

The European Union, Financial Crises and the Regulation of Hedge Funds: A Policy Cul-de-Sac or a Policy Window?

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Abstract

A series of financial crises involving hedge funds has created a general perception that action needs to be taken. A number of key member states and political actors favour tighter regulation. Traditional bureaucratic theory suggests that the European Commission would seek to maximise this 'policy window', and yet there remains no single unified European Union (EU) regulatory framework specifically targeting hedge funds. The nature of the regulatory regime, which has generally demanded a 'light touch' approach, means there are strict limits the EU's ability to act. From an EU perspective, hedge fund regulation appears to be a policy cul-de-sac. However, the relationship between hedge funds and financial crisis is complex and less straightforward than is often portrayed. Hedge fund regulation cannot, however, be considered in isolation but should be viewed in the context of a wider programme to integrate European financial services markets. Viewed from this perspective, EU regulation is in fact changing the landscape of the hedge fund industry through a process of negative integration.

FINANCIAL MARKETS ARE CURRENTLY IN THE GRIP OF A GLOBAL CREDIT CRUNCH. A downturn in the American housing market created the US sub-prime debacle which in turn has reverberated across highly integrated global markets to become what some commentators argue is the worst financial crisis in seventy years (Lomax 2008: 5). Never far from the eye of a financial storm is the hedge fund industry. The sub-prime debacle is the latest in a series of financial crises involving hedge funds, the cumulative affect of which has been to create a general perception, in the minds of the public and politicians, that something needs to be done and that this 'unregulated' industry deserves more attention from regulators and policy makers. Yet there is no single unified EU regulatory framework specifically targeting hedge funds (Gottlieb 2007: 6).

In the context of active support for regulation from key member states and organised interests, some EU action in this area might reasonably have been anticipated. Majone (1996: 74) argues that the Commission has played a considerable role in European integration by creating demand for EU regulation through policy entrepreneurship. Yet, despite support for action the European Commission has continued to rule out any specific EU legislation in the area of hedge funds. Public choice theory suggests that bureaucracies will always seek to maximise the size of their agency. This holds true for

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the Commission, which given the limited opportunities for budgetary expansion, seeks to expand the quantitative scope of its competencies (Majone 1996: p.64). Majone (2006) describes this as *integration by stealth*. Control of the policy agenda, and absence of clear accountability standards, has allowed the Commission to pursue objectives of political integration and self-aggrandisement whilst appearing to solve policy problems (Majone 2006: 613). From this perspective the case of hedge fund regulation at the EU level presents an interesting puzzle; why is the Commission not capitalising on the 'policy window' offered by public concern to strengthen its position through an enhanced regulatory role?

The current policy debate is reminiscent of Downs' (1972) issue attention cycle. The continued presence of hedge funds across a series of financial crises has created public alarm. This 'alarmed discovery' has been followed by 'euphoric enthusiasm' that regulation is the solution. The 'costs of significant progress' have become increasingly apparent as the issue of hedge-fund regulation has progressed through the issue-attention cycle (Downs 1972: p39-40). In this paper, I seek to develop the debate on the regulation of hedge funds and the role of the EU by placing it in an historical, institutional and theoretical context. I also explore the question; is hedge fund regulation a policy window or policy cul-de-sac? In order to do this I consider the regulatory context in which hedge funds currently operate, and demonstrate that there are limitations on the capacity of EU institutions to regulate in this area, which at first glance might explain the lack of action at the EU level. However, I argue that hedge fund regulation cannot be considered in isolation, but rather should be viewed in the context of a wider programme to integrate European financial services markets. Viewed from this perspective, EU regulation is in fact changing the landscape of the hedge fund industry through a process of negative integration. Drawing on Majone's (2006) theory of *integration by stealth* (Majone 2006: p.613), I argue that the consequences of continued negative integration in the EU securities regime (rather than financial crises) may drive future pressure for regulatory action on hedge funds.

Financial crises: 'alarmed discovery'

The current policy debate on hedge funds recalls Downs' issue attention cycle in particular stage two; "alarmed discovery and euphoric enthusiasm" (Downs 1972: p.39-40). An issue reaches stage two of the cycle when, as a result of some dramatic series of events, the public suddenly becomes aware of, and alarmed by, the 'evils' of a particular problem. Downs argues that this alarmed discovery is invariably accompanied by 'euphoric enthusiasm' about society's ability to solve the problem or do something effective within a relatively short time period (Downs 1972: 39-40). In the case of hedge funds, 'alarmed discovery' has been driven by two factors; firstly the large movement of capital into the industry in recent years alongside a wider investor base (Gottlieb 2007: 5) and secondly the continued presence of hedge funds across a series of financial crises. Both factors have contributed to a sense of public alarm about hedge funds, and 'enthusiasm' for regulation as a solution to the problem. The deputy governor of the Bank of England said in a speech in May 2007: "If we face a financial crisis in the next few years we are almost bound to find some hedge funds at or near the centre of it..." (Gieve 2008: 6).

There is no comprehensive, uniform and universally accepted definition of a hedge fund or a hedge fund manager (CEC 2006b: 10). Hedge funds aim to provide investors with an 'alpha' return. Alpha is the rate of return above the level that would have been achieved by investing in traditional investment strategies such as stocks and shares. The ability of hedge funds to achieve alpha over time is not universally accepted (Gieve 2008: 4), but they have been successful in delivering average returns comparable with investing in stocks and shares without the volatility (Gieve 2008: 3). Although hedge funds date back to the 1940s, it was during the 1990s that the phenomenal growth of the industry was witnessed. The Bank of England reports the global assets under

management to have grown from \$200 billion in 1998 to \$1.25 trillion in 2006 (Gieve 2008: 3). By 2007 the industry had breached the \$2 trillion mark (Intelligence 2007; Thomas 2007).

The success of hedge funds is in their ability to unpack traditional investments, like equities and bonds, into their component parts and to then sell them separately, or in new bundles, to appeal to particular investors (Gieve 2008: 3). As the industry has matured, investment strategies have become increasingly complex, often relying on statistical models, or 'black-boxes', which analyse inefficiencies in commodity markets in order to take multiple long-short (see later) positions, known as arbitrage. Banks have responded by setting up their own internal hedge funds or by adding hedge funds to their range of investments; thus blurring the distinction between traditional asset management and alternative investment. The major financial institutions have also emerged as key service providers to the hedge fund industry, providing credit lines in the form of leverage and back office services. In this way they have benefited hugely in terms of fees, interest and the trading income generated by hedge funds (Gieve 2008: 3). The growing size of the market and its interconnectedness with mainstream institutions created cause for concern about this unregulated industry. This concern was heightened by the presence of hedge funds in a series of financial crises throughout the 1990s that were widely reported in the media.

The first and most infamous financial crisis involving hedge funds was the ejection of sterling from the European Exchange Rate Mechanism (ERM) in 1992. Hedge fund manager, George Soros, was reported to have profited \$1 billion by short selling sterling (Kaletsky 1992). The 'long-short' strategy is the most common hedge fund strategy and provides the origin of the word 'hedge'. The hedge is a 'bet' against the security going up (long selling) and down (short selling). Soros 'bet' against the UK government being able to keep sterling within the ERM (Kaletsky 1992). Hedge funds were again linked to a national currency crisis in 1997 when fund managers were accused of deliberately causing a sell-off of Malaysian currency. The then Prime Minister, Mahathir Mohamad, called hedge funds "unscrupulous profiteers" involved in an "unnecessary, unproductive and immoral" trade (Vines 1997). Less than a year after the Asia financial crisis a high profile US hedge fund, Long-term Capital Management (LTCM), collapsed and shocked the financial world because it revealed the extent to which mainstream financial institutions were exposed to hedge funds (Sunday Business Post 1998: 8). When LTCM collapsed it was borrowing \$200 billion on an original capital base of \$5 billion (Rees-Mogg 1998). LTCM highlighted the risk that the collapse of a highly leveraged hedge fund could bring down with it a major financial institution, and spread a crisis within the global banking system (Sunday Business Post 1998: 8).

The sub-prime debacle is the latest 'drama' and has further fuelled public alarm that hedge funds are intrinsically threatening to the economy. The roots of the sub-prime crisis lay in a change in the way the major banks treated debt on their balance sheets. Driven by a boom in house prices through the late 1990s and early 2000s, banks shifted from a 'lend and hold' to an 'originate and distribute model' which resulted in sub-prime mortgages being "sliced, diced, recombined and sold on" (Gieve 2008: 3). Hedge funds, always at the forefront of financial innovation, traded sub-prime loans as securities on the structured credit market and as a result became embroiled in the crisis. The crisis began to unfold in 2006 with a downturn in the US housing market which was further compounded by rising interest rates. An increase in the number of mortgage defaults forced lenders to make provisions for bad debts and by the summer of 2007, fearing the scale and location of losses arising from sub-prime mortgages, there was effectively an investor strike from global securitisation markets (Gieve 2008: 3). With little transparency between the original underlying loan and the end investors, when the system began to unwind panic spread quickly because of the complexity and opaque nature of the loans. Two hedge funds run by the investment bank, Bear Sterns, collapsed as a direct result of the sub-prime crisis, creating pressure for action on hedge fund regulation (Tett 2007: 13). In the summer of 2007 French President Sarkozy

wrote to the German Chancellor, Angela Merkel, urging the German government to use its G8 presidency to improve the transparency of hedge funds (Atkins and Hollinger 2007b: 4). The Chairman of Barclays Capital meanwhile urged politician's to act on "a completely unregulated sector standing apart from banks, which does not have the necessary transparency" (Kramb and Larsen 2007: p.22) .

Although much of the current debate centres on the role of hedge funds in financial crises, the activities of some private equity firms have also raised concern. Some hedge funds trade in equity investments in companies not listed on a public stock exchange. Hedge funds and private equity funds are two components of the continuum of investor appetite and liquidity obligations. Private equity funds have long been the target of trade union groups, who accuse them of having no vested interest in the long term development of their acquisitions. In fact, some in the industry argue that the private equity debate has led to the public examination of hedge funds.¹ In the UK, the General Workers Union (GMB) has led a campaign against the private equity fund that owns the Automobile Association (AA), accusing it of eroding workers pay and conditions and asset stripping to increase profits (Mawson 2006). In 2005 a senior member of the German Social Democratic party accused hedge funds of "routing the economy – browbeating management, stripping assets and axing jobs" after a group of hedge funds and a private equity fund blocked the German company, Deutsche Börse, from buying the London Stock Exchange (Jenkins 2005: 8). The present German coalition government has continued to be the most outspoken of the EU member states on hedge funds and used its presidency of the European Council and the G8 in 2007 to put forward proposals for an international register of hedge funds, greater transparency of their dealings and a code of conduct (Benoit and Atkins 2007).

As has become evident of late, there are considerable grounds for concern in relation to the threat posed by hedge fund activities to financial stability. Their continued presence within the vicinity of each crisis is a recurring phenomenon, and has also allowed hedge funds to be used as something of a scapegoat for national politicians trying to explain domestic failures within a highly complex international financial system. There has been mounting pressure for EU action on hedge funds around the areas of transparency and the potential posed by hedge funds to cause financial instability. Support for policy initiatives specifically dealing with hedge funds has come from a range of actors including national governments (mainly Germany and the Netherlands and to a lesser extend France) (Atkins and Hollinger 2007a: ; EurActiv 2007b), the socialist grouping in the European Parliament (PSE 2007), Trade Unions (Mawson 2006) and the European Central Bank. However, despite growing 'public alarm', the causal relationship between hedge funds and financial crises is not straightforward. Hedge funds are at, or near, the centre of financial crises because by their nature they are designed to exploit opportunities created by market failures and inefficiencies. Therefore their presence, and even role, in a financial crisis is arguably unremarkable. The sub-prime crisis and its consequences on global markets is, arguably, the result of a loss of trust in the whole style of modern finance with its complex dispersion of risk, but not in hedge funds specifically. Although Soros profited from the UK's ejection from the ERM, he did not cause it and in the case of the Asian financial crisis, hedge funds were later exonerated by the International Monetary Fund (IMF), who concluded that whilst some funds may have determined the timing of the crisis they were not themselves the cause and, in fact, played only a "relatively limited" role (Atkinson 1997: 16). In summary, the 'public alarm' created by financial crisis and the growth of the industry opened a 'policy window' for action, but the causal relationship between hedge funds, financial crisis and financial instability is more complex than is often portrayed.

¹ Comments by Andrew Ashworth, senior executive in hedge fund industry – see acknowledgements

Hedge funds: The regulatory environment

Hedge funds operate in a highly integrated global financial market and trade in transnational capital, which crosses national and regional boundaries. In fact, most hedge funds are actually domiciled outside the authority of EU institutions in offshore markets like the Bahamas and the Cayman Islands in the Caribbean and the Isle of Man and Channel Islands in Europe (PSE 2007: 10). The offshore markets have developed their own regulatory rules governing hedge funds but these are generally light-touch in style offering the funds certain types of additional flexibility, but most have adopted a consistent approach to regulation in terms of money laundering, risk and transparency. Importantly, the offshore markets offer hedge funds tax minimization and tax exemption strategies (Morgan and Knights 1997: 34). The existence of these offshore markets considerably complicates the creation of any new regulatory system as they have emerged and developed precisely to avoid regulation (Morgan and Knights 1997: 34). Although hedge funds are domiciled in one jurisdiction they are normally managed from another (CEC 2006b: 14). The USA dominates the fund management industry, with 53 per cent of the all hedge funds having a fund manager located there, but the EU industry has grown consistently throughout the 1990s, and now manages 27 per cent of global assets (Gottlieb 2007: 2). Hedge fund managers are subject to a patchwork of national regulatory regimes which oversee registration and limit access to retail markets but they operate in a light-touch regulatory environment compared to traditional financial markets such as the stock exchange or investment vehicles like pension funds, where rules on transparency, valuation and disclosure are strictly laid down (CEC 2006b: 16).

The light-touch nature of hedge fund regulation can be attributed to two factors. Firstly, hedge funds have expanded and grown without attracting much attention from regulators because they target 'sophisticated investors'. There is no commonly held definition of a sophisticated investor but it is generally held to mean institutional or high net-worth individuals (HNWI) who are sufficiently resourced and experienced to assess their own risk. Ordinary investors are generally excluded by high minimum investment levels, and restrictions on the funds ability to market into what is known as the 'retail' market. For this reason hedge fund investors do not require the same level of investor protection afforded to traditional investment vehicles where ordinary members of the public make up the bulk of the investor base, such as pension funds. Secondly, the light-touch regulatory context is underpinned by a belief that regulatory light zones are necessary to ensure the continued competitiveness of the EU financial services sector (Gottlieb 2007; Wymeersch 2005). Wymeersch (2005: 993) argues that most financial innovation takes place outside of strictly regulated areas and cites hedge funds as an example. Many have argued that a light-touch regulatory zone ensures entrepreneurial hedge fund managers are not stifled by excessive regulation and bureaucracy.

As highlighted above, traditional approaches to the study of bureaucracies would suggest that the Commission would exploit the 'policy window' created by public alarm over hedge fund regulation. In the context of active support for regulation from key member states and important interests, some EU action in this area might reasonably have been anticipated. Examination of the regulatory environment within which hedge funds operate, however, reveals that there is limited scope for EU institutions to regulate in this area. Firstly, the majority of hedge funds are not subject to EU authority. Secondly, hedge fund managers are already subject to national regulation and supervision. Thirdly, there is no consumer or public protection imperative, because hedge funds are targeted at sophisticated investors. Finally there is recognition that a 'hands-off' regulatory approach is required to ensure the continued competitiveness and financial innovation in EU financial services market. So, although public alarm has opened a 'policy window', the regulatory context provides limited scope for EU institutions to solve this policy problem. Indeed the (lack of) EU response would seem to confirm this.

EU regulation specifically targeting hedge funds was addressed in the 'Green Paper on the Enhancement of the EU Framework for Investment Funds' (2005) in which the Commission asked, "[a]re there particular risks (from an investor protection or market stability perspective) associated with the activities of either private equity or hedge funds which might warrant particular attention?" (CEC 2005: 9). The question can be viewed as a policy response to public alarm about hedge funds, but the White Paper, 'Enhancing the Single Market Framework for Investment Funds', concluded that there was "currently no regulatory gaps which call for EU-level intervention to regulate hedge funds..." (CEC 2006a). This position was underlined at a conference of financiers in London when DG Internal Markets Commissioner, Charlie McCreevy, announced that the Commission would not regulate hedge funds (EurActiv 2007a). The Commission has also recognised that given the nature of global capital mobility, any EU legislation would be meaningless without global agreement (EurActiv 2007a). Commissioner McCreevy has defended hedge funds in the face of the sub-prime crisis, and continued to rule out regulation (Buck 2007: 8), arguing that hedge funds promote financial innovation which is good for the European economy (Reuters 2007).

The German government managed to keep the issue on the debating table using its 2007 presidency of the G7. After drafting legislation governing the disclosure of shareholdings as a direct result of the role hedge funds in the Deutsche Börse affair, Chancellor Schroder introduced the issue of hedge fund regulation at the G8 summit in Scotland 2005 (BBC 2005). In 2006 Germany underlined this commitment and announced that it would use its 2007 presidency to put hedge fund regulation on the agenda (Benoit 2006), and at the G7 meeting in Essen, ministers announced, "Given the strong growth of the hedge fund industry and the instruments they trade, we need to be vigilant" and asked the Financial Stability Forum (FSF) to update its 2000 report in advance of the G8 Heiligendamm Summit in Germany (Declaration 2007 ; Treasury 2007: 3). In June 2007 the FSF published a report, which stated that the relationship between hedge funds and prime brokers and other counter parties (banks and financial institutions) had "...become central to the robustness of the financial system", and concluded there was a risk that a hedge fund, perhaps through forced liquidation, might cause a sharp deterioration in market liquidity and prices that could bring down one or more of its counterparties (FSF 2007: p.1). In the summit declaration G8 ministers warned the industry to review existing practices particularly in the area of valuations, risk and disclosures. (Declaration 2007: 3). The industry responded with the establishment of the Hedge Fund Working Group (HFWG) set up in June 2007 and chaired by Sir Andrew Large (former deputy governor of the Bank of England). The HFWG brought together 14, mainly London based, fund managers with a remit to "review best practice and to examine the application of industry-wide standards where appropriate" (HFWG 2007). The HFWG published its report in January 2008 and recommended voluntary guidelines on best practice for hedge fund managers. The report set out five areas of concern, which included disclosure to investors and counterparties, valuation and risk management (EuroWeek 2008b). Although the recommendations of the HFWG have been generally welcomed, their relevance is questionable. Not a single firm beyond the original 14 signatories has signed up to the compliance standards since their launch (Evans 2008: 2).

Despite the recent deepening of financial turbulence, no further policy initiatives that specifically target hedge fund regulation have emerged from the Commission. There continues, however, to be opposition to, and pressure on, the Commission's position from within the European Parliament (EP). Poul Nyrup Rasmussen, MEP and president of the Party of European Socialists accused Commissioner McCreevy of being "the only player in Europe who doesn't believe that private equity and hedge funds should not be subject to tougher transparency rules" (Gow 2007). In June 2008 the EP's Legal Affairs Committee unanimously adopted a report by German MEP, Klaus-Heiner Lehne, which called on the Commission to bring forward legislation on the transparency of institutional investors, requiring companies to disclose their investment policies and associated risks (European Report 2008). It is worth noting that such a formal call for

legislation must be approved within a plenary session of the EP by an absolute majority.

The Commission has made a 'non-decision' (Bachrach and Baratz 1963) on the regulation of hedge funds, but perhaps this is unsurprising given the complex causal relationship between hedge funds and financial instability, and the limited authority of EU institutions in the global regulatory context within which hedge funds operate. In Downs' (1972) terms, the 'costs of significant progress' have become increasingly apparent as the issue of hedge-fund regulation has progressed through the issue-attention cycle. At first sight, it appears that EU policymaking is marginal to the debate about hedge fund regulation. Rather than a 'policy window', hedge fund regulation has apparently proven to be a 'policy cul-de-sac'. However, I argue that the policy response of the Commission on hedge fund regulation should not be viewed in isolation. Instead, the Commission response should be analysed within the wider and longer-term programme to integrate European financial services markets. The financial services sector is functionally divided into three segments - banking, insurance and securities - with hedge funds falling within the later. From this perspective EU institutions are far from irrelevant and are in fact changing the regulatory landscape for hedge funds. In order to understand the legislative response to the hedge fund debate it is necessary to shift the research lens. A narrow focus on the Commission's response to the 'public alarm' and on regulation, or 'positive' integration, only explains half of the story. The research lens should be drawn back to view hedge fund regulation in the context of a wider policy regime in financial services. This provides a new perspective on the issue.

The Commission and the EU financial services regime: between positive and negative integration

The Commission through its agenda setting role has acted as a powerful policy entrepreneur with the result that a coherent policy regime has emerged in financial services policy (Quaglia 2007: 8). Initially, the Commission attempted to harmonise the diverse national systems into a single unitary framework, but in the early phase of financial services integration it struggled to make any significant advances (Story and Walter 1997: 26). The landmark ruling by the European Court of Justice on the Cassis de Dijon case in 1979 established the principle of mutual recognition and offered the Commission a new policy approach; rather than attempting to harmonise diverse systems into a unitary framework, harmonisation now came to mean the establishment of common standards (Story and Walter 1997: 16). The Single European Act (1987) boosted the new approach with a treaty basis and committed member states to work progressively towards a single market in financial services. However, divergent national rules on licensing, market access and prudential measures persisted into the early nineties and remained effective barriers to a fully integrated market (Hager 2007: 14). Monetary union and the introduction of the Euro provided a new stimulus (Grahl *et al.* 2005: 1005) and in 1999 the Commission put forward the Financial Services Action Plan (FSAP) which contained 43 measures to be implemented by 2005. It took a European Council initiative to ensure the FSAP was completed on schedule. The European Council appointed a 'Council of Wise Men' to explore how best to adapt securities regulation and co-operation between national regulators in an effort to overcome the difficulties experienced during earlier attempts to integrate European securities' markets (Visscher *et al.* 2007: p.5). The Council's committee, chaired by Alexandre Lamfalussy, former President of the European Monetary Institute, resulted in the Lamfalussy process which created a four level system to improve the legislative process (Visscher *et al.* 2007: 5).

Over the last fifty years financial services policy has evolved into a coherent policy regime. European financial regulation has become increasingly centralised, with rulemaking and policy formulation the result of either EU legislation, or secondary rules

drawn up by the committees within the Lamfalussy agreement (Wymeersch 2005: 1009). The policy regime that has emerged is characterised by minimum standards, mutual recognition, removal of barriers to free trade and rule making through the Lamfalussy process. The effectiveness of the regime is illustrated by its ability to deliver the completion of the FSAP largely within the deadline. In spite of formidable technical difficulties and significant conflicts of interest amongst the financial sectors of member states, a very ambitious legislative programme was completed (Grahl *et al.* 2005: 1018). The key element of the regime for hedge fund regulation is the framework to facilitate negative integration; in other words the impetus to remove barriers to the development of an integrated market. However, financial service integration is also characterised by asymmetry; between 'supervision' which deals with monitoring of financial actors and remains very much a national effort, and the application of rules which are increasingly concentrated at the EU level. This is consistent with the nature of regulation in the EU. Wymeersch (2005: 988) argues that it is necessary to think about EU regulation in terms of these two distinct concepts; supervision and regulation, or rule making. Whereas in the US regulators tend to carry out both functions, in the EU they are clearly distinguished. Whilst 'regulation' or rule making is increasingly centralised at the EU level, 'supervision' is decentralised. National regulators are the primary agents in the implementation of the rules and the supervision of the market. Majone (2006: 622) argues that this asymmetric treatment of positive and negative has been a long-standing feature of European integration and is evidenced in the disproportionate use of negative integration over positive in the completion of the common market.

It is in the context of the asymmetrical regulatory framework in financial services that the Commission's policy response on hedge funds needs to be understood. The Commission's capacity to act, given the regulatory context of hedge funds, is limited and in the context of the wider financial services policy regime positive integration, which involves the creation of supranational regulation and perhaps supranational supervisory institutions, is at odds with the policy approach that has emerged. On the other hand the logic of negative integration that seeks to remove barriers to the development of an integrated EU market is, in practice, changing the landscape of the hedge fund industry.

Alongside the question of regulatory action to address investor protection and market stability issues the Green Paper on the Enhancement of the EU Framework for Investment Funds (2005) also asks;

To what extent do problems of regulatory fragmentation give rise to market access problems which might call for a common EU approach to... b). hedge funds...? (CEC 2005: 9)

The Green Paper sought to explore whether a single market framework should be created for non-harmonised investment products (CEC 2006c: 12). Although there is no EU legislation which specifically covers hedge funds, amendments to the original 1985, 'Undertakings for Collective Investments in Transferable Securities Directive (UCITS), have reduced the line of difference between traditional investment funds (such as pension funds) and hedge funds (Pallesi 2007: 104). UCITS funds are generally aimed at the retail market (or general public) and as such they carry a greater degree of regulation. Products, which are considered eligible under UCITS, are called harmonised products and are afforded a EU passport, which means they can be marketed across borders. All other investment vehicles such as hedge funds and private equity funds are non-harmonised products and cannot be cross-border marketed. Continued innovation and technological development in financial services means there is a gap between the Directive and market reality, (CEC 2006c: p.4) with the result that products that cannot comply with UCITS are being marketed as retail products at a national level (CEC 2006c: 2). Revisions to the UCITS (UCITS II & III) have dealt with this issue by reducing the line of difference between eligible investment funds and non-harmonised products such as hedge funds (Pallesi 2007: 104). The White Paper, 'Enhancing the

Single Market Framework for Investment Funds' (2007), recognises that non-harmonised funds are aimed at 'sophisticated investors' and therefore concludes that there is a case for removing cross border barriers to sales and marketing for these products as well as barriers to the private placement of these funds (CEC 2006c: 13). In effect this would mean certain hedge funds would become eligible funds under UCITS and form part of an UCITS fund diversified portfolio and benefit from the ability to be marketed across the EU.

The Commission's legislative action on hedge fund regulation is entirely consistent with the 'regulatory' policy regime in financial services; the primary concern is to remove barriers that impede the development of a fully integrated European financial services market. The proposal to look at removing barriers to the marketing of non-harmonised products for professional investors is wholly consistent with a programme of negative integration, which can be traced all the way through financial services legislation. The consequences of the Commission's actions could have a profound effect not just on the industry but on EU citizens. If certain hedge funds become eligible to form part of an UCITS fund diversified portfolio and benefit from the ability to be marketed across the EU, this is likely to accelerate a trend toward 'retailisation'. As the hedge fund market has developed it has become more 'institutionalised'. Hedge funds are now no longer just the reserve of HNWI but increasingly capture a larger share of institutional investment from banks and pension funds. In the last ten years the EU pension fund industry has increased its exposure to hedge funds and is now heavily invested in the sector (Gottlieb 2007: 2). Negative EU integration in the hedge fund sector could have the consequence that more and more ordinary investors will be exposed to hedge funds through their pensions and investments, but supervision will be subject to a patchwork of regulatory regimes, and it has been shown that the EU's ability to drive positive integration in this field is limited.

Conclusion

This article has sought to place the current debate on the regulation of hedge funds and the role of the EU in a historical, institutional and theoretical context. There is considerable popular feeling that hedge funds constitute a threat to financial stability and that they need to be regulated in some way. The current policy debate recalls Downs' issue attention cycle; there has been an alarmed discovery created by the role of hedge funds in a series of financial crises with sub-prime being the latest, and a 'euphoric enthusiasm' that regulation is the solution. Extensive theoretical work, particularly by Majone (1996 & 2006), demonstrates that the Commission will always seek to expand its competencies by acting as a policy entrepreneur. Ostensibly, hedge fund regulation presents an ideal 'policy window' to the Commission to act. Yet even in the face of worsening financial turbulence the Commission has defended its 'non-decision' in this area. Despite continued calls for action within the EP, no new initiatives to directly regulate hedge funds have emerged from the Commission. It would appear that hedge fund regulation is a 'policy cul-de-sac' as far as the Commission is concerned.

However, this paper demonstrates that in this policy area things are not as straightforward as they first appear. The relationship between hedge funds and financial crises is complex and less causal than is often portrayed; there is consensus that something needs to be done, but not always consensus on what. From an EU perspective, there are strict limits on its ability to act, not least as a result of the international nature of the regulatory environment and the conflict between key actors, but also because the regulatory regime has traditionally demanded a 'light-touch' approach. However, while there is little evidence of EU action in terms of regulation or so-called positive integration, a wider view, which places hedge fund regulation in the longer-term programme of financial services integration, reveals that the Commission is far from inactive in relation to the environment in which hedge

funds operate. The logic of negative integration that seeks to remove barriers to the development of an integrated EU market is in practice changing the landscape of the hedge fund industry. It is short-sighted to consider regulation to be simply supervision; it is both rule making and supervision. European financial regulation has become increasingly centralised with rulemaking and policy formulation the result of EU legislation.

This process has significant implications for the type of investors exposed to hedge-fund activities. Hedge funds are no longer the sole preserve of 'high net worth individuals' and 'sophisticated investors', rather 'ordinary investors' are increasingly exposed through their pensions and investments. In this way, the rationale for the 'light touch' regime comes into question. The ability of the Commission to drive positive integration in this field may be limited as, in Downs' (1972) terms, "the cost of significant progress" in terms of positive integration have been revealed. However, the Commission may yet find itself at the centre of a regulatory nexus in relation to hedge-funds – responding to a regulatory vacuum resulting from the process of negative integration or to a new 'policy window' in relation to the regulation of hedge-funds.

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