European hedge funds lobbied the European Commission far later in the financial crisis than their US counterparts. They now face tougher regulation.

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*Unlike the banks, European hedge funds did not require bailouts during the Euro crisis, leaving their public image relatively untarnished. However, **Gil Shidlo** argues hedge funds in Europe will now be regulated more heavily than in the US due to their failure to lobby the European Commission until too late in the financial crisis.*

The economic crisis of 2008 shed light on the self-regulating practices of hedge funds and private equities, raising questions with regard to their efficacy and the role they played in the financial crash. Until now, these funds have been self-regulated by a variety of associations such as the European Private Equity and Venture Capital Association (EVCA). Calls for supra-imposed regulations seem to have gained momentum and have received the support of parliamentary, congressional and EU communities in various countries. Europe, though, seems to be stepping up legislation at a quicker pace than the US. It is interesting that the outcome of government regulation of funds has not been identical in Europe and in the US. How is it that in Europe hedge funds will face tougher regulation and likely earlier, than in the US?

The new EU rules on hedge funds will take effect in 2013. By November 2012, naked credit default swaps related to sovereign debt will be banned and measures to curb excessive shorting of bonds and shares if they cause volatility in the markets will be implemented. In addition, the European Commission has proposed a Financial Transaction Tax (FTT) set at 0.1% for shares and bonds and 0.01% for derivatives. This measure targets not only hedge funds but also high frequency traders, who seem to be major players in many markets. A clear indication of the end of self-regulation is the requirement placed on each hedge fund to acquire a "Passport" if it wants to operate in the EU. This licence to operate will be issued by ESMA, a new EU watchdog based in Paris.

European Parliament approving new EU rules for hedge funds and private equity, November 2010 - Credit: European Parliament, Creative Commons: BY NC ND

In the US, the Volcker Rule, part of the Dodd-Frank Act, has redefined the way banks trade. US based banks are forced to sell their investments in hedge funds and private equity funds as well as banned from making trades for their accounts while allowing them to continue short term trading for hedging or market making. In the US, the announcement of the original Volcker Rule was followed by at least a dozen proprietary trading desks being sold off by the banks that owned them. US banks have already sold off quite a significant part of their investments in hedge funds and private equity funds but are planning to appeal to regulators to extend the time frame. Dodd-Frank gives banks two years to liquidate most funds but they have an option to apply for three one-year extensions. Banks are lobbying regulators to give them even more time to liquidate certain funds – especially real estate investments –

to avoid “fire sale” prices to third parties. The date for imposing the Volcker Rule-banning banks from sponsoring or investing in hedge funds as well as proprietary trading may be postponed by up to two years before it is fully implemented.

The final ruling of the SEC in October 2011 in regard to reporting requirements by advisers to hedge funds and private equity funds is much less burdensome. The most comprehensive reporting will apply to advisers of large funds such as Carlyle or Bridgewater. Smaller funds will have to report less frequently to the SEC, with rules applying to larger funds as follows:

- Alternative investment funds with over $150 million in assets will have to report basic information only once a year.
- Large hedge funds will have to report quarterly but only if they have over $1.5 billion in assets under management (originally the SEC threshold was $1 billion).
- Private equity advisers will report quarterly only if they have $2 billion in assets. Private equity funds are considered to be less risky as their trading strategies are different and they tend to buy and hold for longer periods.

While numerous players voice clear discontent with the imposition of Volcker’s Rule, the hedge fund and private equity industry seems surprisingly mute.

The $2 trillion hedge fund industry in fact stands to benefit greatly from the harnessing of banks under the newly imposed regulations. While banks drew heavily on government aid throughout the bailout period private equity and hedge funds drew none. As a result hedge funds will be mostly affected by light regulation in the form of registration which will allow the SEC to inspect their books and request more disclosure. The most significant regulatory change will on the burden of reporting, for example, any single trade above 2 million shares on a single day or $200 million during a calendar month, and from December 2012, any hedge fund managing $1.5 billion or over, are required to make frequent disclosures.

The UK, together with the US, is home to about 85 percent of the hedge fund assets under management globally. Other European countries such as France, Italy and Germany do not have such a developed hedge fund industry thus its politicians had no problem in calling such funds “vultures” which only try to get a quick profit with no consideration of the social costs. Although the UK was opposed to a pan-European regulation of hedge funds, in the end it agreed with some alterations to the original plan. A new set of EU rules on Alternative Investment Fund Managers (AIFMs) was designed introducing a legally binding authorisation and supervisory regime for all such managers of these funds in the EU irrespective of the legal domicile of the alternative funds. The directive instituted a European ‘Passport’ for AIFMs enabling a fund authorised in one European country to market its funds to professional investors in other member states.

In the US, hedge funds were quick to hire lobbyists in the early stages of the financial crisis in an attempt to lighten the burden of regulatory imposition. In addition, hedge funds in the US were not perceived as equal culprits to banks. Their role in the crisis was downplayed and their public image not tarnished by the need of public funding to remain afloat. Lobbying activities in Europe took off quite late in the regulatory cycle. A recent study on the hedge fund industry reports “many members of the investment industry only realized how imminent EU regulation was when they read the first proposal of the European Commission in April 2009”. European investment funds were used to being unregulated for many years. The lobbying by CEOs of funds after the publication of the regulatory proposal was rather late in the stage and unsuccessful. The same study (p.13) also reports that due to this delayed response “most business associations ended up endorsing the general ambition of the proposal but suggested substantial modifications to the heart of the text. The EVCA then withdrew an initial policy statement in which it had spoken entirely against the proposal and began to support the idea of a

European harmonization in order to be able to shape the details of the directive".

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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Gil Shidlo took his PhD in political science at the LSE. After working in academia and international organizations, his main interests have focused on investing in stock markets. He contributes regularly to Moneynews.com as well as the Financial Intelligence Report. Most recently he has been studying the increasing role of private equity funds in taking over formerly government assets and companies on both side of the Atlantic.

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