

# Alternative Investment Funds as Potential Catalysts in the Realization of Systemic Risk in Financial Markets

## An Analysis of the Current Regulatory Framework in Europe Focusing on Hedge Funds and Private Equity Funds – Thesis summary

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### I. Introduction: setting the scene

The creation and introduction of a European framework for collective investment funds in the European Union in 1985 marked a watershed moment for Europe's investment fund market. This framework, with the so-called UCITS (Undertakings for the Collective Investment in Transferable Securities) directive<sup>1</sup> at its heart can be seen as the first substantial step taken by the European Union to attain its objective of establishing a single market with unified standards and rules for the marketing and distribution of investment funds across Europe.<sup>2</sup>

Prior to the UCITS framework, the rulesets governing investment funds in Europe consisted of an extremely heterogeneous collection of national laws and regulations, which would have made any cross-border or international distribution efforts of investment funds difficult, complex, time-consuming, and costly.<sup>3</sup> For an investment fund or its parent company to comply with these different, divergent, and distinctive rules required by each member state to operate, sell, and market funds across various jurisdictions in the Union therefore prevented the organic, bot-

tom-up creation of a single market for investment funds.<sup>4</sup> The initial iteration of UCITS created a blueprint, which would influence subsequent amendments and new legislation on the European level over the next several decades, as the European Union would continue to pursue the objective of creating a single market governed by a universal ruleset for European investment funds.<sup>5</sup>

While the original UCITS framework was only moderately successful due to comparatively restrictive rules on the allocation of assets,<sup>6</sup> it laid the groundwork for its successor and, eventually, for the AIFMD,<sup>7</sup> which represented the second puzzle piece needed for the establishment of an all-encompassing regulatory framework for European investment funds. The successor to UCITS, usually referred to as UCITS III<sup>8</sup> (as the UCITS II project was never finalized or implemented, although a number

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<sup>1</sup> Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Official Journal L 375 of 31 December 1985.

<sup>2</sup> BRUCE G.A. POLLOCK, *Alternative Investment Funds as Potential Catalysts in the Realization of Systemic Risk in Financial Markets: An Analysis of the Current Regulatory Framework in Europe Focusing on Hedge Funds and Private Equity Funds*, PhD thesis University of Zurich 2020 (zur Publikation im Dike Verlag AG vorgesehen), 110 et seqq.

<sup>3</sup> POLLOCK (fn. 2), 109 et seqq.

<sup>4</sup> POLLOCK (fn. 2), 109.

<sup>5</sup> POLLOCK (fn.2), 110.

<sup>6</sup> POLLOCK (fn.2), 112.

<sup>7</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, Official Journal L 174 of 1 July 2011.

<sup>8</sup> Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, Official Journal L 41 of 13 February 2002. See also Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS, Official Journal L 41 of 13 February 2002.

of its concepts were incorporated into UCITS III<sup>9</sup> was introduced in 2002 and essentially acted as a catalyst for the rapid expansion of the market for European retail investment funds.<sup>10</sup>

Just two years later, the AIFMD, or Alternative Investment Fund Managers Directive, entered into force. The AIFMD, as the name suggests, brought alternative investment fund managers into the purview of the European Union's regulatory efforts.<sup>11</sup> The directive and its accompanying regulation went beyond simply defining an additional category of European fund, but additionally acted (and still acts) as a «catch-all», a residual category for all European fund managers not subject to UCITS or not regulated (i.e. active) within a single national jurisdiction.<sup>12</sup>

It is essential to note here that there is a difference in the regulatory object of the two frameworks, which is conceptually and structurally highly relevant, but in practice has limited ultimate effects. The UCITS framework regulates both the management company and the fund directly (UCITS III was even introduced as two separate directives, the «management directive»<sup>13</sup> and the «product directive»<sup>14</sup>, the product in question being the fund and/or its shares or units), whereas the AIFMD directly regulates the manager of alternative investment funds. Due to the structure and effects of many of the rules, the AIFMD also has the indirect effect of regulating the funds managed by said directors, however.<sup>15</sup>

The most recent chapter in the story of the regulation of investment funds has finally seen a consolidation through the introduction of various amendments to both frameworks. This consolidation effort seeks to create a more level playing field as well as to achieve a more consistent

and equal application of essential regulatory rulesets to all types of European investment funds and their managers.<sup>16</sup>

UCITS III has since seen two major amendments and revisions, meaning the current framework is the UCITS IV/V framework.<sup>17</sup> The AIFMD has been calibrated by introducing several Regulations, consisting primarily of the implementing Regulation, the EuVECA,<sup>18</sup> ELTIF,<sup>19</sup> EuSEF<sup>20</sup> Regulations, and finally the MMFR<sup>21</sup>. These amendments create distinct rulesets for certain subcategories of alternative investment fund managers (and indirectly their funds), namely for venture capital funds, long-term investment funds, social entrepreneurship funds, and money market funds.<sup>22</sup>

## II. A financial crisis as an opportunity

The narrative thread presented above describes the intent of the European Union to establish a single market for investment funds but omits a second fundamental influence that has shaped both the UCITS and the AIFMD frameworks. The global financial crisis of 2007–2008 and all its downstream effects fundamentally altered the course of global financial market regulatory efforts in general, as well as European efforts in particular.<sup>23</sup> A marked shift away from a microprudential focus toward an all-encompassing macroprudential approach to regulation would

<sup>9</sup> POLLOCK (fn.2), 113.

<sup>10</sup> POLLOCK (fn.2), 115.

<sup>11</sup> POLLOCK (fn. 2), 180

<sup>12</sup> POLLOCK (fn. 2), 181.

<sup>13</sup> Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, Official Journal L 41 of 13 February 2002.

<sup>14</sup> Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS, Official Journal L 41 of 13 February 2002.

<sup>15</sup> POLLOCK (fn. 2), 179 et seqq.

<sup>16</sup> POLLOCK (fn. 2), 264 et seqq.

<sup>17</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Official Journal L 302 of 17 November 2009. See also Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, Official Journal L 257 of 28 August 2014.

<sup>18</sup> Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds, Official Journal L 115 of 25 April 2013.

<sup>19</sup> Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds, Official Journal L 123 of 19 May 2015.

<sup>20</sup> Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds, Official Journal L 115 of 25 April 2013.

<sup>21</sup> Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, Official Journal L 169 of 30 June 2017.

<sup>22</sup> POLLOCK (fn. 2), 243 et seqq.

<sup>23</sup> POLLOCK (fn. 2), 109, 179.

likely count as one of the most essential facets resulting from the recent financial crisis.<sup>24</sup>

This shift and renewed focus on what is termed «systemic risk» had substantial impacts on the two European frameworks governing investment funds as well. The crisis also triggered a regulatory frenzy, where regulators sought with renewed fervour to re-establish stable, robust, and resilient financial institutions as well as stable financial markets.<sup>25</sup> These efforts have left direct traces in the structure and form of the UCITS and AIFMD frameworks, specifically leading to the mitigation of systemic risk to emerge as both a conceptual idea and an express regulatory objective. This objective was a central reason for the creation and introduction of the AIFMD.<sup>26</sup>

### A. Systemic risk and investment funds

«Systemic risk» is a term which has no universal definition but has been described by numerous authors as a «know-it-when-i-see-it» concept. This phrase, originally coined by Justice Potter Stewart in the 1960s,<sup>27</sup> epitomizes the nature of systemic risk as a shorthand of sorts for a process or narrative occurring during a period of financial turbulence.<sup>28</sup>

Perhaps one of the most concise definitions has been offered by STEVEN SCHWARCZ, which will be used here to familiarize the reader with this concept. SCHWARCZ defines systemic risk as: «[...] a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both.»<sup>29</sup>

So where would investment funds factor into this and how relevant are they to the creation and manifestation of systemic risk in financial markets? While the definitive answer to this question remains elusive and likely could only be analysed in detail with the aid of statistical, probabilistic, and quantitative methods,<sup>30</sup> a tacit consensus

exists within economic and legal literature on the topic that funds primarily act as conduits in the propagation of systemic risks as it spreads through a financial system.<sup>31</sup>

Investment funds are catalysts and may trigger or accelerate financial instability and volatility in markets due to their function as conduits or «nodes» between other, larger market participants. Investment funds and their trading activities further heighten the degree of interconnectedness of financial institutions, and therefore funds are likely to spread financial shocks and act as propagation mechanisms. Investment funds also may contribute to the «velocity», i.e. the speed with which manifestations of systemic risk spread through financial markets and lead to further contagion.<sup>32</sup>

### B. Regulatory measures mitigating systemic risk posed by investment funds

Having examined systemic risk and financial crises and having described the role investment funds play in the propagation of financial shocks, the approaches of both the AIFMD and UCITS frameworks to addressing these facets of investment funds is the next logical step. In essence, both frameworks attempt to limit the systemic dimensions of funds by establishing rules in three specific areas. While these rules predominantly are microprudential in nature, they frequently also have macroprudential secondary effects.<sup>33</sup>

Primarily, both frameworks establish risk management procedures and prescribe the structure of risk management functions within funds or their management companies. These prerequisites for authorization define the baseline, which aims at enforcing an acceptable standard of risk management by the managers (or by the self-managed funds) themselves. In addition to these provisions, reporting provisions allow supervisory bodies to gather or be supplied with the relevant information in a timely manner, so that they can effectively monitor the activities of funds or fund managers and take corrective action where necessary. Finally, both UCITS and the AIFMD place limitations on the composition of portfolios. UCITS is more explicit in this, as it directly creates rules for and places limits on specific types and combinations of assets, whereas the AIFMD contains more general rules related

<sup>24</sup> POLLOCK (fn. 2), 71.

<sup>25</sup> POLLOCK (fn. 2), 179.

<sup>26</sup> See for example AIFMD recitals 17, 49, 63, 69, 79, 88, 90 and UCITS V art. 99b.

<sup>27</sup> *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

<sup>28</sup> POLLOCK (fn. 2), 64 et seqq.

<sup>29</sup> STEVEN L. SCHWARCZ, *Systemic Risk*, *Georgetown Law Journal* 2008 97, 193 et seqq., 198.

<sup>30</sup> POLLOCK (fn. 2), 75 et seqq.

<sup>31</sup> POLLOCK (fn. 2), 88 et seqq.

<sup>32</sup> POLLOCK (fn. 2), 66 et seqq.; see also 88 et seqq.

<sup>33</sup> POLLOCK (fn. 2), 194 et seqq.; see also 250 et seqq. and 271 et seqq.

to liquidity management, risk concentrations, and leverage limits.<sup>34</sup>

### III. The future of European investment fund regulation

#### A. Impact and effectiveness of rules related to systemic risk

The future of the UCITS framework remains unclear. In 2012, a consultation for the next iteration of UCITS, UCITS VI, was published, but has since then not been developed further. A number of key aspects of this project have since been integrated into UCITS V as well as related legislation and hence, the UCITS VI project will likely remain «dead in the water». While the concrete direction the UCITS framework will develop into is, as of the time of writing, still unclear, it is likely that the framework will experience amendments that will bring it closer in line with the provisions of the AIFMD framework, thus creating a more aligned and integrated overall system of fund regulation in Europe.<sup>35</sup>

The AIFMD framework was reviewed in 2019 and the resulting report on its effectiveness and operation gave clues to what the likely future versions of the framework might look like. In a general sense, the provisions of the AIFMD and accompanying regulation were deemed to have been sufficiently effective and successful in achieving the overarching objective of the regulatory efforts. At the same time, the report brought several deficiencies to light. The alternative investment fund management industry representatives questioned as part of the report were less positive on select portions of the framework, noting that compliance with some provisions prove to be onerous, costly, and insufficiently coordinated with other legislation to avoid duplicate reporting. Specifically, four areas were mentioned: reporting requirements to competent authorities, rules on cross-border marketing, net assets, and various rules related to operational set-ups and processes.<sup>36</sup>

Whether the AIFMD (and to a lesser degree, UCITS) has been successful at mitigating systemic risk cannot be ascertained, but the effectiveness of the overall rule-set may be tested when the next financial crisis manifests itself. A subset of alternative investment funds, so-called

hedge funds, have been termed the «Galapagos Islands of finance»<sup>37</sup> as well as the «canary in the coalmine»<sup>38</sup>, due to their innovative nature and tendency to act as early warning signs of looming financial instability.<sup>39</sup> The true litmus test for the European investment fund framework will hence be the robustness of hedge funds, other alternative investment funds, and UCITS funds more generally and their capacity to survive financial crises. This will demonstrate the effectiveness (or ineffectiveness) of the regulatory framework as a systemic risk mitigation mechanism.

#### B. The way forward and proposed solutions

Having gained an overview of the current state of regulation and potential future developments, one might be curious to read what the optimal future structure of the regulatory framework in question would need to look like in order to be effective at mitigating systemic risk while maintaining and expanding the single market for investment funds.<sup>40</sup>

The most probable development of the framework will likely take the form of a plethora of amendments and additional implementing legal acts. This will lead to a «patchwork» of extensive regulation contained in a wide variety of legislative documents and amended directives. The reason why this development is likely to take place is the twofold: on the one hand the lawmaking process tends to favor gradual smaller amendments and implementing regulation with a limited scope over sweeping amendments and the introduction of politically unpopular extensive legal acts. On the other hand, a gradual transition and «fine-tuning» of legislation permits a more granular approach and allows a form of regulatory «tinkering» with a given framework, rather than being forced to consolidate and create a comprehensive and extensive new legal act.<sup>41</sup>

If forced to make a prediction, the author would wager that gradual consolidation will be the eventual outcome of future developments, despite the fact that there would be a structurally and conceptually more optimal solution to regulate collective asset management in the European Union.

<sup>34</sup> POLLOCK (fn. 2), 164 et seqq.; see also 179 et seq. and 249 et seqq.

<sup>35</sup> POLLOCK (fn. 2), 116 et seqq.; see also 29.

<sup>36</sup> POLLOCK (fn. 2), 282 et seqq.

<sup>37</sup> ANDREW W. LO, *Adaptive Markets: Financial Evolution at the Speed of Thought*, Princeton 2017, 222.

<sup>38</sup> MILA GETMANSKY/PETER A. LEE/ANDREW W. LO, *Hedge Funds: A Dynamic Industry in Transition*, *Annual Review of Financial Economics* 2015 7, 483 et seqq., 531

<sup>39</sup> POLLOCK (fn. 2), 88.

<sup>40</sup> POLLOCK (fn. 2), 295 et seq.

<sup>41</sup> POLLOCK (fn. 2), 288 et seqq.

Such an alternative approach would warrant a fundamental rethinking of the underlying framework by shifting the focus from an entity-based classification to a strategy-based approach, however. As mentioned above, the current UCITS and AIFMD frameworks place a fund or a manager in one of two «baskets», UCITS funds, and all other types (which are regulated by the AIFMD framework). This means that any fund or manager must be authorized and comply with one of the two frameworks, regardless of the actual investment strategy of the fund itself. The inherent flaw in this approach can most easily be illustrated by examining so-called «alternative UCITS», i.e. alternative investment funds that have been structured according to the UCITS framework. While the core investment strategy in many cases may correspond to that of a hedge fund or similar alternative investment fund, the UCITS «wrapper» allows it to be marketed and sold to potential investors under the UCITS framework.<sup>42</sup>

This example underlines the fundamental structural weakness of the current regulatory approach in the European Union with regards to systemic risk. The systemic relevance of an alternative investment fund depends primarily on parameters related to its size (usually determined by measuring the AuM or «assets under management»), interconnectedness, liquidity, leverage, and, most importantly, portfolio composition and investment strategy, whereas the classification or «wrapper» is only of secondary importance.<sup>43</sup>

The author therefore proposes a fundamental reimagining of the regulatory approach, which would consist of sorting investment funds, particularly alternative investment funds, into various categories related to their systemic relevance, which primarily would be determined by their investment strategy. The investment strategy would also dictate which investors (retail or professional) would be permitted to invest in the fund in question. The reason for this is similar to the reason for utilizing a fund's strategy as the primary basis for categorization: the risk parameters that result from the firm's strategy and trading activities directly dictate how likely an investor would be to understand and be able to assess the risks involved in investing in the fund. Investors which would possess neither the understanding nor the financial resilience to invest in high-risk investment funds would be prohibited from doing so, thus fulfilling one fundamental function of investor protection principles.<sup>44</sup>

#### IV. Conclusion: staying competitive in a globalized market for funds

Any future iteration of the European collective investment scheme (i.e. investment fund) regulatory framework needs to strike a balance between facilitating and catalyzing the single market for investment vehicles in Europe while concurrently maintaining financial stability. In addition, certain fundamental aspects of investor protection standards must also be taken into account when designing the regulatory environment for funds and fund managers. Enabling cross-border fund marketing and management activity while keeping markets stable and protecting investors is and will remain a delicate balancing act.

The European Union has been remarkably successful in creating two popular and trusted «brands» of investment funds,<sup>45</sup> UCITS and AIFs (funds authorized according to the AIFMD), but the provisions aimed at protecting against the realization of systemic risk have yet to be tested. The sincere hope of the author is that the «trial by fire» of the frameworks during the next financial crisis will demonstrate that the rules are indeed already sufficiently effective at preventing systemic risk from manifesting itself.

<sup>42</sup> See the description in POLLOCK (fn. 2), 174 et seq.; see also 306 et seq.

<sup>43</sup> POLLOCK (fn. 2), 88 et seq.

<sup>44</sup> See the extensive discussion in POLLOCK (fn. 2), 296 et seq.

<sup>45</sup> POLLOCK (fn. 2), 164; see also 292 et seq.