Bringing hedge funds into the regulatory mainstream

ECMI Commentary No. 24/23 June 2009

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The European Commission's draft rules for hedge funds, in keeping with their G-20 commitment, have been a long time coming. The rules bring all non-harmonised funds under the EU's regulatory umbrella, largely reproducing the rules of existing directives, and adding some new elements in response to the crisis. They introduce a single licence for such funds, something that does not exist today.

The London G-20 summit was seen to be a remarkable success in global governance. The world's leaders managed to agree on a set of detailed measures to combat the global slowdown and improve financial regulation. It included, among others, the commitment that "all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight". With this, governments wanted to bring an end to regulatory arbitrage, which was seen to be one of the catalysts of the financial crisis. G-20 leaders also stated clearly that they agreed hedge funds should be regulated; that they should be registered and disclose information about their leverage to supervisors. In addition, they should be subject to effective risk management.

With its proposal of the 29th April and other initiatives, the EU Commission is consistently following this line and making global governance work from its perspective. It is not acting completely out of the blue on hedge funds, however. The Commission has been consulting on the possible regulation of alternative investment schemes, including real estate funds, commodity funds and hedge funds, since 2006. One of the concerns was the absence of a European passport for such an investment vehicle. Some member states had regulations and allowed retail investors to buy this type of product, whereas others did not. Opportunities for European financial markets could be missed here, since the regulatory discrepancies are creating distortions for European investors.

In addition, deputies on the right and left of the European Parliament have been calling for the regulation and transparency of hedge funds and private equity. The Lehne and Rasmussen reports, both approved by the European Parliament in September 2008, were slow to see the light of day. They are 'own initiative' reports, which were adopted by a large majority in the European Parliament (562 to 86 votes for the Rasmussen Report), calling the European Commission to take a legislative initiative or formally explain why

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this should not be the case. The complexities of democracy have obviously been at work here.

A regulatory hard landing was thus in the making. As early as April 2007, well before the financial crisis erupted, we detected signs that a regulatory initiative was imminent.[1] This was based on the findings that there was a glaring divergence in the regulatory framework for funds in Europe, which meant that these products could be sold to retail investors in some member states, but not in others; that there was a need for more disclosure on the activities of funds and their degree of leverage; and that there were inconsistencies and uncertainties about the impact of EU directives, mainly of the Markets in Financial Instruments (MiFID) and the Undertakings for Collective Investments in Transferable Securities (UCITS) directives on the non-harmonised funds sector.

The financial crisis accelerated and crystallised the positions of policy-makers, ending the cosy environment in which the industry had operated. In particular, the collapse of the Lehman Brothers highlighted the risks to financial stability of highly leveraged positions and trading techniques used by alternative funds (e.g. short selling). What is proposed by the Commission today largely follows the provisions of MiFID on the conduct of business, organisational (including outsourcing), reporting and prudential requirements. In addition, the proposal takes on board elements that have come up in the crisis, such as the need for appropriate liquidity management, segregation between asset management and depositary function, and additional reporting requirements for highly leveraged funds.

It should be added that the draft directive applies some ‘generous’ thresholds. In effect, it will not be applicable to leveraged funds below € 100 million, and to non-leveraged funds below € 500 million. Such thresholds do not apply to investment advisers and asset managers, which fall under the MiFID or UCITS rules. The transparency threshold for private equity funds with stakes in non-listed companies is 30%, while it is 3% for listed companies. In addition, ‘empty’ voting rights (a common tool for alternative funds) will indirectly be included in the threshold set by the proposal.

To make sure the directive is comprehensive, and to level the playing field, the rules apply to managers of alternative investment funds, not only to the funds. In this sense, and by adding a reciprocity provision, the Commission ensures that the whole non-harmonised funds sector is covered. This may lead to some inconsistencies, as the directive may have been drafted only with hedge funds or private equity groups in mind and not, for example, real estate funds. Nevertheless, it has the advantage of being all-inclusive. The reciprocity provisions are most open to criticism as being extra-territorial and protectionist, but if world leaders keep their G-20 promises, this should be not a problem, since the EU has generally accepted the principle of regulatory equivalence.

The industry has thus probably woken up to something it should have been aware of for years. The approaching storm was visible on the horizon; the industry just didn't see it coming and somehow still believes it can be avoided. By reacting so ferociously to the proposal, which largely follows the EU mainstream and accepted wisdom on the crisis, the industry is behaving as though it has something to hide.

[1] See Charles Gottlieb, *Hedge Funds: Heading for a regulatory hard landing?*, ECMI Policy Brief No. 5, retrievable at: http://shop.ceps.eu/BookDetail.php?item_id=1486.