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## REGULATION AND DEVELOPMENT OF ALTERNATIVE INVESTMENT FUNDS IN LITHUANIA

*Мета роботи полягає в тому, щоб проаналізувати правила, що застосовуються до альтернативних інвестиційних фондів (АІФ), зміни за останні роки, пов'язані зі створенням АІФ в Литві. Хоча розмір капіталів АІФ в Литві зростає, більшості зареєстрованих в Литві АІФ не вдалося залучити інвесторів.*

*Ключові слова: альтернативні інвестиційні фонди, фонди прямих інвестицій, хедж-фонди, нерухомість, законодавство.*

*Цель работы состоит в том, чтобы проанализировать правила, применяемые к альтернативным инвестиционным фондам (АИФ), изменения за последние годы, связанные с созданием АИФ в Литве. Хотя размер капиталов АИФ в Литве растет, большинству зарегистрированных в Литве АИФ не удалось привлечь инвесторов.*

*Ключевые слова: альтернативные инвестиционные фонды, фонды прямых инвестиций, хедж-фонды, недвижимость, законодательство.*

*The aim is to analyse regulations applied to Alternative Investment Funds (AIF) and the changes in recent years as well as the related establishment of AIF in Lithuania. Although the size of AIF capital in Lithuania is growing the majority of AIFs registered in Lithuania are not able to attract investors.*

*Keywords: alternative investment funds, private equity, hedge funds, real estate, legislation.*

The research on the analysed subject is relatively scarce due to the closed nature of AIFs, their poor regulation and dissemination of information. However, the amount of scientific research related to AIFs is lately on the increase as these funds gain a greater importance and their controlled equity continues to make up a larger share of the overall investment flows. The Financial Planning Association survey [1] shows a clear trend where in the global perspective the share of the alternative funds is continually growing among the investments in general. The investors are willing to utilize them because of the weak correlation of such investments with common investment instruments (i.e. shares, bonds) and, thus, decreasing the general fluctuation of the portfolio. It has become especially relevant for the financial markets as they experience continual pressure and stress while the world's economies are trying to overcome the crisis. Numerous researches were dedicated to the analysis of the effects of different types of AIFs on the economy: the works by Rankin B. [2], Rubin R. E. [3], Stulz R. M. [4] discuss the influence of hedge funds on the economy, the effects of private equity funds (further – PEF) on the economy are researched in such sources as Venture Impact [5], Phalippou L., Gottschlag O. [6], Metrick A., Yasuda A. [7], while the assessments of real estate funds (further – REF) can be found in the works by Bednarczyk T. P. [8], Bivainis J., Volodzkienė L. [9], Galinienė B., Bumelytė J. [10]. Despite the fact that the scientific literature is abundant with the evaluations of AIF types and activity analyses there is a lack of research with an overall systematic assessment of the entire AIF sector.

It has been believed that the AIFs (hedge funds in particular) could contribute to the subprime mortgage crisis in 2007 which later evolved into a financial and economic crisis [11]. The recently growing anxiety over the AIF activities and the aspirations to put stricter regulations on these investment funds are partly related to this. The objective of this article is to analyse the regulations applied to the AIFs active in Lithuania as well as the related activities of such funds.

The methods used in this research: analysis of scientific literature and legislation as well as review, synthesis and interpretation of historical data.

### Regulation of AIFs in Lithuania and the global trends

On March 1, 2008 the Law on collective investment undertakings [12] (further – LCIU) came into force and opened the way for the registration of alternative investment funds in Lithuania. Due to the fact that the law which regulates AIFs has been operative for a relatively short time and has been

constantly amended, the subject of the activity of such funds in Lithuania is still new and not sufficiently researched. The issue of regulation is also important because the investors, especially the institutional bodies, have more confidence in the regulated AIFs. Therefore, continual improvement of the regulation of alternative investments is crucial in providing security for all the parties involved.

According to LCIU, special collective investment undertakings in Lithuania are classified into the following types: 1) Undertakings for collective investment in transferable securities; 2) Real estate collective investment undertakings (i.e. real estate funds); 3) Private equity collective investment undertakings (i.e. private equity funds); 4) Collective investment undertakings investing in the units of other collective investment undertakings; 5) alternative collective investment undertakings (i.e. hedge funds). In accordance with this legal act three types of AIFs can function in Lithuania, and these three are usually associated with AIFs, even though there is no single and established viewpoint on which investment types can be subsumed under alternative investments. Spangler T., Paisner B. L. [13] state that AIFs can include three types of funds: hedge funds, private equity funds and real estate funds. Dönges T. [14] mentions that alternative investments comprise hedge funds, private equity, currencies and raw materials. One of the distinctive features indicated to assist in classifying certain classes of investments as alternative investments is the weak correlation with common investment classes (shares, bonds).

Some authors tend to include raw materials in the AIFs, however, the authors of this article (as of now) would not recommend to do so. Thorsten Dönges [14] offers one of the distinctive features allowing to classify certain classes of investments as alternative investments which is the weak correlation with common investment classes (shares, bonds). Based on calculations by Jarašius G. [15, p. 3], the price variation correlation coefficient of raw materials Dow Jones UBS Commodity Index and stock index of S&P 500 is approximately 0,58 which in turn shows a strong linear correlation. With regard to this during the period of analysis it would be advisable to class only three types of funds as AIFs: hedge funds, PEFs and REFs, i.e. those that are legal according to LCIU.

It can be stated that until the financial crisis which emerged in 2007 the AIFs were not so strictly regulated since quite often such funds are registered in the countries which are famous for their favourable policies of taxation and regulatory framework. Due to their closed nature and narrower scope of investors even in cases when AIFs were

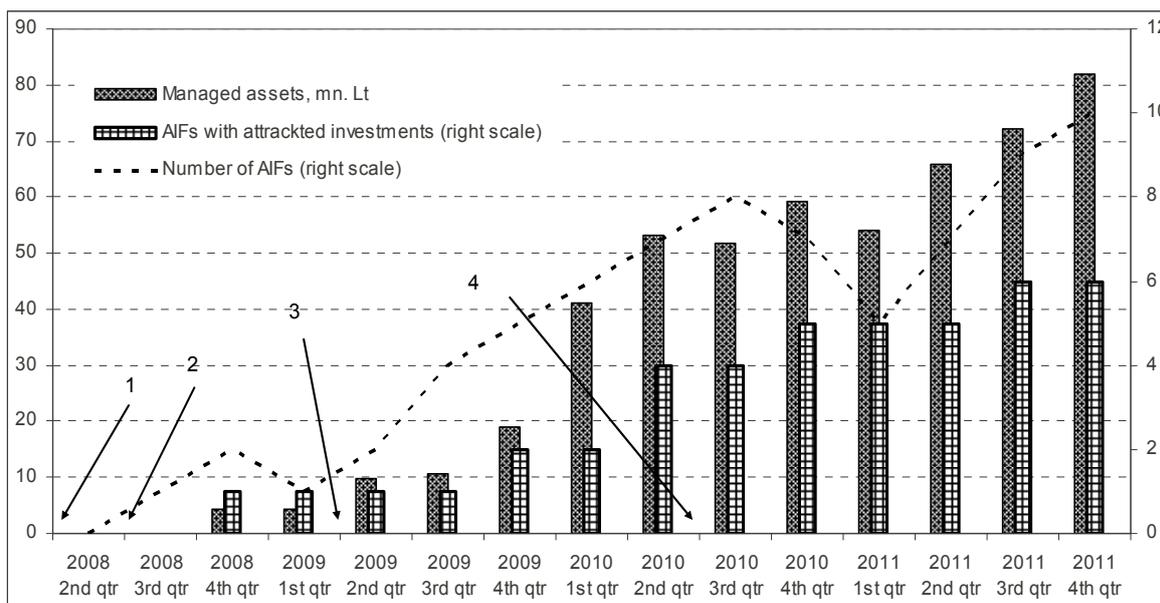
established in the USA or the EU countries, such funds were not obligated to provide reports or other information on their activities, thus, their regulation was only nominal.

Since the start of the financial and economic crisis in 2007 all major economies of the world have become noticeably concerned with the activities and control of the financial sector, as well as AIFs, attempting to make it more transparent and clear. Initiated by the European Commission a new Directive on Alternative Investment Fund Managers was adopted in the month of July 2011 [16]. As stated in the proposal for a directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC [17], the experience of the financial crisis exposed important failures, therefore, to ensure relevant regulation and supervision gaps in certain areas need to be bridged – and one of them is related to AIFs and their managers. In accordance with this directive AIF managers shall be authorized and subject to harmonized regulation standards. Even though this directive will affect only the minority of AIF managers, their assets under management will constitute approximately 90 per cent of total AIF assets registered in the EU, as only the large AIFs shall be regulated [17, p. 6]. Based on such equity requirement even when the directive is transferred to the national legal acts (until July 22, 2013) the amendments will not affect AIFs registered in Lithuania in any way, as the Lithuanian market and capitalization are small. As of the end of 2011 none of the operating funds were able to

reach at least the minimum sum which makes the directive applicable (100 mn. Euros; when the initial five-year lock-in period of funds is applicable – up to 500 mn. Euros). The analysis of trends shows a weak probability of reaching this level in the near future. Choosing Lithuania as a place of registration of alternative investment funds during this period of analysis would not be sensible as the applicable restrictions are quite strict compared with other countries (e.g. the USA or "tax paradise" countries), so Lithuania would not have AIFs which would be subject to the framework of the directive.

**The trends of AIF activities in Lithuania**

After three and a half years since the validation of the registration of AIFs in Lithuania such funds were quite successful in establishing their position in the common investment funds' market. Picture 1 shows the data of AIF expansion in Lithuania in 2008-2011 with their relation to the major changes within the legal regulation of AIFs. The recast of LCIU was adopted in November 2007. The basic difference from the prior versions were the establishment conditions provided to special collective investment undertakings such as private equity funds, real estate funds and alternative collective investment undertakings. This recast also offered an opportunity to establish closed-end type collective investment undertakings. The law has been effective since March 1, 2008 and this event is marked as No. 1 in the timeline of the figure.



**Fig. 1. AIF expansion and LCIU amendments over the period of 2008-2011**

Source: compiled by authors based on [12; 21; 22]

Until the end of 2011 LCIU was amended three times, however, it did not change the regulations significantly. No. 2 in the picture is another LCIU amendment (2008, 2nd quarter) related to the changes in the definitions used in the legal act which were not related to AIFs. The first AIFs were registered in Lithuania as early as in the 3rd quarter of 2008, however, investors did not show considerable enthusiasm in relation to these funds. This is undoubtedly associated not with the insufficiently clear and attractive AIF regulation, but with general macroeconomic trends – economic recession and uncertainty in the financial markets where a more conservative and less risky investment character was prioritized.

LCIU amendments indicated as No. 3 and 4 were among other addenda related to REFs – ensuring clearer REF investment diversification principles and opportunities given to REFs to affect the issuer. The analysis of LCIU amendments with respect to the dynamics of AIF activities in Lithuania it can be stated that LCIU does not have a clear influence on the number of AIFs or the growth of the scope of assets under management. Even in case of considering the period of time needed for decisions on administrative or other procedures and circumstances to come into force and affect the previously established or future funds, LCIU amendments still do not have any impact on the number of the operating AIFs or their managed assets. The changes of the legal regulation did not show any affect

over the period of one or two quarters. It may, from the first glance, seem that events No. 3 and 4 could condition the decrease in the number of AIFs in the 4th quarter of 2010 and the 1st quarter of 2011. However, this decline was caused by two PEFs which terminated their activities as well as one hedge fund. As mentioned before, the latest LCIU amendments were related to REFs and were not to influence other types of AIFs.

Since AIFs were legalized in Lithuania in the period when AIFs were widely known and quite popular in the main financial centres (moreover, because the EU regulation was taken into consideration), the basic provisions of the law were applied in a sensible manner with regard to the new tendencies, thus, there was no need to change them to a large extent. It can be mentioned that due to such circumstances even the small LCIU amendments do not exert almost any influence on the AIF market which was formed in Lithuania.

The AIF activity in Lithuania is obviously successful. Despite the fact that these funds became legal during the very culmination of the global economic and financial crisis, since early 2008 up till late 2011 the AIF investment share in all the CIU investments grew as high as 16% and this is the largest part from the very outset of the AIF activity in Lithuania. As seen from figure 1, the absolute amount of AIF managed assets were on the increase almost continually with insignificant declines over several quarters. In view of such fast AIF growth one should note that AIFs can also cause a number of negative consequences for the economic and financial market, especially with funds acquiring more and more assets. Without a separate analysis of each AIF type it can be stated that AIF can experience difficulties due to leverage and not always liquid investments when the atmosphere on the financial markets gets worse and uncertainty rules. Problems with large AIFs can also lead to systemic risk. Therefore, it is necessary to maintain adequate AIF regulation by ensuring timely decisions and blocking the negative impact of the AIF activities.

While analysing the individual features of each type of AIFs a trend is clearly seen where the most popular type is REF both in managed assets scope and number of participants. The initial AIF activity stage in Lithuania was different – among the AIFs the most popular ones were the PEFs – 3 registered, 1 one them attracted two participants and controlled the major part of all AIF managed assets (until 4th quart. of 2009 these were the only funds which attracted investments which made up 10,96 mn litas in the above mentioned quarter [22]). However, starting from 2010 2nd quarter hedge funds and especially REFs gained popularity. For the end of 2011 according to the data supplied by the Bank of Lithuania [21] two PEFs were registered in Lithuania – both of them are not involved in any activity and have not attracted investments. Since early 2008 a total of 4 PEFs were registered in Lithuania. Thus, it can be concluded that under current conditions PEFs are not highly demanded in Lithuania, as they fail to attract the required investments.

PEFs are often presented as favourable, their effect on the economy is being analysed only through a positive prism (e.g. Alemana L., Martí J. [18], Venture Impact [5]), that is why it could be said that the AIFs of this type were the most attractive in Lithuania as well. The assessment of LCIU regulations applied to PEFs it can also be noticed that they have relatively more advantageous conditions compared with other AIFs (less diversification requirements, wide variety of investment instrument choice and financial leverage). The activity of PEFs is mainly focused on the young, promising and developing companies and can offer funding under favourable conditions. For these reasons it could be expected to see more popularity for PEFs in the conditions of the recovering and progressing

economy. Nonetheless, by the end of 2011 there were no actually functioning PEFs in Lithuania [22]. The authors believe that this can be due to the funding provided by the EU structural funds and the recently popular risk capital financing for small and medium-sized enterprises (e.g. JEREMIE initiative which creates conditions for the allocated EU structural funds and national funds to be used for the support of SMEs via the holding funds).

The recent development is the dominating position of REF on the Lithuanian AIF market – the real estate funds attract most participants and manage the largest share of assets. Essentially there are two types of REFs authorized in Lithuania – open-end and close-end types. REFs offer a possibility for the small investors to have real estate in their portfolio not only in a customary form, i.e. by acquiring real estate, but also as non-traditional form. Moreover, the correlation of such funds with the share markets (as in case of other AIFs) is weak [19].

Based on data of JP Morgan Asset Management [20] investments in real estate are more profitable than the instruments of the money market, but in terms of risk-profit they are not as attractive as the investments in shares. Despite the fact that in the long term real estate is affected by macroeconomic variables and economic cycles, this class of assets has an insignificant correlation with the stock market. Moreover, the cash flows generated by real estate are more stable. In view of this fact it can be stated that such investments are attractive and promising. With the decrease of real estate prices in mind the recent popularity of REFs can be easily explained. As of the end of 2011, according to the data provided by the Bank of Lithuania, there were 5 REFs registered in this country. As two of them were established in the second half of the analysed period they did not attract any investments, thus, in reality only 3 REFs are marked by activity. The managed assets of these REFs as of the end of 2011 reached 75,62 mn. litas which constitute 14,8% of the total assets managed by CIUs. At this time REF is the only type of AIFs which can work successfully in Lithuania (in terms of the managed assets scope) and increase its managed assets. Despite the fact that as of the end of 2011 three hedge funds were functioning in Lithuania, and all of them have attracted investments, their managed assets as of the data of the end of year 2011 stood at 6,31 mn. litas, it makes up 1,2% of the total CIU managed assets in Lithuania [21]. Even in case of considering the possibility of AIF to use financial leverage (which for hedge funds is allowed up to 200% of net asset value, and 75% respectively for REFs [12]), it can be stated that REFs are the most attractive in Lithuania at the present period under scrutiny.

**Conclusion.** Despite the fact that AIFs were allowed by the legislation of Lithuania quite recently their market is fully formed and functions in a sufficiently successful way. It is proven by the ratio of the AIF managed assets and the total CIU managed assets which stand at 16%. Moreover, historical data shows that this is a growing tendency. However, the analysis of the AIF activities in Lithuania a trend was noticed where a large number of such funds (10 out of the 15 registered AIFs are currently functioning while only 6 of them have attracted investments) fail to attract investments and are finally compelled to stop their activity. Therefore, the AIF managers should not be extremely optimistic and while establishing AIFs they should consider the size of the market, its level of maturity and the willingness of investors to invest funds in AIFs.

The expansion of AIFs in Lithuania allows investors to have broader diversification opportunities and a more varied choice of investment instruments. Nonetheless, it is necessary to also consider the threats of such funds which can arise due to their investment actions, leverage, etc. Despite the fact that due to its small size and relatively

strict regulation at the analysed period AIFs do not pose any dangers to the economy and financial market of Lithuania, it is important to further analyse the AIF activities and in case of necessity to improve the legal base in order to prevent the possible speculations and other negative types of AIF activities.

As a consequence of the recent global economic decline it was decided to put stricter regulations on the non-traditional investment instruments, AIFs among others. However, due to the small market and the insignificant size of AIFs registered in Lithuania the globally accepted regulation will not affect the AIFs functioning in Lithuania during the analysed period. Despite the fact that during the short-term and intermediate period shows only a slight probability of AIFs registered in Lithuania to emerge within the framework of the newly adopted directive on AIF managers, it is important to analyse the legal AIF regulation on a world-scale and implement respective improvements in the national legal base.

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## EVALUATION OF INTERNAL CONTROL: RISK MANAGEMENT IN EXTRACTIVE INDUSTRY ENTERPRISES

*В даний час в конкурентному світі технології стрімко розвиваються і змінюються, змінюються і потреби ринку, бізнес-процеси стають все більш складними, та стає все більш і більш складним контролювати підприємство і здійснювати його внутрішній контроль. Мета цієї статті полягає в проведенні аналізу системи внутрішнього контролю та його системи управління. Більш того, тільки ефективна система внутрішнього контролю робить позитивний вплив на всі інші системи управління компанією, і, коли компанія має ефективну систему внутрішнього контролю, вона може конкурувати з іншими компаніями, що працюють в галузі, і прагнути нових стратегічних цілей, поставлених управлінням.*

**Ключові слова:** внутрішній контроль, оцінювання, ризик шахрайства.

*В настоящее время в конкурентном мире технологии стремительно развиваются и изменяются, меняются и потребности рынка, бизнес-процессы становятся более сложными, и становится все более и более сложным управлять предприятием и выполнять его внутренний контроль. Цель этой статьи заключается в проведении анализа системы внутреннего контроля и его системы управления. Более того, только эффективная система внутреннего контроля оказывает положительное влияние на все другие системы управления компании, и, когда компания имеет эффективную систему внутреннего контроля, она может конкурировать с другими компаниями, работающими в отрасли, и стремиться к новым стратегическим целям, поставленным управлением.*

**Ключевые слова:** внутренний контроль, оценивание, риск мошенничества.

*In the nowadays competitive world, technologies are rapidly developing and varying, market needs are changing, business processes becoming more difficult, and it is getting more and more complicated to control the enterprise and to perform its internal control. Purpose of the article is to perform an analysis of internal control and its management system. Moreover, only the effective internal control system has positive influence on all other control systems of the company, and when the company has an effective internal control, it may compete with other companies operating within the branch, and to endeavor at new strategic goals set by the management.*

**Keywords:** internal control, evaluation, fraud risk.

The internal control system is very important in all enterprises without any exception, be they large, medium or small [1]. This is why the purpose of internal control is to manage business risk, i.e. to find the coordinated methods and means of the system of internal control so as to mini-

mize the risk related to business environment, to the processes happening in the enterprise, and to generate the information that would be an essential background for making business decisions. Indeterminacy of these three types are common for every business, and managing to control