

Hedge Funds

*David Howarth and Lucia Quaglia*¹

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Introduction

Hedge funds have exploded into prominence over the last two decades, with global assets under management growing fifty-fold between 1990 and 2007, reaching approximately \$2 trillion in 2007 (Commission 2008). In recent years, trading by hedge funds has accounted for over 50 per cent of the daily trading volume in equities markets. Hedge funds have become crucial providers of liquidity and drivers of price formation in global financial markets.

Prior to the global financial crisis, hedge funds had come under the spotlight for promoting herding behaviour during the Asian financial crisis of 1997. In the following year, the failure of the American hedge fund Long-Term Capital Management (LTCM) highlighted the potential systemic repercussions ensuing from the failure of large hedge funds. In Europe, episodes such as the failed merger between the Deutsche Börse and the London Stock Exchange highlighted the potential disruptive effects that hedge funds can have on corporate governance in continental European countries, first and foremost in Germany (*The Economist*, 23 April 2005).

The global financial crisis that began in 2007 brought new urgency to the debate on regulating hedge funds. Although hedge funds were not the main cause of the crisis (Brunnermeier et al. 2009; de Larosière Group 2009), they did play a part in its worsening, mainly through the massive selling of shares and short-selling transactions (Group of Thirty 2009; FSA 2009). The large-scale fraud perpetrated by Bernard Madoff's hedge funds had considerable political resonance within and outside the USA and further intensified the debate on regulation.

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This chapter analyses the EU and the international regulation of hedge funds, addressing two key questions posed in the introduction to this volume: how have European and global rules influenced each other up to the present day? And which factors inform the global influence of European regulatory efforts and the relevance of global initiatives for European rules? We find that the absence of agreement at the EU level has weakened the EU's position internationally and increased the influence of the USA in EU policy-making. The differences within the EU owe principally to different financial systems. Countries with many hedge fund managers (the UK and, to a less extent, Sweden) were the most cautious regarding EU legislation, while the lobbying of financial services firms contributed to national positioning.

The main legislative response to the international financial crisis concerning hedge funds has been the EU's Alternative Investment Fund Managers Directive (AIFMD). Proposed by the Commission in April 2009 (EC 2009a) and agreed at the December 2010 European Council, it was formally adopted in June 2011 (EC 2011) with a deadline to transpose into national legislation by 22 July 2013. The AIFMD's 'third country' provisions raised the question of 'equivalence' and sparked the direct intervention of the US federal administration—opposed to the export of EU norms in this area—into the EU policy-making process. Although the original 'third country' provisions proposed by the Commission were significantly watered down in the adopted directive, questions remained about the impact of the eleven conditions that non-EU-based funds and fund managers would have to meet in order to access the EU passport. The delay on Level 2 implementing regulation, published by the Commission in December 2012, contributed to on-going debate and consternation over the international impact of AIFMD.

The chapter is structured as follows. The remainder of this introduction outlines some key concepts in the regulation of hedge funds. Sections 2 and 3 outline, respectively, the regulation of hedge funds internationally and in the EU, before and after the crisis. Section 4 discusses the debate surrounding third country access resulting from the AIFMD. Section 5 concludes with an overall assessment.

Some key concepts concerning hedge fund regulation

How to define a hedge fund is controversial, with jurisdictions employing different definitions. The International Organization of Securities Commission (IOSCO), the international body whose regulatory remit covers hedge funds—has been unable to produce a common or shared

definition, noting that ‘each jurisdiction has views on what a hedge fund is’ (IOSCO 2006: 9). Generally speaking, hedge funds tend to have the following characteristics (EC 2008; IOSCO 2009): (1) they focus on the delivery of absolute returns; (2) their investment strategies are typically based on a relatively high and systematic use of leverage (they are often defined as ‘highly leveraged institutions’, see for example BCBS 1999a,b) through borrowing, short-selling,² and derivatives positions; (3) their investor base has traditionally been confined to institutional or other sophisticated investors; (4) 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 (5) managers often have their ‘own funds’ invested. Unlike private equity firms, hedge funds tend to invest in liquid securities rather than long-term illiquid assets and do not intervene in the management of companies in which they invest. Prior to the crisis, hedge funds tended to be ‘unregulated’. Indeed, the IOSCO task force analysing regulatory options for hedge funds was named the ‘Task Force on Unregulated Entities’.

The main actors in the hedge funds business are the hedge fund manager, the fund itself (often legally distinct from the manager), the fund’s administrator (responsible for processing trades and valuing assets), and the prime brokers (investment banks and securities firms) which act as settlement agents, have custody over assets, and provide financing (EC 2008; FSA 2005). Although it depends on the jurisdiction, hedge fund 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 partially correct. First, one should distinguish between the direct and indirect regulation of hedge funds. Indirect regulation entails regulation of the financial institutions that interact with hedge funds, in particular the prime brokers through which hedge funds operate in 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 and thus cannot be regulated, and the regulation of fund managers in the jurisdiction in which they are based.

² Naked or uncovered short selling involves the sale of an asset that the seller does not own.

Regulating hedge funds internationally

Prior to the global financial turmoil, research and fact finding on hedge funds was 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 USA, a set of policy documents were issued by the Basel Committee on Banking Supervision (BCBS) (1999a,b), IOSCO (1999), and subsequently by the newly created Financial Stability Forum (FSF) (2000, updated in 2007, when the first signs of the crisis emerged). The USA also conducted its own review through the President's Working Group (PWG) on Financial Markets (1999). Basically, all these documents concluded in favour of the indirect regulation of hedge funds, which was indeed strengthened.

In policy discussions in international fora, two different approaches were apparent: one in favour of direct regulation supported by Germany and France, and the other resisting such regulation supported by the USA and the UK (interviews, Basel, November 2008, Madrid, March 2009; Fioretos 2010). In 2007, German officials used their presidency of the EU and of the G8 to push for direct regulation; they receiving some backing from the FSF, which the G8 had charged with studying the issue.³ 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 USA 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). An impasse followed and no action was taken to deal with the problems posed by hedge and private-equity funds.

However, 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 in the UK and US jurisdictions: the Hedge Fund Working Group (HFWG)/Hedge Fund Standards Board (HFSB) (2008) and the alternative investment industry association (AIMA) in the UK, and the Managed Funds Association (MFA) based in the USA (2007). Their recommendations covered sound practices for hedge fund governance, transparency, and processes and methodologies for the valuation of hedge fund portfolios.

³ Previously, in July 2005, then Chancellor of Germany Gerhard Schröder, a Social Democrat, had pressed for tighter controls on hedge funds at the G7 summit in Britain, where it was blocked by 'Wall Street and London' (Schröder in *The Independent*, 16 June 2005).

After the eruption of the global financial crisis, the international division over how to regulate hedge funds re-emerged in preparations for the April 2009 G20 summit. Several European countries, led by France and Germany and supported by Italy (*Reuters*, 11 October 2008), pushed for a tougher regulatory regime and for hedge funds to be overseen similarly to banks (*Financial Times*, 23 February 2009; Quaglia 2011). In contrast, US and UK authorities favoured greater disclosure over more regulation, proposing that hedge funds be required to register with the government and disclose additional information with a view to increase transparency (*Wall Street Journal*, 14 March 2009). European leaders also wanted to clamp down on tax havens.

In February 2009, 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. 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 was seen as a victory for France and Germany which had championed a comprehensive regulatory architecture (*Financial Times*, 23 February 2009). The UK Chancellor of the Exchequer Gordon Brown reportedly agreed to restrictions on hedge funds to clear the way for an overall accord, which included strengthening the International Monetary Fund (*The Daily Telegraph*, 23 February 2009).

A joint letter from French President Nicolas Sarkozy and German Chancellor Angela Merkel (2009) to the EU Council President Mirek Topolanek and President of the European Commission Jose Manuel Barroso in preparation for the G20 Summit in April 2009 reiterated the goal of a joint EU position on the 'appropriate registration, regulation, and oversight' of hedge funds and other funds presenting potential systemic risk. After protracted negotiations, the G20 in London in April 2009 agreed that:

4 <http://www.diplo.de/diplo/en/WillkommeninD/D-Informationen/Nachrichten/090224-1.html> (accessed May 2009).

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....

Following the G20 recommendations, IOSCO published a report (2009) containing some rather general recommendations on the regulation of hedge funds. During preparatory discussions, participants—member state regulators—had been unable to agree on the fundamental issue of whether the hedge fund or the hedge fund manager should be regulated, as there were different views and legislation in place in the participating jurisdictions (interview, Madrid, March 2009). In the end, the IOSCO report left this issue ambiguous.

Since 2009, hedge fund managers based in the USA have been working on new industry standards under the auspices of the President Working Group (PWG). The PWG contained two separate committees: the Asset Managers' Committee made up of institutional alternative asset managers representing diverse perspectives charged with developing guidelines that define best practices for the hedge fund industry (Asset Managers Committee 2009), and the Investors Committee, which also issued a set of best practice standards to reduce systemic risk and foster investor protection (Investors Committee 2009). Under the aegis of IOSCO, industry associations have worked together to produce a single summary standards document, the Hedge Fund Matrix.⁵

EU regulation of hedge funds

Prior to the global financial crisis, hedge funds (and fund managers) were not regulated at the EU level (Lutton 2008). But hedge funds, or more precisely some of their activities, were subject to EU legislation, notably the Markets in Financial Instruments Directive (MIFID), the Transparency Directive, and the Market Abuse Directive. Some prudential reporting to supervisors was required by a European Central Bank (ECB) regulation concerning statistics on the assets and liabilities of investment funds. According to this regulation, issued in 2007 in the

⁵ <http://www.hedgefundmatrix.com/> (accessed August 2009).

early stages of the global financial crisis, all investment funds in the EU, including hedge funds, had to provide certain information to national central banks. At the national level, hedge fund managers were regulated entities in some member states though not subject to specific legislation. In other words, they were regulated as 'normal' fund managers. In other countries such as France, Italy, Spain, and Germany, the fund itself was a regulated onshore vehicle (IOSCO 2006, 2009), though often it was domiciled in a third country.

Since the early 2000s, some EU member states, most notably Germany, as well as some members of the European Parliament (see e.g. the Kaforis report) had encouraged discussion on 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, which included several hedge funds managers and other alternative investment fund managers (AIFMs) amongst its members, 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 G8 summit (*The Economist*, 26 May 2007) but with scant support (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 interviewees, the Barroso Commission and Commissioner McCreevy in particular favoured the 'better regulation' of financial services, which often meant '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). But the global financial crisis shifted the political dynamics in Brussels (Buckley and Howarth 2011; Quaglia 2011). The top echelons of the Commission, led by President Barroso, began to favour regulation—seen in the decision to propose regulation for credit rating agencies and AIFMs which the Commission had previously ruled out. The European Parliament became particularly vocal on the need to regulate hedge funds, producing two reports: the 'Rasmussen' report and the 'Lehne' report (EP 2008a,b). An EP resolution on 23 September 2008 requested the Commission to submit a legislative proposal or proposals covering all relevant actors and financial market participants, including hedge fund managers and private equity firms.

In December 2008, the Commission issued a consultation document discussing regulatory measures for hedge funds. Most government respondents argued that an international or global response would be superior to an EU response. But a small majority of government respondents believed that it was nevertheless appropriate to move forward with EU-level action. Many respondents, most notably the French and German governments, 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 2009b: 8).

In June 2009 the Commission presented its draft directive on AIFMs, which covered managers of hedge funds, private equities funds, and real estate funds (EC 2009a). It introduced a legally binding authorization and supervisory regime for all AIFMs in the EU, irrespective of the legal domicile of the managed alternative investment fund. AIFMs would be subject to authorization from the competent authority of the home member state and to reporting systemically important data to supervisors. The draft directive recommended a European passport for AIFMs: an AIFM authorized in its home member state would be entitled to market its funds to professional investors in other member states, which would not be permitted to impose additional requirements. The Commission’s initial draft directive had extensive, potential extraterritorial effects, discussed in the following section. This was seen by some member states, especially the UK, and the hedge funds industry as protectionist and likely to result in retaliatory action from the US federal government (especially the provision on ‘equivalence’). Other member states, first and foremost France and Germany, argued that such an approach was necessary to prevent Europe from becoming ‘the Trojan horse for offshore funds’, as the French finance minister put it (*European Voice*, 29 April 2009).

The draft directive was revised following intense lobbying from affected financial service firms (see Woll 2012, 2014) and the American and British governments. In the end, the most controversial proposals, including plans to impose fixed caps on leverage and capital requirements, were either removed or significantly watered down. AIFMD required fund managers to appoint a separate custodian for hedge fund assets and provide independent portfolio valuations, but this provision reflected what was already standard industry practice for most funds operating in the EU. Questions remained over the power of the European Securities Markets Authority (ESMA) in relation to national authorities in the authorization of AIFMs. While

the reporting requirements imposed unwelcome, albeit limited, compliance costs on hedge funds, their existing business practices were not affected in any significant way. Provisions on third country access are considered below.

The adopted EU directive aligned closely to existing US legislation passed in the aftermath of the financial crisis, which observers have described as not onerous or likely to restrict existing business activities (Brown et al. 2010). The Dodd-Frank Wall Street Reform and Consumer Protection Act of July 2009 requires all hedge funds above a minimum size to register with the Securities and Exchange Commission (SEC), imposes minimal reporting requirements, and subjects funds to periodic SEC examinations and inspections.

To sum up, the main line of division on the regulation of hedge funds within the EU were rooted in different financial systems. France, Germany, and Italy were worried about activist investors, such as hedge fund managers and private equity firms, loosening the traditional finance-industry ties that enabled long-term investment for manufacturing firms (*Financial Times*, 30 April 2009; for a similar argument see Zimmermann 2010). For this reason, hedge funds were subject to rather strict regulation in these countries prior to the crisis. Moreover, as Woll (2012, 2014) has pointed out, France hosted a thriving assets management industry including the largest collective investment fund (UCITS) industry in Europe that competed with hedge funds. UCITS were already heavily regulated in the EU and in certain respects competed for business with hedge fund managers.

Prior to the crisis, the UK—which hosts four-fifths of Europe’s hedge funds—opposed EU regulation. But in the wake of the crisis the British government relaxed its opposition, in part to appease British public opinion (Helleiner and Pagliari 2010). But British policy-makers were also concerned with how AIFMs would react to the costs of complying with EU rules and their threat to relocate, endangering the primacy of London as a global financial centre. As London competes with other financial centres worldwide to attract business, concern for international ‘regulatory arbitrage’⁶ has traditionally been at the forefront of British policy-makers’ minds (interviews, London, May 2007, July 2008).

⁶ This expression is used frequently in policy documents produced by the British Treasury, the FSA, and the Bank of England.

The debate on third country access in the EU and equivalence

One of the most controversial issues during negotiations on the directive was ‘third-country’ access: the rules according to which the managers of non-EU-based funds—whether based inside or outside the EU—can obtain the ‘EU passport’ to market to professional investors throughout the Union (Buckley and Howarth 2011). This issue is important for the overall theme of this volume because, given the absence of robust rules on hedge funds at the international level, domestic rules in the main jurisdictions, namely the EU and the USA, are paramount for their governance. The interaction between hedge fund rules in these jurisdictions moreover poses potential problems for future regulation.

In the making of the AIFM directive, the French government in particular sought to restrict the ability of funds based in low tax jurisdictions (whether managed in the EU or not) to access its market. The French argued that the passport should be granted to the managers of non-EU based funds only when the applicable regulatory regime is deemed equivalent to that of the EU (*Financial Times*, 14 April 2010). Many in the European Parliament, in particular Socialist MEPS, were in favour of similarly tough rules.

As noted above, the British and American governments, amongst others, together with the fund management industry, challenged these proposals as protectionist. The US administration made very public its opposition to the ‘third country’ element in the proposed directive and its perception of EU efforts to dictate the global regulatory landscape. The US SEC stated that it would probably be unable to comply with the equivalence criteria suggested in AIFMD drafts, which would close the EU market to US-based funds (Harris 2010).

A 1 March letter from US Secretary of the Treasury Timothy Geithner to Michel Barnier, the Commissioner for Internal Market and Services and the Spanish chair of the Ecofin Council, was leaked to the press and published in full in the *Financial Times* (11 March 2010). So was a 5 April letter from Mr Geithner to the UK Chancellor of the Exchequer Alistair Darling and the German, French, and Spanish finance ministers enjoining them to reconsider the AIFMD (*Financial Times*, 6 April 2010). In the 1 March letter, Mr Geithner notes:

... I believe we agree that [it] is essential to fulfill our G-20 commitment to avoid discrimination and maintain a level playing field. In this context, we are concerned with various proposals that would

discriminate against US firms and deny them the access to the EU market that they currently have. We strongly hope that the rule that you put in place will ensure that non-EU fund managers and global custodian banks have the same access as their EU counterparts. You will see that our approach in the US maintains full access for EU fund managers and custodians to our market (*Financial Times*, 11 March 2010).

The USA stopped short of threatening retaliatory action. However, if the third country rules of the directive were not significantly watered down, EU-based fund managers could face reprisals in the US Congress. Senior EU officials responded to US concerns by insisting that the proposed directive was in line with G20 guidelines to improve transparency in the financial system and noted that Mr Barnier sought to work with the US administration to ensure 'robust standards' (*Financial Times*, 12 March 2010). The British Labour government joined forces with the Obama administration to water down the demands imposed on third country funds. Many British AIFMs ran funds which were based outside the EU for tax purposes. The British sought a regime that allowed non-EU funds to be marketed across the EU provided the jurisdiction in which they were based had 'equivalent' regulatory standards, with a relaxed set of criteria to determine 'equivalence'. Ireland, the Czech Republic, Malta, Sweden, and Austria adopted similar positions.

Industry associations echoed the concerns of the American Treasury secretary to the third country proposal, warning of retaliatory action in non-EU jurisdictions damaging to the interests of EU-based financial services firms (*Financial Times*, 13 May 2010). The uncertainty also hit offshore centres, including the Cayman Islands, which had already lost funds to onshore locations in Europe. Despite the recent financial crisis, hedge and other funds in the EU enjoyed significant growth in both total assets and, from early-2009, the number of funds under management (*Financial Times*, 2 May 2010). For the first time, the Channel Islands of Jersey and Guernsey established a diplomatic mission in Brussels reflecting their governments' fears that their financial services industry could be damaged by new EU regulations (*Financial Times*, 3 July 2010). Half of Jersey's economy consisted of financial services.

With the failure to reach a compromise deal on the third country issue at the March 2010 European Council, MEPs went ahead with their own efforts to produce a more acceptable draft. Surprisingly, the Monetary and Economic Affairs Committee responsible for the directive shifted

its views. The AIFMD rapporteur, the French conservative MEP Jean-Paul Gauzès, put forward compromise solutions more popular in the UK than in France (*Financial Times*, 4 April 2010). The committee organised discussions of a possible transitional arrangement on the issue; in the intervening period, national rules would continue to apply.

In the end, the most controversial provisions of the draft directive were substantially scaled back. The French government’s hard-line position on third country funds lost support from other member states. The existing system of individual market application was to continue until 2015 (Griffiths 2010). As before, third country managers wishing to market their funds in the EU would have to do so in accordance with the private placement regimes (PPRs) of the EU member states into which they were marketing. Yet compliance with certain aspects of the AIFMD would still be necessary (as summarized in Table 1) and real burdens were imposed not only on non-EU based managers but also on third country supervisory authorities.

<Place Table 1 about here>

Table 1: Necessary Compliance with AIFMD from 2013

	Imposition on manager	Imposition on third country authorities
EU manager with third country fund (not marketed in the EU)	Full compliance with AIFMD, except depositary and annual reporting requirements.	Cooperation arrangements between supervisory authorities and the competent authorities of the country of domicile of the EU manager.
EU manager with third country fund (marketed in the EU)	Full compliance with AIFMD, except depositary requirements.	Cooperation arrangements between supervisory authorities and the competent authorities of the country of domicile of the EU manager. Third country fund must not be domiciled in a so-called Non-Cooperative Country and Territory (NCCT) as determined by the Financial Action Task Force.
Third country	Annual report for each fund.	Cooperation arrangements between

manager with EU fund or a third country fund (marketed in the EU)	Rules on improved disclosure to investors on investment strategy, risk factors, service providers, and investors’ fees and expenses. Regular reporting to regulators of markets where manager trades. Where a fund acquires control of a non-listed company, notification and reporting requirements to the shareholders of the company and relevant regulators.	supervisory authorities where the fund and manager are based and the competent authorities in each EU member state where the fund is to be marketed. Neither the fund nor the manager should be domiciled in a NCCT.
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A dual system of national PPRs and EU passports was to exist between 2015 and 2018, when ESMA would review the passport regime and consider recommending an end to the PPRs. Nevertheless, member states would not be forced to adopt the passport in 2018. If they were, a passport to market in the EU would be required for all funds managed by third country managers.

A two-tiered system was thus to be introduced in 2018. Funds managed within an EU member state but domiciled outside would be eligible for a passport provided the country of domicile met four conditions: that the foreign regulator supplies EU regulators with required information; that the foreign jurisdiction allows European funds to be sold there; that regulation to prevent money laundering and funding terrorism is in place; and that an acceptable tax agreement exists. Were a jurisdiction to fall short on some of these standards, funds may still be able to seek country-by-country marketing approval. But should a jurisdiction fall short on all of them, the funds would be barred from being marketing in the EU.

Funds both domiciled and managed outside the EU would, after five years, have to meet a higher standard to access the EU market—to obtain a passport, they would have to show that their home jurisdiction had ‘equivalent’ regulation to the EU (*Financial Times*, 13 May 2010). The policy on ‘equivalence’ ended up reflecting policy already established in international financial fora. The home jurisdiction of the non-EU funds applying for an EU passport would have to

comply with IOSCO standards on hedge fund oversight, including compliance with international tax and anti-money laundering agreements. It was very likely that the USA and other key markets would be deemed appropriately regulated jurisdictions (Plumridge 2010). While this compromise appeared to lower the hurdle for third country access, many investor and industry groups remained concerned by the definition of 'equivalent', with conditions to be clarified by a regulation implementing the directive. Critics also noted that funds investing in emerging markets would find it hardest to comply, making it more difficult for EU investors to back fund managers in African and other countries, with negative implications for growth in the developing world (*Financial Times*, 13 May 2010).

The fears of EU fund managers and the US Treasury resurfaced in the spring of 2012 following a leak of the Commission's draft regulation to adopt 'Level 2' measures (supplementary rules) implementing the AIMFD, which was perceived as a hawkish departure from the more flexible position previously presented by ESMA in November 2011 (*Financial Times*, 1 April 2012, 11 July 2012). The Commission was accused of renegeing on the compromises of 2010 on a range of matters (ibid.) including the definition of conditions that fund managers and funds in non-EU jurisdictions would have to meet to access EU investors. From April to December 2012, industry pressure helped redirect the Commission back towards the flexibility outlined in the ESMA recommendations. On 19 December 2012, the Commission adopted the 'Level 2' implementing regulations for the AIFMD, finally approved unaltered by the Council and European Parliament on 15 May 2013 (EC 2013a,b). These Level 2 regulations were long anticipated by fund managers and governments in Europe and abroad to clarify the conditions and procedures for the authorization of AIFMs and to set out the rules to be applied to third country managers, funds, and authorities, including conditions for delegation, rules on depositories, reporting requirements, leverage calculation, and rules for cooperation arrangements. But a considerable degree of uncertainty remained. In the spring of 2013, top US Treasury officials expressed broad satisfaction with the adopted Level 2 regulations that aligned broadly with the provisions of the Dodd Frank Act (interview, Washington, 6 May 2013). However, several US hedge fund managers and their representative law firms continued to express the concern that tightened reporting requirements would result in some managers withdrawing from the EU market or opting not to enter it (*Financial Times* 2 June 2013). There was no indication that the UK—where the bulk of EU fund managers were based—would abolish its current national PPR. But the possibility remained that the British government would apply additional AIFMD

requirements on the home-based managers of non-EU funds and on third country-based funds and fund managers.

An overall assessment

Prior to the crisis, the international regulation of hedge funds was mostly ‘indirect’ and the EU lacked its own rules; hence there could be no formal linkage between EU and global rules. As for ties between EU and global institutions, regulators from EU countries sat in IOSCO but IOSCO only endorsed the indirect regulation of hedge funds. Within the EU and in international financial regulatory fora, some national policy-makers called for hedge fund regulation but British and American policy-makers blocked it.

In this period, the EU was a ‘policy-taker’ rather than a policy-maker, waiting for international rules to be agreed rather than setting its own rules on hedge funds. The EU, internally divided, was unable to project its influence internationally or to call for international rules. Diverging national preferences on regulating hedge funds were mostly rooted in different national financial systems, which also hampered progress towards the establishment of EU rules.

After the onslaught of the crisis, continental policy-makers grew more vocal on hedge funds while US and UK policy-makers endorsed G20 commitments to regulate systemically important hedge funds. At least in the wake of the crisis, the EU was better able to coordinate its international influence, with its members meeting to agree on language prior to G20 summit meetings. The EU thus played a significant role in advancing the international regulation of hedge funds, which came to be supported by the UK and the USA mostly for domestic political reasons (Helleiner and Pagliari 2010).

Yet international rules remained ‘thin’, the often cited—but very general—G20 commitment and the vague IOSCO principles notwithstanding. In contrast, the EU moved ahead with its own set of rules, the AIFM directive, while the US strengthened its own national legislation on hedge funds. Even after the global financial crisis, there are thus no formal linkages between European and global rules in the regulation of hedge funds. The main regulatory discussions have revolved around the issue of third country access envisaged by EU and US legislation.

As for those factors encouraging or hampering the ability of the EU to project its regulatory influence prior to the crisis, the literature (Simmons 2001; Drezner 2007) has most often

focused on economic power (to be more precise, market size). For hedge funds, market size can be measured in various ways. If one considers hedge fund managers, most are located in the USA and, within the EU, in the UK. If one considers hedge funds, some are based in the US but most are in tax havens. And although investment in hedge funds is more common in the USA than in continental Europe, the financial markets which funds and managers can tap are more or less the same size in the USA and the EU. Considering all this, the market size for hedge funds is not the main determinant of EU influence—or the lack thereof—on global regulation. While market size remained constant before and after the outbreak of the global financial crisis, in the wake of the crisis the EU was able to set up its own rules on hedge funds—although it still had limited influence on the work done in IOSCO.

Other authors have argued that the cross-border integration and consolidation of the financial industry altered industry coalitions supporting or opposing regulatory harmonization both within and beyond the EU (Mügge 2010). In this case, the crucial point is that the entire hedge fund industry—regardless of where it was located—opposed EU and international rules. In the USA, it lobbied hard to maintain the weak regulatory template (based on a series of exemptions) to which it was subject (Horsfield-Bradbury 2008). However, the financial crisis weakened the industry's ability to withstand regulatory reform. Pagliari (2012) notes that the hedge fund industry deftly accepted the need for some form of public regulation and focused its efforts on shaping the content of the new rules in order to avoid burdensome requirements.

The main issue was that the EU lacked regulatory capacity (see Bach and Newmann 2007; Posner 2009, 2010). Prior to 2009, member states had very different preferences and rules on hedge funds, while there were no EU rules in place. After the crisis, the preferences of core states (the UK) shifted and so did their bargaining power, at least temporarily.

The specific character of EU multi-level governance weakened the EU's international bargaining power as divisions between its members prevented the formulation of clear policy positions (Mügge 2011). The EU was unable to project a strong voice with clearly articulated preferences in international fora. After the outbreak of the crisis, the main channel through which the EU was able to increase its international clout was through the adoption of its own set of regional rules, in particular the use of equivalence clauses. However, we have shown that the conditions imposed by the AIMFD and its two implementing regulations create very limited additional requirements on non-EU based fund managers and supervisory authorities. The AIMFD also

allows member states to maintain their own private placement regimes, ensuring the continuation of divergence within the EU.

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