The 'old' and 'new' political economy of hedge funds regulation in the EU*

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Abstract

Why has the European Union decided to regulate hedge fund managers through the draft directive on Alternative Investment Fund Managers (AIFM) in the aftermath of the global financial crisis? After having dismissed 'functional' and international level explanations, the research argues that the Franco-German alliance, with the support of Italy, other Mediterranean countries, and some quarters of the European Parliament (EP), have driven the EU's attempt to regulate hedge funds (to be precise, AIFM). The proposed EU rules are explained by economic interests rooted in national varieties of capitalism – the 'old' political economy of hedge fund regulation. However, 'ideas', in the form of competing regulatory paradigms, are instrumental in explaining why one coalition of actors has prevailed over the other in EU rule-making – the 'new' political economy of hedge funds regulation. A 'market-shaping' regulatory paradigm has gained ground in the EU regulatory space following the global financial crisis, empowering the coalition sponsoring that paradigm, and silencing the 'market-making' regulatory paradigm advocated first and foremost by the UK and the hedge funds industry. The EU has also attempted to export some tenets of its regulatory paradigm to other jurisdictions.

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Introduction

Over the last two decades or so, hedge funds have gained a great deal of economic and political prominence. Economically, hedge funds have grown fifty-fold globally in terms of assets under management since 1990. In recent years, trading by hedge funds has accounted for over 50% of the daily trading volume in equities markets (Commission 2008). Global hedge fund assets under management reached approximately $2 trillion in 2007. Hedge funds have become crucial providers of liquidity and drivers of price formation in global financial markets (Commission 2008). In the building up of the global financial crisis, hedge funds were amongst the leading buyers and sellers of many of the credit derivatives and other structured products that were at the origins of the turmoil. During the financial crisis hedge funds were criticised for engaging in short selling, worsening the financial downturn (Brunnermeier at al. 2009; Group of Thirty 2009).

Politically, the activity of hedge funds has come into the spotlight due the role they played in the Asian financial crisis in 1997 and after the failure of the LTCM in the US in 1998. These two episodes highlighted, respectively, the potential systemic repercussions ensuing from the herding behaviour of hedge funds and from the failure of large hedge funds. In Europe, episodes such as the failed merger between the Deutsche Börse and the London Stock Exchange brought to the fore the potential disruptive effects that hedge funds can have on corporate governance in continental European countries, first and foremost Germany (*The Economist,* 23 April 2005). Moreover, the large scale fraud perpetrated by the hedge funds run by Bernard

Madoff, who made use of a Ponzi scheme, had considerable political resonance within and without the US.

Over the last decade, there has been an ongoing debate about the regulation of hedge funds at the international level, as well as in national and regional jurisdictions, such as the European Union (EU). The policy discussion, which was reignited by the outbreak of the global financial crisis in 2007-8, concerned the scope and type of regulation, as well as the level of governance, the sphere of action (public or private) and specific fora in which the regulatory activity should be undertaken. Indeed, the regulation of hedge funds is a very clear example of multi-level governance in financial services (Baker et al. 2005) because there are some soft rules issued by a plethora of international bodies, more or less binding rules issued by national jurisdictions and voluntary rules issued by private sector bodies, as explained below.

This notwithstanding, in April 2009 the European Commission decided to propose a directive to regulate Alternative Investment Funds Managers (AIFM), amongst which mangers of hedge funds featured prominently. In so doing, it added an additional regional (ie EU) layer to the multi-level governance of financial services. Although the Commission had held an open consultation on this topic over the preceding months, this move was rather unexpected, not least because certain member states, first and foremost the UK, which hosts 4/5 of hedge funds in Europe, and certain stakeholders, first and foremost the associations representing alternative investment funds had argued against such course of action in their responses to the Commission’s consultation and in other public venues, as elaborated below.

The puzzle

Besides the rather obvious opposition of some of the policy-makers and stake holders most directly affected by the proposed legislation, the Commission’s decision to propose legislation was somewhat puzzling for a variety of reasons. First, hedge funds were not the main causes of the global financial crisis that began in 2007 (Geneva Report 2009; de Larosière group 2009). According to several accounts, they did play a part in worsening it, mainly through a transmission function, notably due to the massive selling of shares and short-selling transactions (Group of Thirty 2009; FSA 2009). However, hedge funds and their managers would argue that they were themselves negatively affected by the crisis, which had been caused by other financial (regulated) institutions, such as banks and mortgage lenders. If anything, hedge funds had been part of the solution and not the problem (AIMA 2008).

Second, unlike credit rating agencies, which prior to the passing of the EU regulation on credit rating agencies in April 2009 were not regulated either at the EU level nor in the member states, hedge fund managers and in some cases hedge fund themselves were subject to national regulation across the EU, even though national legislation differed considerable in certain respects (for an overview see IOSCO 2006). Existing differences in national legislation across the EU and vis-à-vis non-EU countries, first and foremost the US, were likely to make harmonisation more difficult because different national standards would need to converge towards common EU rules.

Third, EU legislation on hedge funds managers could have a considerable extra territorial impact, for example in the US, were a sizeable number of hedge fund managers are located and are therefore subject to US law. Although US rules on hedge funds prior to the crisis were 'light' as explained below, the argument could be made that hedge funds and fund managers located outside the EU (to be precise, in the US) were not unregulated. Furthermore, EU legislation on this matter could trigger regulatory arbitrage, placing Europe at a competitive disadvantage vis-à-vis less regulated jurisdictions (including the US), as claimed, for example, by British policy-makers and hedge funds industry (House of Lords 2009). Hence, their argument went, hedge funds managers could decide to relocate outside the EU, in particular in Switzerland (*Financial Times*, 14 July 2009; 7 July 2009; 16 June 2009; 4 June 2009). This possibility would be made more likely by the fact that hedge funds are often domiciliated outside the EU, generally in tax havens, for tax-related purposes.

Why has the EU decided to regulate hedge funds managers, to be precise AIFM?[1] How have the key features of the proposed directive on AIFM been decided and why? This research addresses these questions by evaluating the explanatory power of a variety of theoretically-informed explanations against the empirical record. These explanations, which can be located at the international level and the EU level, are derived from a large body of international and domestic political economy literature to which the main findings of this research contribute with a view to shed light onto the 'old' and 'new' political economy of hedge funds regulation in the EU.

This paper is organised as follows. Section 2 discusses the research design, reviewing a set of theoretically-informed accounts, arguing that 'functionalist' and international

[1] In examining the AIFM draft directive, the focus will be on its implications for hedge funds and fund managers, not for managers of private equities funds and real estate funds, which are also covered by the directive.

level explanations can be dismissed at the outset. Section 3 outlines the regulatory context in which hedge funds operate by defining hedge funds, their key features, their main components, and the main types of regulation they can be subject to. This section also outlines the international and private sector regulatory responses concerning the activities of hedge funds in the aftermath of the global financial crisis. Section 4 discusses the content and policy process of the draft EU directive on AIFM. Section 5 provides an overall assessment.

2. Literature review and research design

Several theoretically-informed accounts can be put forward in order to explain why the EU has decided to regulated hedge funds managers. They can be articulated at two levels of analysis: the international level and the EU level. For analytical purposes, such explanations can be grouped under three main headings: interests, ideas and institutions, even though the division into these heuristic categories is not always neat.

The first explanation that can be relatively easily ruled out is a purely functional (or economic) explanation; namely, that the crisis clearly demonstrated the need to revise the regulation of hedge funds and that the EU public authorities rationally reacted by proposing legislation and stimulating the discussion on new international rules in this field. This explanation has several points in common with liberal institutionalism, which postulates that international institutions are created to solve collective action and commitment problems (Keohane 1984; Keohane and Nye 2001). As argued in several reports, hedge funds were not the main causes of the crisis and several (mainly British) policy-makers would question the effectiveness of the EU proposed legislation from a theoretical and practical point of view (see, for example, House of Lords 2009), articulating the view that – ‘if it is not broken do not fix it’.

International level explanations can also be ruled out at the outset. An interest-based explanation would focus on the power of the dominant jurisdiction/s in the international system, generally the US, arguing that the pressure to regulate hedge fund in the EU or internationally came primarily from there, as it happened, for example, in the case of the Basel I accord in banking (Simmons 2001; for an extension of this argument to a limited number of big international players, amongst which the EU, see Drezner 2007).

However, a cursory look at the empirical record presented in Section 3 rules out this explanation because there is no evidence that the US put pressure on the EU to regulate hedge funds. If anything, the pressure went the other way around in that in at the various G 20 meetings, EU representatives or national leaders of European countries insisted on issuing statements along the lines that ‘all systemic institutions should be regulated’. The existing regulation of hedge funds in the US prior to the crisis was less strict than the one in place in several EU countries in that the registration of hedge funds managers with the Securities and Exchange Commission (SEC) was basically voluntary. By contrast in the UK, which together with the US is home to about 85% of hedge fund assets under management globally, the registration of hedge fund mangers with the Financial Services Authority (FSA) was compulsory, as was in France, Germany and Italy. After the crisis, a revision of US rules was discussed, but it was not a drastic one (*Financial Times*, 14 July 2009; Department of the Treasury 2009), as elaborated in Section 5. Hence, there was no point for the US to pressurise the EU and its member states to upgrade their regulatory standards.

An idea-based systemic explanation, which could be associated with sociological institutionalism, would highlight the international development of a policy paradigm (Hall 1993) concerning the regulation of hedge funds in response to the crisis. This socialisation process could be fostered by international organisations (Chiewroth 2007), or some of the main jurisdictions (Abdelal 2007), mainly through the interaction of macroeconomic policy elites. However, the empirical record does not find much evidence of this – no document produced by international organisation or by the US (or other jurisdictions, besides the EU) explicitly called for the regulation of hedge funds in the form proposed by the EU. In the wake of the financial crisis, it was the EU, under the impulse of France and Germany, that called for strengthening the regulation of hedge funds in international fora, most notably at G 20 meeting in London in April 2009, as evidenced in Section 3. This was followed up by the IOSCO, the Financial Stability Forum (FSF), later renamed and reshaped into the Financial Stability Board (FSB) and private sector bodies.

Finally, there is an institutionalist explanation, which can be linked to historical institutionalism (Büthe 2008; Mattli and Büthe 2003) given the fact that a liberal institutionalist (or functionalist) explanation and sociological institutionalism have been discussed above. The historical institutionalist explanation does not seem to have much explanatory power because there was no path dependence at work in that hedge funds were not regulated internationally, though there were some soft rules in place concerning the indirect regulation of hedge funds. However, the EU legislation took a different approach based on the direct regulation of fund managers. One could argue that there was a shift in the punctuated equilibrium (Campbell 2004), following the historical juncture represented by the global financial crisis, but one would then need to explain how and why such a shift took place. In order to do so, the explanation would need to focus at the EU level because some European countries acted as a pace-setter in calling for a stricter regulation of hedge funds in the EU and internationally.

Mirroring the systemic level, three main explanations could be postulated at the EU level. Some of them can be dismissed at the outset, whereas others will be elaborated in the following sections. An interest-based account would highlight the fact that the most powerful member states (or a large majority of member states) were in favour of the proposed EU rules on AIFM. In order to explain why this was the case, one could consider the configuration of domestic interests as determined by political economy factors (Story and Walter 1997; Underhill 1997). This explanation seems to be quite promising given the fact that the empirical record presented in sections 4 and 5 suggests that some member states (primarily Germany, France and Italy) repeatedly called for strict EU regulation of hedge funds, whereas others (first and foremost the UK) opposed it.

A different variation of this explanation would focus on the role of the private sector, in particular the influence of transnational capital in shaping EU rules (Van Apeldoorn 2002; Bieling 2003; Mügge 2006; Macartney forthcoming). However, this explanation can be ruled out at the outset in this case study because the alternative investment funds industry opposed some of the proposed EU rules, and so did other large financial players, such as pension funds, insurance, etc as outlined in their responses to the Commission's consultation and as elaborated Section 5. Banks and prime brokers did not support the legislation either, as evidence by their response to consultation.[2]

An idea-based explanation would focus on the emergence of a new regulatory paradigm in the EU, or the gaining ground of a regulatory paradigm that existed prior to the crisis but was not in 'good currency', meaning that it was not widely shared by the main member states and EU institutions. In the field of European monetary integration, Dyson (1994), McNamara (1998), Marcussen (2000) and Verdun (1999) explained how the stability-oriented economic paradigm developed by Germany was exported across the EU and enshrined into the EMU project. Busch (2004) highlighted the importance of national discourses about financial regulation and Jabko (2006) stressed the 'strategic constructivism' deployed by the European Commission in order to construct the Single Market, including financial services.

An institutionalist approach would focus on EU institutions - in particular the Commission (Posner 2005; Jabko 2006) - as the key players in the making of financial market integration and regulation. However, as detailed in Section 4, prior to the global financial crisis the Commission had opposed the regulation of hedge funds by the EU. In the aftermath of the crisis, the Commission was put under a considerable

[2] The responses of the public authorises and the private sector to the Commission's consultation on the regulation of hedge funds as can be found at http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/hedge_funds&vm=detailed&sb=Title, accessed in July 2009

amount of political pressure by some member states, first and foremost Germany and France (which held the rotating presidency of the EU in the second semester of 2008), and parts of the European Parliament (EP) to issue the proposed rules, as evidenced in Section 5.

Another variation of the institutionalist explanation would point to a processes of path dependence in the EU. An historical institutionalist explanation is implicitly adopted by Lutton (2008), arguing that EU regulation has been changing the landscape of the hedge fund industry through a process of 'negative integration'. The prediction was that over time the exposure of ordinary investors to hedge funds products would lead to an incremental regulation of these financial services. However, the decision to propose the EU directive was a major change, not incremental evolution. One could argue that there was a shift in the punctuated equilibrium, due to the occurrence of the crisis, but one would need to explain why and how this happened.

To sum up, in the examination of the empirical record there are two explanations worth pursuing: the account that focuses on the interests and bargaining power of the main member states in promoting or opposing EU rules on hedge funds on the basis of domestic political economy; and the account that focuses on the emergence or gaining ground of a regulatory paradigm favouring strict regulation of hedge funds, promoted by some member states or EU institutions.

3. The multi-level governance of hedge funds

Not only there is not an internationally or EU agreed definition of hedge funds, but also hedge funds are generally not defined in national jurisdictions, even though as noted by the IOSCO, which has carried out several studies and surveys of hedge funds activities, ‘each jurisdiction has views on what a hedge fund is’ (IOSCO 2006: 9).

Hedge funds tend to have the following characteristics (Commission 2008; IOSCO 2009): they focus on delivery of absolute returns; their investment strategies is typically based on a relatively high and systematic use of leverage (in fact, they are often defined as ‘highly leveraged institutions’, see for example BCBS 1999) through borrowing, short-selling[3] and derivatives positions; their investor base has traditionally been confined to institutional or other sophisticated investors; significant performance fees (for instance, in the form of a percentage of profits) are paid to the manager in addition to an annual management fee and often significant own funds are invested by the manager. Last but not least, hedge funds tend to be ‘unregulated’. Indeed the IOSCO task force analysing regulatory options concerning hedge funds was named ‘Task force on Unregulated Entities’. However, this statement is subject to some qualifications.

The main actors in the hedge funds business are the hedge fund manager, the fund itself (which is often legally distinct from the manager), the administrator of the fund (responsible for processing trades and valuing assets) and the prime brokers (investment banks and securities firms) which acts as settlement agents, carry out custody of assets, and provide financing to hedge funds (Commission 2008; FSA

[3] Naked or uncovered short selling involves the sale of an asset that the seller does not own.

2005). Although it depends on the jurisdiction, hedge funds managers and prime brokers tend to be regulated, at least in Europe.

Hedge funds are often referred to as ‘unregulated’ financial entities, even though this definition is only partly correct. First, one should distinguish between direct regulation of hedge funds, that is the regulation of the funds as such, and indirect regulation. Indirect regulation means to regulate the financial institutions that interact with hedge funds, in particular the prime brokers, through which hedge funds operate in the securities markets and banks (in particular investment banks) investing in or lending to hedge funds. Second, one should distinguish between the regulation of hedge funds, many of which are located offshore, hence they cannot be regulated because they are based in foreign jurisdictions and the regulation of fund managers in the jurisdiction in which they are based.

Regulating hedge funds internationally

Prior to the global financial turmoil, some research and fact finding exercises on hedge funds had been undertaken by international financial regulatory fora, generally following policy failures. After the Asian financial crisis and the collapse of the hedge fund LTCM in the US, a set of policy documents were issued by BCBS (1999), IOSCO (1999), and subsequently by the newly created FSF (2000, updated in 2007, when the first signs of the crisis emerged). The US also conducted its own review through the President Working Group (PWG) on Financial Markets (1999). Basically, all these documents concluded in favour of indirect regulation of hedge fund, which was indeed strengthened.

The situation changed in the aftermath of the global financial crisis, when the EU became more active in the international debate on the reform of the international financial architecture, in particular hedge funds regulation. In February 2009, the German Chancellor Angela Merkel hosted a summit of German, French, Italian, Spanish, Dutch and British leaders in Berlin. The purpose of the gathering was to prepare a common EU policy in advance of London's G20 summit in April 2009. In relation to hedge funds, the press statement issued after the meeting pointed out that ‘all financial markets, products and participants must be subject to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk’.[4]

The consensus reached was seen as a victory for France and Germany, which championed the need for a comprehensive regulatory architecture in the face of resistance from the UK, where many hedge funds are based (*Financial Times*, 23 February 2009). Reportedly, at the meeting Gordon Brown agreed to restrictions on hedge funds in order to clear the way for an overall accord, which included the call for strengthening the International Monetary Fund (IMF) and endowing it with more resources (*The Daily Telegraph*, 23 February 2009).

A letter sent jointly by Nicolas Sarkozy, President of France and Angela Merkel, Chancellor of Germany to Mirek Topolanek, Prime Minister of the Czech Republic and Jose Manuel Barroso, President of the European Commission, in preparation for

[4] http://www.diplo.de/diplo/en/WillkommeninD/D-Informationen/Nachrichten/090224-1.html accessed in May 2009.

the G 20 Summit in April 2009 reiterated that ‘The first priority is to build a new global financial architecture. The European Union must assert a common position and take the lead on this….. On the basis of the achievements of the Berlin preparatory summit in February we are determined to obtain at the London summit concrete results on strengthening international financial regulation…. The European Union must propose that all hedge funds and other funds presenting a potential systemic risk be subject to appropriate registration, regulation and oversight.’

In policy discussions in international fora, two different approaches could be detected, one championed by Germany and France on the one side and the US and the UK on the other side (interviews, Basel, November 2008; Madrid, March 2009). In 2007, German officials used their presidency of the EU and of the G 8 to push for regulation, receiving some backing from the FSF, which the G 8 charged with studying the issue.[5] At the outset of the global financial crisis, the German finance minister Peer Steinbrück called for a formal code of conduct for hedge funds. The US opposed a code of conduct, while the US Treasury Secretary Henry Paulson Jr. supported a set of principles that informed investors, leaving them to monitor risk (*International Herald Tribune*, 23 April 2007; Bloomberg News, 23 April 2007). Impasse followed and no action was taken in order to deal with the problems posed by hedge and private-equity funds.

[5] Previously, in July 2005, the then-Chancellor of Germany, Gerhard Schröder (Social Democrat) had pressed fro tighter controls on hedge funds at G-7 Summit in Britain, where it was blocked—as Schröder himself revealed by ‘Wall Street and London’ (*The Independent*, 16 June 2005).

In the preparation of the April 2009 G 20 summit, the split over how to regulate hedge funds re-emerged. Several European countries, led by France and Germany - as suggested by the Sarkozy's and Merkel's joint letter - with the support of the Italy (Italian Treasury Minister Giulio Tremonti had vociferously called for the regulation of hedge funds) [6] pushed for a tougher regulatory regime for hedge funds and wanted the funds to be overseen similarly to banks (*Financial Times,* 23 February 2009). By contrast, the US and UK authorities favoured more disclosure over more regulation, proposing instead that funds be required to register with the government and disclose more information with a view to increase transparency (*Wall Street Journal,* 14 March 2009). European leaders also wanted to clamp down on tax havens.

In the end, the G 20 in London in April 2009 agreed that

'hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management….'

[6] The Italian Treasury minister Giulio Tremonti argued that the rewriting of financial market rules should target 'absolutely crazy bodies, like hedge funds which have nothing to do with capitalism' and are 'dark and opaque'. He fell short of proposing the abolition of hedge funds, causing a backlash from the industry concerned (*Reuters,* 11 October 2008).

After the crisis and following the G 20 recommendations, the IOSCO (2009) put forward some rather general recommendations on the regulation of hedge fund. However, the report that contained such recommendations could not reach an agreement on the fundamental issue of whether the hedge fund or the hedge fund manager should be regulated, as there were different views and national legislation in place in the participating jurisdictions.

Private sector regulation of hedge funds

In 2007, the FSF called on the hedge fund industry to develop a code of best practices. In response, several standards were issued by private sector bodies located in different jurisdictions. First, there were the standards issued by the Hedge Fund Working Group (HFWG)/Hedge Fund Standards Board (HFSB) based in the UK (2007) and to which managers can decide to sign up to. Second, there were the standards issued by the Managed Funds Association (MFA) based in the US (2007). Thirdly, there was the alternative investment industry association (AIMA)'s guide to sound practices for hedge fund valuation (2007), based in the UK. Basically, all these recommendations tended to cover issues related to sound practices for hedge fund governance, transparency, processes and methodology related to the valuation of hedge fund portfolios.

Furthermore, once the worst of the crisis was over, managers based in the US undertook a process of developing new industry standards under the auspices of the PWG, which had two separate committees: the Asset Managers' Committee, which comprised institutional alternative asset managers representing diverse strategies and perspectives and whose first task was to develop guidelines that define best practices for the hedge fund industry (Asset Managers Committee 2009); and the Investors Committee, which also issued a set of standards of best practices to reduce systemic risk and foster investor protection (Investors Committee 2009). Under the aegis of the IOSCO, industry associations have worked together to produce a single summary standards document – the Hedge Fund Matrix.[7]

4. Regulating hedge funds in the EU

Prior to the global financial crisis, hedge funds (or fund managers) were not regulated at the EU level. However, hedge funds, or to be precise some of their activities, were subject to EU legislation, notably the Markets in Financial Instruments directive, the Transparency directive and the Market Abuse directive. Some prudential reporting to supervisors was required by a regulation of the European Central Bank (ECB) concerning statistics on the assets and liabilities of investment funds. According to this regulation, which was issued in 2007 in the midst of the global financial crisis, all investment funds in the EU, including hedge funds, had to notify certain information to national central banks.

At the national level, hedge fund managers were regulated entities in some member states, though they were not subject to specific legislation concerning hedge fund managers. In other words, they were regulated as 'normal' fund managers. In other countries, such as in France, Italy, Spain and Germany, the fund itself was a regulated onshore vehicle (IOSCO 2006, 2009), though often it could be domiciled in a third country.

[7] http://www.hedgefundmatrix.com/ accessed in August 2009.

Prior to the financial crisis, some member states, first and foremost Germany, as well as parts of the EP (see the Kaforis report), had encouraged discussions concerning the regulation of hedge funds at the EU level. Partly to assuage these concerns, the Commission set up a group of experts -the Alternative Investment Expert Group – to discuss the issue. The group issued a report in 2006, *Managing, Servicing and Marketing Hedge Funds in Europe*, which concluded against EU legislation on hedge funds (2006). The issue was raised again by the German presidency of the EU in 2007 and during its hosting of the G 8 summit (*The Economist*, 26 May 2007). However, at that time there were not many takers for the proposal (interviews, Berlin, April 2008) .

In the past, the Commission, notably the Commissioner for the Internal Market Charles McCreevy, had ruled out EU legislation on hedge funds. According to several people interviewed, the Barroso Commission and Commissioner McCreevy in particular displayed a regulatory approach in favour of ‘better regulation’ on financial services (as elsewhere), which often translated into ‘light touch’ regulation, or no regulation at all, as in the case of hedge funds and credit rating agencies (interviews, Brussels, June 2007; Paris, July 2007; Rome, December 2007). Yet, the global financial crisis shifted the political dynamics in the regulatory mileu in Brussels. The top echelons of the Commission, led by president Barroso, began to display a different pro-regulatory stance, as demonstrated by the decision to propose a regulation on credit rating agencies and AIFM, which had been ostensibly opposed in the past.

The attempt to regulate hedge funds in the EU was given new momentum by the financial crisis. The EP became particularly vocal on this, producing two own initiative reports: the 'Rasmussen' report and the 'Lehne' report. A Resolution of the European Parliament issued on 23 September 2008 requested the Commission to submit a legislative proposal or proposals covering all relevant actors and financial market participants, including hedge funds and private equity.

In December 2008, the Commission issued for consultation a document discussing regulatory measures on hedge funds. The results of the consultation were discussed at a high-level conference in Brussels in late February 2009, and served as the basis for European input into the parallel reflections on hedge funds at international level by the G20. The issues addressed by the consultation concerned the potential systemic risks posed by hedge fund; the potential risk posed by hedge funds concerning market integrity and efficiency; the role (if any) of the public authorities in the risk management of hedge funds; and the need for adequate rules on transparency towards investors and investor protection (Commission 2008).

Most respondents to the Commission’s consultation believed that an international or global response would be superior to an EU response. However, a small majority of respondents believed that it was nevertheless appropriate to move forward with EU level action. Many respondents, most notably France and Germany, argued that ‘Europe should play an instrumental role in shaping a global regulatory regime for hedge funds through the creation of a "European label". An EU framework could serve as a reference for global regulation of alternative investment management activity’ (Commission 2009: 8).

In June 2009, the European Commission presented its proposal for the draft directive on AIFM, which includes managers of hedge funds, private equities funds and real estate funds, hence covering quite a broad range of financial entities. The Commission adopted a ‘carrot and stick strategy’ as McCrevy put it (*Financial Times,* 14 July 2009). On the one hand, the Commission argued that the cross-border dimension of the risks posed by alternative investment funds called for a coherent EU regulatory framework. On the other hand, it pointed out that an EU framework would remove the legal and regulatory obstacles to the efficient cross-border marketing of alternative investment funds across the EU. Hence, an AIFM domiciled in one member state would be allowed to market alternative investment funds to professional investors in another member state.

The proposed directive introduces a legally binding authorisation and supervisory regime for all AIFM in the EU, irrespective of the legal domicile of the alternative investment funds managed. Hence, AIFM will be subject to authorisation from the competent authority of the home member state and to reporting requirements of systemically important data to supervisors. For reasons of proportionality, the directive will not apply to AIFM managing portfolios of alternative investment funds with less than a certain amount, currently subject to negotiations. The AIFM will be required to hold a minimum level of capital and provide a minimum level of information to its (professional) investors.

The proposed directive sets up a European passport for AIFM. Hence, an AIFM authorised in its home member state will be entitled to market its funds to professional investors in other member states. Member states will not be permitted to impose additional requirements on AIFM domiciled in another member state. After a three-year transition period, the proposed directive will allow AIFM to market in the EU alternative investment funds located in third country domiciles only if their country of domicile has entered into an agreement based on the OECD Model Tax Convention and other regulatory requirements are met. Non-EU AIFM can apply for authorisation in the EU, which can be granted only if the regulatory framework and supervisory arrangements in their home country are deemed to be equivalent to those of the proposed directive and if EU operators enjoy comparable access to that third country market. In all cases, decisions on the equivalence of the relevant third country legislation and comparable market access will be taken by the Commission (Commission 2009b).

The parts of the directive that were more problematic for industry and some member states, first and foremost the UK, were: the imposition of a leverage cap on hedge fund activities; the requirement for AIFM to use an external depositary, namely a custodian bank, which was seen as a way of safeguarding investors but which would increase operational costs because banks would charge for the service provided; the arrangements for the passporting of non-EU funds, which were subject to a three-year freeze and the authorisation of non-EU AIFM (interviews, London, August 2009). The latter aspect was seen by its detractors as protectionist and potentially subject to politicisation (especially, the decision on 'equivalence'), whereas the supporters argued that such approach was necessary to prevent Europe from becoming 'the Trojan horse for offshore funds', as the French Treasury minister put it (*European Voice*, 29 April 2009). .

5. Evaluating theoretically-informed explanations against the empirical record

Amongst the member states, the main promoters of the directive on AIFM were France and Germany, with the support of Italy and other Mediterranean countries (*Financial Times*, 30 April 2009; interviews, London, August 2009). Domestic political economy factors rooted in national varieties of capitalism account for member states preferences on this matter (on varieties of capitalism in Europe see Schmidt 2002; Hall and Soskice 2001; Hancké, Rhodes, and Thatcher 2007). Hence, as in the case of the Takeover directive, varieties of capitalism in Europe clashed in the making of EU rules on hedge funds (Clift 2009).

First, France, Germany and Italy were worried about activist investors threatening to overturn ‘cosy corporatism’ in their domestic economies (*Financial Times,* 30 April 2009). Second, they were eager to boost the position of Paris and London as major European (and international?) financial centres, challenging the supremacy of the City, which thrived on the presence of the hedge funds industry in London. Third, hedge funds were subject to a rather strict regulation in the these countries (see IOSCO 2006). This was motivated by policy-makers beliefs about the potential threat posed by hedge funds to financial stability, the need to protect investors and an deeply ingrained dislike of ‘casino capitalism’ (Strange 1997), which was seen as serving well the fortunes of the City of London (interviews, Berlin, April 2008; Paris, July 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008). This was part and parcel of a ‘market-shaping’ regulatory paradigm that informed financial regulation in continental countries.

German policy-makers have long called for the regulation of hedge funds in the EU because their activity clashed with the German model of capitalism on more than one occasion. Two notable episodes were the Deutsche Börse’s failed attempt to buy the London Stock Exchange (LSE), which was prevented by a London based hedge fund that owned 8% of its shares. The battle subsequently extended to the German Börse's governance structure (*The Economist*, 23 April 2005). Afterward, hedge funds were accused of ‘ripping heart out of German economy’ (*The Independent*, 11 May 2005), as Rolf Breuer, the outgoing chairman of the Frankfurt stock exchange described the shareholder revolt at Deutsche Börse. Franz Müentefering, the chairman of the Social Democratic Party compared hedge funds and private equity investors to plagues of locusts ‘that descend on companies, chew them up and move on’.

Hedge funds do not fit comfortably with the variety of French ‘managed’ capitalism (Schmidt 2002). President Sarkozy articulated its vision of hedge funds and private equity as ‘aggressive’ gangs of ‘speculators’, bent on snapping up firms, sacking workers and creaming off profits (*The Economist*, 23 July 2009). Towards the end of the French presidency of the EU, President Sarkozy reassured the European Parliament that no financial institution would escape regulation (Rasmussen, Schulz, Berès 2008; interview, Paris, May 2009). After the Commission officially presented its proposal for an EU directive on AIFM, Christine Lagarde, the French Finance Minister, called for tighter regulation of hedge funds and private equity groups, arguing that the authorities should adopt a ‘maximalist’ regulatory approach (*Financial Times*, 6 May 2009). Moreover, French policy-makers objected to proposals that would allow offshore funds to be marketed across the EU provided that certain conditions were met. The Commission's proposal that these provisions should be delayed for three years was seen as a concession to the French (*Financial Times*, 6 May 2009).

The Socialists in the EP pushed for hedge fund regulation before and after the financial crisis. In December 2008, three leading members of the European Socialists (Rasmussen, Schulz, Berès 2008) sent a letter to the President of the Commisison, Jose' Manuel Barroso, calling for a Commission's proposal on hedge funds and private equities regulation. After the draft directive was issued, they argued that it did not go far enough, as reported in a letter sent to Barroso in April 2009 (Rasmussen, Schulz, Berès 2009). However, this political group lost at the 2009 European elections and the chairmanship of the key economic and monetary affairs committee passed from a French Socialist MEP (Pervenche Berès) to a British Liberal Democrat (Sharon Bowles), who was seen as 'fairly industry-friendly' (*Financial Times*, 14 July 2009).

The main opponents of the directive on AIFM as initially drafted were the UK and the hedge fund industry, which is mainly based in London. To be sure, they opposed certain provisions of the draft directive, not the directive as a whole. Private equities funds and real estate funds also criticised the draft directive, for different reasons, but this is outside the scope of this research. Lord Myners, a UK Treasury minister, criticised European countries seeking to 'make political capital' from advocating a clampdown on the hedge fund industry, calling their actions 'woefully short-sighted' and 'bordering on a weak form of protectionism' (*Financial Times*, 7 July 2009). It also argued that it was perhaps easy for other European countries to make political capital out of demanding ‘intrusive regulation of an industry of which they have little or no direct experience’ (*Financial Times,* 1 July 2009).

Domestic political economy factors rooted in the British variety of capitalism explain why the British authorities were critical of the draft proposed by the Commission. The UK, which hosts 4/5 of hedge funds in the EU, was concerned about the AIFM’s reaction to the costs of complying with the proposed EU rules and their threat of relocating outside the EU, engendering the primacy of London as a global financial centre. The concern about ‘regulatory arbitrage’ [8] has traditionally been at the forefront of British policy-makers’ mind, given the fact that London is a leading financial centre, which hosts many non British owned financial institutions and successfully competes with other financial centres to attract business (interviews, London, May 2007; July 2008). This can be summed up as a ‘market-making’ or ‘competition-friendly’ approach to financial services regulation.

Once the draft directive was published by the Commission, British policy-makers engaged in bilateral lobbying across the EU to find allies with a view to modify the proposed rules. They also attempted to enlist the support of the US authorities and international financial industry, pointing out the implications of the proposed EU rules for hedge fund and fund managers domiciliated outside the EU (House of Lords 2009). By contrast, European regulators argued that the directive would make life easier for non-EU funds, as a passport system would mean they would need to seek approval

[8] This expression used very frequently in the policy documents produced by the British Treasury, the FSA, and the Bank of England.

only once, rather than from each different country, to market to European investors. As mentioned before, this was a controversial issue, especially for France.

The London based hedge funds industry reacted negatively to the draft directive, arguing that some of the proposed rules were too strict, over prescriptive and unnecessary (interviews, London, August 2009). The City of London engaged in a joint lobbying effort with the British government. Seven experts working groups comprising officials form the Treasury and industry were set up to follow the proposed directive. The City undertook intensive lobbying in Brussels. It also engaged in direct lobbying of the US Treasury and of key financial committees in the Congress with a view to prevent excessively restrictive EU rules (as they saw it) and the danger of ‘tit-for-tat regulation’ between Europe and the US (*Financial Times*, 22 July 2009). The UK and Dutch institutional investors, which are some of the hedge funds' biggest customers, criticized the compliance implications of the proposed directive and suggested there would be conflicts and overlaps with other EU rules, such as the Markets in Financial Instruments directive (*Financial Times*, 16 June 2009). So did the Association of British Insurers. Another concern raised was that the proposed rules would effectively limit access to third country funds.

The Swedish presidency of the EU that began in July 2009, perhaps aware of the country's significant private equity industry, seemed to be well disposed towards several arguments put forward by the UK. This, together with the intense lobbying undertaken by British policy-makers and industry and the potential support elicited from outside the EU (at least concerning the amendments of provisions on the treatment of third countries) are likely to lead to a partial revision of the content of the directive, which is scheduled to be adopted in early 2010.

In an overall assessment, economic interests rooted in national varieties of capitaliasm have considerable analytical leverage in explaining why certain countries and quarters of the EP were eager to strictly regulate hedge funds, whereas others were not - this is the ‘old’ political economy of hedge funds regulation. Does this suffice to address the research question informing this paper, ie why the EU has decided to regulate AIFM? The answer is partly negative in that one is left to explain why the Franco-German alliance with the support of the ‘Club Med’ and of some political groups in the EP has prevailed over the preferences of others, namely British policy-makers and a large part of the industry.

This step requires a reference to ideas, at least in a ‘strategic’ form (see Jabko 2006) - this is the ‘new’ political economy of hedge funds regulation. Indeed, the global financial crisis was seen – rightly or wrongly - as implicitly validating the ‘market-shaping’ regulatory paradigm exposed by the pro-regulation countries, empowering the coalition of forces that subscribed to it. By contrast, the crisis challenged the rival ‘market-making’ (or ‘light touch’) regulatory paradigm, silencing, at least in the short term, the coalition that supported it. Consequently, the first set of ideas prevailed over the others in the EU’s rule-making process. It should however be noted that several continental countries, amongst which the three largest member states, had also been severely affected by the crisis. Hence, their regulatory model was not immune from criticisms.

The empirical material presented in this paper does not warrant granting independent explanatory power to ideas because, undoubtedly, domestic political economy interests were paramount in triggering and shaping the EU's decision to regulate hedge funds. However, ideas about financial regulation (ie regulatory paradigms) explain the shifting balance of power within and without the EU in the making of rules on financial services. Prior to the global financial crisis, British policy-makers and their regulatory philosophy had been very influential in shaping EU's regulation of financial services. Their model was however perceived as discredited by the global financial crisis (*The Economist,* 2 July 2009; interviews, London, August 2009). As *The Economist* (7 May 2009) put it, a 'new pecking order' emerged (at least temporarily) in the EU, with tangible implications for the redesign of the EU regulatory architecture in financial services.

Conclusion

In the multi-level governance of financial services, the EU has emerged as a prominent player in the aftermath of the global financial crisis. It has attempted with mixed success to shape the international regulatory initiatives unfolding in this field. It has also proposed a new set of stringent rules on AIFM, which will have potential extra territorial effects, though this will depend on the final version of the directive as co-decided by the Council and the EP.

This paper presents evidence that suggests that certain member states, backed up by some quarters of the EP, were the driving forces in the re-design of EU regulation. Their actions were motivated by domestic political economy interests, but were also informed by their ‘market-shaping’ regulatory approach concerning financial services. The global financial crisis partly discredited what can be labelled as the ‘British model’ of financial services regulation, which had been in good currency in the EU since the late 1990s and had informed a large part of the EU rules adopted prior to the global financial crisis. An alternative regulatory paradigm has gained ground in the wake of the crisis, shifting (perhaps temporarily) the balance of regulatory power in the EU. Thus, ideas are instrumental in explaining why one set of actors and their interests prevailed over the others in shaping EU rules on AIFM.

The explanation articulated in this research has implications for financial services regulation in the EU *tout court*, as it suggests that a stricter (ie market-shaping) regulatory approach will prevail, at least in the short term, while the dramatic memories of the crisis are still fresh. The findings also highlight the strategic use of ideas (or regulatory paradigms) in policy making by covering up or reinforcing power based dynamics.

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