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Regulatory Discretion in Financial Markets Law: An Effective Remedy Against Financial Crises?

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This article discusses the regulatory discretion of competent national authorities as a mechanism to prevent financial crises, on the example of investment funds and their managers. The ability to impose stricter conditions on fund managers and define the procedures for efficient intervention allows responding efficiently to the financial shocks. Whilst EU law cannot respond quickly enough to the changes in financial markets, Member States and their respective regulatory authorities can provide for a tailor-made approach for each fund and its manager registered within their territories.

Keywords: AIFMD, financial markets authorities, investment funds (managers), MiFID II

1. INTRODUCTION

Almost fifteen years have passed since the beginning of the last financial crisis (2007–2008). Numerous attempts have been made at the level of international, European and national policymakers to put in place the regulatory mechanisms that will prevent the occurrence of similar events in the future. Yet, the role of discretionary power of national regulatory authorities to impose specific conditions on the financial services providers has not been studied extensively in this context.

The discretion can be defined as a margin of manoeuvre that Member States have regarding the implementation of European law, e.g., Markets in Financial Instruments Directive II ('MiFID II')[1] and Alternative Investment Fund Managers Directive ('AIFMD').[2] These instruments of European law include a number of so-called opt-in/opt-out provisions, which allow Member States to decide whether or not to transpose them into national law.[3]

In addition, discretion in financial markets law can be invoked in situations where the competent national authorities, such as Autorité des marchés financiers ('AMF') in France have the ability to impose stricter conditions on certain financial entities as compared to the provisions of EU law.

One of the reasons of the last financial crisis was the failure of the legal framework to regulate the activities of financial market participants in an adequate and effective manner.[4] This was compounded by a lack of national regulatory authorities' power to quickly limit the damage caused by the opportunistic conduct of financial service providers.[5]

In order to be able to impose stricter conditions on financial service providers, legislative acts providing for these powers need to be adopted. These adoption deadlines are not short enough to allow for an efficient intervention. The financial scandals that occurred during this period, such as the spectacular bankruptcies of Lehman Brothers (Luxembourg), Northern Rock (UK) and Madoff pyramid (US), represent some well-known examples.[6] They demonstrate the failure of so-called strict regulation, which does not give sufficient discretion to national authorities to intervene quickly. It should be highlighted that this concerned particularly the regulation of investment funds.

This article therefore assesses whether a discretionary power of Member States and their respective regulatory authorities in the regulation of alternative investment funds ('AIFs') can play a key role in the safeguard of financial stability. Additionally, we question the extent to which the EU financial markets law provides for a sufficient discretionary power of national regulatory authorities in this context.

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1 Directive 2014/65/EU of the European parliament and of the council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L173/349) ('MiFID II').

2 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 (OJ L174/1) ('AIFMD').

3 For an in-depth study of the discretionary power, *see* A. Bouveresse, *Le pouvoir discrétionnaire dans l'ordre juridique communautaire*, Tome 14 (Bruylant 2010).

4 M. Domina-Repiquet, *EU Law (MiFID II) and Effective Regulation: A Step Towards Financial Stability?*, 26(3) Maastricht J. Eur. & Comp. L. 833 (2019).

5 D. Bentley, *Devil in the Detail: A New EU Directive to Regulate the Financial Services Industry Has Received a Lukewarm Response from Lawyers*, 63(6) Int'l Bar News 23 (2009).

6 For an in-depth analysis of these legal cases, *see* I. Riassetto, *L'investisseur, le teneur de compte conservateur et la SICAV Luxalpha*, (10) Bull. Joly Bourse 423 (1 Oct. 2012) ; M. Storck, *La Cour d'appel de Paris confirme les injonctions prononcées par l'AMF à l'encontre des dépositaires RBC Dexia et Société Générale*, RTD (Apr. 2009).

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We will first present the approach of strict regulation in European financial markets law on the example of the AIFMD (2). Further, we will put forth several advantages of discretionary power in financial markets law and propose the mechanisms of its implementation via national law and soft law (3).

2. THE APPROACH OF STRICT REGULATION IN EUROPEAN FINANCIAL MARKETS LAW

European financial markets law includes the regulation of different financial actors, such as investment firms and fund managers. For the purposes of this article, we will focus on the alternative investment fund managers ('AIFM'), whose regulation was the first priority of EU policymakers in the aftermath of the financial crisis.[7] This article will first discuss the reasons for the introduction of the AIFMD (2.1), followed by some criticism of its approach in preventing financial crises, namely a use of systemic risk criteria (2.2) and the need for an efficient intervention in financial markets (2.3).

2.1. Reasons for the Introduction of the AIFMD

After the 2007–2008 financial crisis, EU policy was largely based on the objective of regulating all financial market participants to limit the emergence of the next financial downturn. Although hedge funds and private equity funds – the most prominent examples of AIF – did not directly cause financial turmoil, their somewhat opaque nature has prompted European politicians to scrutinize their operations.[8] These funds are part of a shadow banking system composed of various non-bank financial institutions, which were hardly regulated and supervised prior to 2007.

The main lesson of the 2007–2008 financial crisis is that financial risks can spread quickly across borders, leading to a general financial disruption. Such a global financial downturn occurs when financial market participants are unregulated or lightly regulated. This so-called light touch regulation allows them to behave opportunistically, which can lead to disruption of the financial system on a national and even international scale. It follows that all financial market participants need to be regulated and monitored to limit the potential financial crisis (strict regulation).[9]

The AIFMD is a first post-crisis directive in the EU financial services sector. One of its objectives is to preserve the financial soundness of the EU. By imposing a specific set of duties that EU AIFM must comply with, the directive seeks to ensure that they perform their functions in a prescribed manner.[10] This will help to maintain a minimum level of financial stability throughout the European AIF industry and prevent possible opportunistic behaviour of fund managers.

The overall spirit of the directive is to tackle the legal problems that led to the last financial crisis and, therefore, to prevent the occurrence of a new financial meltdown. However, we argue that its success in this context is rather questionable, which will be discussed below.

2.2. Systemic Risk

The AIFM Directive is based on the concept of systemic risk. It can be defined as a negative impact of the failure of a financial market participant on its counterparties, which presents a danger to the overall financial system.[11] This chain of counterparties can be represented as a chain in which the failure of one 'ring' often leads to a breakdown of the whole structure.

Systemic risk has two components: (1) credit risk; and (2) market risk.

Credit risk refers to the negative effect that the failure of a financial service provider may have on its creditors and other counterparties. According to Bodellini, this type of risk is 'inversely correlated with the availability of credit'.[12] When financial institutions issue fewer loans, they send a 'bad' message to the market. The funding becomes scarce and expensive, giving the impression that banks are in a state of near bankruptcy. Holders can start withdrawing their money quickly. This can cause a run on the bank, as witnessed by the failure of Northern Rock in 2007. Such a sequence of events can have a domino effect, where many banks start being questioned about their stability. As the deposit holders of all these banks are withdrawing their capital, this could have a negative impact on the banks' counterparties, leading to a general collapse of the financial system.[13]

Market risk refers to the possibility that the failure of a financial institution may generate adverse market movements. This may lead to a withdrawal of credit and redemptions by investors. As a result, other financial intermediaries trading in the market will have to exit their positions at fire-sale prices, causing a vicious circle of forced sales. In turn, this may lead to a global financial crisis. In other words, because of the interrelatedness of financial markets and their participants, a downturn in one market can affect all other markets. This can trigger the vicious circle of driving all markets into an illiquid state and leading to a collapse of the global financial system.[14]

In order to combat the accumulation of systemic risks, the AIFMD requires competent national authorities to gather the

7 For the discussion of the historical background of the AIFMD, *see* M. Domina-Repiquet, *The Alternative Investment Fund Managers Directive, Ten Years After*, 17(4) Eur. Co. L. J. 108–114 (2020).
8 J. Danielsson, A. Taylor & J.-P. Zigrand, *Highwaymen or Heroes: Should Hedge Funds Be Regulated? A Survey*, (1) J. Fin. Stability 522 (2005).
9 Declaration of the European commission during the vote of European parliament on the AIFMD, 11 Nov. 2010, no. MEMO/10/573.
10 D.-A. Zetzsche, *Introduction*, in *The Alternative Investment Fund Managers Directive* 10–12, Ch. 1 (D.-A. Zetzsche ed., 2d éd., Wolters Kluwer 2015).
11 A. Seretakis, *Regulating Hedge Funds in the EU? The Case Against the AIFM Directive*, (2) RTDF 1 (2014).
12 M. Bodellini, *Does It Make Still Sense, from the EU Perspective, to Distinguish Between UCITS and Non-UCITS Schemes*, 11(4) Capital Mkts. L.J. (2016).
13 T.-R. Hurst, *Hedge Funds in the 21st Century: Do the Benefits Overweight Potential Dangers to the Financial Markets?*, 28(8) Comp. L. 228 (2007).
14 D. Awrey, *The Limits of EU Hedge Fund Regulation*, 5(2) L. & Fin. Mkts. Rev. 119 (2011).

information from the AIFM on the limits of the fund's leverage.[15] The AIFMD defines leverage as 'any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions … '.[16] The competent national authorities have a possibility to impose stricter leverage limits if these are deemed to be more appropriate to prevent the accumulation of systemic risks.

However, we argue that the use of a single criteria – leverage employed by the AIF – to give more power to competent national authorities to impose stricter conditions on the AIFM is not enough to prevent the occurrence of further financial crises.[17] Many other situations, even without the use of leverage, may undermine the financial well-being and lead to the accumulation of systemic risks. This refers to the specificities of the AIF's portfolio (classes of investment assets, diversification strategy) and the jurisdiction where it is registered (legal and political risks), as well as the past record of AIFM's conduct.

What is needed, in our view, is to give more freedom to national authorities to choose the criteria for stricter regulation by themselves. This could include, for example, the size of financial transactions in the last thirty days, the questionable behaviour of a manager in the past, the industry in which the fund's assets are invested or the portfolio diversification strategy. This will allow competent national authorities to have a tailor-made approach to each AIFM and AIF that are registered within their respective territories. Let us bear in mind that the objective of the directive is to harmonize and not to unify the national law of Member States. As such, the possibility to impose stricter operating conditions on specific AIFMs shall not be seen as an obstacle to the harmonization, but rather as a way to preserve financial well-being.

2.3. The Need for an Efficient and Timely Intervention in Financial Markets

The development and implementation of EU directives and regulations takes a long time. Although the AIFMD was adopted in 2011, its few (key) provisions are not yet in force, ten years later.[18]

This shows that the provisions of EU law cannot respond quickly enough to the possible sudden shocks in the market. In this respect, national regulatory authorities can provide for a much better and quicker response. They can adjust their policy almost overnight to tackle these sudden issues, e.g., by imposing the limits or freezing the AIFM's activity. Such a possibility to deviate somehow from the existing provisions of EU law may provide for a tailor-made response to any financial problem occurring within the single jurisdiction.

Specific problems may arise in the context of cross-border fund management. An AIFM registered in France needs to comply with the provisions of French law. However, if it manages and/or markets an AIF registered in Luxembourg, AIFM will also have to comply with Luxembourg law. The AIFMD had harmonized the national law of Member States in this context, which means that the compliance will be rather straightforward. Yet, the questions may be asked in the context of EU AIFM marketing third-country AIFs to European investors. Even though the AIFMD provides some guidelines in this context,[19] the power of national regulatory authorities of the EU AIFM's Member State is rather limited. Giving more discretionary power to competent national authorities to impose stricter conditions on EU AIFM managing a third-country AIF in exceptional situations, e.g., legal and political risks in this third country, will help to preserve financial stability within the Union.

Once again, it should be noted that our proposal does not question the need to harmonize the AIF industry. Whilst, in normal times, the rules should be similar for all AIFM operating within the EU, the sudden financial and political shocks occurring in specific jurisdictions justify the exceptional deviation from the provisions of EU law. Since the objective of the AIFMD is to preserve financial well-being, any measure taken by Member State should be scrutinized throughout the lens of this aim.

Having analysed some of the drawbacks of strict regulation in financial markets and the need for a larger degree of discretionary power of competent national authorities on the example of the AIFMD, we will now put forth some arguments on how to achieve this objective.

3. THE USEFULNESS OF DISCRETIONARY POWER

The discretionary power allows Member States to respond effectively to the latest developments in the financial markets. They must be able to create the legally safe environment for all financial market participants, sanction negligent conduct and ensure that a new financial crisis does not arise. These measures shall be taken without waiting for the instrument of EU Law to be adopted.

We argue that European financial markets law does not adapt quickly enough to the changing economic conditions. Let us not forget that the investment business is based on the idea of offering the most innovative products. As financial markets evolve daily, so should their regulation. This will ensure an appropriate level of financial stability and security for all market participants.

This is where the discretionary power of national regulatory authorities may be of outmost importance. First, they can evaluate

15 Article 25 AIFMD.
16 Article 4(1)(v) AIFMD.
17 We do not consider here the power of Member States to impose stricter conditions of the AIFMs that market their AIF to retail investors.
18 This refers, in particular, to the third-country passport and private placement regime.
19 Chapter VII 'Specific rules in relation to third countries', AIFMD.

whether the existing EU rules correspond to the realities of investment industry within their jurisdictions (e.g., a tailor-made regulation of sophisticated investment products, the need to impose additional safeguards in terms of proper taxation). Secondly, they can impose stricter limits on the activity of AIFM where deemed appropriate and take all necessary steps to remedy the faulty behaviour of fund managers.

We will put forward two solutions to grant more discretionary power to the competent national authorities regarding the regulation of financial markets, namely national law (3.1) and soft law (3.2).

3.1. National Law

It has been mentioned that the AIFMD harmonizes national law with regard to the regulation of AIFMs. According to Article 115 TFEU, a directive is a privileged legal instrument for the approximation of the national laws of the Member States in a particular field of legal relations. Article 288 (3) TFEU provides that 'a directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods'. As such, a directive imposes an obligation of result, but gives discretion as to the means used to achieve that result. In contrast to unification of law by EU regulations, harmonization gives a certain freedom to the Member States vis-à-vis the legal framework governing a particular area of relations. This refers, inter alia, to the possibility of deciding the criteria which justify closer supervision of investment managers. The competent national authority has the necessary information on the conduct of the managers and the funds under their management. This allows for an individual approach at the level of each Member State which takes into account the specificities of domestic financial markets.

We argue that the national law should allow national regulatory authorities to impose stricter thresholds than those under the AIFMD, which can be further adjusted if necessary. In addition, national law should set forth specific sanctions that can be imposed upon fund managers, such as the temporary injunction procedure. The aim here is to allow national courts to adopt temporary injunctions, while waiting for the opinion of the European Securities and Markets Authority ('ESMA'). The role of the ESMA, inter alia, is to issue opinions and provide conclusions as to the systemic risks of a particular AIFM, which will then justify an intervention of competent national authorities. The temporary injunction procedure will have the immediate effect of slowing down the damaging economic conduct of investment funds.

Our proposal is based on the Single Supervisory Mechanism procedure in banking law.[20] In this context, the European Central Bank ('ECB') is responsible for the supervision of so-called significant financial entities. It has the power to impose stricter measures on these entities and to adopt a stricter supervisory approach than for non-significant entities. The ECB also has the power to supervise other entities, even if they are less significant. To date, the only supranational body in financial markets law – ESMA – has no such power. That is why we propose to give discretionary power to Member States in this context.

3.2. Soft Law

Binding legal norms are called 'hard law'. Examples include the provisions of the AIFMD and the provisions of national legal acts.[21] The parties must comply with these legal standards unless the law provides otherwise.[22] In other words, as the name suggests, hard law is binding.

These mandatory rules must be compared to soft law, which is not legally binding. According to Guzman and Meyer, soft law rules can be defined as 'non-binding rules that interpret or inform our understanding of binding rules or that represent promises which, in turn, create expectations about future conduct'.[23] For instance, the following instruments are considered as soft law in France: the doctrine of national regulatory authorities (instructions, positions and position-recommendations), as well as Codes of Conduct established by national professional associations in the field of asset management.[24] As regards international soft law, some of the examples include ESMA's legal opinions.

Industry participants are expected to comply with the principles set out in these documents. These guiding principles complement or explain the hard law which is represented by the AIFMD.

An example of soft law, which is applicable to investment firms, is ESMA's advice in relation to firms marketing complex investment products.[25] These guidelines apply to new complex investment products, such as financial derivatives and financial products based on

20 M. Domina-Repiquet, *Solving Methodological Enigma: Intervention of the European Central Bank Under the Single Supervisory Mechanism*, (3) Dialogues mulhousiens, Intervention (s), Journées doctorales humanités 2018 93 (janvier 2019).

21 For example, in France these are codified in the Monetary and Financial Code.

22 T.-M.-J. Mollers, *Sources of Law in European Securities Regulation – Rffective Regulation, Soft Law and Legal Taxonomy from Lamfalussy to de Larosiere*, 11(3) Eur. Bus. Org. L. Rev. 379, at 387 (2010).

23 A.-T. Guzman & T.-L. Meyer, *International Soft Law*, (2) J. Legal Analysis 171 (2010).

24 I. Riassetto, § 1913, d, at 30–31, in *Le Lamy Droit du Financement* (J. Deveze, Wolters Kluwer 2018).

25 *See* inter alia, Questions and Answers on MiFID II and MiFIR investor protection and intermediaries' topics, 11 July 2019, AEMF35-43-349; Annual report on the statistics « EU Alternative Investment Funds », 7 Mar. 2019, AEMF50-165-748; Questions and Answers. Application of the AIFMD, 4 Oct. 2018, AEMF34-32-352; Opinion on asset segregation and application of depositary delegation rules to CSDs, AEMF34-45-277, 20 July 2017; General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union, 31 May 2017; AEMF42-110-443 Guidelines on reporting obligations under Arts 3(3)(d) and 24(1), (2) and (4) of the AIFMD, 8 Aug. 2014, AEMF/2014/869; Guidelines on the transparency obligations, 31 Jan. 2014, AEMF/2013/232; Guidelines on key concepts of the AIFMD, 13 Aug. 2013, AEMF/2013/611; Guidelines on the model MoU concerning consultation, cooperation and the exchange of information related to the supervision of AIFMD entities, 18 July

non-standard indices. ESMA's objective is to provide for more certainty and security to potential investors in these products through enhanced duties. These guidelines, although not binding, should be taken into account by national authorities on a 'comply or explain' basis. In other words, Member States that do not wish to clarify their national law with regard to ESMA's legal advice should explain this choice.[26]

The main advantage of soft law is its ability to react quickly to changes in the investment industry. Whereas the development and entry into force of an EU directive typically take years, ESMA's legal opinions can be issued within days. This allows ESMA to react to the first signs of opportunistic behaviour by investment firms and to adopt the necessary guidelines to limit such potentially destabilizing behaviour. As the lessons of the last financial crisis have shown, the ability to react quickly to dangerous activities of financial market participants and to impose sanctions is essential for preserving financial stability.

It goes without saying that ESMA's legal advice should not be considered superior to the provisions of EU law. However, we suggest that ESMA could be the first step in monitoring potentially disruptive behaviour by investment firms. There is nothing to prevent legislators from following ESMA's advice and adopting the relevant legal acts. However, because it takes a long time to enact such legislation, the soft law rules will act as a temporary measure.

The same parallel can be drawn with the doctrine of national regulatory authorities. The positions and recommendations of AMF can be issued within days, which is much quicker as compared to the timeline needed for adopting a legal act. These instruments of national soft law can issue guidance on the need to impose stricter legal requirements on certain types of fund managers and/or funds. This will allow national regulatory authorities to intervene in an efficient manner and preserve financial well-being of the economy.

4. CONCLUSION

We have analysed the role of the regulatory discretion in the prevention of financial crises, on the example of AIF industry. The last financial crisis of 2007/2008 showed that inadequate regulation of financial market participants can lead to a global economic recession.

This explained recourse to the strict regulatory approach, whereby legal rules set forth the extensive legal regime governing a particular area of relationships. The AIFMD is one of such examples. It is aimed at regulating all AIFMs that manage or market their AIF to EU-based investors.

This article argues that the AIFMD role in preventing further financial crises is open to criticism, namely because it solely focuses on the leverage as a criterion for allowing Member States to impose stricter conditions on AIFM, except for AIF marketed to retail clients, and does not provide for an efficient intervention of competent national authorities.

We have established that the regulatory direction of competent national authorities can play an important role in preventing further financial shocks. This implies that these authorities are given enough discretion to define the criteria of a stricter regulation by themselves, as well as the mechanisms to exercise this discretion. The foundations for this discretionary power should be provided by national and soft law. Such a regime will help to preserve financial well-being and prevent or at least limit possible future financial shocks.

2013, AEMF/2013/998; Guidelines on sound remuneration policies under the AIFMD, 3 July 2013, AEMF/2013/232; Guidelines on the key concepts of the AIFMD, 24 May 2013, AEMF/2013/600; Final report. AEMF's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 16 Nov. 2011, AEMF/2011/379.

26 Guzman & Meyer, *supra* n. 23.