Commentary: U.S. Reacts to European Hedge Fund Regulation

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On March 1, 2010, U.S. Treasury Secretary Timothy Geithner wrote a letter to Michael Barnier, the European Commissioner for Internal Market and Services, who is roughly Mr. Geithner's counterpart in the European Union. There were the usual pleasantries, including an invitation to visit Mr. Geithner in Washington in the near future. Then, Mr. Geithner got to the point. The United States is not happy with the European Commission's proposal to regulate European private equity and hedge funds.

Before the continuing financial crisis, it would have seemed passing strange for a U.S. official to make a public comment about proposed legislation in another country dealing with the regulation of financial services. Legislation that adversely affected civil rights, perhaps. But, the regulation of hedge funds? I wonder how the U.S. Congress will react when German or French finance ministers write to complain about the proposals to reform financial services regulation in the United States.

The U.S. reaction to the European Commission's proposals raises questions for several other reasons.

Secretary Geithner's letter reminds Commissioner Barnier that regulation of the "alternative investment fund management industry" was discussed at the G-20 conference in Pittsburgh, where a roadmap was created for everyone to follow. In short, Geithner is telling Barnier that we had a deal and, in language that traders understand, is suggesting that the European Commission is "backing away."

The public pronouncements that emerged from the G-20 conference offered a lot less specificity than the roadmap Mr. Geithner is describing. Mr. Geithner's letter suggests that there is a more specific "roadmap." Many of us would like to see this roadmap.

The existence of some sort of understanding has been evident from some obvious coincidences. For example, the "Private Fund Investment Advisers Registration Act of 2009" (PFIARA), passed by Congress on December 11, 2009, would not require federal registration for any investment adviser that manages only private funds in an amount less than $150 million in assets. This portion of the act drew considerable criticism from State regulators, who perceived in this exemption yet another attempt to dump a federal burden on their resource-constrained shoulders. Coincidentally, the European Commission's proposal would also exempt from European-wide regulation any "Alternative Investment Fund Manager" (AIFM) managing assets of less than €100 million, which is roughly equivalent to $150 million. It seems clear that a deal was cut at the G-20, which is now reflected in the House bill.

The timing of Secretary Geithner's complaint is also interesting. The European Commission's proposal was released on April 29, 2010. It seems odd that Secretary Geithner has only now gotten around to complaining about it.

Two elements explain this timing. First, with health care in the bag, the Obama administration is now focused on financial services reform. Second, the administration is seeking to garner industry support for the reform legislation.

The European Commission's proposal would prevent any AIFM from managing a European fund, or marketing a fund to European investors, unless it is domiciled in the United States. In his letter, Mr. Geithner points out that U.S. investment adviser regulation does not prevent European investment advisers from competing for U.S. business. PFIARA also would not restrict European competition. The complaint made by Secretary Geithner is that the European Commission's proposal will restrict the ability of U.S. investment advisers to compete for European business. Geithner's letter to the European Commission therefore demonstrates that the Obama administration is committed to facilitating the competitive capacity of U.S. investment advisers, which will be popular within the industry, even as it seeks to impose greater regulation on them.

In its proposal, the European Commission goes to great lengths to explain the good reasons for this prohibition. The Commission acknowledges that investment managers did not cause the financial crisis. Nonetheless, the Commission believes that the industry's behavior caused things to be worse than they otherwise would have been. Primarily, the Commission seeks to address this by requiring AIFMs to provide a lot of information about their activity. The use of leverage would be regulated and capital requirements would be imposed. Special requirements would apply to private equity funds to improve the transparency of their interactions with issuers. Since the target of the regulation is the investment manager, it is essential, in the view of the European Commission, that the investment manager be domiciled in a European nation.

The European Commission rejects the notion that the target of the regulation should be the funds themselves. In its view, the funds are merely shells that behave as directed by the investment manager. Indirect regulation of the investment manager by regulation of its prime broker would also be inadequate. Large investment managers often have several prime brokers, and in any event, no prime broker has complete information about the activities of the investment manager.

Most important, the European Commission rejects the idea the investment managers can be regulated on a global basis through agreements with other sovereign powers. The Commission argues that significant legal and practical barriers restrict the ability to reach consensus on an international level in a timely fashion. Referring to the agreement reached at the G-20 summit, the Commission acknowledges that there was a convergence of views regarding the regulation of investment managers. "However, agreement on broad principles falls short of specifying detailed global standards."

That view seems consistent with the high-flown pronouncements that were floated after the summit. Nonetheless, it seems that Secretary Geithner has a different understanding about the level of consensus reached at the G-20. Is he telling tales out of school?

The SEC has long grappled with the problem of non-U.S. entities that wish to market their securities or financial services in the United States. The SEC has no authority outside the United States and cannot bring legal actions against non-U.S. firms that violate U.S. securities laws without the assistance of non-U.S. regulatory authorities and courts. So, non-U.S. investment advisers are permitted to register with the SEC, as are non-U.S. broker-dealers, under arrangements that make their books and records available in the United States and permit the SEC to bring legal actions against them in U.S. courts. These arrangements usually involve creating an affiliated U.S.-domiciled entity that is subject to the jurisdiction of U.S. courts.

So, notwithstanding the irritation of Secretary Geithner with the anti-competitive nature of the European Commission's proposal, it turns out that the regulation proposed in the United States to regulate investment advisers is really not all that far apart from the European solution, as a practical matter.

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