INTERNATIONAL PERSPECTIVES ON COMMERCIAL AND FINANCIAL LAW 01

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

BRUCE G. A. POLLOCK

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6.1 Introduction

This chapter contains current developments in the regulation of alternative investment funds, as well as policy suggestions. The groundwork for these proposals has been laid in the previous chapters. The ideas presented in the course of this chapter represent possible starting points for further developments of the UCITS and AIFMD frameworks. While the two frameworks do contain certain provisions related to systemic risk, the measures remain relatively limited and fairly basic. This chapter therefore examines additional measures that could be taken to ensure financial stability. The chapter is structured as follows: Initially, the regulatory rationale is examined, which provides the conceptual basis for the policy suggestions. In a second step, the current developments of the UCITS and AIFMD frameworks are described and analyzed. Finally, a number of policy suggestions are presented and evaluated. The final section of this chapter summarizes the main points and provides a concrete suggestion of which future developments of the frameworks would be optimal from a systemic perspective.

6.2 Regulatory Rationale

The regulatory rationale for any legal document provides the justification for any regulatory effort. In principle, if the regulatory rationale is not present or is insufficient, no regulation should take place. The rationale for regulation as presented in this chapter rests on three principal pillars: a description of the issue that requires a remedy, the weighing of the impact of the proposed measures, and an estimation of the effectiveness and efficiency of the measures. The rationale for regulation presented in this thesis relies primarily on an economic approach. The economic approach relies on a cost-benefit analysis, where the net benefit of a regulatory effort is evaluated. While intuitive in theory, a cost-benefit analysis in practice is difficult to achieve due to the absence of precise and reliable metrics. Such an analysis thus remains only an approximation of reality. Where available, surveys and economic analyses are presented as arguments for or against the specific provisions being discussed.

6.2.1 Regulatory Approaches

6.2.1.1 Precautionary Principle

The precautionary principle has a wide array of definitions,[1163] but most essentially describes a concept that permits prophylactic and preventive action to be taken, even when scientific evidence and technical data is inconclusive. The concept forms a part of law and policy aimed at protecting the environment and is enshrined in EU law, as it forms a core component of article 191 of the TFEU.[1164] This precautionary approach seeks to make it possible for policymakers to make timely decisions and take preventive measures, even when scientific or data-driven analysis is inconclusive. In the field of environmental protection, the concept is well established and has been an accepted approach since at least the 1970s.[1165] The precautionary principle is to be utilized only where serious or irreversible damage could be the result of inaction,[1166] though more expansive and radical definitions of the principle demand that in less severe cases, taking action should also be permitted.[1167]

The essential question is whether this precautionary principle could form a part of a regulatory approach in the regulation of financial markets. One proponent of this approach, Pesendorfer, elaborates on the idea of implementing the precautionary principle in the context of financial law, but highlights many of the difficulties involved in doing so.[1168] Pesendorfer questions the need for introducing new spec-

[1163] For a discussion of how to formulate the precautionary principle, see eg Per Sandin, 'Dimensions of the Precautionary Principle' (1999) 5 Human and Ecological Risk Assessment: An International Journal 889.

[1164] Treaty on the Functioning of the European Union. See article 191(2) of the Consolidated Version of the Treaty on the Functioning of the European Union [2012] OJ C326/47. See also Treaty on European Union
Consolidated Version of the Treaty on European Union, OJ C326/13 [2012] art 5.

[1165] Owen McIntyre and Thomas Mosedale, 'The Precautionary Principle as a Norm of Customary International Law' (1997) 9 Journal of Environmental Law 221, 221–223.

[1166] Dieter Pesendorfer, 'Goodbye Neo-Liberalism? Contested Policy Responses to Uncertain Consequences of the 2007–09 Financial Crisis' in Kern Alexander and Rahul Dhumale (eds), *Research Handbook on International Financial Regulation* (Edward Elgar Publishing 2012) 430. See also Joseph Norman, Yaneer Bar-Yam and Nassim Nicholas Taleb, 'Systemic Risk of Pandemic via Novel Pathogens—Coronavirus: A Note' (New England Complex Systems Institute, 2020) 1 <https://necsi.edu/systemic-risk-of-pandemic-via-novel-pathogens-coronavirus-a-note> accessed 31 August 2020.

[1167] Pesendorfer (n 1166) 430.

[1168] ibid 430–431.

ulative financial products as well as authorizing high risk, hedge fund-style investment vehicles, and also raises the question of whether the precautionary principle might be applicable in this context. He argues that for financial products and investment vehicles of a more speculative nature, perhaps an approach more in line with 'better safe than sorry' might be more appropriate than the current one.[1169] While highly controversial, it is evident that the concept is appealing, especially in light of the last financial crisis.

The precautionary principle is only to be applied in cases where the potential damage so far outweighs the cost of the preventive measures to justify such an approach. When regulating alternative investment funds, the precautionary principle only fulfills this prerequisite with respect to systemic risk. In the case of a systemic crisis, if triggered by an alternative investment fund, the overall cost to both the fund and to society would result in a fallout of such a magnitude that preventive ex-ante regulation is justified.[1170] In the case of investor protection, which forms the second rationale for regulation discussed in depth in this chapter, the precautionary principle may not be applied. While this may appear harsh in light of the potential losses that investors may suffer, a balance must be struck between protecting investors and enabling them and fund managers to take risks. In addition, cases where losses are incurred that could have been avoided through more aggressive investor protection measures rarely have direct systemic consequences. Where systemic effects and externalities are not of a disruptive, ruinous magnitude, the precautionary principle should not be invoked to justify regulation.[1171] Investor protection should rather be structured in a manner that reflects both the capacity of investors to make informed decisions and so their appetite for risk corresponds to the losses they are capable of sustaining. Instead of restricting investments across the board, the risk-return profile of an investment, as well as the transparency of its functioning, should determine which investors are suited for and permitted to invest in which types of investment products.

[1169] ibid 431.

[1170] See Nassim Nicholas Taleb and others, 'The Precautionary Principle: Fragility and Black Swans from Policy Actions' (2014) NYU Extreme Risk Initiative Working Paper 1 <www.fooledbyrandomness.com/precautionary.pdf%3E> accessed 20 August 2020.

[1171] ibid 9. Classically, the EU has taken a more precautionary approach to investor protection, see eg Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) 13 European Business Organization Law Review 169, 174.

6.2.1.2 Behavioral Economics and Investor Protection

A recurring theme of this chapter is the interplay between designing provisions that address both systemic risk and investor protection. While systemic risk is the primary topic of this thesis, investor protection, due to its prominence in the UCITS framework, also has to be analyzed. Investor protection in the context of the sale of financial products is classically achieved by providing sufficient information to enable him or her to make an informed decision on whether to invest.[1172] More restrictive rules can prohibit the sale of certain products in more risky or opaque markets to less informed investors, which are usually referred to as 'retail', 'nonprofessional', or 'non-sophisticated' investors. These investors of the protected category are limited in their investment possibilities.[1173] By contrast, professional, institutional, or sophisticated investors will be unconstrained by investment limitations and the general level of their protection is reduced. This is justified by the fact that they are either better informed (as professionals or dedicated institutions) or more able to absorb losses (for example in the case of high-net-worth individuals, which can, depending on the rules, buy financial products other investor types are not allowed to invest in). Finally, investor protection can also be achieved by utilizing more specialized middlemen acting as advisors and brokers. These middlemen are typically bound by conduct-of-business rules and obligations to provide advice and investment services in the best interests of their clients.[1174]

These points lead to three essential questions: First, how well are investors actually able to analyze information and make investment decisions based on it? Second, what exactly constitutes a 'retail' investor, and which assets can be made available to this type? Third, do advisors effectively improve the selection of investment products, and are they sufficiently specialized to give specific advice on complex and alternative investment products?

The first question would, under a classical paradigm which assumed the rational investor to be akin to a pure analytical machine, be answered in the affirmative. In cases where the information might be insufficient under this paradigm, the solution would be to provide more comprehensive information, which would presumably lead to better investment decisions and reduce informational asymmetries between

[1172] Alexander and Madders (n 420) 1084–1085. See also Moloney (n 1171) 184.

[1173] Alexander and Madders (n 420) 1090–1091.

[1174] ibid 1091.

investor and originator, as well as the investor and the advisor.[1175] The comparably young fields of behavioral psychology and economics show, however, that investors exhibit so-called 'bounded rationality'[1176] and are subject to a number of biases and nonrational patterns of behavior.[1177] In this direct context, this obstacle cannot be removed simply by providing an ever-increasing amount of information to the investor. There is a point of diminishing returns, after which additional information does not aid in an investor's understanding, or it simply will not be read or absorbed at all. As a consequence, information to investors must find an effective medium and structure to present only the most relevant information in a format that can be absorbed easily. This format must account for the fact that the investor ultimately is a human with a limited capacity for understanding and a fleeting attention span. This necessarily means that certain information will be omitted in doing this, and the information presented will be simplified and non-technical. The most prominent example of this in the context of alternative investment funds is the KIID, a template for which is included in the appendix of chapter 4.

The second question of differentiating between investor types is fairly simple on the surface, but has facets that are more difficult to reconcile with the underlying rationale for regulation. As described above, two categories are usually created, one for the 'average' investor with no specific expertise or outsized capital reserves, and one for professionals, high-net-worth individuals, or institutions. This is fairly straightforward at first glance, but the question becomes more complicated when it is actually examined more closely. It is relatively difficult to draw the line between the investor who should be able to bear the risk of certain investments,

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[1175] ibid 1085.

[1176] Bounded rationality can be defined as: 'The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world or even for a reasonable approximation to such objective rationality.' Herbert A Simson, *Models of Man. Social and Rational* (Wiley 1957) 198. See also Richard H Thaler, *Quasi Rational Economics* (Russell Sage Foundation 1994) 4. There appears to be a neurological component that limits rationality of investors as well, see N Gregory Mankiw and Mark P Taylor, *Economics* (3rd edn, Cengage Learning 2014) 129–131.

[1177] Alexander and Madders (n 420) 1086. A history of the emergence of behavioral economics can be found with Richard H Thaler, *Misbehaving: How Economics Became Behavioural* (Allen Lane 2015). The preceding development of behavioral psychology is described in Michael Lewis, *The Undoing Project: A Friendship That Changed the World* (Penguin UK 2016).

and the protection-worthy, mere 'consumer-type' investor in financial products.[1178] Retail, nonprofessional investors exhibit rather poor financial knowledge and literacy across the board,[1179] and appear to be prone to making uninformed and poorly though-out investment choices.[1180] Professional investors perform slightly better and are also capable of analyzing information provided to them.[1181] Yet, ultimately, one specific overarching objective that one would want to achieve in designing a financial system would be to unlock previously undeployed capital of retail investors that could be invested in various asset classes previously unavailable to them. Here the primary challenge would be to find a balance between making as many different investments available to retail investors as possible while restricting those where the retail investor cannot understand or assess the risk he or she is taking by investing.

A sort of 'remedy' to this difficulty that is frequently proposed is to incentivize retail investors to seek out investment advice from professionals. Whether this is an effective remedy also provides the answer to the third question of whether advisors actually cause retail investors to make better investment decisions. A large body of literature exists on this topic, and a meta-analysis shows that the evidence that investment advice leads to better investment by retail investors is mixed.[1182] On the positive side, it is estimated that between three-quarters and four-fifths of retail investors appear to seek out investment advice to make up for their limited

[1178] Moloney (n 1171) 172–174.

[1179] G20 and OECD, 'G20/OECD INFE Report on Adult Financial Literacy in G20 Countries' (2017) 7–9 <www.oecd.org/daf/fin/financial-education/G20-OECD-INFE-report-adult-financial-literacy-in-G20-countries.pdf> accessed 1 September 2020. Globally, financial literacy appears also to be quite low, see Annamaria Lusardi and Olivia S Mitchell, 'Financial Literacy around the World: An Overview' (2011) National Bureau of Economic Research, Working Paper No 17107 13–14 <www.nber.org/papers/w17107.pdf> accessed 26 August 2020.

[1180] Hussein A Hassan Al-Tamimi, 'Financial Literacy and Investment Decisions of UAE Investors' [2009] The Journal of Risk Finance 514–515. See also Oscar A Stolper and Andreas Walter, 'Financial Literacy, Financial Advice, and Financial Behavior' (2017) 87 Journal of Business Economics 581, 616.

[1181] W Brooke Elliott, Frank D Hodge and Kevin E Jackson, 'The Association between Nonprofessional Investors' Information Choices and Their Portfolio Returns: The Importance of Investing Experience' (2008) 25 Contemporary Accounting Research 473, 474, 477–478.

[1182] Stolper and Walter (n 1180) 626.

knowledge.[1183] While certain more recent studies point toward investment advice being at least somewhat useful, especially when sought out as a complement to, rather than a substitute for, investment knowledge,[1184] the overall picture indicates that investment advice is only partially effective in compensating for a lack of financial literacy.[1185] This problem is compounded by a host of agency problems that are inherent in the provision of investment advice, which is why, as mentioned above, certain conduct-of-business rules are usually put in place to prevent advisors from taking advantage of informational asymmetries.[1186]

So, what does this all mean when applied to the design of investor protection? Unfortunately, it demonstrates that the retail, non-sophisticated, consumer-type investor cannot fully overcome the limits to his or her capacity to make investment decisions regarding certain types of investments. In addition, advisors are not the solution, as these cannot fully compensate for the deficiencies of their clients, and they also create an additional layer of costs for investors. Advisors also create agency problems, which regulation must address with additional rules. This ultimately leads to only one possible conclusion: The solution to such a problem must primarily be sought in investment products themselves. The product itself has to be classified according to its risk-return profile, as well as how easily investors can understand this profile. This classification must impact the fashion in which the product is regulated and which investors it may be marketed and sold to. In addition, as a secondary measure, the form in which information on investments is presented to retail investors must adhere to the principles of simplicity, coherence, and comprehensibility, and not provide information that is excessively complex, comprehensive, or overly technical.

The argument that supports this can be simply formulated in the following way: If the limitations of the retail investor cannot be overcome, products must be designed and regulated in such a way that they are sufficiently safe to be offered to such investments. Products that do not satisfy this requirement must be restricted to professional investors.

[1183] ibid 626, 630.

[1184] ibid 630. See also J Michael Collins, 'Financial Advice: A Substitute for Financial Literacy?' (2012) 21 Financial Services Review 307, 318–319. See also Riccardo Calcagno and Chiara Monticone, 'Financial Literacy and the Demand for Financial Advice' (2015) 50 Journal of Banking & Finance 363, 364–365, 372.

[1185] Stolper and Walter (n 1180) 626. See also Calcagno and Monticone (n 1184) 364–366.

[1186] Alexander and Madders (n 420) 1100.

6.2.2 UCITS VI

6.2.2.1 The UCITS Consultation from 2012

The next evolution of the UCITS framework would have begun with a consultation document, which was published on 26 July 2012. This consultation document contains a laundry list of possible areas of reform, including product rules, liquidity management, depositaries, money market funds, and long-term investments.[1187] The eight areas forming part of the study are included below as a table.

Following the consultation, no further action was taken by the Commission, hence, it can be assumed that the proposal likely will not mature into the next iteration of UCITS. It is interesting to note that a number of areas of potential reform that formed a part of the consultation have either been implemented in separate legislation or become part of the UCITS and AIFMD reforms without explicitly having been connected to this consultation from 2012. For example, both money market funds and long-term investments subsequently received their own regulations, but are seen as a part of the AIFMD framework, as these two types of funds became essentially AIF-variants subject to various exceptions and less-onerous rules. Also following the consultation, two new regulations that seek to create a level playing field across the board for the cross-border distribution of funds have been implemented. The proposals and implementation are described in section 6.3.1. As it appears that parts of the UCITS VI reform process have thus become implemented in different forms and other aspects never were addressed after 2012, it can be assumed that the UCITS VI process, as begun in 2012, is 'dead-in-the-water'. It is likely that instead of a comprehensive reform process under the UCITS banner, the reformation efforts will take the form of smaller regulations or will become part of the looming AIFMD reform, which, at the time of writing, could likely result in a proposal for a new directive sometime in late 2020 or early 2021.[1188]

[1187] Commission, 'Consultation Document on Undertakings for Collective Investment in Transferable Securities (UCITS) – Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-Term Investments' (n 779) 1.

[1188] See the Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (FISMA/2016/105(02)/C, European Commission, 2018), Commission, 'Commission Staff Working Document Assessing the Application and the Scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers' SWD (2020) 110 final and the Commission, 'Report from the Commission to the European Parliament and the Council Assessing the Application and the Scope of Directive

One interesting aspect to note is that the Commission explicitly included a section asking respondents whether the UCITS and AIFMD frameworks were sufficiently aligned, and in what areas further harmonization might be necessary. The fact that this was already a central issue at the time the consultation document was released demonstrates that the two frameworks are likely going to become increasingly aligned as they are reformed and developed further. This also points to the fact that the two frameworks inevitably will need to become more similar and comprehensive to create a truly coherent set of rules for governing investment funds and their managers.[1189] The author argues that since this trend already leads to a convergence of the two frameworks, it would be most effective and efficient to ultimately pursue a unification and restructuring of the two frameworks to create one single system. This idea is explored further in section 6.4.5.1.[1190]

6.2.2.2 Table 6a: The Eight Areas of Review in the UCITS VI Consultation[1191]

1. Eligible assets and use of derivatives:	• Rules on portfolio management & composition (eligible assets) • Fund investment policies • Exposure limits and risk spreading rules
2. Efficient portfolio management techniques:	• Management of collateral • Counterparty risk
3. Over the counter (OTC) derivatives:	• Clearing of OTC derivatives • Operational risk and conflicts of interest • Frequency of calculation of counterparty risk exposures

2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers' (n 352). See also section 6.2.3.

1189 Commission, 'Consultation Document on Undertakings for Collective Investment in Transferable Securities (UCITS) – Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-Term Investments' (n 779) 19.

1190 See section 6.4.5.1.

1191 See Commission, 'Consultation Document on Undertakings for Collective Investment in Transferable Securities (UCITS) – Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-Term Investments' (n 779) 3–19.

4. Extraordinary liquidity management rules:	• Liquidity safeguards • Internal policies on liquidity constraints • Suspension of redemptions • Side-pockets
5. Depositary passport:	• Assessment on whether a depositary passport should be introduced for UCITS depositaries
6. Money Market Funds (MMF):	• Strengthening the resilience of the MMFs • Macroprudential risks posed by MMFs • Need to harmonize legislation on MMFs at the EU level • Valuation and capital buffers of MMFs • Liquidity bottlenecks • Redemption gates for investors and liquidity fees imposed on investors who redeem their investment
7. Long term investments:	• Appetite of retail investors to invest in funds invested in long term assets • Eligible assets for such funds • Investor protection and protection of retail investors • Whether UCITS funds should be permitted to invest in such long term funds
8. Addressing UCITS IV:	• Self-managed investment companies • Fund mergers • Notification procedure • Alignment with the AIFM Directive

6.2.3 The AIFMD Review Process

6.2.3.1 The Timeline and Content of the AIFMD Review Process

Article 69 of the AIFMD states that the European Commission must begin the directive's review process by 22 July 2017.[1192] The review takes into account inputs from both the industry and from regulatory authorities by conducting a public consultation, The report also includes an analysis of the effectiveness of the AIFMD in achieving its objectives and its impact on investors. Article 69 also

[1192] AIFMD, art 69.

prescribes some of the focuses of the review by naming specific rules that are to be examined and analyzed.[1193] The areas that are principally focused on include the passporting system, which is the AIFMD's marketing and management procedure and the impact of depository rules, as well as the transparency and reporting requirements, and their effect on the assessment of systemic risk. In addition, investments by professional investors and the impact on retail investors are mentioned, as well as the impact on investor access and investment in developing countries. Finally, the impact of the directive on the European private equity and venture capital market, as well as the impact and protection of small non-listed companies and issuers are mentioned as well.[1194]

6.2.3.2 The Report on the Operation of the AIFMD

As a direct consequence of the procedure described above, the European Commission has since published a report on the operation of the AIFMD. This analysis was submitted on 10 December 2018. The report gives an extensive overview of the impact the AIFMD has had on the European alternative investment market.[1195] The first part of the report utilized a general survey in order to evaluate the opinions of stakeholders, including asset managers, advisors, and other entities involved in the management of alternative investment funds. In addition, the opinions of national, European, and global industry representatives were sought.[1196] The second part of the report is an assessment of the impact the AIFMD has had. To assess the impact of the directive, the report uses several sources of infor-

[1193] ibid.

[1194] See AIFMD, art 69.

[1195] See Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188).

[1196] ibid 19–20. The exact composition of the stakeholders questioned as part of the survey can be found on page 55 of the same document. 51% of stakeholders were alternative investment fund managers, 12% were investment managers or advisors to alternative investment funds, 9% were industry representatives, an additional 9% were fund administrators, 8% were depositaries, 7% institutional investors or counterparties investing on their own account, 6% external valuers, 5% entities that market, sell, or select funds for investors, 4% fund accountants, and the remaining 19% were other entities. The question was multiple choice, which means certain respondents belonged to multiple categories at once.

mation:[1197] first, research;[1198] second, interviews;[1199] third, results from general survey;[1200] fourth, interviews;[1201] and fifth, quantitative data[1202] from ESMA's database,[1203] NCA's data,[1204] trade association data from across Europe,[1205] and investor complaints data.[1206]

6.2.3.2.1 Issues Identified by the General Survey

The results of the survey highlight several key areas where the effects of the AIFMD might require optimization. The focus of the survey was on the following areas: reporting requirements, rules on leverage, valuation procedures, remuneration policies, the separation of risk management from other functions, depositary rules, disclosure to investors, private equity investments, the passporting system and its impact on the European market for funds, and how the AIFMD interfaces with other European frameworks.

6.2.3.2.2 Macroprudential Aspects

6.2.3.2.2.1 Reporting Requirements

Reporting requirements are a foundational element of the AIFMD. It could even be argued that were there no reporting of data by alternative investment fund managers to regulators, many, if not most, provisions of the AIFMD would become ineffective. A regulator would not be able to monitor effectively, nor could compliance be assured. Without the mandatory periodic disclosure of information, su-

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[1197] ibid 19.

[1198] ibid.

[1199] ibid.

[1200] ibid.

[1201] ibid.

[1202] ibid.

[1203] ibid 125–126.

[1204] ibid 126. National competent authority or NCA is a general term used to refer to the various competent supervisory authorities within member states. The abbreviation NCA appears frequently in official European Union documentation. See, for example, European Securities and Markets Authority, 'Board of Supervisors and NCAs' (2019) <www.esma.europa.eu/about-esma/governance/board-supervisors-and-ncas> accessed 31 August 2020.

[1205] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 127.

[1206] ibid.

pervisory bodies would likely find it extremely difficult, if not impossible, to regulate alternative investment fund managers.

The results of the survey were divided into two parts: responses given by national competent authorities[1207] and responses given by fund managers. An overwhelming majority of respondents agreed that accurate, timely, and complete reports on all managed alternative investment funds were provided by managers and received by the competent authorities. There was a broad consensus that the flow of information from fund manager to authorities functions in principle. Responses to the question of whether a consistent understanding existed on what must be reported according to the reporting template were less positive. Only a third of the national competent authorities and around a quarter of managers felt that a 'consistent understanding' exists. The number of fund managers responding that consistent understanding is present within their member state was more than half, while only a quarter felt this understanding existed across the EU. Additionally, fund managers were not in agreement on whether the data covered was essential and without duplicates. Only around a third of the fund managers that participated in the survey agreed that data was essential. The same ratio agreed that data is not duplicated, meaning it has to be reported in other sections of the reporting template.[1208]

The results of the survey indicate that the reporting mechanism functions relatively well, and that both mangers and authorities see the implementation of the AIFMD as successful. Interestingly, slightly more than half of respondents felt that reporting requirements have not changed significantly since the introduction of the AIFMD, and that reporting requirements prior to the directive were similar.[1209] While at first glance this may seem disheartening, in the sense that the AIFMD's rule set might have proved superfluous in cases where robust data reporting requirements already existed, it also means that the directive provides some continuity for authorities and management companies familiar with the mechanics of reporting. The fact that both the competent authorities and fund managers felt that understanding of reporting templates was not consistent highlights an issue with the fundamental reporting mechanism. It appears that in certain jurisdictions, the implementation of the AIFMD framework has not been conducted in a clear manner. It will be interesting to follow how the situation develops in the future and

[1207] As mentioned above, national competent authority or NCA refers to the various competent supervisory authorities within member states. See fn 1204.

[1208] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 82–84.

[1209] ibid 83.

whether these difficulties are mere teething problems of a young directive, or whether detailed additional rules and mechanisms will be needed to create transparent and clear reporting processes.

6.2.3.2.2.2 Leverage in Alternative Investment Funds[1210]

Leverage in alternative investment funds that are subject to the AIFMD is relatively low and rare, with the exception of hedge funds, which are primarily synthetically leveraged through the use of derivatives.[1211] The results of the survey confirm this. Almost nine in ten respondents reported a leverage ratio of less than two to one, while almost half of the respondents reported a leverage ratio below even 1.1. National competent authorities that were questioned indicated that the effect of alternative investment funds on the buildup of leverage, and by extension on systemic risk, was 'quite moderate'.[1212] Less than 10% felt that alternative investment funds had a significant effect.[1213]

Despite leverage being low, the respondents to the survey pushed for clarification on the rules on calculating leverage, some calling for a change to the rules. The reason for this, as stated by respondents, was a discrepancy between the rules of the AIFMD and industry practice, and the poor fit of these rules with closed-ended funds.[1214]

The results of this survey are quite telling, as they demonstrate a fundamental structural deficit of the AIFMD that results from creating a single set of rules for all alternative investment funds. Leverage is very low for most alternative investment funds. Consequently, the assessment of NCAs is likely correct, in that the alternative investment fund industry as a whole is not particularly systemically relevant. This bird's-eye view masks one fundamental fact, however: Within the world of all alternative investment funds, hedge funds stand out as comparably prolific users of leverage, even if this occurs through the use of derivatives. Hence, the heterogeneous nature of the industry as a whole obscures the focus on hedge funds and also does not exclude categories of funds that, through the nature of

[1210] ibid 86–88.

[1211] European Securities and Markets Authority, 'ESMA Annual Statistical Report on EU Alternative Investment Funds 2019' (ESMA, 2019) 5 <www.esma.europa.eu/sites/default/files/library/esma50-165-748_aif_report_2019.pdf> accessed 31 August 2020.

[1212] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 86.

[1213] ibid 87.

[1214] ibid.

their investment strategy, are not suited to or interested in using leverage. Optimally, provisions related to leverage would need to be tailored to fund types and strongly focused on funds trading in derivatives. In addition, reporting and measuring requirements could potentially be lightened for funds which, by design, do not benefit from high degrees of leverage. As requested by respondents, rules on the calculation of leverage need to be optimized, for example by designing them with industry practices in mind, provided this does not limit supervisory efficiency.

6.2.3.2.2.3 Valuation[1215]

While survey respondents generally felt that valuation requirements of the AIFMD were appropriate, most agreed that NAV calculations are not carried out more frequently post-AIFMD than before.[1216] Slightly less than half of respondents felt the AIFMD has led to an overall improvement in valuation processes. Additionally, when asked whether the liability of external valuers has had an influence on their ability or willingness to carry out their function, the responses were nearly evenly split between agreement, disagreement, and neutral responses.[1217] Further interviews generally agreed with these assessments. Generally, it was found that much of the external valuation carried out prior to the introduction of the AIFMD is now done internally. The requirement of professional indemnity insurance has led to a higher cost base, and many external valuers are unwilling to value complex assets due to the expansion of potential liability.[1218]

The respondents in the survey identified several interesting points. Fundamentally, alternative investment funds will be dealing with the challenge of valuing assets that are less liquid and whose fundamental value might be more difficult to determine than traditional assets. From a regulatory perspective, this situation leads to several fundamental dangers. Firstly, this makes any assessment of alternative investment funds with the objective of ensuring financial stability exceptionally dif-

[1215] ibid 90–93.

[1216] ibid 91.

[1217] ibid. 30% agreed, 25% disagreed, and 20% were neutral (the remaining respondents had no opinion) on the issue of whether valuers were *not* hampered or unwilling to carry out their functions. Interestingly, as the report points out, French and German respondents were more inclined to agree than respondents from the United Kingdom and Luxembourg (the United Kingdom and Luxembourg are two of the larger hubs for alternative investment and hedge funds).

[1218] ibid.

ficult. The difficulty of valuing alternative investments will be compounded when funds are invested in a multitude of such assets, particularly if the task is to be carried out by a regulator one step removed from the process. Consequently, it is disappointing that the AIFMD has not, according to respondents, led to substantial increases in the frequency and accuracy of the valuation process. In fact, it is concerning that external valuation has been reduced through the creation of expanded liability resulting from external valuation. While the design of valuation rules remains a challenge and is limited in its effectiveness by the fact that illiquid investments are by design more difficult to value accurately, the balance between utilizing liability as a tool to prevent fraudulent behavior and the existence of a sufficient number of external valuers must be reexamined. While internal valuation appears to function reasonably well as an alternative, the drop in the number of external valuers due to changed liability rules and the increased cost caused by professional indemnity insurance merits a recalibration of the existing rules.

6.2.3.2.2.4 Remuneration

The results of the survey indicate that the rules on remuneration are applied proportionally, though this was self-reported by authorities. Almost half of respondents reported that no change in the compensation of persons engaged in risk taking has taken place due to the introduction of the AIFMD. The composition of total compensation, however, has changed due to the AIFMD. Half of the respondents indicated that the fixed components of their remuneration packages had increased and variable remuneration had decreased.[1219]

Compensation arrangements have also changed due to the AIFMD. A shift away from variable compensation to fixed compensation has taken place. The effects of this change in focus on the incentives of fund managers will likely be mixed, leading to reduced risk-taking, but likely also reducing overall returns generated. How remuneration should be structured and what effects it has on the behavior of managers with regard to risk management and the pursuit of absolute returns is discussed extensively in section 6.4.7.

[1219] ibid 88.

6.2.3.2.3 Microprudential Measures and Investor Protection

6.2.3.2.3.1 Functional and Hierarchical Separation of Risk Management Functions[1220]

The provisions of the AIFMD led to an overwhelming majority[1221] of management companies to review risk management procedures and structures, though only slightly over forty percent[1222] of respondents made significant adjustments. Accordingly, the AIFMD has led to only minor adjustments to risk management processes.[1223] Though a majority of respondents reviewed their liquidity management processes, few made substantial adjustments to them.[1224]

Private equity fund managers were more critical of the risk management provisions contained in the AIFMD. The provisions of the AIFMD are structurally closely related[1225] to the risk management provisions of the UCITS framework and consequently are primarily derived from rules for managers of funds investing in specific types of securities that differ substantially from private equity investments. Due to their design and intended regulatory function, the provisions in question are more difficult to implement in the relatively distinct private equity business. The same applies when strategies are pursued that involve non-listed or illiquid investments, such as real estate. It is therefore unsurprising that respondents felt that separating risk management from portfolio management functions is a sensible solution for hedge fund strategies, but were more critical when asked to assess the rule's suitability for managers managing other types of funds. Separating risk and portfolio management was reported to be quite difficult for smaller managers as well, as smaller companies might not have sufficient staff to fully divide the two functions.[1226]

An assessment of the risk management measures cannot be purely positive. On a conceptual level, as respondents correctly indicated, effective, unbiased, and accurate risk management is an essential element of any portfolio management operation. It is also one of the aspects of the AIFMD where, in principle, the interests of the management companies and the regulators are fairly closely aligned. Meas-

[1220] ibid 89.

[1221] 94% of respondents. ibid.

[1222] 42%. ibid.

[1223] ibid.

[1224] ibid 90.

[1225] ibid 89.

[1226] ibid.

uring and mitigating risk, whether systemic in nature or otherwise, is in the interest of both the authorities and the portfolio manager in question. While discrepancies and slight deviations from fully aligned incentives will inevitably still exist, generally the interests of both will be similar. More critical to assess are the internal interests within and across functions. The asset management division or individual trader might not necessarily be interested primarily in the mitigation of risk for the fund or funds in question. Moreover, risk management as a function must by design limit risks, but will necessarily thereby frequently limit potential returns as well. This might very well lead to friction within a company. Such issues are what the functional and hierarchical separation of risk and portfolio management functions seeks to address. In the case of the AIFMD, apparently only minor changes have been necessary, which presumably means compliance by managers has been comparably cost-effective and uncomplicated. In addition, the fact that respondents generally see the provisions as sensible is also positive. For a subset of respondents, and hence, presumably for a subset of alternative investment fund managers, the provisions appear to have been difficult to implement. Certain strategies are sufficiently different that the provisions designed around more conventional investment funds are a poor fit. These difficulties are a direct consequence of the extremely broad scope of the AIFMD directive. The reader will recall that the AIFMD directive is similar to a catch-all clause, in that, with only a small number of exceptions, *all* managers *not* subject to the UCITS framework are subject to the AIFMD. It is therefore unsurprising that some provisions simply cannot account for the specificities of various more exotic investment strategies of certain funds and their managers. This fundamental problem would therefore need to be addressed at a fundamental legislative level. To create additional rules and appendices governing each edge case and peculiarity that might emerge due to the scope of the directive would run counter to the objective of creating a coherent, efficient, effective, and comprehensible framework. Hence, as this thesis argues,[1227] a comprehensive European framework governing collective asset management in the European Union would need to be created which would ideally divide funds and managers into discrete categories according to the risk profiles of their strategies, while preserving a minimal amount of flexibility and simplicity for each rule in order to be able to either incorporate or exclude exotic fund types. This risk-based approach would avoid the danger of prescribing rules to managers engaged in low-risk investment strategies purely due to the scope of a directive.

[1227] See section 6.4.5.1.

6.2.3.2.3.2 Depositary Rules[1228]

Generally, the results of the survey indicate that the AIFMD has had almost no impact on managers' choice of depositary. Respondents also agreed, though not overwhelmingly, that monitoring responsibilities of depositaries, including cash monitoring requirements, were appropriate and sufficiently detailed. A few difficulties were highlighted by respondents, however. The implementation of depositary rules differs across the Union or the rules adopted are not sufficiently clear, and asset segregation rules are seen as costly without providing much of a benefit. Reporting requirements under the AIFMD to the depositary by US prime brokers is also difficult, as they are subject to different rules.[1229]

The depositary rules serve the function of protecting assets of managers and their funds, but also to protect investors. Additionally, there is a systemic risk component to the provisions, as counterparty risks to funds are limited to a single depositary. The results of the survey indicate that depositary rules appear to function fairly well, with some limited exceptions. Asset segregation rules are seen as expensive but not useful. The level of harmonization and the interplay between EU depositaries and brokers in third countries appear to be less successful. A fundamental difficulty of creating rules governing relationships with institutions in third countries is accounting for vastly different rules and practices, but represents the reality of a globalized and interconnected world of finance. Optimally, depositary rules could be maintained, but would need to be successively adjusted to the challenges and practices that are experienced within the industry. This might be an obvious statement, but reflects a less apparent argument. Where a discrepancy exists between the behavior prescribed by a high-level rule set like a directive and the actual situation, the rules must exhibit sufficient flexibility to permit compliance, even if the reality might not adhere to the exact letter of the law. Alternatively, the law can delegate rulemaking authority to lower level technical bodies to achieve more precise and practical solutions. In the case of depositary rules under the AIFMD, the review of the directive might spawn amendments to depositary rules. The true litmus test for these provisions might be the next financial crisis, where the effectiveness of the AIFMD as a whole will likely be tested, together with those provisions aimed at mitigating systemic risk.

[1228] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 94.

[1229] ibid 94, 95.

6.2.3.2.3.3 Disclosure to Investors[1230]

Disclosure to investors both prior and after investment in an alternative investment fund has increased, as respondents indicated in the survey. Most respondents felt that disclosure to investors had expanded in scope, but the quality of the information disclosed has not necessarily increased. The main problem with the provisions on disclosure, according to respondents, were the duplication of information that needs to be provided and inconsistent application of rules across member states. The duplication of information is mainly a result of earlier legislation demanding disclosure of the same information as is now required by the AIFMD.[1231] As an example, for closed-ended funds, the prospectus directive[1232] is also applicable[1233] if the fund's units are sold to the public or traded as securities on an exchange.[1234] Inconsistencies in fee disclosures, and calculations of fund performances, and disclosure under MiFID II were mentioned. The existence of similar inconsistencies between disclosure rules under the AIFMD and those of the PRIIP KID were also brought up, as were inconsistent forms and document formatting in various different member states.[1235]

While disclosure rules to investors are primarily an investor protection tool and do not serve primarily as systemic risk mitigants, indirectly, the confidence of investors in markets is an essential concern. Disclosure rules are also in the collective interest of the alternative investment fund industry, as investors are provided with more information and presumably should be able to make informed decisions in choosing the funds to invest in, which, to a point, should drive at least some of the underperforming or outright fraudulent managers out of the market.[1236] The survey

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[1230] ibid 96.

[1231] ibid.

[1232] See Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC [2017] OJ L168/12. (Prospectus Regulation).

[1233] Prospectus Regulation, art 1(2)(a).

[1234] See Prospectus Regulation, art 3(1).

[1235] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 96.

[1236] In principle, this mirrors the adverse selection problem, where asymmetric information leads to underperforming or lower-quality offerings in a market to drive out the higher-quality or superior offerings. The proposed solution to the problem is to remove informational asymmetries, which makes identification of lower-quality offerings, or 'lemons', possible and mitigates or removes the adverse selection problem. See generally

shows, however, that the AIFMD has not been calibrated properly to avoid redundancies and duplicated reporting, as well as inconsistencies regarding disclosure rules. This can primarily be traced back to the comparably recent introduction of the AIFMD and the ever-evolving nature of financial regulation. As the AIFMD could arguably be seen as a niche regulation when compared to legislative efforts related to banking and financial market regulation in both scope and frequency of its evolution,[1237] friction and overlaps with other legislative documents are unavoidable. It is nonetheless imperative that the reform process eventually addresses such duplicated disclosure requirements in order to achieve consistency and efficiency in the regulation of financial markets as a whole, rather than maintaining an opaque and overlapping amalgamation of directives and regulations in the EU system.

6.2.3.2.3.4 Private Equity Investments[1238]

As has been stated in the previous chapter,[1239] the provisions of the AIFMD related to buyouts and asset stripping are thematically somewhat disjointed from the rest

Akerlof's seminal paper: George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 The Quarterly Journal of Economics 488. For an explanation of the same mechanisms in the context of hedge funds, see Baker and Filbeck (n 40) 25–27.

[1237] The regulation of collective asset management in the EU also only forms a small subset of the overall Capital Markets Union that is the overarching objective of European regulatory reforms in the area of financial markets law. For an overview of the objectives of the Capital Markets Union, see Danny Busch, Emilios Avgouleas and Guido Ferrarini, 'Capital Markets Union after Brexit' in Danny Busch, Emilios Avgouleas and Guido Ferrarini (eds), *Capital Markets Union in Europe* (Oxford University Press 2018) ss 1.01-1.09. Post-crisis adjustments to the project are described in Diego Valiante, 'CMU and the Deepening of Financial Integration' in Danny Busch, Emilios Avgouleas and Guido Ferrarini (eds), *Capital Markets Union in Europe* (Oxford University Press 2018) ss 2.09-2.12. For the position of UCITS and the AIFMD in the context of the reform efforts, see Matteo Gargantini, Carmine Di Noia and Georgios Dimitropoulos, 'Cross-Border Distribution of Collective Investment Products in the EU' in Danny Busch, Emilios Avgouleas and Guido Ferrarini (eds), *Capital Markets Union in Europe* (Oxford University Press 2018) ss 19.01-19.05.

[1238] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 98–100.

[1239] See chapter 5.

of the directive and do not appear wholly coherent with the directive's stated objective of mitigating systemic risk and maintaining financial stability.[1240]

Nonetheless, there is a necessity for minimum standards in this area, as the survey showed that a majority of alternative investment funds are or were previously invested in non-listed entities in one form or another. Only a small portion of these investments were part of a larger objective to acquire control of non-listed companies, however.[1241] The overwhelming majority of respondents disagreed with the statement that the notification requirements to national authorities were useful, essential, and not overly burdensome. This reveals that the overwhelming majority of interviewees appear to see notification requirements as a burden and of limited value. The responses related to provisions on asset stripping were less negative. A third of the responses gave no opinion on the usefulness of the provisions aimed at preventing asset stripping, while the remainder was evenly split between agreement, neutral, or disagreement with the statement that the provisions provide an appropriate level of protection.[1242]

The responses to the survey demonstrate that the provisions on private equity and asset stripping have not been well received by the industry, and that they are seen as a tedious requirement without a clear benefit. Whether this view rings true would need to be examined in greater detail as part of a holistic analysis, but it is nonetheless alarming that the respondents were at best neutral and at worst strongly disagreed that the provisions in question provide a benefit while not being overly burdensome. These provisions, therefore, might need to be simplified and moved into a separate or related piece of legislation, which would also enable their integration into the European regulation on issues more closely related to issues of corporate control. Perhaps future legislation on the private equity industry could be integrated with existing rules to create an overarching set of rules governing questions of corporate governance, mergers and acquisitions by funds and other entities, and finally comprehensive rules on the liquidation of company assets and shareholder dividend payments, of which the existing rules on asset stripping would form a part.

[1240] See AIFMD, recital 2.

[1241] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 98.

[1242] ibid 98, 99.

6.2.3.2.3.5 Passport Regime and Marketing[1243]

As has been mentioned, cross-border marketing and distribution, which constitutes the passporting system for fund managers and, by consequence, their funds, is a second core objective of the AIFMD.[1244] Principally, the system aims at facilitating the flow of capital throughout the European Union, in this case through the sale and distribution of alternative investment funds.[1245] To achieve this, the provisions of the AIFMD need to be structured to simplify distribution across the European Union while concurrently creating a set of rules that do not undermine the other objective of maintaining financial stability.[1246]

The responses to the survey on the AIFMD indicate that this objective has, in part, been achieved. Almost two thirds of management companies surveyed market their funds in different EU or EEA countries. More than half also market to non-EU/EEA countries. Regarding investor types, almost forty percent of respondents market funds to retail or semi-professional investors. Within this category, 38% of these marketed to retail and semi-professional investors in other member states or EEA members on a cross-border basis, while 58% concentrated on investors in their home country. Slightly more than half of the respondents do not manage non-EU or non-EEA funds. Among the minority that does manage non-EU/EEA funds, only 43% of this subset marketed these non-European funds in the European Union. A third of surveyed management companies managed alternative investment funds domiciled in other member states. A larger percentage of management companies with their domicile in France or the United Kingdom managed funds on a cross-border basis. 60% and 55% of British and French management companies managed funds domiciled in other member states. The two European States with the largest number of European alternative investment funds incorporated are Luxembourg and the Cayman Islands, with 26% and 21%, respectively.[1247]

Slightly over a quarter of respondents saw an increase in their willingness or ability to manage and market alternative investment funds jurisdictions that differ from their own, while the desire of 45% of all respondents remained unchanged. A little over half the management companies surveyed indicated that the access to

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[1243] ibid 100–103.

[1244] AIFMD, recital 4.

[1245] AIFMD, recital 6ff.

[1246] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 100.

[1247] ibid.

national markets has increased due to the introduction of the AIFMD. At the same time, a slight majority of respondents indicated that the complexity of procedures related to authorizing or registering has increased. In addition, the results of the survey indicate that marketing and distribution of funds and their units or shares to retail and semi-professional investors had become more difficult. More than half of respondents that were not indifferent to the issue noted that access to retail and semi-professional investors has become more restrictive following the introduction of the AIFMD framework.[1248] Notable is that investment in private equity and venture capital has become considerably more complicated and onerous as a result of the AIMFD. Furthermore, overall, compliance costs have risen across the board, especially for private equity and venture capital funds. Finally, for non-EU funds, access to the European market has become more difficult both due to higher costs and regulatory burdens.[1249]

The results of the survey illustrate that the objective of creating a single market for alternative investment funds has been achieved in a general sense. It also shows that fund managers are effectively operating and marketing their funds on a cross-border basis. Nevertheless, the survey does demonstrate that the process remains fairly complex, and the overall level of harmonization is still too low across member states to eradicate complicated and specific national rules in some member states. While it is important to strike a balance between permitting member states to find solutions that best fit the specificities of their respective countries, it appears the AIFMD would require a higher level of obligatory harmonization in its rules to create a relatively frictionless process of management, distribution, and marketing of alternative investment funds across European borders.

6.2.3.2.3.6 Market and Commercial Impact[1250]

The impact of the AIFMD on the operations of management companies and the funds they manage has been substantial in some areas, but less impactful in others. The view of respondents regarding the authorization process was mixed, as some felt the process did not enhance access to investors or improve their internal organizational structures. Respondents were more positive on the impact of the AIFMD on the reputation of authorized funds with investors, their access to a wider range of professional investors, the management of funds in other member states, the creation of a level playing field with regards to the unified set of rules

[1248] ibid 101.

[1249] ibid 102.

[1250] ibid 104–111.

within the European Union, and risk management processes. Marketing rules in the AIFMD which enable cross-border marketing of alternative investment funds were also seen in a more positive light. The AIFMD did not, however, cause the majority of respondents to change the range of alternative investment funds they manage or market. Almost a fifth of respondents had expanded the range of funds, while slightly less than a tenth of respondents had reduced or limited their range.[1251]

A large majority (75%) of respondents agreed in the survey that compliance costs have increased, although no clear consensus exists on which factors exactly have contributed to this rise in costs.[1252] For slightly less than a third of respondents, portfolio management costs have increased, while for a slight majority (53%), they have remained unchanged. Slightly over forty percent have seen a rise in distribution costs. The three areas where costs have clearly increased for a majority of respondents are fund administration costs (58%), disclosure to investors and risk management (62%), and especially reporting requirements to authorities (88%). Costs for depositary services appear to have increased as well, with 68% of depositaries and fund accountants surveyed indicating an increase.[1253] In general, this increase in costs is not passed on to investors, and has not had a significant decrease in the volume and variety of investment opportunities offered to investors. Over half of respondents (62%) have made no adjustments to the fees they charge their investors, while only 18% have increased investment management fees. Service offerings have not been reduced substantially as a result of the AIMFD. Offerings of alternative investment funds overall have been restricted according to 23% of respondents, with private equity and hedge fund offerings having been restricted the most. Leverage in funds has reportedly also been reduced.[1254]

From an investor standpoint, the AIFMD appears to have had almost no impact on the decision of whether to invest in alternative investment funds. An overwhelming majority (84%) of respondents representing institutional investors indicated that the AIFMD had no bearing on investment decisions regarding alternative investment funds. The same holds true for the decision of whether to invest in a European or EEA fund versus investing in a fund registered in a third country. A

[1251] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188).

[1252] ibid 105.

[1253] ibid 106.

[1254] ibid 108–109.

similar majority (83%) indicated that the AIFMD framework does not influence the decision.[1255] The effect of the AIFMD on retail investment is less clear, as 44% of respondents noted an increase in the level of retail investment, 22% a strong decrease, and 22% see no change. According to the results of the survey, the main impediments to retail investment are higher costs, local private placement regimes, and smaller management companies not being able to comply with all requirements.[1256]

6.2.3.2.3.7 Interplay with other Legislation[1257]

As the AIFMD is embedded in an extensive framework of existing regulation, the interplay of its provisions with other legislation is a central issue. Optimally, the AIFMD's regulatory effects would be distinct and complementary to other legislation, while creating a clearly defined boundary between each piece of legislation and each specific regulatory objective. Overlapping portions would need to either conform to a stated hierarchy, or be structured in such a way as to run parallel without contradictory or duplicated rules. The results of the survey show that this objective has only partially been achieved.

The interplay of the AIFMD and UCITS was praised, as the rules are similar and complementary. Fund managers that manage or market both types of funds benefit from similar rules and standardized procedures, and neither framework contains provisions which contradict the rules of the other framework.[1258] The PRIIPs KID[1259] is also seen as positive, as it permits increased disclosure to investors, but was also criticized as it contains duplicate information.[1260] The exemption of central securities depositaries from the scope of the AIFMD is also viewed as positive,

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[1255] ibid 110.

[1256] ibid 111.

[1257] ibid 111–113.

[1258] ibid 113.

[1259] As mentioned in chapter 4, the KID is the Key Information Document prescribed by the PRIIPs framework, which governs packaged retail and insurance-based investment products. The reader will recall from chapter 4 that UCITS funds do not have to publish a KID for now, but are still obligated to publish a KIID. Alternative investment funds may be required to publish a KID, however, if they make shares or units available to retail investors.

[1260] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 112, 113.

as the corresponding regulation is clearly separate from rules governing alternative investment funds and managers.[1261]

The interplay between the AIFMD and a number of other EU legislation or regulations were seen as negative. The first is the impact that MiFID II has on the AIFMD. The scope of MiFID II and the AIFMD is seen as unclear, as is the definition of a professional investor. The fact that alternative investment funds are classified as complex products by ESMA makes these funds less attractive for retail investors and leads to difficulties related to product governance rules. The AIFMD also appears to clash with EMIR[1262] and the SFTR[1263], as the regulation imposes operational and reporting requirements on alternative investment funds, and classification issues exist. Furthermore, prospectus requirements lead to a duplication of information disclosure for closed-ended, publicly offered funds. Finally, the disclosure requirements under the PRIIPs framework mandate measures based on past performance, which hinders the comparability of data.[1264]

A further core issue with the AIFMD and other EU legislation and regulations is friction related to reporting requirements.[1265] The main difficulty is the lack of coherence or consistency in data collection and aggregation. Data standards and technical formats, as well as various diverging reporting channels and data repositories are not consistent across the board and lead to an overall lack of clarity of reporting requirements. This leads to duplication and higher costs when reporting to authorities under the various overlapping frameworks.[1266] On the national level,

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[1261] ibid 112. The regulation in question is Regulation (EU) 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 [2014] OJ L257/1 (CSDR).

[1262] Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [2012] OJ L201/1 (EMIR).

[1263] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 [2015] OJ L337/1 (SFTR).

[1264] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188) 111–112.

[1265] And in some cases, the same issues related to disclosure requirements to investors. See ibid 112–113.

[1266] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188).

a lack of consistency, coherence, and convergence was noted by respondents. Duplication of rules exists here as well.[1267] This all leads to regulatory arbitrage, an increase in costs, and complexity. Finally, the sheer amount of regulation, which in part is overlapping, additionally creates barriers to entry.[1268]

6.2.3.2.4 Study on the Achievement of AIFMD Objectives.[1269]

Five overall questions must be answered to estimate whether the main objectives of the AIFMD have been achieved:

1. 'Has AIFMD provided an effective legal framework for monitoring and managing the risks associated with the activities of AIFMs?'[1270]
2. 'Are the macro- and micro-prudential risks adequately addressed by the provisions of AIFMD?'[1271]
3. 'Is the information provided to the investors and employees of non-listed companies sufficient to safeguard their interests?'[1272]
4. 'Is the AIFMD passport working efficiently?'[1273]
5. Finally, the assessment of the value added by AIFMD to the EU in the review answers the following question: 'What changes has the AIFM and AIF market structure undergone since the adoption of AIFMD?'[1274]

The first two objectives, which seek to ensure risks are addressed, monitored, and managed have broadly been achieved, setting aside various weaknesses that are listed below in greater detail.[1275] The results on whether the rules on information that must be provided when non-listed companies are invested in are sufficient to safeguard interests of investors and employees are inconclusive, partly because these measures have rarely needed to be applied.[1276] These provisions, however, exhibit a number of shortcomings, which are discussed further below. The answer

[1267] ibid.
[1268] ibid.
[1269] ibid.
[1270] ibid 263.
[1271] ibid.
[1272] ibid.
[1273] ibid.
[1274] ibid.
[1275] ibid 264.
[1276] ibid.

to the fourth question, which relates to the functioning of the EU management and marketing passports is also not wholly positive. The management passport is fairly functional, but the marketing passport is impacted in a substantial way by divergent national requirements.[1277] The final question on whether market structures have changed since the introduction of the AIFMD also leads to a mixed conclusion. The AIFMD has had little to no impact on net assets of alternative investment funds, has not had any substantial influence on the attractiveness of alternative investment funds, and has not had a positive effect on investments that could benefit developing countries.[1278] Competition between managers has only slightly increased.[1279] Mixed responses were also given on 'operational set-up and processes',[1280] and on whether the AIFMD has expanded product offerings due to its implementation.[1281] The AIFMD has, however, lead to the introduction of several national rulesets that govern unlisted and unauthorized types of alternative investment funds.[1282] Finally, national law that gives access to alternative investment funds for retail investors has been implemented extensively and can be seen as very important, but responses were mixed on whether retail clients' investment activity has been impacted positively or negatively.[1283]

Overall, the AIFMD achieves its overall objective of addressing risks emanating from alternative investment funds, and has been reasonably successful in introducing a passporting system, although the management passport has been more successful than the marketing passport. The AIFMD has had an impact on market structures, but has not led to a complete change when compared to the situation prior to its introduction. This can be seen as positive in the sense that the European market has not been thrown into turmoil, but one would have hoped the AIFMD might have had a more substantial impact. Finally, the rules on investment in non-listed companies have been least successful and, as the sections below demonstrate, might need to be reevaluated.

[1277] ibid.

[1278] ibid 264–265.

[1279] ibid 265.

[1280] ibid.

[1281] ibid.

[1282] ibid.

[1283] ibid 264–265.

The following sections will examine in greater detail which areas still exhibit weaknesses with regards to their effectiveness, efficiency, coherence, EU added value, and relevance.

6.2.3.2.4.1 Effectiveness

The report identified several areas where the AIFMD is not effective and exhibits weaknesses. Certain member states impose requirements on alternative investment funds that are below the threshold and not subject to its rules, which makes it difficult to assess how well the threshold provisions are implemented and how effective they are.[1284] The information that is supplied to competent authorities is seen as incomplete by authorities. At the same time, funds and managers transmit large data volumes to authorities which can also include irrelevant or redundant information, encumbering the processing and analysis thereof.[1285] Furthermore, as the valuation rules only allow external or internal valuers, this restriction on the choices is overly limiting and may have had an impact on the effectiveness of valuation rules.[1286] Depositary rules of the AIFMD also appear to be interpreted in different ways in various member states, which impacts their effectiveness.[1287] The marketing passport, which allows cross-border marketing of funds, is seen as largely successful, but various member states appear to diverge from the original intent of the directive by applying the rules in an inconsistent fashion and varying in their requirements.[1288]

The rules on investing in private, non-listed companies, which consist mainly of the provisions guarding against 'asset stripping' in private equity deals, were widely criticized and their effectiveness severely questioned. Authorities feel that the information they are provided is not relevant, and they are unsure how to utilize this information. Additionally, the information requirements are seen as burdensome. Furthermore, the precise definition of a non-listed company is still seen as unclear, as certain investment vehicles might fall under this definition in addition to the more traditional types of private companies.[1289]

[1284] ibid 265.

[1285] ibid.

[1286] ibid.

[1287] ibid 266.

[1288] ibid.

[1289] ibid.

6.2.3.2.4.2 Efficiency

Particular weaknesses that persist are seen in the reporting requirements, the appointment of external valuers, separating risk and portfolio management, and asset segregation rules. Moreover, the rules on investments in non-listed companies and the marketing passport are mentioned again, as they are still seen as neither sufficiently effective, nor efficient.[1290]

Reporting requirements, as has been previously mentioned, are not well coordinated with other rules from related EU law, and therefore the same information must be supplied multiple times under various requirements. Some of the information that is required is also seen as unnecessary, and some is insufficient.[1291] This is a fundamental inefficiency that creates redundancies and unnecessary costs, which would need to be addressed in the AIFMD reform process.

External valuers have decreased in number due to the AIFMD in some member states, which creates inefficiencies and higher costs to funds and managers.[1292] Smaller funds and managers struggle to cope with the costs associated with separating risk and portfolio management in both hierarchical and functional respects. Private equity and real estate funds also question if this is necessary for their investment strategies.[1293] The AIFMD has provisions that are too coarse and inadequately detailed, as it does not differentiate according to size of strategy in this regard. The rules on asset segregation, where the depositary must keep accounts strictly separate from its own and from those of other funds, are seen as complicated, costly, and operationally demanding to implement consistently.[1294]

The frequency of disclosures that the rules on investment in private, non-listed companies require are also seen as too high, which increases costs and the administrative burden. This is compounded by the fact that many venture capital and private equity firms and funds in the European Union are comparably small and, therefore, struggle disproportionately to comply with these rules.[1295] As is the case with the effectiveness of the marketing passport, its efficiency has also been called into question. The marketing passport is perceived as being inefficient due to the

[1290] ibid 266–267.
[1291] ibid 266.
[1292] ibid.
[1293] ibid.
[1294] ibid 267.
[1295] ibid.

fact that various member states vary widely in the specific requirements they impose and the non-transparent nature of all the specific national provisions on marketing.[1296] It appears that the precision of the provisions of the marketing passport has to be improved to achieve a level of harmonization that permits efficient cross-border marketing under the passporting system.

6.2.3.2.4.3 Coherence

AIFMD remuneration rules, disclosure to investors rules, and rules on investments in non-listed companies are seen as lacking coherence with other EU legislation. These three categories are poorly optimized and not embedded in the wider European framework, which leads to an inconsistent overall framework and reduces legal certainty. Additionally, as various calculation methodologies are permitted and utilized to calculate fund leverage, these provisions lack coherence and are inconsistent with other legislation. Consequently, these rules would need to be harmonized.[1297]

6.2.3.2.4.4 Relevance

Only one one weakness with regards to relevance has emerged from the report, which again is related to provisions on investments in non-listed companies. While the report describes these provisions as relevant, it recognizes they might need to be revalued in the light of the CMU's objective to promote startups, non-listed companies, and innovation financing.[1298]

6.2.3.2.4.5 EU Added Value

Generally, the four aspects above, effectiveness, efficiency, coherence, and relevance, convey where value is added and where weaknesses persist. Nonetheless, four additional aspects are addressed under this heading. Reporting requirements, which are extensive, are connected to substantial cost increases, which might necessitate their streamlining.[1299] As has been mentioned, asset segregation requirements should also be amended and simplified to avoid unnecessary administrative burdens and costs.[1300] The depositary rules regarding the appointment of deposi-

[1296] ibid.

[1297] ibid.

[1298] ibid.

[1299] ibid 268.

[1300] ibid.

taries could also be slightly adjusted to enhance the overall framework.[1301] Finally, as non-EU funds and managers can market shares or units in member states that allow this under national law, and since at the time of writing, the marketing passport has not been extended to third countries, these national rules are seen as useful and regarded as a mechanism that adds value.[1302]

6.2.3.2.4.6 Summary

The five main objectives of the AIFMD have generally been achieved, but several areas require optimization, as the sections above emphasize. How much information is provided, and in what form it is provided must be adjusted, so duplication as well as increased costs and bureaucracy for all parties involved can be avoided. Funds and managers must be able to provide the necessary data, so authorities can process this information better. Furthermore, the passporting system for marketing needs to be amended to prevent various fragmented national regimes and requirements from impeding cross-border marketing. Finally, the rules on investing in non-listed companies need to be reexamined thoroughly, as the results of the report indicate that they exhibit weaknesses with regards to their effectiveness, efficiency, coherence, and relevance, all of which clearly show that these mechanisms need to be restructured in an elemental way.

6.3 Current Developments of the UCITS and AIFMD Frameworks

As a follow-up to the report on the AIFMD's operation,[1303] the commission published its own report, which reiterates the main points of the initial report.[1304] The

[1301] ibid. This would mainly be related to the exception under article 61(5) of the AIFMD, where some member states can permit the appointment of credit insitutions in other member states as depositaries. This point shows that the depositary rules could also benefit from some adjustments that would slightly extend the type and number of eligible institutions.

[1302] ibid. This national law is referred to as a National Private Placement Regime, or NPPR. This is governed by articles 36 and 42 of the AIFMD, which has been discussed in chapter 5.

[1303] Commission, 'Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU' (n 1188).

[1304] Commission, 'Report from the Commission to the European Parliament and the Council Assessing the Application and the Scope of Directive 2011/61/EU of the