then reports the details of these reportable persons and of their investments into the fund to the tax authority of the country of the domicile of the fund, which will transfer them to the tax authorities of the States of residence of the reportable persons. An example may clarify the mechanics. Suppose that a Luxembourg domiciled, internally managed hedge fund has a certain number of Italian investors. It will collect data about them and about their investments in the fund and it will transfer them to the Administration des contributions directes (i.e. the Luxembourg competent tax authority) which will then transfer it on a yearly, automated basis to the Agenzia delle Entrate (i.e. the Italian competent tax authority) which will use them to check, inter alia, whether the Italian investors had declared in their tax returns their investments in the Luxembourg hedge fund and the proceeds from said investments.

Additional reporting obligation can apply for funds which use derivatives. This occurs very often in case of hedge funds, but also for other funds which may use these sophisticated

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24 For a broader discussion of the role of soft law, see infra paragraph 3.3.3.
27 In case the fund manager and the fund are established in different jurisdiction, some changes to this procedure may apply.
financial instruments to hedge their investments against, for instance, interest rate or exchange rate risk.
Funds or companies part of fund structures (or central counterparties\textsuperscript{28} authorised by national competent authorities) have to report detailed information on the derivative contracts that they conclude to trade repositories (which are central data centres, registered with the ESMA\textsuperscript{29}, that collect and maintain the records of derivatives). They must also promptly report when said derivative contracts are terminated or modified. Trade repositories must in turn publish aggregate positions by class of derivatives, for both over the counter and listed derivatives.\textsuperscript{30}

The fund regularly reports information not only to public authorities but also to its investors. In particular, on a yearly basis and within six months from the end of the financial year, the fund manager, for each alternative fund that it manages, must make a report available, providing at least the following information: a balance-sheet (or, alternatively a statement of assets and liabilities), an income and expenditure account, a report on the activities, the total amount of remuneration for the financial year paid by the fund manager to its staff and directors (including performance fees and “carried interest”) and any modification of the information disclosed to investors at the moment the fund was marketed to them and which are included in the issuing document, prospectus or other incorporation document of the fund itself.\textsuperscript{31}

Moreover, the net asset value (NAV) of the fund must be periodically calculated and then reported to investors. This is regarded as one of the most useful form of reporting to investors, even though some authors suggest that the best option remains a full disclosure of the holdings of the fund, which would enable investors to value the fund, and as a result their investment, with the techniques they deem to be more appropriate (which, \textit{inter alia}, would discourage in a more effective way fund managers from increasing the value of the assets under management in an artificial way). (Goltz, F. and Schröder, D. (2012) (Krepely Pool, V. 2012).

Details about NAV computation and reporting can change from country to country. However, art. 19 of the AIFM directive and 67 of regulation 231/2013 lay down some rules. The valuation is made at least once a year (without prejudice for the possibility for the fund to commit in its issuing document and/or prospectus and/or incorporation document to do this more frequently) and in any case on the occasion of each issue or subscription or redemption or cancellation of units or shares. The valuation can be made by an independent and authorised external valuer (and its appointment is made under a written contract which is also notified to the competent supervisory authority) (Athanassiou, P. and Bullman, T. 2012) or by the fund manager itself, but in this case the CSSF has the power to require that said valuation, (and/or the procedures used to perform it) are further verified by an external valuer or by an independent auditor.

\textsuperscript{28} Central counterparts are legal persons that interpose themselves between the counterparties to the derivative contracts, thus becoming the buyers to every sellers and the sellers to every buyers.

\textsuperscript{29} ESMA is the European Securities and Market Authority.

\textsuperscript{30} Regulation 648/2012. Its applicability to alternative funds is provided in its art. 2.8 and the details concerning reporting in art. 9.

\textsuperscript{31} Directive 2011/61/EU, art 22 and art. 23.
3. The notion of legal risk in the investment fund industry.

3.1 From a definition of risk to a definition of legal risk.

To properly understand the notion of legal risk, it is first needed to define what risk is. Reference can be made to the definition provided by the International Organization for Standardization (ISO), according to which risk is the “effect of uncertainty on objectives”. It further specifies that “an effect is a deviation from the expected.” Said deviation “can be positive, negative or both”. Therefore it “can address, create or result in opportunities and threats.”[32] This last point is extremely important. In fact, it directly connects the existence of a threat to the existence of an opportunity. The same uncertainty can lead to a threat or to an opportunity, and this might depend also on the ability of the organisation affected by the uncertainty to properly cope with it, or, in other words, to properly manage risk.

Risk management is defined, again in the ISO, as a set of “coordinated activities to direct and control an organization with regard to risk”.[33] These arguments suggest that managing the risk, and in detail preventing uncertainty from creating a threat, could and should also be done in a way to transform uncertainty into an opportunity. It should be stressed that (legal) risk management functions, rather than being seen merely as supporting functions or as necessary costs for the business, could become, at the same time, functions which contribute to boost the business. Therefore, they would not only avoid value destruction by preventing threats, but also contribute in value creation by helping to seize opportunities and to enhance the overall performance of the organisation. ([Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C., 2011], [Collard, C., Roquilly, C., 2010], [Roquilly, C., (ed.) 2011]).

Finally, it should be noted that risk is a function of the following elements: (1) risk sources (defined as “element which alone or in combination has the potential to give rise to risk”), (2) potential events (“occurrence or change of a particular set of circumstances”), (3) their consequences (“outcome of an event affecting objectives”) and (4) their likelihood (“chance of something happening”).[34]

Based on the above, it is possible to define legal risk in the business of the fund industry as the risk that the combination of (the uncertainty of) an event and (the uncertainty of) a rule, may prevent the creation of value of a company in the business of the fund management. This definition suggests that uncertainty may arise in connection with three areas.

- Uncertainty of the event
- Uncertainty of the rule
- Uncertainty of the combination of the uncertain event and the uncertain rule ([Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C., 2011] [Collard, C., Roquilly, C., 2010] [Roquilly, C., (ed.) 2011]).

3.2 The uncertainty of the event.

Events that may impact the business of fund management, like any other human activity, are uncertain. At each different phase of the fund lifecycle that has been described in chapter 2,
there are different activities which are performed and different events that can occur. Their likelihood is uncertain, and uncertain is the impact that their occurrence may have. These events by themselves pertain to the pre-legal sphere; however, their relationship with the legal sphere may be threefold.

First, exogenous events, not depending on the fund or on the fund manager’s will, may cause the fund or the fund manager to be in breach of a rule applicable to it. The following example may clarify this circumstance. Suppose that a fund specialised in European real estate is obliged (by law or by prospectus) not to have more than 30% of the assets under its management invested in properties situated in France. The fall in value of certain other assets in its portfolio, like properties situated in other countries, is clearly an exogenous event not depending on the fund itself, but it would make the properties located in France which previously only weighted 25% of the entire portfolio, account now for, say, 35% of the portfolio, thus breaching the rules according to which no more than 30% of the assets of the fund may be invested in France.

Second, an event may consist by itself into a breach on an applicable rule. In this case it could be regarded as an endogenous event, as it originates from the organisation and the operation of the fund and/or of its management company itself. An easy example can be the following one: a fund required to calculate and report its NAV within a certain deadline, fails to do so.

Third, an event, be it endogenous or exogenous to the fund, may cause the fund to damage a third party and then expose it to a claim for compensation. An example could clarify this. Suppose that a fund, when it makes periodical distributions to investors, is required by applicable law to withhold certain taxes. The amount withheld may however be credited by the investors, thus reducing their total tax liability. If the fund fails to collect the withholding tax within the legal deadline, investors initially receive a higher amount, since the amount of the withholding tax has not been subtracted from the amount of the distribution made to them. However, afterwards, the fund must pay higher taxes (as they include late payment interests) and penalties and this will reduce its ability to make subsequent distributions to investors. Moreover, investors are not able to credit against their own taxable base the penalties and the late interest payments of the fund whereas they were able to credit the amount of the withholding tax initially due but not correctly withheld because of the negligence of the fund. It results from this situation that an event consisting in the breach of a rule (in the example a provision of tax law), causes an event consisting in a third party (in this specific example an investor) be legally entitled to claim for a damage.

3.3 The uncertainty of the rule.

The exact scope and content of the rules applicable to the fund management industry, like in all business activities is to a large extent uncertain for the following reasons:

1. the operations of the fund industry take place across several jurisdictions;
2. many laws have an extraterritorial character;
3. applicable rules may result from a plurality of sources (because of the multi layered framework governing investment funds);
4. additional rules result from the commitments taken by the fund, for instance when it enters into a contract with a third party.
3.3.1 The plurality of jurisdictions involved.

Rules applicable in various jurisdictions may impact the operations of a fund insofar as it operates across said jurisdictions. The following example of a Luxembourg domiciled, externally managed, real estate fund may easily clarify this concept.

The Fund is domiciled in Luxembourg and this means that Luxembourg law applies to it. However, the fund manager in charge of the portfolio and risk management is established in France and subject to the law of this country. The fund sells its shares or units to investors that are resident in various jurisdictions and relevant provisions of the law of any country in which the fund is marketed may apply. The fund uses the financial resources thus collected to purchase properties located in various jurisdictions and, necessarily its operations are impacted by the laws of each of these jurisdictions. Moreover, for the corporate and tax structuring reasons that have been described supra in chapter 2.3, the fund may need to structure the acquisition and the sale of the assets by using intermediary companies which are based in a third jurisdiction. For instance, to buy an asset in country X, it could first incorporate in country Y an intermediary company, a fully owned subsidiary which will acquire the target asset. In this case, the law of the registered address and / or of the real seat of the intermediary company will also apply. Moreover, in the course of its operations, the fund enters into a broad array of contracts. They include contracts with buyers and sellers of the invested assets and also with various service providers, which include investment advisors, brokers, banks, property managers, real estate valuers, accountants, lawyers, tax advisors notaries…. At least in theory, all these contracts may be governed by the law chosen by the parties (unless mandatory provisions of private international law require the application of rules of a specific jurisdiction), and this might further increase the number of national legal systems which can impact the activities of the fund.

3.3.2. The extraterritoriality of certain laws.

Certain domestic laws produce legal effects beyond the borders of the State that adopts them and may impact persons that are neither resident nor citizens of this State and that have not breached said laws on its territory. For instance, a fund that is not established in the UK and that does not carry out business in the UK may still be sanctioned by UK authorities and according to UK law if it violates UK provisions concerning corruption, because of the extraterritorial character of said provisions. Other examples of extraterritorial laws include EU and US competition law, and various provisions governing the enforcement of sanctions, the fight against money laundering and terrorist financing (Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C. 2011) and, more recently, certain EU rules concerning protection of data.

3.3.3. The multi layered legal framework governing investment funds.

So far, when talking about applicable rules, I mainly focused on domestic primary law. However, the heavily regulated investment sector is subject to a complex and multi-layered set of rules, having different sources and hierarchy. Coming back to the previous example of the Luxembourg real estate fund, it is governed by Luxembourg fund law and, in detail, by the “Loi du 13 février 2007 relative aux fonds d’investissement spécialisés”, which lays down the main rules concerning specialised investment funds, by the “Loi du 12 juillet 2013 relative aux gestionnaires de fonds d’investissement alternatifs”, which mainly provides the rules applicable to its fund manager and, if the fund is formed as a company by the “Loi du 10 août 1915
concernant les sociétés commerciales”. However, the fund is also governed by regulations and circulars issued by the CSSF (the Luxembourg financial supervisor) and by the competent tax authorities.

It should be noted that the “Loi du 12 juillet 2013 relative aux gestionnaires de fonds d’investissement alternatifs” transposes into the Luxembourg legal order the relevant EU directive (in this case, the AIFM directive as the fund of the example is an alternative fund), therefore the rules directly applicable to it are not those laid down in the EU directive but in the Luxembourg law provisions. However, other sources of EU law are relevant in this field and are directly applicable. It is the case, for instance of the EU Delegated Regulation 231/2013, which, differently from the directive, is directly applicable to the fund of the example and does not require prior transposition into the domestic legal order. EU institutions and bodies (in particular the ESMA) may issue additional documents having legal implications for the fund of the example. (Lamandini, M. 2012).

Moreover, the fund is impacted not only by provisions of hard law, but also by provisions of soft law. They include codes of conduct, codes of good practises, guidelines, technical standards, drafted by a plurality of organisations. These organisations can be intergovernmental organisations like the Organization for Economic Cooperation and development (OECD) or also private professional associations like the Association of Luxembourg Fund Industry (ALFI) and in this second case some authors correctly talk about self-regulations of the investment funds themselves (Lamandini, M. (2012). Even though instruments of soft law are not formally binding, their relevance cannot be neglected (Shaffer, G. C., Pollack, M. A. 2009-2010) at least for the following reasons.

First, a document of soft law, after its adoption, may be endorsed by a group of States and turned into an international treaty or, at the EU level, into a directive and, subsequently, into national legislation. The so-called “base erosion and profit shifting” (BEPS) provides a relevant example. BEPS was initially a (non-legally-binding) report of the OECD but many of its principles were subsequently included in double tax treaties (Kok, R. 2016) and into the parent subsidiary directive and they may impact the corporate and tax structuring of the fund designed to maximise the tax efficiency of the acquisition undertaken by the fund (Weber, D., 2016). A similar case is represented by the OECD CRS, already analysed supra at paragraph 2.7 of this paper, which where embedded into the Berlin Convention and in directive 2014/107 and finally into national legislation.

From a different perspective, it can be argued that soft law often indicates not (yet) what the fund is obliged to do but what it should do. It indicates that a consensus is in the process of being reached as to whether and how certain conducts and / or activities should be accepted and regulated (Shaffer, G. C., Pollack, M. A. 2009-2010). For instance, coming back to the previous example of BEPS, this instrument of soft law showed that a consensus was arising within the international community as to the fact that certain forms of tax planning had negative effects on the society and on the economy and then had to be restricted. This consensus was initially crystallised into instruments of soft law (the BEPS report and related recommendations), but it

36 Detailed information on BEPS can be found on the webpage of the OECD at the link: http://www.oecd.org/tax/beps/
was reasonable to expect that the States which adopted these documents would have reached a
consensus also in transforming at least a part of its principles into legal rules, as it indeed
happened within a few years.
Therefore, understanding the scope and the content of similar soft law documents may help the
fund to anticipate future changes in applicable rules, and then to make sure that it will be able
to fully and proactively comply with them at the time they become binding. Furthermore, even
before the documents of soft law are transformed into instruments of hard law, the fund would
be interested in abiding by them for ethical and reputational reasons.
Finally, soft law may be used as an ancillary tool to interpret hard law rules which are inspired
by it or that are adopted to “implement” hard law. For instance, should the wording of a rule of
hard law not be clear, to understand its objective and to properly interpret it, reference could be
made to the instrument of soft law that “inspired” the adoption of the related instrument of
(Guzman, A. T., Meyer, T. L., 2010).

3.3.4. Contracts.
The rules applicable to a fund are not only those enacted by regulators (this notion including
public authorities at national, European and international level), but also from commitments
undertaken by the fund itself mainly in two ways. First, by entering into contracts with any third
party, including buyers and sellers of the invested assets, third party service providers and
investors. Second, under the same constitutive document of the fund, like the prospectus (or
issuing document) and the articles of association or limited partnership contract of the fund
itself and of the companies part of the fund corporate structure.

3.3.5. Conclusions on the uncertainty of the rule.
For the reasons explained in this paragraph, the fund might find itself in a difficult situation to
know if and to what extent a rule is applicable to it. Moreover, once it assesses that a rule is
applicable, its interpretation can be unclear. Even if the way the norm must be interpreted is
clear, then uncertainty may arise because several rules (coming, for instance from different legal
orders) may be simultaneously applicable and then it is still necessary to understand which one
should prevail and whether application of the prevailing rule would represent a valid ground
for disapplication or waiver of the other rules or whether this could entail in any case a breach
of some of the rules at issue. All these elements determine the uncertainty of the rules,
uncertainty that, as explained, is one of the essential elements of legal risk.

3.4 Uncertainty of the combined effect of the uncertainty of the event and the uncertainty of
the rule.
Even when there is a reasonable certainty that an event as described in paragraph 3.2 above
may occur and even if there is a reasonable certainty about the existence and applicability of a
rule as discussed paragraph 3.3 above, it is still uncertain:
• whether the occurrence of an event may in abstracto cause the violation of a rule,
• the likelihood that the rule is actually breached as a result of said event (except in
the case were the event itself consist in the breach of the rule) and
• the exact consequences of the breach.
3.5 Management of legal risk vs. legal management of risk.

The notion of management of legal risk is related but distinguished from the notion of legal management of risk. In fact, the former focuses on the legal character of the risk to be managed, the latter on the legal character of the tools to manage it (Collard, C. Roquilly, C. 2010).

For instance, management of legal risk means to manage the risk that the fund might fail to calculate and to communicate the NAV on a yearly basis, insofar as the performance of said calculation represents a legal obligation. The risk could be managed from the legal point of view for example by checking that there is no change in the rule mandating for yearly calculation of the NAV and then, once the breach occurred, by properly inform the authorities of this and discuss viable remedies. However, it can (and must) also be managed from an operational and organisational point of view, e.g. by allocating sufficient resources to the team in charge of the NAV calculation and by scheduling its work in a way that no deadline is missed.

Likewise, a risk that is not legal by itself could be managed (also) by means of legal tools. For instance, the risk that an investor fails to pay the amount requested by a fund when the fund issues to it a capital call notice to raise needed capital in the view of an acquisition, does not constitute by itself a legal risk. However, it may have a huge impact, because it could bring to the situation that the fund is unable to complete the envisaged acquisition because of lack of monetary resources. One possible way to manage this (non-legal) risk may consist in ensuring proper ex ante communication to investors, for instance by informing them when an acquisition requesting a certain amount of monetary resources is planned and when they should get ready to pay the amount requested upon receipt of the drawdown notice. Another (complementary) approach consists in adding a clause in the subscription agreement between the investor and the fund, clarifying the exact timing of the payment of the amount called upon receipt of the drawdown notice and the penalties that the investor can incur in in case of noncompliance. This would be an example of legal management of a (non-legal) risk.

More in general, it must be stressed that in economic transaction parties agree, inter alia, on how to allocate among them the various risks that are always implied in any transaction. A proper legal management of risk must ensure that contracts concluded by the fund and its manager do not impose a disproportionate part of these risks upon them and that acceptance of risks is adequately remunerated.
4. **Identification of legal risks for each phase of the fund lifecycle.**

4.1 **The activities related to the management of legal risk.**

The management of legal risk encompasses the following activities.

a) Identification of the legal risks, which in turn consists in the detection of the events and rules whose interplay may cause uncertainty. Referring again to the Luxembourg fund used in the previous example, when it markets its units to investors in a certain country it should consider which are the applicable laws, which is their exact content and how they should be interpreted in the case at issue, which are the events that may occur in connection with this marketing stage and how they can cause the occurrence of a breach of the relevant rules.

b) Assessment of the likelihood that the combination of the uncertainty of the event and of the rule may actually determine the existence of a legal risk.

c) Assessment of the impact (severity) of the legal risk, especially in terms of the consequences they may entail.

d) Combination of the assessment of the likelihood and of the impact of the legal risk to create a map of all the legal risks and define which risks are completely unacceptable and which risks are acceptable but need to be mitigated. (Collard, C., Roquilly C. 2010) Developing the previous example further, the fund could assess that marketing its units to a certain investor would very likely result in said investor using the fund for the purposes of money laundering. In this case, as the likelihood and the gravity of the risk are extremely high, the risk related to marketing units of the fund to that investor should be regarded as unacceptable and then the prospective investor simply should be not allowed to invest in the fund.

On the contrary, a preliminary presentation of the fund to prospective investors (without entering into any subscription agreement for the time being) when the fund has already received an informal approval by the Luxembourg supervisor but before the fund is formally registered, should entail a low and then acceptable legal risk. In fact, in this case the likelihood that the fund will not be registered is very low (low uncertainty of the event) and the initial presentation of the fund to potential investor can hardly be constructed as a legal commitment to actually sell the units of the fund (low uncertainty of the rule or, more precisely, high certainty that at that stage there is no applicable rule mandating to finalise the subscription of the shares or the units of the fund to the potential investor).

e) Prioritization and identification of the acceptable risks that need special efforts to be properly monitored and mitigated (Collard, C., Roquilly C. 2010).

f) Determination of the most appropriate tools, procedures and business models to monitor and mitigate said legal risks (Mahler, T. 2010).

The activities described in items a) to c) above will be analysed in this chapter 4. The activities described in items d) to f) will be discussed in chapter 5.

To identify which are the main legal risks for each of the phases of the fund lifecycle as described in chapter 2 above, I will investigate:

- the uncertain events that may occur;
- the applicable rules and their degree of uncertainty;
• the legal risk which can materialise as a result of the combination of the uncertainty of the events with the uncertainty of the rules;
• the likeliness and of the impact of each the legal risk thus identified.

4.2 Legal risks connected to the set up and maintenance of the fund and the fund manager.
The uncertain events that may reasonably occur when setting up the fund and the fund manager, and that may also impact the day-to-day activities needed to keep them in good standing, can be summarised as follows.

Both the fund manager and the fund need to be duly authorised by the competent authorities and said authorisation must remain valid for all the time the fund and its manager carry out their activities. The outcome of the application for authorization process and its timing may present a certain degree of uncertainty that is related both to the ability of the fund manager to handle the process and on the responsiveness of the competent authority in charge of the authorisation. Moreover, various uncertain events may impact the ability of the fund and of its manager to continue holding said authorisations, which may be withdrawn in certain extreme cases that include severe misconducts of the fund, the fund managers or their key employees. The possibility of the fund manager to continue operating its business can also be impacted by the fact that its key persons cease to work for it or lose their ability to hold their office (for instance because they do not meet anymore the requirements concerning honourability and professionality mandated by the competent authorities). The events that may cause this are clearly uncertain.

The rules that are particularly relevant in this phase are first of all those provided under the fund laws both of the State of establishment of the fund and of the State of establishment of the fund manager. They include the national laws transposing the AIFM directive, together with any decree and circular issued by competent authorities to implement them and the EU regulation 231/2013. As the fund manager is a company, relevant provisions of company law, tax law and accounting law of the country of establishment of the fund manager shall apply as well. If the fund is set up as a company, or as a trust, company law and trust law respectively, together with tax and accounting law of the State of domiciliation of the fund shall also apply, except when fund law, as lex specialis, derogates them. The degree of uncertainty of the rules mentioned above is mainly caused by their complexity and by their multi layered character and from the fact that different laws (even of the same jurisdiction) may simultaneously apply to the same fund and to the same fund manager.

Based on the above, one of the legal risks relevant in these phases of the fund lifecycle may occur when, as a result of a change of the applicable provisions of fund law, company law (and, secondarily, accounting and tax law), the fund or the fund manager find themselves in breach of these provisions. In this case the fund and its manager do not have penalties provided that they regularly monitor the regulatory developments and make sure that changes in the fund, and fund manager are made to keep the them compliant with new rules. If the fund (manager) performs a normally diligent regulatory watch, the legal risks related to changes in applicable rules are very likely, but their impact is low.

Another legal risk is related to the refusal of the competent authority to authorise the fund manager to manage and / or to market the fund, or to withdraw the authorisation to the fund
manager. Refusal to release authorisation or withdrawal of the authorisation are quite extreme measures: then likelihood of the legal risk that they entail is moderate, but the impact can be high or very high. In case of minor violations of fund and company laws, usually there is no ground for withdrawal of authorisation, but penalties can be inflicted. In this case, the legal risk connected to this is more likely, but its impact should be lower.

It should be considered that, insofar as the situations mentioned above lead to relevant financial losses to the fund, investors in that fund could be entitled, in principle, to initiate legal proceedings against the fund manager to obtain compensations for damages. The violation of rules which may cause an economic damage to the fund with sufficient degree of materiality to prompt investors to start long and expensive legal proceedings should be quite a rare event. For all these reasons, likelihood of this legal risk is quite low, but impact can be high.

4.3. Legal risks connected to the set up and maintenance of the fund corporate structure.

The uncertain events that may reasonably occur when setting up, maintaining and operating on a day-to-day basis the fund corporate structure can be summarised as follows. The structure may present cash traps: they could be the consequence of poor tax and corporate structuring, but also of material events outside the control of the fund manager like the fall of the value of the assets held by one company part of the fund structure that, if booked, causes an accounting loss at the level of that company and then prevents its ability to distribute profits. Moreover, the greater the complexity of the structure, the greater is the number of companies and then of the people involved in the process of down-streaming and up-streaming cash across the structure to finance investments and to make distributions to investors respectively. These operations usually involve the cooperation of various teams of the fund manager across countries and of many service providers (like banks, but also lawyers, notaries and domiciliation companies). It is uncertain whether they could always ensure the cash transfers and the preparation of all the related legal and accounting documentation in a correct and timely manner. In particular, delays in down-streaming monetary resources collected from investors after the capital call, may jeopardise the ability of the fund to complete the investments.

The rules that are particularly relevant in this phase are those found in company, finance and commercial law of the countries where the companies that are part of the fund corporate structure are established. Finance and commercial law apply in particular to govern the financial instruments that are used to upstream and downstream cash along the structure, and to receive, if applicable, third party financing from banks and co-investors. Rules included in the contracts between various entities of the fund structure and governing intragroup financing, together with rules included in contracts with banks and co-investors providing third party financing, also apply. Considering that one of the main reason of the fund structuring is tax optimisation, tax law is extremely relevant. Provisions of accounting law are also important insofar as they affect the ability of the companies that are part of the fund structure to distribute profits. The uncertainty related to the applicable rules is related to their complexity, to the fact that they may change from time to time and, most important from the fact that the same fund structure may be impacted by rules resulting from many different jurisdictions.

37 This example was described more in detail supra at paragraph 2.3.
The provisions determining the tax treatment of the fund structure present a particular degree of uncertainty especially because tax structuring in many key jurisdictions for fund and fund structures (like Luxembourg, the Netherlands, Ireland) is not entirely based on clear provisions of statutory law. On the contrary, it is often based on ambiguous interpretation of the law, on administrative agreements concluded with tax authorities or on informal and not always clear and transparent administrative practices. The certainty and the stability of this legal framework is very weak. A practise which is commonly accepted for years by tax authorities in the absence of formal legislation preventing it, may suddenly become forbidden if it is perceived as tantamount to abuse of law or at least discouraged if it is regarded as aggressive tax planning or tax avoidance.

Based on the above, the main legal risks in these phases of the fund lifecycle can be summarised as follows.

Applicable provisions of company, commercial, financial and accounting law may change. The fund manager may find it difficult to stay fully updated with the content and the correct interpretation of all these rules, especially as they result from a great number of different countries. Therefore, legal risk connected to failure to update the structure pursuant to changes in company, commercial, financial and accounting law across jurisdictions is quite high and impact may be moderate to high.

A legal risk may materialise when cash is down-streamed or up-streamed along the fund structure, especially when cash traps exists. Usually these cash movements occur in connection to acquisitions of assets or distributions of profits and pressure to complete them as fast as possible may be high. The risk of willingly or unwillingly breach or circumvent the applicable provisions of company and accounting law may be quite likely and its impact may be moderate to high (especially with respect to the rules concerning the amounts that a company has to set aside in its reserves before making distributions to investors.)\(^{38}\)

A huge legal risk is finally related to the event that the fund corporate structure is regarded as an artificial way to illegitimately avoid paying taxes. The likelihood of this risk is high and the impact is also high.

4.4. Legal risks connected to the marketing of the fund to investors

The uncertainty of the events that may reasonably occur when marketing the fund to investors depends to a certain extent on the uncertainty about the characteristics, the aims and the conduct of the investors. It also depends on the ability of the fund to handle the investor onboarding process, including the ability to perform an effective and efficient customer due diligence.

It is uncertain whether the investor is a person targeted by economic sanctions and using the investment into the fund to circumvent said sanctions. Likewise, uncertainty exists as to whether the investor is using the fund for the purposes of money laundering and terrorism financing.

Moreover, it may be uncertain whether the investor is eligible to invest into the fund both based on applicable provisions of law that in many countries restrict the ability of non-professional investors to purchase shares or units in alternative investment funds and based on the fund prospectus or issuing document.

\(^{38}\) On possible ways to manage the complexity of these structures and the related legal risk especially when up streaming and distributing proceeds to investors see: Mayrell, R. C. 2014.
Uncertainty also exists as to whether the investor will be able to wire the amounts, that it committed to pay upon entering into the subscription agreement, when the fund issues a capital call.

The fund regularly collects a huge amount of information from its investors both for practical reasons (for instance, to know on which bank account it has to pay dividends or other profit distributions) and to perform the KYC (“Know your customer”) obligations as mandated by applicable rules concerning inter alia the enforcement of sanctions and the fight against money laundering and the financing of terrorism. A certain degree of uncertainty may exist about the ability of the fund to properly store and process all these pieces of information and to avoid any leakage or loss of them.

Finally, when marketing funds, managers may use different channels, including distribution agreements with other financial intermediaries. It is uncertain whether these distribution arrangements may have no adverse impact on competition and free market.

The rules that are particularly relevant in this phase are those enforcing sanctions, tackling money laundering and fighting terrorism financing.

Rules adopting sanctions may result from different sources of law. They include binding and directly applicable rules adopted by international organisations (especially in the case of sanctions adopted by the EU), binding resolutions of the UN (Craven, M. 2002) which however need transposition into municipal legal order, rules unilaterally adopted by a country but having extraterritorial effect.

Rules governing money laundering present various similarities across the main financial centres and also in the EU where they are harmonised by virtue of the AML directive. These similarities may reduce complexity and then uncertainty, but the extraterritorial character, on the opposite side, increase said uncertainty.

In detail, money laundering consists in three phases: placement, layering, integration. The layering stage (also referred to as structuring) aims at separating the illicit money from its source and it is done by means of sophisticated financial transactions that make it possible to sever the link with the original criminal activity. Investing in a fund can be used for layering purposes and the fund is treated as liable of the offence of money laundering if it, willingly or unwillingly, knowingly or unknowingly, is used by money launderers. Virtually all countries have rules fighting money laundering and many of them are extraterritorial. It is therefore possible that a fund that is involved in money laundering may be impacted by the application of anti-money laundering provisions of countries other than those of its domicile.

Other rules that are relevant during the marketing phase are those provided in fund law and also in the fund prospectus that set the requirements to be met by eligible investors. For instance, in Luxembourg, an alternative investment fund established as a “specialised investment fund” may only accept “well-informed investors”, which means: institutional investors, professional investors or all those investors who have confirmed in writing that they adhere to the status of well-informed investor, and either invest a minimum of 125,000 Euro in the fund, or have obtained a certification from a credit institution, an investment firm or a management company stating that their skills and knowledge qualify them as a well-informed investors.

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Additional rules that are relevant are those included in the subscription agreements between the fund and the investor. In principle parties are free to choose which law shall be applicable to these contracts and usually the subscription agreement is governed by the law of the country where the fund is domiciled and tends to be the same for all investors. However, it is possible (although this possibility is quite remote) that mandatory rules of private international law of the country of the investors may be applicable, preventing the application of some of the provisions of the subscription of the agreement.

Other rules that may be relevant are those governing the protection of data. The recent entry into force of the GDPR\(^{40}\) imposes complex obligations also to fund managers that have to face the uncertainty that typically accompany newly enacted legislation.

Finally, provisions of competition law may be relevant, when fund managers make use of their dominant position or when they conclude a formal or informal agreement among them for instance not to lower fees to be charged to investors. Competition law may apply also if agreements restricting competition are concluded between fund managers on one side and other third-party service providers (for instance distribution agents). The degree of uncertainty of the applicable rules of competition law may be quite high especially because of their extraterritorial character.

Finally, as the shares or units of the fund are financial products, certain provisions of the so-called Mifid \(^2\) \(^{41}\) and Mifir \(^2\) \(^{42}\) may apply in this phase, including those governing investment advise, execution and transfer of orders, portfolio management, in connection to “Units in collective investment undertakings”. \(^{43}\)

Based on the above analysis, the main legal risks connected to the marketing of the fund are related to possible breaches of rules enforcing sanctions and of rules fighting money laundering and terrorism financing. The likelihood of committing these breaches is very high, also because a fund and/or its manager may be held liable of money laundering not only if they willingly participate in money laundering activities but also if they are unable to detect and prevent investors from using the fund to launder the proceeds from their criminal activities. The impact is very high as penalties may range from extremely huge fines to withdrawal of authorisation and prosecution of certain officers or directors of the fund and/or of its managers.

Additional legal risks are related to possible breaches of fund law and of fund documentation (like the fund prospectus/issuing document) in the case subscription agreements are concluded with non-eligible investors or remain in force with investors not meeting the eligibility requirements anymore. Likelihood of this risk is quite low and its impact is moderate.

Breach of rules governing the protection and the processing of personal data represent another legal risk, whose likelihood is high and whose impact too may be moderate to high. Violation of competition law is relatively unlikely, but its impact would be very high.

\(^{40}\) Regulation (EU) 2016/679.
\(^{41}\) Directive 2014/65/EU.
\(^{42}\) Regulation (EU) 600/2014.
4.5. Legal risks connected to the investments and divestments.

The typical uncertain event that may occur in relation to the investment and divestments activity of a fund can be summarised as follows.

When making investments or divestments, a fund cannot know in advance and with certainty whether it is doing a good investment or divestment decision. It is uncertain whether the information, based on which investment and divestment decisions are made, are always complete, entirely correct and meaningful. Moreover, uncertainty affects the process through which said information are analysed and transformed into a final investment or divestment decision. In addition, uncertainty exists as to the accuracy and correctness of the advice received from the various consultants of the fund. For instance, failure to detect some construction issues at the stage of the technical due diligence in connection to the purchase of a building may cause a real estate fund to accept to pay an excessively high price. Likewise, failure to detect some hidden or potential tax liability at the stage of the tax due diligence in connection to the purchase of a privately held company may cause a private equity fund to accept to pay an excessively high price.

More broadly speaking, uncertainty characterizes all the events that can affect the price of an invested asset. This includes, for instance, an unexpected macro-economic event determining the rise of the price of certain securities when a hedge fund has a net short position on these securities.

Moreover, it is uncertain whether directors and officers of the fund will always be able to resist the temptation to obtain huge personal gains by means of insider trading or participation in practises that are often referred to as market manipulation.

If co-investors or banks commit to provide financing, a certain degree of uncertainty exists as to whether they will be actually able and willing to provide said financing at the moment of the acquisition. More in general, uncertainty is connected to the so-called counterparty risk, that includes failures of buyers and sellers or also prime brokers to honour their obligations.

The rules applicable to these phases are those provided in fund law of the country of domiciliation of the fund as well as in the fund prospectus / issuing document, especially in relation to the definition of eligible investments and portfolio diversification requirements.

Other relevant rules include those governing insider trading and market manipulation. They can be very technical and various documents may need to be considered to fully assess which provision may apply to specific conducts. For these reasons, the degree of uncertainty of these rules may be quite high.

Competition law, and especially the provisions governing the abuses of dominant position like art. 102 of the Treaty on the Functioning of the European Union may be particularly relevant for private equity funds. Hedge funds, private equity and real estate funds are also impacted by, respectively, securities and finance law, company law (of the country where the invested company is established), and real estate law (of the country where the acquired immovable property is situated). As various contracts are concluded both with buyers and sellers of invested assets and to service providers that assist the fund in the transactions, all the rules provided in these contracts are applicable, with varying degree of complexity and uncertainty. In many cases these contracts are concluded based on standard models drafted by the service providers. However, some of them may be particularly complex, like in the case of service level agreements concluded between a hedge fund and a prime broker, whereas the latter provides
services including, *inter alia*, securities lending for short selling and margin loans. The same degree of complexity and related uncertainty may characterise the contracts with co-investors and third-party lenders.

Therefore, the legal risks connected to the investment and divestment phases may include, first of all, the risk of breaching the fund prospectus or the fund law when investing in non-eligible assets or when diversification thresholds are not respected. The likelihood is low, the impact moderately high. Wrong investment decisions that adversely impact the value of the fund and cause a financial loss to investors could entail a legal risk insofar as investors are entitled to claim that the fund manager is legally responsible for this and then they may be entitled to ask for compensation. The likelihood is moderate as it may be difficult to assess whether bad investment decisions may entail a legal responsibility of the fund manager. Impact, however, could be moderate to high.

Legal risk may also arise in connection to a violation of a clause in one of the contract concluded with service providers or with buyers and sellers of the invested assets. The likelihood is moderate, the impact may be moderate to high. Breaches of provisions on insider trading and market manipulation are associated to a legal risk whose likelihood is high and whose impact may be very high. The risk of violating competition law is moderately likely only for certain private equity funds that acquire companies in the same sector and subsequently merge them. In this case there is the risk that the invested companies, upon completion of the merger, are in a dominant position which cause them to be subject to increased scrutiny of antitrust authorities. Moreover, should the portfolio company resulting from the merger commit an abuse of dominant position, the stiff penalties that may be inflicted may considerably reduce its value and then the value of the fund investing it. In this case the impact of this legal risk may be extremely high. Violation of competition law may also occur when fund managers use their dominant position (which however is rare as the market is not concentrated) or agreements among them and other companies in the financial sectors (like investment banks when they conduct proprietary trading) to manipulate prices of the assets and then gaining from their fall or rise. (Harrison, D. 2012). Likelihood is quite low, but impact could be high.

Finally, it is worth mentioning the high likelihood and the potentially high impact of violations of securities and finance law, company law (of the country where the invested company is established), and real estate law (of the country where the acquired immovable property is situated).

**4.6. Legal risks connected to the management of the invested assets.**

The ability of a fund to create value for its investors is a function of: (1) the increase in value of the assets that it purchased (which can be measured as the difference between the sale price and the purchase price and which is referred to as capital gain) and (2) the increase in the amount of the periodic (cash) distributions to investors that the fund makes from its inception until its liquidation. It is undeniable the uncertain character of all those events that may reduce the sale price of the fund assets or their ability to pay an income to the fund and ultimately to investors. Without attempting to provide an exhaustive list, it is possible to mention the following examples.
For real estate funds, uncertain macroeconomic events like a worldwide economic recession or the slowdown of the economy of the specific area where real estate assets are situated may reduce the demand for buildings and lands and then compress rents and prices of assets in the fund’s portfolio. Moreover, interest rates growth tends to reduce the price of real estate and then the ability of the fund to create value thanks to an increase of the price of its assets. Other uncertain events may be specific to the individual real estate asset in the fund portfolio. For instance, unexpected needs for repairs or the increase of delinquent tenants adversely affect the value of the individual asset experiencing these issues and, indirectly, of the fund as a whole. A real estate fund may try to increase the value of the invested assets with strategic maintenance and repairs, by improving the service to tenants so that they may accept to pay higher rents, by monitoring the financial situation of tenants to anticipate and prevent delinquency. (Manganelli, B. 2015). However, uncertainty remains as to whether these initiatives (which clearly entail costs) might bring the expected results.

For private equity funds, the arguments concerning the uncertainty of the macro-economic situation are quite similar to those discussed above for real estate funds and then they will not be repeated. At microeconomic level it should be noted that many efforts could be undertaken to increase the profitability (and ultimately the market price and the sale price of the invested company). They may affect every function of the portfolio company and of course their result is uncertain. Moreover, it must be reminded that each risk (including legal risk) that may directly concern the invested companies is tantamount to an uncertain event liable of affecting the fund in an indirect way.

For hedge funds the same consideration developed above for private equity funds may apply insofar as their shareholdings in the invested company (or also their holding of other financial instruments issues by the invested company) is large enough to allow them to exert some control on the decisions of the management of the company. This phenomenon is often referred to as hedge fund activism (Brav, A., Jiang, W., Kim, H. 2012). Besides the specific case of activist hedge funds, considering the variety of strategies adopted by hedge funds the events that may affect the increase and decrease in value of the assets under their management are manifold, and as a result their uncertainty is extremely high.

The rules that are relevant in this phase are basically the same as those described in the investment (and divestment) phase and therefore they will not be repeated. In addition to them, a mention should be made to the possible relevance of the labour law of the country where the invested company is situated. Private equity and activist hedge fund often create value for their investors by reducing costs and increasing efficiency in portfolio companies, which may entail layoffs of a considerable number of employees. Possible disputes may arise with them and may possibly involve trade unions or also local or national public authorities and in these cases provisions of labour law could be invoked to ask for compensation or other forms of payments or to even restrict the plans that the fund had in relation to drastic restructuring of workforce in the invested company. The degree of uncertainty of the content and of the actual application of labour law may be quite high, also considering the social and political implications that massive layoff may have.

It can be concluded that the main legal risks along this phase of the fund’s lifecycle are related to limits imposed by applicable provisions of real estate law, company law, securities law,
labour law that the fund my encounter when trying to increase the value of the invested asset. Likelihood is rather high, impact moderate to high.

4.7 Legal risks connected to the reporting, disclosure, transfer of information.
Uncertainty exists as to whether the staff in charge of the reporting might always be able to report all the required data and information in a complete and correct way and within the obligatory deadlines. It may simply be unable to do so also because of understaffing or poor organisation of work and suboptimal allocation of workload.

The applicable rules have already been described in detail in paragraph 2.7 above and at it is now possible to limit the discussion only to their degree of uncertainty. FATCA and CRS present quite a high degree of uncertainty, notwithstanding the fact they are written in a very detailed way, because the specific obligations they impose to investment funds result from a multi-layered, complex framework. In case of EMIR, uncertainty as to the content of the rule is reduced by the fact that EMIR is a regulation directly applicable in all EU member States, which reduce the possibility of differences in implementation across countries. Furthermore, the fact that ESMA adopts technical standards and guidelines may help funds to interpret correctly the text of EMIR. Rules of the AIFM concerning reporting and disclosure (both to competent authorities and to investors) present a certain degree of uncertainty due to their multi-layered character and their high degree of complexity. This uncertainty is partially reduced thanks to the contribution of ESMA in drafting technical standards.

Based on this discussion, the legal risks connected to this phase of the fund lifecycle mainly consist in breaches of the rules requiring to correctly and timely report to the competent tax authorities (under FATCA and CRS), to competent supervisory authorities (under AIFM directive and implementing instruments) and to trade repositories (according to EMIR). The likelihood is quite high, impact may be moderate to high. An additional legal risk originates from failure to comply with rules (mainly provided in the AIFM directive framework) to report to investors, which may also entail a breach of contractual obligations entered into between the fund and the investor (thus allowing the investor, under certain circumstances, to claim for damages). The likelihood of this risk is moderate, and its impact too is usually moderate.

4.8. Legal risks that may occur along the entire fund lifecycle.
The uncertain events that may affect the fund and the fund manager irrespective of the specific phase of the fund lifecycle are summarised as follows.
Employees of the fund, acting within their professional functions, risk to be involved in corruption, which can be defined as the abuse of power for private gains and includes bribery, trading in influence and abuse of functions. In detail, bribery can be defined as the “offering, giving, soliciting, or receiving of any item of value as a means of influencing the actions of an individual holding a public or legal duty” whereas “this type of action results in matters that should be handled objectively being handled in a manner best suiting the private interests of the decision maker”44. Without attempting to provide an exhaustive list of cases, this definition may cover situations in which an employee of the fund manager offers bribes to an officer.

44 Legal Information Institute, Cornell University. [https://www.law.cornell.edu/wex/bribery](https://www.law.cornell.edu/wex/bribery) retrieved in June 2018.
working at a public supervisory authority (a “competent authority” as it has often been called in this paper) to obtain the authorisation to market the fund whereas the fund would not meet the legal requirements to obtain said authorisation. It would also cover the event an officer of the fund manager promises a benefit to a senior employee of the depositary bank if the latter fails to report certain irregularities that he discovered. The above-mentioned examples are cases of active corruption, in the sense that it is the fund manager, through its officers and employee, that corrupts another person. However, also the event of passive corruption may materialise. It is the case, for instance, of the employee of a fund manager receiving money from one investor to unduly obtain a more favourable treatment than other investors.

Events in which a fraud may occur may be even more frequent. They may include any attempt to artificially increase the value of the assets under management for instance to attract more investors and to obtain higher fees. The event a conflict of interest may occur is also very frequent, when the fund manager’s conduct instead of ensuring the respect of the rights of the investors tends to favour its own interests.

Specific rules aiming at tackling corruption are included in all domestic legal systems and many of them have extraterritorial character. (Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C. 2011). Even though it is often clear and certain which conduct are to be regarded as corruption and then to be absolutely avoided, a certain degree of uncertainty may be caused by said extraterritorial character, because the same conduct may be sanctioned by tribunals of various jurisdictions under their respective law.

Fraud and conflicts of interests are governed by a variety of national rules. Considering the huge number of specific cases to which the notion of fraud and conflict of interest may apply, the uncertainty of the specific provision that are applicable in the specific circumstance is quite high. Conflicts of interests of alternative asset managers are specifically addressed in regulation 231/2013 at art. 30 and 63 seq.. The provisions of regulation 231/2013, albeit very important, cannot prevent the simultaneous application to investment funds of many other relevant rules also under different domestic legislations.

For the reasons explained in this paragraph, the legal risk connected to the involvement of the fund and the fund manager in corruption, fraud and conflicts of interest is extremely high, as both the likelihood and the impact are very high.

4.9. Summary of the uncertain events and the uncertain rules.

Figure 6 (Appendix 1) provides a summary of the discussion developed in this chapter. The phases of the fund lifecycle are described in the blue cases, the uncertain events in the yellow cases and the uncertain rules in the orange cases.

It should be noted that, in addition to what is depicted in figure 6 and as it has been discussed in this chapter, legal risk may also materialise in case of failure to comply with fund documentation or contracts concluded with any third party (from investors, to buyers and sellers, to external service providers).
5. Risk mitigation measures.

5.1 Mapping and prioritizing.
As resources (intended in a very broad way, so as to include, for instance, money, workforce, and time) are necessarily limited, it is crucial to distinguish the risks that can never be accepted from those that can be tolerated and possibly mitigated. This consists, in other words, in drawing up a map of legal risks, from which it is possible to assess the legal risks that present the highest combination of likelihood and severity and based on which it is possible to take decisions about prioritisation. This exercise can be done by using the same findings of the analysis developed in the previous chapter and then by consolidating them into a single matrix, like the one presented in figure 7 (Appendix 1). It must be noted that this matrix is a “general” and “abstract” one in the sense that it is a tentative synthesis of several inputs gained consulting relevant literature and received from a broad array of professionals from many different companies. Therefore, individual organisations within the investment funds industry may need to slightly customise it, depending on their peculiar features and business models. However, I am convinced that this customisation would not lead to a very different map of legal risk.

5.2 The three lines of defence.
A fund manager must set up a structure that allows a proper detection and then prevention and mitigation of the legal risks as they have been identified and “mapped” according to the procedure described in the previous chapters. A model that is widely used in risk management (including but not limited to legal risk) is the one often referred to as the “three lines of defence”, which is represented in figure 8 (Appendix 1).

The first line of defence is represented by the so called “business owners”, in other words, those who perform the activities related to the core business of the organisation. In the case of investment funds, business owners are those who are actually setting up, managing and administering the funds. This category includes portfolio managers, accountants, fund operations specialists just to mention a few. All of them must be aware of and must deal with specific risks like market risk, liquidity risks, operational risk, counterparty risk. The first line of defence also includes the legal and corporate department. The in-house counsels and the legal and corporate officers (who are in principle the two main professional profiles that can be found in an in-house legal department) are business owners in the sense that they are immediately involved in the core business of the fund in a wide variety of ways. They play a key role at the moment of setting up the fund and in designing, implementing and administering the fund corporate structure. In practise they have the primary responsibility of drafting the fund documentation which includes the fund issuing document or prospectus and the articles of incorporation if the fund is set up as a company, or the management regulation if it is set up in a contractual form, or the trust deed if it is set up as a trust. They are also responsible for drafting the legal documentation for the incorporation of the companies that are part of the fund structure and the instruments governing intragroup financing (from plain-vanilla intragroup loans and equity contribution to the most complicated and exotic hybrid financing instruments). They are also in charge of the contracts with all the third-party service providers (like the depository bank, the advisors, the prime broker), co-investors, providers of third party debt financing and buyers and sellers of the invested assets. In practise, many of the documents mentioned above
are not physically drafted in their entirety by the legal department of the fund manager but by its lawyers and advisors. However, the legal department must at least review them and ensure that they are in line with the needs and the peculiarities of the fund. An example based on the (not so hypothetical) real estate fund described in chapter 1 of this paper may clarify this interplay between the in-house counsels and their external legal advisors. This fund is domiciled in Luxembourg and it is acquiring buildings in Spain, Italy and Germany. The in-house counsels of the fund are in principle expert of Luxembourg law (with a focus on fund law, company and commercial law and sometimes on taxation). They cannot be expert of detailed provisions of Italian, German and Spanish company law, real estate law and administrative law. Therefore, for the acquisitions of assets in these countries they need to rely on law firms established in Italy, Germany and Spain respectively. However, these law firms have a limited knowledge of their (client) fund, and on the peculiar features, also from a legal perspective, of a fund situated in a country other than the one where they are established. For these reasons even when the in-house legal department of the fund outsources the performance of legal tasks to external advisors, it must always have a full understanding of the content and of the implications of the advice it receives and of the legal documentation whose draft has been outsourced to ensure consistency and coordination.

In addition, it should be stressed that the in-house legal department is regularly interacting with the other departments of the fund manager. Among the almost endless examples that can be provided, it could be mentioned the confirmation that the legal department may give to finance department that certain calculations of amounts due to investors or to be paid within the framework of intragroup transactions are in line with applicable legal documentation (like intragroup financing instruments and the fund prospectus). Likewise, the legal department may ensure that the prospective investment envisaged by the portfolio managers are consistent, *inter alia*, with the applicable legislation and with the fund prospectus.

The second line of defence is performed by those actors who are often referred to as “standards setters”. This notion in turn covers several components of internal governance like compliance, risk management, quality, and other control departments that are entrusted with the task of monitoring and facilitating the implementation of effective risk management practices. Focusing on the second line of defence in relation to legal risk, a key role is played by the compliance department.

The compliance department carries out an important role in managing legal risk both *ex ante*, i.e. before business owners perform their duties and *ex post*, i.e. after business owners have completed their tasks. Even though the ultimate goal of both compliance and legal department is the correct application of the relevant rules, the perspective from which they achieve this objective and their *modus operandi* are and must be different. Also for this reason, an healthy organisation should make sure that legal and compliance departments are separate or, if there is a single department in charge both of legal and compliance tasks, that the in-house counsel and the compliance officer functions should remain separate and the (chief) compliance officer should not be subordinate to the in-house counsel or to the head of legal department, but he should rather report directly to the CEO or to the board of directors. This is consistent with the need for the compliance function, as part of the second line of defence, to be able to independently monitor and if needed challenge (also) the legal department, the latter being part of the first line of defence. On the other side, exchange of information and know-how between
legal department and compliance department remains essential, especially considering that both departments need to analyse and interpret the applicable rules. Furthermore, they should both ensure that application of said rules is made in the most correct but also in the most efficient way for the achievement of the business objectives of the fund manager.

One of the key tasks of the compliance function consists in monitoring, collecting, analysing and consolidating rules that come from a complex, multi-layered and fast changing framework into a single consistent and clear set of internal procedures. This requires the performance of a regular and systematic “regulatory watch” which must lead to the constant update of said internal procedures. This task may entail a certain degree of overlapping with the legal department, but this does not represent an issue by itself. The only point of attention consists in making sure that regulatory watch is not performed twice (i.e. by both compliance and legal department) as this could cause useless cost duplication.

Another key task of the compliance function consists in constantly training business owners to make sure that they are aware of the internal procedures discussed above. Setting up formal and mandatory training programs is essential, but it is even more useful when the compliance department is able to rapidly and appropriately answer to any query from business owners concerning these procedures and their practical application to specific situations that may be dealing with in their day-to-day activity. This is consistent with the need to maintain a constant dialogue with business owners, which would enable compliance to be informed of possible issues, challenges and uncertainties that are not covered or are not properly addressed by the internal procedures (which should then be updated accordingly). This would help the compliance department to understand the extent to which the internal procedures that it developed are effective in managing the legal risk, if they impose an excessive burden and if other procedures could ensure the same degree of risk detection and mitigation with less costs. Moreover, compliance should constantly monitor and review the respect of the procedures and the extent to which they have indeed helped to prevent legal risk from materialising or, in the case legal risk materialised, how they have proven effective in reducing its impact. This pertains to the ex post management of legal risk. Ex post controls, however are primarily the responsibility of the third line of defence.

Internal audit forms the organisation’s third line of defence. The assurance provided by internal auditors should cover how effectively the organisation assesses and manages its risks. Internal auditors are also entrusted with the task of assessing the effectiveness of the first and second lines of defence. Compliance and internal audit should coordinate between them the performance of controls a posteriori of the first line of defence. It this case it should be clarified well in advance which are the specific duties and obligations of compliance and internal audit respectively and this should be formalised in mandatory internal corporate documents or policies which should be regarded as a key element of the corporate governance of the fund and the fund manager. The controls mentioned above include both the periodic reviews of the activities of the business owners, that must be conducted on a regular and systematic basis, and the ad hoc and more in-depth investigations that are necessary when an unexpected situation is detected that may cause legal risks to materialise. These situations are usually detected either during the performance of regular and planned controls and file reviews or when a whistle-blower reports severe violations of applicable rules to the compliance functions. It is essential that clear procedures are in place to ensure that irregularities detected during routine file reviews
or by whistle blowing are escalated and dealt with. The protection of the whistle-blower (which entails, in primis, that his or her identity should not be disclosed) is essential (Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C., 2011) (Webster, A., 2015) and the lack of appropriate internal procedures ensuring this may represents itself a relevant legal risk for the fund manager.

The AIFM directive and especially its level 2 delegated regulation 231/2013 require alternative investment fund managers to ensure that an effective compliance and internal audit function are established and maintained. The compliance function must operate independently, and the persons involved in the compliance functions must not perform the tasks that the compliance function is due to monitor (thus preserving the separation between first and second line of defence). The compliance function must be provided with necessary “authority, resources, expertise and access to all relevant information” to be able to properly perform its tasks. The internal audit function too must be separate from the other functions and its main task is to establish, implement and maintain an audit plan based on which it shall examine and evaluate the adequacy and effectiveness of the systems, internal control mechanisms and arrangements of the fund manager, issuing recommendations, if needed, on the results of its evaluations.

To complete the overview of the system of the three lines of defence, it should be mentioned that also actors external to the fund manager may play an important role in detecting and possibly mitigating the legal risk. Reference is made in particular to external auditors, that are mandated by law to audit both the fund and the fund manager, and also to the depository, the transfer agent and the registrar. In the performance of their respective duties, they receive and verify several information and documents of and from the fund and are in a suitable position to detect potential or actual infringements of the applicable rules and to work with the fund manager to prevent and/or mitigate the legal risk associated with these violations.

Finally, it must be noted that the management of legal risk is ultimately a duty and a task of all the functions and persons working at the fund manager. In particular, awareness of legal risk and of the need to ensure that the organisation is able to properly manage it, should be fostered and promoted in primis at the level of the board of directors and of the top management, which is also ultimately responsible for the severe violations of the law and for failure to put in place adequate measures and internal processes to detect and avoid them or to mitigate their effects. (Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C., 2011) (Collard, C., Roquilly, C., 2010). (Roquilly, C., (ed.) 2011). Likewise, the top management should promote a company culture where illegal and unethical behaviours are not tolerated, and, at the same time, employees are encouraged to promptly report potential or actual legal risks and breaches of law. (Dauer, E. A. 2006) (Collard, C., Delhaye, C., Loosdregt, H., Roquilly, C., 2011). This does not mean the promotion of a “blame thy colleague” culture, which could lead to the opposite result. In fact, in a company where it is commonplace to harshly criticize and attack employees for any minor mistake, there is the risk that employees prefer to make efforts to hide minor issues rather than reporting them and actively collaborating to prevent them from turning into major legal risks.

45 Delegated Regulation 231/2013, art.61. On the importance that the compliance function is given sufficient autonomy and resources, also considering the crucial but for many aspect fragile position of the compliance officer who may be regarded as a business broker when hindering transactions which present a non-tolerable legal risk see, for instance: DeMott, D. A. 2013.

46 Delegated Regulation 231/2013, art.62.
5.3 The contribution of fund service providers and regtechs in the management of legal risk

The AIFM directive provides that the two key core functions that an alternative fund manager must at least perform are the portfolio management and the risk management. It can delegate only either but not both of them and said delegation must be properly justified. Moreover, the fund manager must always be able to exercise ultimate supervision on the entities to which the function is delegated.

It should be noted that a fund needs several services in addition to portfolio management and risk management. The AIFM directive allows the fund manager to provide them: they consist in regulatory compliance monitoring, legal and corporate secretarial services, accounting, valuations (including NAV calculations that are made usually based on accounting data) customer inquiries, tax returns, maintenance of unitholders or shareholder register, distribution of income, issues and redemptions of units and shares, record keeping. Moreover, the fund manager may directly take care of marketing the funds under its management to investors and may perform those activities that are related to the administration of the assets of the alternative funds. These services include for instance: administration and exploitation of immovable properties held by the funds, administration of the companies that are part of the fund corporate structure, advice on capital structure, industrial strategy, mergers and acquisitions (which is particularly relevant for private equity funds).

In relation to all these services, the fund manager must carefully decide whether to insource or outsource them. (Chirico, A. 2010). The pros and cons of each option may be summarised as follows.

If the fund manager externalises one or more of these services, it could focus on its core activities and on the tasks for which it has special expertise. For instance, a hedge fund focusing on convertible arbitrage strategies would reasonably aim at recruiting the top portfolio managers with great expertise in financial analysis but would find relatively little interest in developing an internal expertise in updating the fund’s register of investors. Moreover, outsourcing certain services allows to choose the service provider that has a special reputation and proven expertise in each service. The same hedge fund of the previous example, rather than building a department in charge of updating the shareholder register just for its funds, may entrust with this task a third-party service provider that specialises in this kind of services and that disposes of adequate workforce and robust procedures to do it in a systematic and organised way, thus achieving economies of scale and reducing the risk for mistakes and inefficiencies. Moreover, as service providers usually are bigger structures than fund managers, they could be able to better handle the employee back-up system and be less affected from organisational problems that may arise in case, for instance, of sickness or resignation of a member of the staff. Finally, the third-party service provider (acting as an additional external third line of defence) would be able to double-check the information and the data that it receives from the fund manager to perform the outsourced tasks and could inform the latter should it find inconsistencies and mistakes. In this sense, outsourcing certain activities to third party service providers could help to increase efficiency, limit mistakes and ultimately reduce the legal risk related to failures to comply with the rules applicable in relation to the performance of outsourced the tasks.

On the other side, outsourcing presents some disadvantages. First, it tends to increase costs. The same service costs much more if it is charged (often on a time spent basis) by a third party service provider rather than if it is performed by salaried staff of the fund manager. 49 From this perspective, outsourcing is acceptable from a financial point of view only if the number of funds under management and the amount of work to be performed for them is so limited not to justify building in-house resources to perform it. Another aspect that must be considered is that by outsourcing the fund manager could lose control on certain processes and information, while remaining ultimately responsible for them. This represents a possible legal risk, as the fund manager would be liable for losses incurred by the fund should outsourcing prove to be severely inappropriate or if it is unable to maintain full control and supervision on the activities that it outsourced.

An additional consideration should be made. In the last few years, rules applicable to funds and their managers have dramatically increased. As a result, compliance costs are rising. Many rules impose burdensome obligations in terms of compliance and reporting (think, for instance, of the FATCA, CRS, EMIR and AIFM annex 4 reporting requirements that have been discussed in the previous chapters). They do not require ad hoc, customised legal advice. They rather impose obligations that can be fulfilled by performing a huge amount of standardised and rather repetitive tasks. It is increasingly clear that humans are not always efficient in performing them, whereas machines could complete them much faster, more efficiently and with virtually no mistakes. This makes it necessary to ensure that a growing number of regulatory reporting and compliance related obligations are done by using automated processes and artificial intelligence. In the last few years a new category of fintech has arisen to satisfy this need. They are referred to as regtech (and sometimes legaltechs). They develop softwares and other IT solutions that may be used by fund managers or by their service providers and that allow computers to perform many tasks that until a few years ago could be done only by humans (Yeoh, P. 2016). Said tasks include the various regulatory filings and reporting discussed before, but also a more effective management of legal documentation, tools for drafting legal documentation and even tools to detect legal risk in an automated way (Mahler, T. 2010) (Mayrell, R. C. 2014). The adoption of these softwares by fund managers may help them to reduce in many situations the risk of errors in the application of the applicable rules and may ultimately result in a viable tool to manage legal risk.

49 A practical example from companies I had experience with in Luxembourg may clarify this point. Let’s assume that the performance of certain corporate secretarial tasks for a group of investment funds require, for instance, 120 working hours per week. Should these tasks be performed by permanent staff of the fund manager, the latter could allocate to them three employees of different seniority that would cost EUR 4,000 per week (an approximation based on gross salaries of EUR 8,000, 5,000 and 3,000 respectively and a month of 4 weeks). Should these services be externalised to an independent service provider, the latter is likely to invoice the fund manager based on the time spent by its staff and applying its standard hourly rate. For people with similar degree of seniority, one work hour may cost to the fund manager EUR 250, 200, and 150 respectively. Even if the service provider, thanks to its specialisation, is able to perform the same tasks more efficiently, let’s assume in only 60 hours, the total amount that the fund manager should pay to the service provider would be EUR 200 x 60 = 12,000, so still three times more expensive than insourcing the same function.
6. Conclusions
This paper has presented a methodology and a process that may be used to identify the main legal risks in the alternative fund management business, and then to assess their likelihood and their impact. Furthermore, the paper indicated how said risks could be properly detected and managed.

It has defined and described the different phases of the fund lifecycle and it has clarified that they could be considered as the different components of the value chain of the fund business, as for each of them value can be created or destroyed. These phases are the following ones: set up of the fund manager, of the fund and the fund corporate structure, marketing of the fund to investors, selection and execution of investments, management of the invested assets, divestments.

Then, the paper has explained that legal risks resulted from the uncertain effect of the combination of the uncertainty of an event and the uncertainty of a rule. It has also mentioned that the same uncertainty that gave rise to a risk could also be transformed into an opportunity. For each component of the value chain of the fund, I detected which were the uncertain events that could occur and the rules that were applicable (together with their degree of uncertainty). I analysed the combination of all these events with these rules and in this way I defined the main legal risks that could arise in connection with each phase of the fund lifecycle. Based on an assessment of the likelihood and of the impact of any of these risks, I prepared a comprehensive matrix of the legal risks. I pointed out that the greatest legal risks are those related to involvement in money laundering, sanction circumventions, terrorism financing, fraud, conflict of interest and market manipulations. Very relevant legal risks are also those related to breaches of competition laws, failure to respect data protection provisions and violation of clauses in contracts with buyers and sellers during investment and divestment processes.

The paper has then explained how, to properly manage the risks thus indicated, an organisational framework needed to be set up which made sure that there was functional separation and independence between business owners, (a notion including the legal department), standard setters (like the compliance department) and internal auditors. I also clarified under which conditions outsourcing to fund service providers or increasing the use of digitalisation, automatization and artificial intelligence could help to reduce legal risk.
APPENDIX 1 – Figures, diagrams and structure charts.

Figure 1. Source: my own elaboration based on Hübner, M., Misra, S., Öztürk, G.Samir, Urtheil, R. and on non-public strategic memos.

Figure 2. Source: my own elaboration based on various non-public corporate and tax structuring memos
Figure 3. Source: my own elaboration based on various non-public corporate and tax structuring memos
Figure 4 Source: my own elaboration based on various non-public corporate and tax structuring memos.

Figure 5 Source: my own elaboration based on various non-public corporate and tax structuring memos
Figure 7. Source: my own elaboration based on the matrix presented in Collard, C., Roquilly, C. (2010).

Figure 8. Source: Chartered Institute of Internal Auditors.\(^{50}\)

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APPENDIX 2 - References

Articles from academic journals.


**Chapters from collective books.**


**Books.**

**Sources of law.**

**EU Law.**
- Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
- Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Luxembourg Law.
• Loi du 12 juillet 2013 relative aux gestionnaires de fonds d’investissement alternatifs (Mém. A 2013, N° 119).

Irish Law.
• Companies Act 1990.
• Unit Trusts Act, 1990.
• Investment Limited Partnership Act 1994.

Italian Law.