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The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis

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Abstract

This article examines the recent development of EU regulatory policy with respect to the alternative investment industry up to and including the adoption of a major new Directive. This Directive is just one part of a much larger package of new EU measures relating to the financial markets but its emergence merits being singled out for three reasons. First, the account of how it came about and what it sets out to do touches upon two overarching concerns that are frequently expressed about laws that are made in the immediate aftermath of a crisis: opportunistic use of crisis situations to achieve unrelated goals, and crisis-induced regulatory over-reaction. Second, with the regulation of alternative investments being addressed internationally as well as in Europe, close examination of this area provides revealing glimpses of ways in which key players in the EU policy formation process have simultaneously used the financial crisis to exert influence internationally and used international developments to further an internal agenda. Finally, out of the exceptional level of controversy that surrounded the legislative process for the Directive come some important insights on relations between the EU Institutions and, in particular, on the European Parliament's increasing deftness in putting its mark on EU financial market regulation.

Keywords: hedge funds, private equity, Alternative Investment Fund Managers Directive, financial crisis, reform, European Union

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Part I: Introduction

It is frequently suggested that the inevitable regulatory backlash after a financial crisis provides an opportunity to push through reforms that have little real connection to the crisis itself. The adoption by the EU of the Alternative Investment Fund Managers Directive appears to support this claim.[1] The financial crisis that began in 2007 was not a hedge funds crisis nor was it caused by problems with private equity. Nevertheless, the alternative investment fund industry, of which hedge funds and private equity are two principal components, now finds itself subject to a vey detailed new pan-European regulatory framework.

Alternative investment fund industry - some working definitions

"Hedge funds" is a term that is not susceptible to an exhaustive definition because of the range of different investment strategies, markets and asset classes involved. Hedge funds are often described by reference to certain commonly satisfied criteria – broad investment mandates, a focus on delivery of absolute returns, high trading volumes/turnover, a high and systematic use of different types of leverage and an investor base mostly confined to institutional or other sophisticated investors.[2] There is also a tendency to describe them by what they are not – that is, they are not funds that operate within the standard detailed regulatory frameworks for collective investments that are designed with retail investors in mind. IOSCO has identified a number of other characteristics that are also associated with hedge funds: significant performance fees (often in the form of a percentage of profits) paid to the manager in addition to an annual management fee; often significant 'own' funds invested by the manager; use of derivatives, often for speculative purposes, and an ability to short sell securities; and permission for investors to redeem their interests periodically, eg, quarterly, semi-annually or annually.[3]

"Private equity" is another non-homogenous segment of market activity that cannot be easily defined. In broad terms private equity funds are funds raised in part from the founders of the fund but mostly from experienced and sophisticated investors, such as funds of funds, pension funds, investment funds, endowments and high net worth individuals.[4] Investors are committed to making their capital available for the life of the fund without redemption rights, and their investments are thus highly illiquid. As with hedge funds, investments in these funds are usually structured so as to fall outside the standard collective investment investor protection regulatory framework. Private equity funds are, in turn, invested in a portfolio of companies that are not quoted on public markets, including "taking private" companies that were previously quoted. These portfolio investments are usually financed through a combination of equity and debt, with the debt component typically provided by banks, and often distributed to other entities.

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[1] Directive _/_/EU (pending).
[2] FSA, *Hedge Funds: A Discussion of Risk and Regulatory Engagement* (DP 05/04) 10.
[3] IOSCO Technical Committee, *Hedge Funds Oversight* (June 2009) para 5.
[4] IOSCO Technical Committee, *Private Equity Conflicts of Interest* (FR11/10, November 2010) ch 3 provides an overview of the private equity market.

Private equity is thus also strongly associated with the use of leverage, although private equity leverage usually occurs at the level of the portfolio companies rather than at the fund level.[5] The motivating idea underlying private equity-backed leveraged buyouts is that the private equity firm will be in a position to increase the value of each portfolio company over the original purchase price in a manner that is sufficient not only to service the debt but also to provide a return to the managers of the fund and to the external investors.[6]

Hedge funds and private equity are different industry segments that have some features in common. Hedge fund investments in private equity-related debt instruments and in companies that are then put in play as leveraged buyout acquisition targets create overlaps between the sectors.[7] Other ways in which hedge fund and private equity business practices have begun to overlap and converge have also been identified.[8]

Part II: Regulatory policy issues arising from the industry's activities

The policy issues raised by alternative investments were identified long before the financial crisis. There is much about the alternative investment industry that can be highly beneficial for the markets in which they operate. Hedge funds can significantly enhance market liquidity.[9] Their dynamic and innovative trading strategies can also enhance market efficiency.[10] Private equity expands the sources of finance available to the corporate sector and can, as IOSCO notes, "form an important part of the development lifecycle of a firm".[11] For investors, alternative investments add to investment diversification options. Regulatory policymakers would naturally want to design policy so as to encourage these beneficial possibilities.

However, there is also the potential for harm. Alternative investments offer investors the possibility of higher returns but they are more risky forms of investment than straightforward equities and bonds. So long as the overall amount involved is relatively small and is sourced from sophisticated investors who should look out for themselves, public officials are unlikely to be much troubled by the fact that money is being channelled into essentially speculative investments. However, as more funds pour into the segment and as the attractions of sharing in the expanded portfolio diversification

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[5] FSA, *Private Equity: A Discussion of Risk and Regulatory Engagement* (DP06/06) 37-8 (identifies where leverage can occur in private equity investments).
[6] A Berg and O Gottschalg, 'Understanding Value Generation in Buyouts' (2005) *Journal of Restructuring Finance* 9.
[7] FSA, *Hedge Funds*, n 2, 12.
[8] C Martin, 'Private Equity: Hedge Funds' Impact - An Exploration of the Wider Impact of Hedge Funds on Private Equity, and the Overlap between the Two Sectors' (2007) 18(2) *Practical Law for Companies* 19; HB Shadab, 'Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds' (2009) 29 *Northwestern Journal of International Law & Business* 603.
[9] FSA, *Hedge Funds*, n 2, 14 (reporting that hedge funds were estimated to account for between a third and a half of daily activity on the New York Stock Exchange and the London Stock Exchange).
[10] Ibid, 13.
[11] IOSCO Technical Committee, *Private Equity* (May 2008), 11.

options that it offers become more widely known, the industry acquires a systemic significance that inevitably invites closer public scrutiny.
Hedge funds are associated with the use of many different forms of leverage. This gives rise to concern about the possible systemic consequences of hedge fund failure. According to the UK Financial Services Authority (FSA), there are two channels through which hedge funds could cause systemic risk.[12] The first is the "credit channel", which is concerned with credit counterparties' exposure and the possibility that hedge fund failures could lead to losses in the banking sector. This second is the "market channel" which is concerned with hedge funds' aggressive, high-volume and often highly-correlated trading strategies. The systemic danger here is that, as noted by the FSA: "where [hedge funds ..] are following similar strategies and/or using similar risk management models, there is a risk that they will enter or exit a market collectively and in doing so disturb liquidity/the normal fundamentally driven operation of supply and demand".[13]

Hedge funds strategies that involve taking stakes in companies in order to pressurise management to take actions designed to enhance shareholder value can also give rise to corporate governance concerns. Even though reliance on shareholder activism as a value-enhancing investment strategy in itself is not peculiar to hedge funds, their activities in this area tend to be singled out for special attention.[14] Sophisticated trading strategies such as the use of derivative products and stock borrowing that may impact on governance and may led to the decoupling of voting rights from economic interests attract particular scrutiny.[15]

A potential systemic concern also arises in relation to private equity in that high leverage levels in private equity-backed buyouts increase the debt-servicing pressures on portfolio companies and could make them more prone to financial distress, which could have adverse consequences for the debt providers and/or secondary markets onto which that debt has been sold. These problems could be exacerbated by opacity as to the true ownership of economic exposure resulting from secondary market trading of leveraged buyout debt and derivative products, as this uncertainty could complicate corporate restructuring and default workouts. However, private equity fund investment strategies do not involve the aggressive trading strategies associated with hedge funds and are not driven by high-intensity investor redemption pressures so there is less reason to see the private equity industry as posing an indirect systemic threat through its capacity to cause this type of market disruption.[16] Leverage concerns are also somewhat different because, typically, little debt is carried at the fund level itself (though investments into funds may

[12] FSA, *Assessing Possible Sources of Systemic Risk from Hedge Funds* (2010) 1-2; FSA, *Financial Risk Outlook 2010*, 45.
[13] FSA, *Hedge Funds*, n 2, 28.
[14] WW Bratton, 'Hedge Funds and Governance Targets' (2007) 95 *Georgetown Law Journal* 1375.
[15] HTC Hu and BS Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811.
[16] M Tresnowski, Testimony on behalf of the Private Equity Council before US Senate Committee on Banking, Housing and Urban Affairs, 15 June 2009 (listing reasons for not regarded private equity as a source of systemic risk).

be debt financed[17]) and funds are invested in straightforward equity instruments rather than derivatives or other products with embedded leverage.

Private equity activity can also give rise to corporate governance concerns. These concerns are similar to those arising in relation to activist hedge funds but there are nuances that flow from the differences the strategies that these funds usually adopt. Private equity funds acquire controlling interests in portfolio companies which they intend to hold for a reasonable period of time in order to make management and other structural changes, whereas activist hedge funds typically have different investment time horizons and tend to rely on minority stakes as an adequate vantage point from which to put pressure on managers to achieve desired goals.[18] One corporate governance issue that is particularly associated with the private equity model arises from the use portfolio companies' assets to repay leveraged buyout debt financing. This gives rise to concerns about misalignment of incentives because, under pressure to meet debt servicing burdens, corporate managers could take wealth-extraction decisions without proper regard for the longer term impact of their actions on employees and other stakeholders.

Prior to the financial crisis, the clearest evidence that any of these concerns had credence came from the near-collapse of Long Term Capital Management (LTCM), a large and highly leveraged hedge fund, in September 1998, which had threatened to cause significant systemic disruption through counterparty exposures. However, all of the issues, both positive and negative, attracted much attention.

Part III: Pre-crisis regulatory engagement with the industry

In the regulatory pause between the completion of the Financial Services Action Plan in 2005 and the emergence of the post-financial crisis regulatory reform agenda, EU policy attention turned to the fashioning of an appropriate pan-European regulatory response to the burgeoning alternative investment fund industry. Although often described as an "unregulated" segment of the market, the European alternative investment fund industry was in fact subject to various regulatory requirements and forms of oversight but it was a patchwork of Member State requirements and limited supervisory oversight rather than a comprehensive EU-wide regime specifically dedicated to alternative investments.[19] The

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[17] eg at the peak of the market, the listed parent company of a new Candover fund committed €1bn to the fund and sold bonds to fund the commitment. Meeting the bond covenants later became a major problem. Facing the prospect of breaching the bond covenants, the parent company was forced to admit that it could not meet its commitment to the fund and the fund had to be suspended.

[18] A Brav, W Jiang, F Partnoy and RS Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (20080 63 *Journal of Finance* 1729; M Kahan and EB Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 *University of Pennsylvania Law Review* 1021; J Armour and BR Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (September 1, 2009). ECGI - Law Working Paper No. 136/2009. Available at SSRN: http://ssrn.com/abstract=1489336; M Becht, J Franks and J Grant, 'Hedge Fund Activism in Europe' (May 26, 2010). ECGI - Finance Working Paper No. 283/2010. Available at SSRN: http://ssrn.com/abstract=1616340.

[19] E Wymeersch, 'The Regulation of Private Equity, Hedge Funds and State Funds' (April 30, 2010). Financial Law Institute Working Paper No. 2010-06. Available at SSRN: http://ssrn.com/abstract=1685202. On the European position see generally P Athanassiou, *Hedge Fund*

European Commission, which has the prerogative to initiate new EU legislation, recognised that the alternative investment fund industry was developing in a way that was likely to create a "growing need for a coherent and enlightened European approach" to this sector.[20] The Commission focused mostly on the potential for regulatory intervention to foster the development of private equity and hedge fund activity in Europe. The Commission established various groups of industry experts to report on ways to improve the efficiency of the EU investment fund market.[21] The pro-market tone of the Commission's rhetoric at that time was associated very closely with the personal preferences of the then Internal Market Commissioner, Charlie McCreevy.

Others, however, were already turning to the role that regulation could play in curbing troubling aspects of industry practice.

In its contribution to the public debate launched by the European Commission in 2005, the Eurosystem acknowledged the many benefits that hedge fund activities had brought to the financial markets but noted that making comprehensive assessments with respect to systemic matters was difficult because of the opacity of the industry.[22] This comment highlighted the immediate problem with hedge funds from the systemic perspective in the years leading up to the financial crisis as being lack of transparency: hedge funds were seen to be part of the "shadow banking" system and, as such, complete information on aggregate investment exposures and leverage within the sector was not available.[23] Whilst the collapse of some large funds during 2000s without significant knock-on effects suggested that improvements in risk management practices since the LTCM episode had successfully contained the risk of hedge funds causing systemic harm, lack of comprehensive data meant that it was impossible to determine the real magnitude of the overall threat.[24]

So far as private equity was concerned, the ECB took a more definite, and also a relatively sanguine, view of possible systemic threats. Based on the results of a survey of large banks' participation in the financing of LBO transactions in the EU as of mid-2006, it found that "the likelihood of LBO activity posing systemic risks for the banking sector appears remote at the EU level".[25]

Regulation in the European Union: Current Trends and Future Prospects (Kluwer Law International, 2009).

[20] European Commission, *Green Paper on the Enhancement of the EU Framework for Investment Funds* COM(2005) 314, para 3.4.

[21] European Commission, *Decision Setting up a Group of Experts to Report on Ways to Improve the Efficiency of the EU Investment Fund Market* C(2005) 4653.

[22] ECB, G*reen Paper on the Enhancement of the EU Framework For Investment Funds: Eurosystem Contribution to the Commission's Public Consultation* (ECB, November 2005). See also T Garbaravicius and F Dierick, 'Hedge Funds and their Implications for Financial Stability' (August 2005). ECB Occasional Paper No. 34. Available at SSRN: http://ssrn.com/abstract=752094

[23] AW Lo, 'Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds' (November 13, 2008). Available at SSRN: http://ssrn.com/abstract=1301217.

[24] In particular, the 2006 implosion of Amaranth Advisors, LLC with a loss of around $6 billion did not have systemic repercussions.

[25] ECB, *Large Banks and Private Equity-sponsored Leveraged Buyouts in the EU* (April 2007) 5.

Influential groups within the European Parliament were prominent critics of the alternative investment fund industry in the years leading up to the financial crisis. The Parliament passed a number of resolutions calling upon the Commission to look more closely at the industry and to adopt a more critical stance.[26] Another notable contribution to the debate was a lengthy report on the need for more robust regulation of hedge funds and private equity, which was published by the Parliamentary Socialist Group.[27] This Report identified a number of concerns about the operation of the industry that were considered to require regulatory intervention, including lack of transparency, short-termism, distorted remuneration incentives, and the threat, especially from hedge funds, to financial stability. The Report was also very critical of the private equity industry and its use of leveraged buyouts in ways that, according to the Report, often had serious negative consequences for the target companies.

Outside the European Institutions and the ECB, other groups, such as the European Trade Unions Conference, were also campaigning against the perceived excesses of the hedge fund and private equity models and the allegedly damaging impact they had on the social economy.[28] In some EU Member States local politicians joined in the public outcry over what were described as locust-like asset-stripping and job-destroying activities of hedge and private equity funds.[29] Hedge funds' role in leading a shareholder revolt that blocked Deutsche Bőrse's plans in 2005 to buy the London Stock Exchange made the issue especially controversial in Germany.[30] Politicians elsewhere in Europe also sought to turn to their advantage widespread public perceptions about ways in which alternative investment strategies could constitute a threat to employees' job security and cherished elements of local corporate cultures.[31]

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[26] European Parliament Resolution of 15 January 2004 on the Future of Hedge Funds and Derivatives (P5_TA(2004)0031); European Parliament Resolutions of 27 April 2006 on Asset Management (P6_TA(2006)0181) and of 13 December 2007 on Asset Management II (P6_TA(2007)0627); European Parliament Resolution of 11 July 2007 on Financial Services Policy (2005-2010), para 19 (P6_TA(2007)0338).
[27] I van den Burg and PN Rasmussen, *Hedge Funds and Private Equity: A Critical Analysis* (PES, March 2007)
[28] D Hencke and P Inman, 'Private Equity Deals Threaten Capitalism' *Guardian* 23 May 2007, 28.
[29] J Warner, 'Outlook: Deutsche Borse's Seifert is Devoured by a Plague of Anglo- American Locusts', *The Independent*, 10 May 2005, 63 reporting comments by Franz Müntefering, the then chairman of Germany's Social Democratic Party.
[30] I Simensen, 'Activist Investors Seek Success in Germany' *Financial Times*, 7 December 2007, 17. For insights into motivations underlying German efforts to push for tighter control of hedge funds: H Zimmermann, 'British and German Approaches to the Financial Market Regulation' in E Helleiner, S Pagliari and H Zimmermann (eds), *Global Finance in Crisis: The Politics of International Regulatory Change* (Routledge, 2010) 121 – 136.
[31] P Betts, 'Seismic Shocks Shake Norway's Cosy Capitalism' *Financial Times*, 7 November 2007, 18; I Bickerton, 'Dutch Left Asking Who is Boss' *Financial Times*, 21 April 2007, 14; J Plender, 'European Politicians Demonise Hedge Funds Again' *Financial Times*, 22 (commenting on odium poured on hedge funds by the Swedish prime minister in the run up to an election); Leader Column, 'Playing With Fire: Sarkozy's Populism Could Burn Down the EU House' *Financial Times*, 5 April 2007, 14.

At the international level, oversight of hedge funds was a matter that received considerable attention from IOSCO, the Basel Committee and the Financial Stability Forum (now Board) throughout the pre-crisis years of the 2000s.[32] IOSCO also took a particular interest in seeking to identify issues of possible regulatory concern arising from the operation of private equity markets.[33] Whilst there was some fluctuation in US policy on the regulation of private pools of capital (especially hedge funds) in this period, under the leadership of Chairman Cox (appointed 2005) a relatively benign approach, which, like that of the European Commission under Commissioner McCreevy, favoured self-regulation, was in the ascendancy.[34] Treasury Secretary Paulson also inclined in this direction.[35] For a time US law went further in leaving room for alternative investment funds to operate outside the regulatory net than was possible under the laws of some of the main European jurisdictions.[36]

During this period the alternative investment fund sector embarked upon a number of self-regulatory initiatives. Various hedge fund associations published their own standards for sound business practices.[37] The private equity industry also published industry guidance on a range of matters including transparency,[38] valuation,[39] and ethics.[40] These attempts at self-policing, which were clearly aimed at forestalling the threat of mandatory intervention, were actively encouraged by some official initiatives.[41] But even as many of these efforts were under development, the conditions in the markets were already deteriorating. Willingness to shape public policy in a way that included reliance on

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[32] Garbaravicius and Dierick, *Hedge Funds*, n 22, summarizes major initiatives up to July 2005.
[33] In early 2007 IOSCO established a Task Force to investigate private equity: IOSCO, *An Overview of the Work of the IOSCO Technical Committee* (March 2007) 17. See Table 1 for outputs from this project.
[34] J Horsfield-Bradbury 'Hedge Fund Self-Regulation in the US and the UK' (2008). Available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Brudney2008_Horsfield-Bradbury.pdf. A shortlived attempt by the SEC to bring hedge fund more fully under official oversight is discussed in T Paredes, 'On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission' (2006) *University of Illinois Law Review* 975.
[35] Horsfield-Bradbury, ibid.
[36] Ibid.
[37] Managed Fund Association, *Sound Practices for Hedge Fund Managers* (first launched in 2000) http://www.managedfunds.org/mfas-sound-practices-for-hedge-fund-managers.asp; Hedge Funds Standards Board, *Better Practice Standards* (launched 2008) http://www.hfsb.org/
And various *Guides to Sound Practices* published by the Alternative Investment Management Association, available at http://www.aima.org/en/knowledge_centre/sound-practices/guides-to-sound-practices.cfm
[38] Guidelines Monitoring Group, *Guidelines for Disclosure and Transparency in Private Equity* (November 2007) http://www.walker-gmg.co.uk/?section=10768.
[39] IPEV, *International Private Equity and Venture Capital Guidelines* (introduced 2005, updated September 2009).
[40] EVCA, *Code of Conduct* (October 2008). Other industry standards maintained by the EVCA are at http://www.evca.eu/toolbox/default.aspx?id=504.
[41] In particular, President's Working Group *Principles and Guidelines Regarding Private Pools of Capital* (February, 2007), which called for adherence to industry sound practices. The President's Working Group (PWG) comprises the US Treasury Secretary and the Chairs of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Later in 2007 the PWG sponsored the establishment of two private sector committees to develop best practices, This resulted in: *Best Practices for the Hedge Fund Industry* (PWG Asset Management Committee, January 2009); *Principles and Best Practices for Hedge Fund Investors* (PWG Investors' Committee, January 2009).

market discipline and private sector best practice standards did not disappear completely with the onset of the financial crisis.[42] However, the light-touch approach became increasingly marginalized as mainstream sentiment shifted markedly towards acceptance of the need for more stringent official controls.

Part IV: The financial crisis and the alternative investment fund industry - the international response

This article has a primarily European focus. However, this section outlines developments at the international level from mid 2007, when it became clear to the world that a major crisis was underway, to the end of 2010. It is important to put the European post-crisis treatment of alternative investments into the context of the bigger picture because the two are closely linked: the international policy response both influenced and was influenced by European thinking.

The financial crisis that began in 2007 did not involve systemically important hedge fund collapses or private equity-backed corporate failures. Certainly the implosion of two Bear Stearns-managed hedge funds in June 2007 was one of the early signs of major problems; and many hedge funds closed in the years that followed.[43] There also were casualties in the private equity world, most notably Candover, which had been one of the great successes of the private equity boom in the mid 2000s but was unable to sustain this in the downturn.[44] However, there was little collateral damage from these failures.

Not being a central part of the problem did not shield the alternative investment fund industry from the attention of reformers. The new global consensus on the need for the "shadow banking" sector to be brought under official oversight made close scrutiny of the alternative investment industry largely inevitable. Although not universally accepted,[45] the new received wisdom that rapidly emerged in relation to hedge funds was that whilst they did not cause the financial crisis, they amplified its consequences because of their trading strategies, reliance on leverage, and need to unwind positions quickly in order to meet investor redemption demands.[46] The involvement of hedge funds in short selling, a practice that was widely condemned as exacerbating market instability during

[42] See Table 1 for G8/G20/FSF&FSB/IOSCO encouragement in 2007-8 of the development of industry best practice standards. The work of the PWG committees continued into this period (see note above). But private sector efforts appear to have had limited success. In a joint initiative steered by IOSCO in 2008 the various private sector bodies combined to produce the "Hedge Funds Matrix", which was designed to be a first step towards harmonization of existing hedge fund industry sound practices. However, this Matrix has not been kept up to date: http://www.hedgefundmatrix.com/en/ [accessed November 2010].

[43] HW Sinn, *Casino Capitalism* (OUP, 2010) 155-6.

[44] M Arnold and P Stafford, 'Candover to Call it a Day as Credit Crunch Takes its Toll' *Financial Times* 1 September 2010, 15 (suspension of fund when parent company forced to admit that it could not meet its funding commitment; parent indicated that it would wind itself up).

[45] Arguing that hedge funds reduced the impact of the financial crisis and boosted recovery: HB Shadab, 'Hedge Funds and the Financial Crisis' (January 2009). Mercatus on Policy, No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31. Available at SSRN: http://ssrn.com/abstract=1564847.

[46] One of the many statements to this effect from public sector bodies and officials can be found in IOSCO, *Hedge Funds Oversight Report*, June 2009, introduction, para 14.

the crisis, kept attention on them.[47] The frauds perpetrated by Bernard Madoff, which came to light in December 2008, further heightened concern.[48] In early 2010 the cross-sectoral Joint Forum, formed by representatives of the Basel Committee, IOSCO and the International Association of Insurance Supervisors, acknowledged that debates continued over whether and to what extent hedge funds might have contributed to or mitigated the expansion of the financial crisis but concluded that there was a "general consensus that hedge funds, given their role in the economy, may have a systemic impact".[49] It was more of stretch to link private equity funds (which, as noted earlier, tend to be relatively long-term illiquid investments) to the systemic problems in the markets exposed by the crisis but as entities that also operated in the "shadows" under business models that had some similarities to hedge funds, they were to some extent swept along by the tide and wrapped up in the same regulatory net.[50] An overarching argument for extending the perimeter of regulation was that this was necessary in order not to leave room for the opportunistic shifting of business to unregulated segments and for the continuation of highly risky practices that could, through competitive pressures, seep back into and contaminate the regulated parts of the industry.

At the international level, key developments in the evolution of regulatory policy with respect to the alternative investment fund industry from mid 2007 to the end of 2010 were as follows (Table 1).

[47] IOSCO, *Regulation of Short Selling,* (Report, 2009), para.1.3 (noting "general concern" that short selling could contribute to disorderly markets). However, the emergency bans on short selling imposed during the crisis had mixed effects: E Avgouleas, 'A New Framework for the Global Regulation of Short Sales: Why Prohibition is Inefficient and Disclosure Insufficient' (2010) 16 *Stanford Journal of Law, Business, and Finance*, 55.
[48] D Brewster and J Chung, 'Hedge Funds Face Crackdown in the Wake of Madoff Affair' *Financial Times*, 30 December 2008, 1.
[49] Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations* (January 2010), 9.
[50] In its *Hedge Funds Oversight Report* (June 2009), IOSCO's Technical Committee Task Force indicated that it had focused on hedge funds rather than dealing with other potentially "unregulated" entities such as private equity funds because of the G20's particular interest in hedge funds. However, it noted that many of its observations and conclusions could be applicable to other market participant entities holding or controlling large pools of capital. See also Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations* (January 2010), 19 (recommendations with a "functional tenor" intended to apply to all pools of capital and to managers/advisers who engaged in activities posing risks substantially similar to hedge funds).

Table 1 – international policy formation

G7/8 & G20	
Summit Declaration: Systemic Stability and Transparency of Financial Markets/ Hedge Funds, Heiligendamn, 7 June 2007	Support for FSF recommendations on highly-leveraged institutions (see below for Report, May 2007); regular FSF monitoring of progress and action on recommendations endorsed.
Communiqué Finance Ministers & Central Bank Governors, São Paulo, 8-9 November 2008 & Summit Declaration, Washington 15 November 2008	Call for extension of regulation/oversight to all sectors of the financial industry, as appropriate Private sector bodies invited to bring forward proposals for set of unified best practices for private pools of capital/hedge funds for vetting by finance ministries.
Leaders' Declaration: Strengthening the Financial System and Reform, London Summit, 2 April 2009	All systemically important financial institutions, markets, and instruments to be subject to an appropriate degree of regulation and oversight Hedge funds/managers to be registered and required to make regular supervisory disclosures; oversight to ensure adequate risk management; FSB to develop mechanisms for cooperation and information sharing between relevant authorities Institutions with hedge funds as their counterparties to have effective risk management, including mechanisms to monitor the funds' leverage and set limits for single counterparty exposures;
Leaders' Statement, Pittsburgh Summit, 24 – 25 September 2009	Confirmed support for global financial regulation reform, including hedge funds
Toronto Summit Declaration, 26-27 June 2010	Agreed to strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds
Seoul Summit Leaders' Declaration, 11 – 12 November 2010	Reaffirmed recommitment o work in an internationally consistent and non-discriminatory manner to strengthen regulation and supervision on hedge funds
FSF/FSB	
Update Report on Highly-Leveraged Institutions, May 2007	Welcomed improvements in risk management, prudential supervision and market discipline since LTCM crisis but noted increasing product complexity and associated operational challenges. Identified 2 systemic risks - "direct" risk to the core firms arising from their direct credit exposures to hedge funds, and "indirect" risk that hedge fund actions (perhaps through the forced liquidation of positions) might cause a sharp deterioration in market liquidity and prices leading to distress at one or more of the core firms; direct exposure thought to be modest; indirect market exposure hard to gauge Recommendations: 1 Supervisory action to require strengthening of counterparty risk management practices. 2. Supervisory action to improve robustness to potential erosion of market liquidity. 3. Supervisory action on development of more systematic and consistent data on consolidated counterparty exposures to hedge funds 4. Counterparties and investors to strengthen the effectiveness of market discipline 5. Global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers
IOSCO	
Principles for the Valuation of Hedge Fund Portfolios - Final Report, November 2007	Set out 9 principles for valuing the investment portfolios of hedge funds.
Private Equity Final Report, May 2008	Announced that IOSCO would conduct analysis of conflicts of interest in private equity; recommended survey of the complexity and leverage of capital structures in LBOs

Funds of Hedge Funds Report, June 2008	Reviewed existing regulations in member jurisdictions. Outlined proposal to consider development of "elements of international regulatory standards on funds of hedge funds" based on best market practices.
Private Equity Conflicts of Interest Report, November 2009	Publication of principles for mitigating potential conflicts of interest between managers and third-party investors
Hedge Funds Oversight Report, June 2009	Publication of six high level principles on the regulation of hedge funds: i. Mandatory registration for hedge funds/ hedge fund managers/advisers; ii. Registered hedge fund managers/advisers to be subject to ongoing regulatory requirements (oganizational and operational standards, conflicts of interest and other conduct of business rules, disclosure to investors, and prudential regulation); iii. Prime brokers and banks providing funding to hedge funds should be subject to mandatory registration/regulation and supervision. iv. Hedge fund managers/advisers and prime brokers to provide supervisory information for systemic risk purposes; v. Regulators to encourage/take account of industry good practices, where appropriate. vi. Regulators to have the authority to co-operate and share information to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds with a view to mitigating such risks across borders.
Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices, September 2009	New guidelines for investor protection regulatory issues in the fund of hedge funds field.
Template for gathering of hedge fund systemic risk data on a global basis, February 2010	Purpose: to assist regulators in collecting comparable and consistent data from hedge fund managers and advisors in relation to, among others, their trading activities, the markets they operate in and funding and counterparty information.
Objectives and Principles of Securities Regulation, June 2010	New principle added: regulation to ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.
Private Equity Conflicts of Interest Report, November 2010	Follow up work setting out a set of principles for the management of conflicts of interest in private equity
	JOINT FORUM
Review of the Differentiated Nature and Scope of Financial Regulation Key Issues and Recommendations, January 2010	Identified lack of a consistent prudential regime for monitoring and assessing hedge funds as a critical gap in the regulatory framework; endorsed the IOSCO principles and added 3 more: i. Supervisors should introduce and/or strengthen appropriate and proportionate minimum risk management regulatory standards for hedge fund operators; ii. Supervisors should impose reporting requirements on hedge fund operators to identify current or potential sources of systemic risk and to enable cross-sectoral monitoring of systemically important hedge funds; iii. In view of the operational risks posed and in order to allow for orderly winding down of a fund operator in the event of bankruptcy, supervisors should impose minimum initial and ongoing capital requirements on operators of systemically relevant hedge funds. Set out other options for systemically relevant pools of assets (on which the JF had not reached a consensus): haircuts and margin requirements; closed-end form/redemption gates; risk-independent leverage requirements; risk-based capital or leverage requirements; risk management procedures for the timely delivery of financial instruments

As can be seen from Table 1, international support for direct, mandatory regulation of hedge funds or their managers took a while to crystallize. One inhibiting factor was that for the first part of the period US policy, which is invariably influential at the international level because of the strength of the US markets, remained disposed to indirect regulation of hedge funds through the regulated banks that dealt with them.[51] However, as the crisis deepened, and especially after the collapse of Lehman Brothers in September 2008 amid much furore about alleged abusive short selling activities in which hedge funds were deeply implicated, this approach, seen by some to be part of a "discredited" under-regulated Anglo-American style of capitalism, came under increasing challenge. German politicians, who were engaged in domestic election campaigns, pointedly drew attention to the fact that Germany had tried, unsuccessfully, at 2007 G7/ G8 meetings to persuade other counties to go further in policing hedge funds.[52] The Italian finance minister described the hedge fund industry as "crazy" and "hellish", and called for it to be abolished.[53] Even so, the outcome of the November 2008 G20 Summit was something of a compromise, with Continental European views being watered down in the face of the continuing US preference for indirect regulation.[54] But US political sentiment was already hardening.[55] By March 2009, the new US Administration had come out in favour of stronger domestic scrutiny of systemically relevant interconnected institutions[56] and of being firmly committed to achieving globally-coordinated regulation through the G20.[57] The process of moving toward the requirement for hedge and private equity fund managers to register with the SEC that has now been enacted in the Wall Street Reform Act and Consumer Protection Act of 2010 was also already underway.[58] These developments narrowed the gap between policy views on either side of the Atlantic and thus smoothed the path for European efforts, led by Germany and France, to secure G20 agreement on the need for tougher action in respect of alternative investments.[59] The outcome of the G20 London Summit in April 2009 did not go as far as some in Europe

[51] J Chung, K Guha and G Tett, 'The Cost of a Lifeline - Humbled Financial Groups Brace for More Regulation', *Financial Times*, 24 April 2008, 9.
[52] R Atkins, 'Merkel Vents Annoyance Over US and UK' *Financial Times*, 22 September 2008, 3.
[53] Lex Column, 'The Italian Locust' *Financial Times*, 18.
[54] K Guha, 'Leaders Aim for Concerted Response to Foster Growth' *Financial Times*, 14 November 2008, 10; K Guha, 'Leaders Open the Way to Wide Reforms' *Financial Times*, 17 November 2008, 6.
[55] Congressional Oversight Panel, *Special Report on Regulatory Reform* (January 2009) (calling for, inter alia, the extension of regulation to hedge funds and other elements of the "shadow" banking system. On the change in US domestic politics relating to hedge funds: E Helleiner and S Pagliari, 'The End of Self-Regulation? Hedge Funds and Derivatives in Global Financial Governance' in E Helleiner, S Pagliari and H Zimmermann (eds), *Global Finance in Crisis*, n 30, 74, at 77–80.
[56] L Summers, 'Responding to an Historic Economic Crisis: The Obama Program', Speech, Brookings Institution, Washington, DC, 13 March 2009. Text of speech available at http://www.whitehouse.gov/the-press-office/remarks-lawrence-summers-director-national-economic-council-brookings-institution [accessed Nov 2010].
[57] Remarks by the President, and Treasury Secretary Geithner After Economic Daily Briefing, 11 March 2009. Text available at , http://www.whitehouse.gov/the-press-office/remarks-president-and-treasury-secretary-geithner-after-economic-daily-briefing.
[58] D Paletta and J Strasburg, 'Treasury Maps New Era of Regulation' *The Wall Street Journal* 27 March 2009, A1.
[59] C Bryant, 'EU Leaders Push Regulation' *Financial Times*, 23 February 2009, 1.

had been calling for but it did send out a clear signal that hedge funds or their advisers would not escape at least mandatory registration and transparency requirements.

The Reports summarized in Table 1 (especially those by IOSCO and the Joint Forum) demonstrate that there is now a general expectation at the international level that that alternative investment managers/advisers or funds should be required to register with a supervisory authority and to comply with certain mandatory requirements, especially with respect to disclosure and to conduct of business. There is also a growing consensus that more stringent prudentially-oriented requirements should apply to those alternative investment funds that are systemically relevant. However, there is no default assumption that all hedge funds or other types of alternative investment funds *are* systemically relevant.[60] Nor do corporate governance concerns about the activities of alternative investment funds occupy the foreground of the international policy debate.

Part V: The financial crisis and the alternative investment fund industry - the EU response

Part IV showed how the political leaders of some major European economies, especially Germany and France, capitalized on the opportunity presented by the crisis to drive forward the international agenda for the strengthened regulation of the alternative investment fund industry. Back "home" in Europe, different coalitions of interests, including the national politicians, were able to push even harder for change. The fact that the issues were being considered simultaneously at a number of different levels provided opportunities that were ripe for strategic exploitation in order to achieve desired policy objectives. Where appropriate – for instance, to counter the view expressed by British politicians and regulators that the regulation of hedge funds was a global issue that required a global response[61] - it was possible to argue that Europe should seize the opportunity to lead the way and thereby play an instrumental role in shaping a new global regulatory regime.[62] But it was also possible to slant the argument in a different way if circumstances demanded: thus, once the G20 had agreed its agenda, a favourable light could be cast over internal actions by saying that they were needed in order for the EU to deliver on its international commitments.[63] Or elements of the two arguments could even be blended together, as demonstrated by European Commission President Barroso when he welcomed the new EU legislation on alternative investments as "another example of how the EU is leading the way in implementing our G20 commitments".[64]

[60] In addition to the materials mentioned in Table 1, see also FSA, *The Turner Review* (FSA, March 2009) 73, which draws a careful distinction between transparency-oriented reforms and the imposition of prudential controls on hedge funds. Lord Turner considered that the latter would be appropriate only if hedge funds became bank-like or otherwise of systemic significance.
[61] HM Treasury & FSA, *European Commission Consultation on Hedge Funds: Response* (January 2009) 6.
[62] European Commission DG Markt Services, *Summary of Reponses to Hedge Funds Consultation Paper* (March 2009), 8-9.
[63] eg, M Barnier, Conference Keynote Speech:– Delivering on the EU's G20 Commitments (Berlin, 20 May 2010). Text of speech available at
http://ec.europa.eu/commission_2010-2014/barnier/docs/speeches/20100520_berlin_en.pdf
[64] European Commission Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity, MEMO/10/573, 11 November 2010.

As discussed in Part III, the pre-crisis internal European debate about the alternative investment industry had been especially wide-ranging and clear distinctions had not always been maintained between different regulatory concerns posed by the alternative investment fund sector, from improving safety and soundness, through strengthening investor protection and preventing fraud, and on to corporate governance issues raised by hedge fund investment in companies and particularly associated with private equity-backed leveraged buyouts. This sometimes laxly-structured policy debate about entities that, from a populist perspective, occupied near-pariah status, in effect meant that everything was already on the same political agenda when the crisis hit. This paved the way to use the opportunity of a crisis that was primarily concerned with systemic matters to pursue other objectives as well.

It was not the case, however, that there was an immediate post-crisis European general consensus on what to do with respect to the regulation of alternative investment funds. Rather there were several power struggles in and between the EU Institutions as to the appropriate way forward.

During 2008 the European Parliament intensified its calls for more stringent regulation and supervision of alterative investments. There were two key reports, as follows (Table 2).

Table 2 – European Parliament demands for closer regulation of alternative investment funds

Report with recommendations to the Commission on transparency of institutional investors (A6-0296/2008), July 2008 (Lehne Report)	Called for directive(s) guaranteeing a common standard of transparency and to tackle issues covering hedge funds (especially voting policies) and private equity (especially asset stripping, leverage and employee rights). Also asked Commission to encourage improvements in transparency by supporting and monitoring the evolution of industry self-regulation.
Report on hedge funds and private equity (A6-0338/2008), September 2008 (Rasmussen Report) & Resolution with recommendations to the Commission on hedge funds and private equity, (P6_TA(2008)0425), September 2008	Requested the Commission to bring forward legislative proposal(s) covering all relevant actors and financial market participants, including hedge funds and private equity. Specific recommendations included: i. Closing of lacunae in existing legislation as regards the regulation of hedge funds and private equity ii. Extension of mandatory capital requirements to all financial institutions, such requirements to be risk rather than entity based iii. Increase in transparency requirements for providers of prime brokerage services iv. Development of a harmonized EU-wide framework for venture capital and private equity and a new legislative private placement regime v. Better disclosure to investors vi. Protection of employees' interests under EU law whenever control of the undertaking or business concerned is transferred by any investors, including private equity and hedge funds. vii. Better information to employees or staff representatives in respect of holdings in hedge funds and private equity by pension funds and insurance companies viii Mandatory restrictions on private equity leverage ix. New controls to prevent unreasonable asset stripping in target companies x. New conflict of interest measures to ensure effective separation between services that investment firms provide for their clients xi. General review of the effects of market concentration and of the effects of dominant players in the financial services industry

As part of these efforts, the Parliament made use of a procedural device that allowed it formally to call on the Commission to bring forward "necessary" proposals.[65]

The Commission did not capitulate without a fight. In a perhaps rather provocative demonstration that it was not yet convinced by the Parliament's views, in December 2008 the Commission issued a pre-legislative consultation that did not even extend to private equity funds.[66] Even into early 2009, the Commission was still battling against overreaction in any regulatory response. In a prominent speech in February 2009, Commissioner McCreevy emphasized the need for policy intervention to be proportionate and targeted on clearly identified market failures.[67] Hedge funds and private equity should not be made "scapegoats", he warned. However, by this time, Commissioner McCreevy's personal credibility was under attack from some prominent MEPs and there were suggestions that the Commissioner was being increasingly sidelined within his own department.[68]

Pressure was also building on the Commission from the direction of the Member States. In March 2009, the Council published a Key Issues Paper in which it declared that the scope of regulation should be extended to actors that were relevant for financial stability and had so far not been sufficiently regulated, *in particular hedge funds and other alternative investment vehicles* (emphasis added).[69] This sentiment was endorsed at the highest political levels at a European Council meeting of EU Member States' political leaders at which a financial regulation reform agenda was agreed, including proposals for "appropriate regulation and oversight of all financial markets, products and participants that may present a systemic risk, without exception and regardless of their country of domicile, *especially private pools of capital, including hedge funds, private equity and alternative investment vehicles*" (emphasis added).[70] This Council meeting, held in the lead up to the London G20 Summit meeting, served the dual purpose of formally both setting out an internal EU political agenda and committing Member States to an agreed EU-wide position with respect to external relations. Significantly, it provided confirmation that the UK had fallen into line with the French/German views on the need for regulation of alternative investments, Prime Minister Brown reportedly having dropped his opposition in order to secure accord on other aspects of the proposed G20

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[65] House of Lords Select European Union Select Committee, *Directive on Alternative Investment Fund Managers* (HL 48-I &II, February 2010) para 17.
[66] European Commission, *Consultation Paper On Hedge Funds* (December 2008, Working Document of the Commission Services (DG Internal Market).
[67] C McCreevy, Opening Speech, EC Conference on Private Equity & Hedge Funds (SPEECH/09/80, Brussels, 26 February 2009). Text of speech available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/80&format=HTML&aged=0&language=EN&guiLanguage=en
[68] J Burns, 'Pushed for Action' *The Sunday Times* 21 December 2008, Features Section, 16 (reporting MEPs loss of confidence and trust in Ireland's European Commissioner); D Gow, 'Hedge Funds and Private Equity Try to Head Off Tighter EU Controls: Self-regulation Has Failed, Declares ECB Chief Trichet: McCreevy Removed From Overseeing Tighter Rules' *Guardian*, 24 February 2009, 28.
[69] Council (ECOFIN), *Key Issues Paper* (6784/2/09 REV 2, March 2009), 3.
[70] European Council, *Presidency Conclusions 19/20 March 2009* (7880/1/09 REV 1) 16.

agenda.[71] A less cynical interpretation of the British position also carries some force: there were indications at that time of a genuine willingness on the part of British political and regulatory chiefs to engage in a quite fundamental reappraisal of the State's role in the operation of open, liberalized markets, and it is thus possible to view the policy shift in relation to hedge funds as having been driven not simply by political compromises but also by a principled, intellectually-grounded move away from formerly orthodox beliefs in the self-correcting effects of markets.[72] The *de Larosière Report*, published in February 2009, was a further relevant factor.[73] Even though this carefully-worded report called for *appropriate* regulation to be extended *in a proportionate manner* to all firms and entities conducting potentially systemic financial activities, it nevertheless helped to build the momentum for reform.[74]

The somewhat febrile atmosphere involving tense relations between key individuals in the EU Institutions and an uneasy political compromise between some of the major Member States, set against a backdrop of several pre-crisis years of wide-ranging, sometimes unstructured, and often politically-charged policy debate, and of a crisis-induced sense of urgency, was not conducive to the development of carefully-crafted, measured legislative proposals aimed at addressing specific problems. From its inception, the EU's post-crisis agenda with respect to the regulation of alternative investments was thus dogged by lacked of clarity about the underlying goals. This made it virtually inevitable that the passage of the reforming legislation would be difficult and controversial – as indeed proved to be the case. The first version of the Directive, published by the Commission in April 2009, was an ill thought-through proposal that showed many signs of having been produced under intense political pressure. It was poorly aligned with existing EU laws on asset management and in spite of earlier Commission thinking, it failed to differentiate adequately between different industry segments and to take due account of the international nature of the industry. Unsurprisingly, it failed to satisfy anyone. For Christine Lagarde, French Finance Minister: "The Commission's proposal is way below the demands that Europeans should have. It is regulation at its minimum. We need to have a maximalist position at the start".[75] But for Paul Marshall, a leading hedge fund manager: "If opponents of the European Union are looking for evidence of political meddling and overreach, they could hardly find a better example than the new draft directive on alternative investment fund management. The proposal, aimed at imposing new regulation on hedge funds and private equity, is a politically-driven effort to place obstacles in the way of an industry that is almost exclusively based in the US and the UK. It makes a mockery of any notion of subsidiarity - taking decisions at the lowest possible level - and is a classic exercise in

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[71] A Evans-Pritchard, 'Europe Gets Tough on Hedge Funds' *Daily Telegraph*, 23 February 2009, 1 (City section) (reporting outcome of mini-summit in Berlin); L Quaglia, 'The 'Old' and 'New' Political Economy of Hedge Funds (2011) 34 *West European Politics* _ (in press).
[72] In particular, FSA, *The Turner Review*, n 60. See also G Brown, *Beyond the Crash: Overcoming the First Crisis of Globalisation* (Simon & Schuster, 2010) (of course recognizing the various caveats that have to be kept in mind when reading on "insider's" own account of events).
[73] Formally entitled *Report of the High Level Group on Financial Supervision in the EU* (February 2009).
[74] At 25.
[75] Quoted in T Barber and N Tait, 'Paris Pushes EU to Impose Tighter Regulation on Hedge Funds' *Financial Times*, 6 May 2009, 7.

closet protectionism".[76] And so began 18 months of concentrated and often heated debate until the Directive was finally agreed in November 2010.[77]

There were three key concerns that persisted throughout the legislative process.[78] First, that the EU was adopting a "one size fits all" approach that failed to differentiate the relative risks posed by different types and sizes of alternative investment fund managers and different types of alternative investment fund. Secondly, that the EU was acting in a disproportionate manner by assuming too readily the systemic significance of the industry and of its various component parts. Thirdly, that the EU's actions were animated by protectionist preferences, especially on the part of certain Member States.

There were intense negotiations and lobbying efforts around numerous different versions of the legislation.[79] The European Parliament played a significant and shrewd role in this process. Whilst maintaining its demands for new controls on the acquisition of stakes in companies by alternative investment funds and pressing for certain restrictions not in the Commission's version, on certain prominent matters its approach appeared to demonstrate a relatively conciliatory attitude towards industry concerns about regulatory excess.[80] This thoughtful, multifaceted approach, which was supported by much more thorough impact assessments than the Commission had conducted, helped to neutralize suggestions that the Parliament was simply exploiting a convenient opportunity to treat the alternative fund industry as a scapegoat.[81] Considerable efforts by successive rotating Council Presidents (Sweden, July-December 2009, Spain, January – June 2010 and Belgium, July – December 2010) to find a compromise version of the text that the Council could support also helped to mitigate some of the problems that plagued the Commission's opening version. However, the uneasy truce that had allowed EU leaders to present a united front at the London G20 meeting in April 2009 did not hold together well.[82] Deliberations in the Council became overshadowed by political disagreements between Member States, especially France and the UK, over third country access rules, which were only settled by an eleventh-hour compromise.

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[76] P Marshall, 'Europe's Classic Exercise in Defending its Interests, *Financial Times*, 18 May 2009, 9.
[77] Formal adoption by the Council followed by publication in the Official Journal is pending at the time of writing.
[78] House of Lords Select European Union Select Committee, *Directive on Alternative Investment Fund Managers* (HL 48-I &II, February 2010) para 28.
[79] European Parliament, *Background Note on the Alternative Investment Fund Managers Directive Differences between Commission, Parliament and Council texts* available at http://www.europarl.europa.eu/en/pressroom/content/20101105BKG92028/6
This provides a useful summary of key differences between the initial Commission, Parliament and Council texts and of the eventual outcome.
[80] The draft Report of the ECON Rapporteur, Jean-Paul Gauzès, published in November 2009 (PE430.709)(the Gauzès Report) shaped the tone of the Parliament's response. This Report was the basis for the Parliament's initial position adopted in the Committee on Economic and Monetary Affairs in May 2010.
[81] House of Lords, *Directive on Alternative Investment Fund Managers*, n 78, paras 194 – 203 (discussing "better regulation" failures by the Commission and noting the Parliament's superior performance in this regard).
[82] Q Peel, 'Germany Presses UK on Hedge Fund Regulation' *Financial Times*, 18 March 2010, 6.

Part VI: The Alternative Investment Fund Managers Directive: an overview of key features

The Alternative Investment Fund Managers Directive (also referred to here as "AIFMD" or "Directive") regulates alternative investment fund managers (also referred to as "AIFM" or "fund managers"). It does not regulate alternative investment funds (also referred to as "AIF" or "funds") directly. An "alternative investment fund" is any collective investment scheme not covered by the UCITS (Undertaking for Collective Investment in Transferable Securities) regime. However, there are certain exemptions. One exemption covers fund managers who manage funds with total assets of less than €100 million or less than €500 million that are not leveraged and with no redemption rights for the first 5 years. Member States must still impose registration and simplified disclosure obligations on these smaller funds. These thresholds are too low to be regarded as a credible attempt to limit the Directive's application only to systemically relevant funds. A limited number of the provisions are relaxed in certain cases and some systemically-oriented requirements apply only in relation to leveraged funds. There may be some scope for further proportionality and differentiation to be introduced into the regulatory framework via the detailed Commission rules and supervisory guidance that must be developed for the regime to become operational. The European Parliament was a prominent advocate of different levels of regulation according to the type of fund rather than a one-size-fits-all approach, but, on the other hand, its approach would not have excluded the smallest funds.

The geographical scope of the Directive is that it applies to all EU-based fund managers managing EU and non-EU alternative investment funds, to non-EU fund managers managing EU funds, and to non-EU fund managers marketing EU or non-EU based funds within the EU.

Fund managers must be authorized under the Directive by their home Member State supervisor.[83] The conditions for authorization include minimum capital and own funds requirements, subject to an overall cap of €10 million but also subject to a further requirement that the amount of own funds must never be less than one-quarter of the preceding year's fixed overheads. Operating conditions for fund managers include remuneration restrictions for employees whose professional activities have a material impact on their funds' risk profiles. These remuneration restrictions are based on those now in place for banks and investment firms.[84] Remuneration provisions were not in the Commission's version of the text but with remuneration in the financial sector generally moving to the forefront of policy concern, their addition, at the instigation of the Parliament and the Council,[85] was predictable. There are also requirements in respect of structures and organizational and administrative procedures relating to the management of conflicts of interest, controls in respect of risk management systems, liquidity

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[83] The Directive provides a system for determining a "reference" Member State to be responsible for oversight of a non-EU fund manager.
[84] E Ferran, 'New Regulation of Remuneration in the Financial Sector in the EU' (Working Paper, forthcoming, 2011).
[85] European Parliament, *Background Note,* n 79.

management requirements, and conditions relating to investments in securitization positions.

Fund managers must ensure that all the alternative investment funds under their management have their assets independently valued at least once a year, by an external or (subject to certain requirements) an internal valuer. There is supervisory oversight of the valuation process. More detailed requirements concerning valuations are to be set out in delegated acts adopted by the Commission. There was support in the European Parliament to exempt private equity funds from periodic valuation requirements on the grounds that regular valuation of private equity funds was inappropriate to their business model and the expectations of their investors. Whilst this idea was not pursued, the final version allows for valuations to be conducted internally, which goes some way towards mitigating the compliance burden.

Fund managers must ensure that a single depositary is appointed for each fund under management. The depositary is responsible for the safekeeping of the fund's assets and for monitoring cash flows. EU credit institutions and certain EU investment firms that are subject to prudential requirements are eligible to act as depositories. So too are non-EU credit institutions and other entities of the same nature as EU eligible institutions, provided they are subject to effectively enforced "equivalent" regulation and supervision. For EU funds, the depositary must be established in the home Member State of the fund. For non-EU funds, the depositary must be established in the third country where the fund is established, the home Member State of the fund manager or, in the case of a non-EU fund manager, the Member State, which is, for the purposes of the Directive, deemed to be the fund manager's "reference" Member State. There are further requirements with respect to the third countries in which depositories can be located, including a requirement that the country must not be listed as a non-cooperative country or territory by the Financial Action Task Force (FATF) on anti money laundering and terrorist financing. It was the European Parliament that first put forward provision for non-EU depositaries.[86] The absence of provision to this effect in the initial texts of the Commission and of the Council was one of the features that attracted considerable criticism as being both unworkable and thinly-disguised protectionism. The liability of a depositary is specified in detail in the Directive. The depository liability provisions were subject to extensive lobbying during the passage of the legislation but, in line with the views of the Parliament in particular, they remain quite strict in the version that was finally adopted. In a concession that is aimed primarily at private equity, where full depositary arrangements would generate unnecessary expense given that investments in portfolio companies are illiquid and held on a long-term basis, in certain circumstances and subject to conditions the depositary can be a professional depositary business rather than a credit or similar institution. There was support in the European Parliament to exempt private equity from the depositary requirements completely. The concession included in the final text was first proposed by the Council.

[86] European Parliament, *Background Note,* n 79.

There is an extensive range of transparency and disclosure requirements. These include an annual reporting requirement in respect of each EU fund under management and each fund (whether EU or not) marketed in the EU. Annual reports, which must be audited, must be made available to supervisors and, on request, to investors. Fund managers must also report regularly to their supervisor on the principal markets and instruments traded in on behalf of managed funds, and on other matters including the main categories of assets in which a fund is invested, the percentage of assets which are illiquid, liquidity arrangements, risk profiles and stress test results. Mandatory requirements with respect to disclosure to investors include requirements with respect to the information made available before any investment takes place and periodic disclosures.

Each fund manager is required to set its own limit on the leverage it uses. Self-imposed leverage limits is a feature that was first advocated by the European Parliament.[87] The Commission's version of the Directive had proposed to empower the Commission itself to set general leverage limits whereas the Council initially favoured neither setting a limit nor requiring managers to set one themselves.[88] The Commission's approach attracted considerable opposition on the grounds that a general limit was likely to be too crude and could even exacerbate systemic problems (eg by triggering mass unwinding of positions in certain circumstances). However, the Commission does not disappear out of the picture completely because it is to specify by means of delegated acts the methods of leverage and how leverage is to be calculated. The total amount of leverage employed by a fund and any changes in the maximum permitted level of leverage are included in the information that must be disclosed to investors. A fund manager managing funds that employ leverage on a substantial basis must, as part of its regular supervisory reporting obligations, make available to its supervisor further information about the overall level of leverage employed by each fund. The details of this obligation, including when leverage is considered to be employed "on a substantial basis" are still to be worked out in Commission delegated acts. The fund manager's supervisor will be able require additional information if this is necessary for the effective monitoring of systemic risk and, in exceptional circumstances, the European Securities and Markets Authority (also referred to as "ESMA") may request the supervisor to impose such additional reporting requirements. Supervisors will use this information in their efforts to monitor the build-up of systemic risk and it will be shared with other Member State supervisors, ESMA and the European Systemic Risk Board. There is power for supervisors to impose limits to the level of leverage that a fund manager can employ or to impose other restrictions to limit the build up of systemic risk in the system. Again, ESMA may "advise" national supervisors on the measures to impose. (ESMA "requests" and "advice" carry considerable force because of both the general obligations of co-operation on national supervisors and the specific steps that ESMA can take if a national supervisor is inclined to take a different view.)

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[87] European Parliament, *Background Note*, n 79.
[88] Ibid.

The Directive imposes a number of special obligations on fund managers managing funds that acquire control of non-listed companies or listed issuers.[89] These obligations are primarily targeted at the perceived excesses of private equity-backed leveraged buyouts but will also catch hedge fund investments if they pass through relevant thresholds. However, investments in small and medium enterprises are excluded (in effect, putting much venture capital activity outside the reach of the Directive) and so are real estate special purpose vehicles. A fund manager must make specified disclosures to its supervisory authority when the proportion of voting rights in a non-listed company held by a managed fund reaches or passes through the thresholds of 10, 20, 30, 50 and 75 per cent. (In respect of listed issuers, there are already notification obligations under the Transparency Obligations Directive.) Once 50 per cent control of a non-listed company is achieved (30 per cent in the case of a listed issuer), the fund manager must notify the company/issuer, its shareholders, and the manager's supervisory authority of this event, and also furnish additional information, including the policy for preventing and managing conflicts of interest, especially between the fund manager, the fund and the company, and the policy for external and internal communication relating to the company in particular as regards employees.[90] When control of a non-listed company is acquired, the fund or the fund manager, acting on its behalf, must also disclose to the company and its shareholders its intentions with regard to the future business of the company and the likely repercussions on employment. The fund manager must endeavour to ensure that disclosed information is passed through to the employee representatives (or to the employees themselves). Information on the financing of an acquisition by which a fund acquires control of a non-listed company must also be provided to the fund manager's supervisor and to the fund's investors. The annual report of a non-listed company controlled by an alternative investment fund or the annual report of the fund itself must contain a fair review of the development of the company's business, and an indication of important events that have occurred since the end of the financial year, of the company's likely future development, and of share buybacks. The fund manager must strive to ensure that the company's board of directors conveys the information in this annual report to employee representatives (or employees directly), and must make it available to the fund's investors.

One particularly interventionist feature of the Directive as it affects private equity is that a fund manager managing a fund that has acquired control of a non-listed company or an issuer is not allowed for a period of 24 months from the acquisition of control to facilitate, support or instruct any distribution, capital reduction, share redemption or acquisition of own shares by the company, nor, insofar as it is authorized to vote on behalf of the fund, may it vote in favour of any of these corporate actions. Furthermore, the fund manager must use its best efforts to prevent these corporate actions taking place. This "asset-stripping" restriction is subject to a few qualifications. The one that is most significant is that it is only distributions that would cause net assets to fall below

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[89] An "issuer" in EU capital markets law means an issuer with shares admitted to trading on a regulated market. Under AIFMD a "non-listed company" means a company that does not have shares admitted to trading on a regulated market.

[90] This requirement also applies in respect of issuers, ie companies with shares admitted to trading on a regulated market.

subscribed capital or which would exceed available net profits that are ruled out. In broad terms, the effect of the asset-stripping restriction, so far as it relates to distributions, is for a limited period to apply distribution restrictions that apply already to European public companies by virtue of the Second Company Law Directive to companies that do not take that form. However, the restriction is tighter in relation to reductions of capital and share buybacks and its effect, therefore, is to narrow the range of options that may be used to return value to shareholders in a tax efficient way. The asset stripping restriction does not appear to extend the Second Directive's controls on the giving of financial assistance by public companies. Accordingly, it should remain possible for acquirers to make use of more relaxed regimes governing financial assistance by private companies, provided no capital reduction is involved.

The Directive provides an entirely new pan-European passporting regime as a counterweight to the strengthened controls that it imposes on the industry. Whether to make a passport available in respect of non-EU funds and fund managers was one of the most contentious issues for the Council and was the subject of an eleventh-hour compromise in the weeks before agreement was finally secured in November 2010. The following tables summarize the position finally adopted.

Table 3: EU fund managers & EU funds

Marketing of fund managed by AIFM to professional investors in EU with passport	Cross-border fund management
• Full compliance with AIFMD required • Pan-European marketing permitted, subject to supervisory notification requirements	• Permitted either directly or via establishment of branch, subject to supervisory notification requirements • Host MS cannot impose additional requirements in respect of matters covered by AIFMD

This pan-European passport will come into effect in 2013, which is the deadline by which the Directive must be transposed into Member States' national laws.

Table 4: EU fund managers & non-EU funds

Marketing of fund managed by AIFM to professional investors in EU with passport	Management of fund & no marketing in EU	Marketing of fund managed by AIFM to professional investors in individual EU MSs without passport – private placement regime
• AIFM must comply in full with AIFMD • Appropriate supervisory cooperation arrangements in place between home MS and 3rd country in which AIF is established • 3rd country not on FATF list of uncooperative jurisdictions re money laundering and terrorist financing • OECD-compliant tax convention in place between 3rd country and the home MS and each of the MSs in which fund is to be marketed • Supervisory notification requirements in respect of marketing intentions	• AIFM must comply in full with AIFMD, apart from requirements in respect of depositary and fund annual report • Appropriate cooperation arrangements in place between AIFM home MS and 3rd country where AIF established	• AIFM must comply with AIFMD, apart from depositary requirements • Appropriate supervisory cooperation arrangements in place between AIFM home MS and 3rd country where AIF established • 3rd country must not be on FATF list • MSs can impose their own stricter requirements

There are complicated rules governing the activation of the passport for the marketing of non-EU funds. In broad terms, for the first two years after the Directive is operative, the marketing of non-EU funds by EU managers must be done on a country-by-country basis via national private placement regimes, as regulated by the Directive (as indicated in the right-hand column of Table 4). ESMA must then deliver an opinion on how the EU managers/EU fund passport and the national private placements regime are functioning and advice on the activation of other passport provisions. If positive, this advice will pave the way for the Commission to adopt a delegated act specifying the date on which the remaining passport provisions in the Directive are to become applicable in all Member States. In effect, therefore, the passport for the marketing of non-EU funds by EU fund managers is not expected to be switched on until 2015. The Directive envisages that for three years thereafter (until 2018) the passport and national private placement regimes will run in tandem, but that the private placement regimes will then be phased out. The "switching off" of national private placement regimes is also subject to ESMA advice and the adoption by the Commission of a delegated act to that effect.

Table 5: Non-EU fund managers & EU funds

Managing and/or marketing managed fund to professional investors in EU with passport	Marketing of managed fund to professional investors in individual EU MSs without passport – private placement regimes
• Full compliance with AIFMD, except where compliance is not compatible with AIFM's national law provided AIFM complies with equivalent rule under national law. • AIFM legal representative in EU appointed • AIFM reference EU MS determined. • Appropriate supervisory cooperation arrangements in place between AIFM reference MS, the MS of the AIF, and the 3rd country in which AIFM is established • OECD-compliant tax convention in place between reference MS and 3rd country in which AIFM established • 3rd country not on FATF's list of uncooperative jurisdictions re money laundering and terrorist financing • 3rd country's laws and supervisory system must not prevent effective exercise of supervisory functions under AIFMD • Reference MS law and jurisdiction applies to disputes between AIFM and supervisory authorities • Disputes between AIFM/AIF and EU investors to be settled according to law and jurisdiction of EU MS • Supervisory notification requirements in respect of marketing intentions • Additional information and notification requirements where AIF is established in MS other than the AIFM's reference MS	• Compliance with AIFMD transparency and disclosure requirements (and with portfolio company requirements where control of a non-listed company is acquired) • Appropriate cooperation arrangements in place between MS where fund is marketed, the MS of the AIF and 3rd country where AIFM established • 3rd country in which AIFM is established must not be on FATF list • MSs can impose their own stricter requirements

Table 6: Non-EU fund managers & non- EU funds

Marketing of managed fund to professional investors in EU with passport	Marketing of managed fund to professional investors in individual EU MSs without passport – private placement regimes
• Full compliance with AIFMD requirements except where compliance is not compatible with AIFM's or AIF's national law and provided there is actual compliance with equivalent rule under foreign law • AIFM legal representative in EU appointed • AIFM reference EU M S determined • Appropriate cooperation arrangements in place between AIFM reference MS, 3rd country in which AIFM is established and 3rd country where non-EU AIF is established • OECD-compliant tax convention in place between reference MS and each of the 3rd countries • Each of the 3rd countries not on FATF's list of uncooperative jurisdictions re money laundering and terrorist financing • AIFM 3rd country's laws and supervisory system	• Compliance with AIFMD transparency and disclosure requirements • Appropriate cooperation arrangements in place between relevant supervisory authorities • 3rd countries in which AIFM and AIF are established must not be on FATF list • MS can impose their own stricter requirements

must not prevent effective exercise of supervisory functions under AIFMD • AIFM reference MS law and jurisdiction applies to disputes between AIFM and supervisory authorities • Disputes between AIFM/AIF and EU investors to be settled according to law and jurisdiction of EU MS • Supervisory notification requirements in respect of marketing intentions	

The applicability of the passport system for non-EU fund managers is also subject to the complicated switching on/switching off arrangements described above. If the passport system become available it will operate in tandem with the national private placement regimes until 2018, but the national regimes will then be phased out, subject to the adoption of a delegated act.

Opposition to the extension of a passport to non-EU fund managers and funds came mainly from within the Council, led in particular by France but with UK strongly advocating the alternative view. The French view was widely seen to be motivated by protectionism. Amidst fears that unilateral action by the EU could trigger retaliation by other countries against EU funds and fund managers, even the US Treasury Secretary, Timothy Geithner, weighed in to encourage the granting of a pan-European passport to third countries.[91] As late as September 2010 the French government was still holding out – by this stage willing to concede on the granting of third country passports but only if ESMA, rather than national supervisors, controlled the process, a condition that involved a redistribution of supervisory power that would have been unacceptable to the UK.[92] Under the compromise that was finally agreed, the granting of passports remains within the remit of national authorities but ESMA's powers have been strengthened in other respects.[93] ESMA is a new body, in operation from January 2011, and its powers in respect of financial market supervision generally are likely to grow incrementally.[94] Such expansion would likely command European Parliament support. Thus, the possibility cannot be ruled out that by 2015, and certainly by 2018, the political conditions could have become more favourable to ESMA assuming a direct role in the passport system.

As indicated in Tables 4-6, the Directive imposes qualifying conditions on national private placement regimes and still more demanding conditions are attached to the third country passport. It is an open question whether these arrangements will actually achieve their intended purpose – of keeping the Union open for non EU fund managers and non-EU funds. Fund managers could simply decide instead to take their business elsewhere

[91] 'Geithner Criticizes France's Opposition To EU Hedge-Fund Plan', *dowjones.com*, 26 October 2010; N Tait and T Braithwaite, 'France Paves Way for Accord on Funds' *Financial Times*, 7 October 2010, 8.
[92] D Charter and M Costello, 'French Set to Stall European Hedge Fund Directive' *The Times*, 29 September 2010, 34.
[93] D Charter, 'Compromise Paves Way for European Hedge Fund Rules' *The Times*, 20 October 2010, 53. ESMA's powers were enhanced as part of this compromise but the granting of passports remains within the remit of national authorities.
[94] E Ferran, Understanding the New Institutional Architecture of EU Financial Market Supervision (November 1, 2010). University of Cambridge Faculty of Law Research Paper. Available at SSRN: http://ssrn.com/abstract=1701147.

and wait for EU investors to seek them out. Indeed, if they are based in jurisdictions that do not satisfy the country-specific criteria, the decision to keep out will be made for them (unless they move). The final version of the Directive does not involve provisions restricting investors to EU-based funds and fund managers. There was support in the European Parliament for "reverse solicitation" restrictions but this was an issue on which it gave way in the face of virtually unanimous opposition from the Council and the Directive, as finally adopted, therefore does not seek to narrow portfolio diversification options in this way.

Part VII: Early assessment – is the AIFMD misguided, ominous or (against the odds) encouraging?

The financial crisis undoubtedly caused suffering to the alternative investment industry. At one stage, there were suggestions that up to 80 per cent of all hedge funds could close.[95] Shrinkage that did occur included the closure of some flagship funds.[96] With debt financing for new deals no longer readily available and forced write-downs on past acquisitions that had been made at peak prices, there was also evidence of mounting problems within some private equity firms.[97] The cynical view of private equity as a business model that was simply good at making money by buying and selling assets in a rising market gained ground.[98]

This talk of decline suggests that making the alternative investment fund industry a regulatory policy priority could have been misguided. Perhaps curbing the excesses of the industry was yesterday's problem (to the extent that it was a problem at all) that had been marginalized by market events? However, the more recent indications are that the alternative investment industry is not dying out. According to data provider Hedge Fund Research Inc, hedge funds represented a $1.65 trillion global industry at the end of June 2010 and they were attracting significant amounts of new money ($23.3 billion in the first half of the year of 2010).[99] Further shrinkage was still expected but mainly affecting smaller funds with less than $100m in assets.[100] By November 2010 the industry was said to have "bounced back strongly" from its 2008/9 nadir.[101] Some commentators also began to see signs of long term resurgence in the private equity industry.[102] Whilst the

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[95] S Grene, 'A Sector Spooked and Struggling to Survive' *Financial Times*, 12 January 2009, 13 (Surveys).
[96] K Burgess, 'Suspect Strategies' *Financial Times*, 23 June 2010, 9 (Surveys) (discussing closure of Atticus funds, which had played a prominent role in the Deutsche Bőrse incident).
[97] M Arnold. 'Lack of Deals Sparks Private Equity Shake-up' *Financial Times* 10 September 2009, 19.
[98] J Guthrie, 'Candover's Humbled Barbarians Ready Rummage Sale' *Financial Times*, 1 September 2010, 16.
[99] H Ebrahimi, 'Largest Hedge Funds Take Bulk of Inflows Despite Volatility' *Daily Telegraph*, 21 July 2010, 4 (Business Section).
[100] Ibid.
[101] S Jones 'Hedge Fund Bonuses Signal Rosier Times' *Financial Times*, 5 November 2010 (ft.com); S Jones, 'Corporate Ambitions' *Financial Times* 27 September 2010, 12 (Surveys).
[102] A Ross, 'Private Equity Still Showing Value, but Only For Long Term' *Financial Times*, 12 September 2009, 9 (Surveys); S Johnson, 'Signs of Life in a Crisis-damaged Sector' *Financial Times*, 26 July 2010, 5 (Surveys); G Zuckerman, 'Blackstone Says Buyouts Overheated' *The Wall Street Journal*, 29 October 2010, C1.

percentage of funds under management by hedge funds and private equity represents only a small part of the global investment universe (estimated to be $71.3 trillion at the end of 2009, with global mutual funds alone totalling $23 trillion[103]) the alternative investment industry is still a force to be reckoned with. As such, it cannot escape public scrutiny on the grounds of being too insignificant to matter.

What of the argument that the alternative investment fund industry did not deserve to be in the regulatory firing line because it did not cause the crisis and incontrovertible proof that it amplified its effects was lacking? A problem with this way of thinking is that the world's economies cannot afford to sit back and wait for incontestable evidence of an actual systemic problem before acting because by then any regulatory response will be too late. Regulation has to aim at trying to prevent the next crisis, not simply cleaning up the mess from the previous one. It may indeed be the case that the alternative investment industry is too small and/or is leveraged at too low a level, at least relative to average bank sector leverage, to be a likely source of future systemic harm but the opacity issue, which has for a long time hampered supervisors' efforts to understand the industry's significance, makes this hard to tell. Requiring the industry to submit at least to disclosure and transparency obligations that help regulators and central banks do a better job of identifying systemic risk concentrations in the system is a reasonable step forward. Resistance to the imposition of obligations of this sort would merely serve to suggest that there is something to hide.

So, in assessing the Alternative Investment Fund Managers Directive, the starting point has to be that it was appropriate for EU policymakers to bring the industry more directly within public control because the existing regulatory treatment was no longer sustainable. However, the Directive goes a lot further than simply requiring fund managers to register with a public authority and to submit to disclosure-oriented obligations that are intended to allow authorities to patrol for the build up of systemic risk. This suggests that the EU Institutions could have indulged in regulatory excess. The legislation is certainly formidable, both in its length and its technical complexity. Given that it is to apply only to a relatively small part of financial market activity, it has a disproportionate feel, implying that it could be the proverbial "sledgehammer to crack a nut".

Based on the criticisms leveled at draft versions of the Directive during the legislative process, the EU certainly seemed to be on the verge of a serious policy mistake that would have threatened to kill off the alternative investment industry in Europe thereby seriously harming the interests of investors, the corporate sector and the wider European economy. However, lobbying tactics sometimes lead to dangers being set out in the starkest terms. Whether or not the risks were exaggerated, the final version of the Directive benefitted from the intense efforts that were made to address some of the more unpalatable features of early proposals. Early industry reaction to the final adoption of the Directive has certainly suggested not only relief at the ending of legal uncertainty (something that industry always abhors) but also a willingness (if somewhat

[103] The CityUK, *Global Financial Markets - Regional Trends* (November 2010) 5.

begrudgingly) to adapt constructively to the new reality.[104] Sentiment has started to move towards the view that a workable compromise might actually have been secured in spite of all the difficulties in the legislative process.[105]

The Directive will not become operative until 2013 and there is an additional layer of regulation and guidance that has to be put in place before then. Full assessment of its impact must await those developments but some tentative comments are possible. On the one hand, many of the fundamental ideas to which the Directive gives effect – such as proper disclosure to investors, regular reporting of investment performance, independent valuation of assets, segregation of assets, and robust risk management and fund governance arrangements – are basically sound and are not a million miles away from what is already found in industry standards, at least for hedge funds. Though much more prescriptive than, and of course lacking the compliance flexibility that is inherent in, self-regulatory standards, to the extent that the Directive is broadly consistent with industry best practice, it is hardly credible to view it as something that is likely to be commercially devastating. It is conceivable that it could boost business by bolstering investor confidence as to safety and soundness of the alternative investment sector. Funds and managers that are presently based outside the EU could re-locate inwards, bringing with them associated tax revenues and other benefits for the wider European economy.

But there also risks the other way. There will be new compliance costs for the industry– not as high, perhaps, as the €3.2 billion one-off adaptation costs and the ongoing compliance costs of €311 million that could have resulted from the Commission's original version according to a study conducted for the FSA, but still very significant.[106] In so far as these costs are passed on to investors, returns will be reduced. For some funds and fund managers, it may cease to make commercial sense to operate in Europe at all. Withdrawal would leave European investors with more to do in seeking out the best available investment opportunities. Another part of the market that could contract and/or become expensive is that for the provision of depositary services because of the combination of new restrictive eligibility criteria and strict liability provisions. For private equity funds that are caught by the Directive, the disclosure requirements in respect of portfolio companies and the asset stripping restriction risk putting them at a competitive disadvantage to other acquirers, including sovereign wealth funds and non-EU private equity funds that do not market to EU investors (and so fall outside the scope of the Directive) but which acquire controlling stakes in EU-based companies.

Full evaluation of the Directive's significance must also be postponed until it is possible to compare its effects to those resulting from similar regulatory developments elsewhere. Other countries are also taking steps to fulfil their G20 commitment to strengthen the public oversight of the alternative investment fund industry. There are, for example, new

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[104] R Sullivan, 'Industry Mulls over Alternatives Directive' *Financial Times*, 22 November 2010, 3 (Surveys) quoting a spokesperson for the British Private Equity and Venture Capital Association as admitting that "on balance the directive is viable", albeit "a compromise and not ideal".
[105] Slaughter and May, *The Alternative Investment Fund Managers Directive: A Tolerable Compromise?* (November 2010).
[106] Charles River Associates, *Impact of the Proposed AIFM Directive across Europe* (October 2009).

requirements on advisers to hedge funds and others under the US Dodd-Frank Act. As in Europe, detailed rules have still to be put in place[107] but the changes are expected materially to increase investment advisers' compliance costs.[108] It is possible that the EU's approach may not fare too badly when it becomes possible to view it in context as part of an international trend.

Since it is too early to come to a final judgment on whether the Directive is an appropriately balanced improvement to the EU's regulatory framework or an own goal from which it will struggle to recover, it would also be premature to allocate praise (blame) to the Institutions that were responsible for its creation.[109] However, this article's close examination of the process by which the Directive came reveals some important findings about the current relative strengths and weakness of the EU Institutions in shaping EU regulatory policy and law for the financial markets. These findings have implications for what we can expect of the EU Institutions in the years to come, a period that looks likely to be characterized by a continuing strong emphasis on legislative change aimed at "strengthening" the regulatory framework and in which, therefore, experience gained and political skills honed in recent past law-making skirmishes will be very salient.[110]

For the European Commission, the Alternative Investment Fund Managers Directive was not one of its finest moments. In effect, it had "backed the wrong horse" in the pre-crisis period and, when finally boxed into a corner by other Institutions as the crisis unfolded, it found itself in the position of having to rush out a defective proposal under severe political pressure. Chastened by this experience, it seems unlikely that the Commission will be keen to re-assert the "determination to control its own regulatory agenda in the face of political pressure" that *Moloney* identified in its pre-crisis approach to alternative investments.[111] In any case, key personalities have moved on and the Commission's leadership is no longer characterized by a strong association with pro-market, deregulatory preferences. The more serious danger now looming is that the Commission, aided and abetted by the new European Supervisory Authorities, could go too far in the opposite direction. With "stronger" and "stricter" regulation now the policy preference in the ascendancy and thus forming the background for the conduct of forthcoming scheduled reviews of existing EU financial market legislation, and with the Commission being formally entrusted, not only in the AIFMD but across the board in EU financial market regulation, with major new rule-writing powers (albeit that it is the new Supervisory Authorities that will mostly be responsible for the actual drafting of these rules), there will be ample opportunities soon to see whether this risk is being realized or appropriately contained.

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[107] SEC and CFTC, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (Joint Proposed Rules, January 2011)
[108] Cadwalader, *Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Clients & Friends Memo, July 2010).
[109] But see D Awrey, 'The Limits of EU Hedge Fund Regulation' [2011] *Law and Financial Markets Review* (forthcoming) for a quite pessimistic view on how things are likely to turn out.
[110] European Commission, *Regulating Financial Services for Sustainable Growth* COM(2010) 301.
[111] N Moloney, *EC Securities Regulation* (OUP, 2nd edn, 2008) 335.

After the Commission got things off on the wrong foot with its flawed version of the AIFMD, it fell to the Council of Ministers and the European Parliament to pick up the pieces. Both institutions made intense efforts to correct shortcomings in the original version. Whilst the Council's contribution was somewhat overshadowed by the political disagreements between certain Member States, it is significant that those disagreements did not delay progress indefinitely. The different domestic political preferences of Member States (especially the three key players, France, Germany and the UK) can still exert considerable influence on the development of EU law but so far as financial market regulation is concerned, an urge to find some form of consensus in order not to impede the intensification of market integration pulls strongly in a different direction. This sense of seriousness of purpose and determination to overcome obstacles created by individual Member States' political preferences and regulatory philosophies that stand in the way of a robust pan-European regulatory framework preceded the financial crisis but it has acquired an additional impetus from recent events.[112] If, as seems likely, we are heading in the "more Europe" direction, for example if there are proposals to strengthen the powers of ESMA or its sister authorities for banking and insurance (which French politicians, in particular, have been advocating and which commands support within the European Parliament), the implications of this new political reality within the Council could be quite troubling for certain Member States.

For its part, the European Parliament played its part in the development of the Directive very cleverly. It deftly distanced itself from its pre-crisis reputation as an indiscriminate scourge of hedge funds and private equity by aligning itself with industry in supporting certain issues, such as a proportionate, differentiated, "one-size-doesn't fit-all" approach and maintaining third country access to EU markets. Its support for self-imposed leverage caps was much less heavy-handed than the Commission's original idea. At same time, however, in many areas it was instrumental in securing significant restrictions that were more intense than the starting position set out by the Commission. Its approach to the regulation of private equity provides an apt illustration of this shrewdly-balanced strategy. Whilst it would have been content to exempt private equity from some obligations under the Directive, the Parliament was adamant throughout on the need for new controls in respect of portfolio companies. These controls constitute the most opportunistic part of the Directive in the sense that they are the sections furthest away from systemic risk concerns, yet their inclusion was never in doubt and, thanks to the Parliament, in their final form they are more onerous than the Commission's initial version. It was also the Parliament that took the initiative in pressing for remuneration restrictions, although the Council quickly followed with its own version.[113] Even on matters on which there is an appearance of common ground between the industry and Parliament, it does not take long to realize - the third country rules provide a clear

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[112] See, in particular, the dispute over order-execution rules in the Markets in Financial Instruments Directive, Directive 2004/39/EC, [2004] OJ L 145/1, which, amidst much acrimony, were adopted in spite of opposition in Council from a number of Member States, including the UK. See N Moloney, *EC Securities Regulation* (2nd edn, 2008) 785 – 797.
[113] European Parliament, *Background Note*, n 79.

example – that the Parliament's support came with very significant regulatory strings attached.

The Parliament's astute performance in this case confirms and consolidates its position of ascendancy with respect to shaping both the broad shape of policy and the specific content of laws relating to the financial markets.[114] It is the Institution that emerges with its reputation for effectiveness in securing its own priorities most enhanced. A more open question is whether the Parliament's political priorities are congruent with well-balanced policy choices that address the risks and uncertainties that are inherent in financial markets but still leave room for a flourishing industry to fulfil its potential to contribute to the common good. The implementation of the Directive should provide some answers.

[114] See also N Moloney, 'EU Financial Market Regulation After the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 CMLRev 1317, 1337-8. In the pre-crisis period, the performance of the Parliament in the somewhat stormy negotiations over MiFID had attracted some praise: M McKee and N Augry, 'MiFID: Where Did It Come From and Where is it Taking Us'? (2007) 22 *Journal of International Banking Law and Regulation* 177.

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