Hedge Fund Regulation – European Style

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A few weeks ago, we wrote about the proposals of the President's Working Group, or PWG, for the regulation of hedge funds. The PWG is the institution originally established under the Reagan Presidency to provide suggestions regarding financial regulation.

While past performance provides no indication of future results, the PWG predictably suggested that additional regulations were not necessary and might even be counter-productive. Instead, the PWG suggested that hedge funds should adopt certain best practices – voluntarily.

Three days after the PWG released its report, on April 18, 2008, the European Parliament produced its own report regarding the regulation of hedge funds and private equity funds. The European Parliament operates something like the U.S. House of Representatives. It is the lower branch of the European legislative process and the only one whose representatives are directly elected by the people. In general, the authority of the European Union is more limited than the U.S. federal government, but it is supreme in economic matters. One major motivation for establishing the European Union was to compete with the economic power of the United States.

The report avoids blaming hedge funds and private equity for the current monetary crisis. However, the report expresses concerns over the role of hedge funds and private equity in financial stability, inadequate risk management, excessive leverage and the valuation of illiquid and complex financial instruments. The report also points out that hedge funds engage in "herding," which apparently refers to everyone trying to move through the same exit at the same time. From a populist perspective, the report finds fault with the tendency for venture capitalists to lay off workers upon completing acquisitions.

In contrast to the PWG, the European Parliament recommends a significant increase in regulation. The proposal would impose risk-weighted capital requirements on hedge funds and private equity vehicles. There would be rules for valuing illiquid investments. Prime brokerage capital requirements would be increased. The amount of leverage any fund could incur would be limited.

To accomplish these goals, managers of hedge funds and private equity would be required to register and receive authorization before doing business or engaging in private placements. In connection with the private placement of fund interests, disclosures would be required, particularly with respect to the fund's investment strategy, leverage exposure, fees (broken down into their parts), sources and amounts of funds raised, past performance, risk management systems, information about the administrator and the shares of the fund owned by management and its staff.

Everyone knows that Europeans prefer more regulation than Americans. Why should we care?

For most of the time since the Second World War, the United States has been able to ignore for all practical purposes capital markets existing outside its borders. The United States has been far and away the most important source of capital. It just didn't matter what anyone was doing in Europe.

Regulation mirrored the realities of economic power. The SEC promulgated rules that, for the most part, were indifferent to the regimes of other nations.

This global balance of economic power is undergoing a seismic shift. For the last decade or so, U.S. financial institutions have increased their European and other overseas operations. Europe, and to a lesser extent Asia, have relatively more robust capital markets. In short, the economic goals of the European Union – to compete more effectively with the United States – are being attained. As a result, the regulatory balance of power is also shifting.

The first real evidence of this regulatory shift appeared when the SEC agreed to accept IFRS, the European accounting standard, for European issuers with registered securities sold in the United States, rather than insisting that financial reports using this other standard be reconciled with U.S. GAAP. Rumor has it that the SEC was told by representatives of the G-8 nations that if it refused to accept IFRS without reconciliation, U.S. issuers selling securities into Europe would be required to reconcile U.S. GAAP with IFRS. This threat only makes sense because many prominent U.S. issuers have a significant shareholder base in Europe.

What this means is that when European regulators sneeze, U.S. regulators are catching colds. A decision by European regulators to require hedge funds to register, to adhere to capital requirements, and to make disclosures to investors is likely to force the hand of U.S. regulators.

That is not all.

Buried in the European Parliament's proposal is the creation of a European regulator, or perhaps two regulators, to manage all of this new regulation. Europe does not currently have a unified European regulator for financial services. Instead, each European nation has its own securities regulator. There is something called the Committee of European Securities Regulators (CESR) that functions more or less as an advisory group for European securities legislation. A European regulator would be much more like the SEC, a much more robust and powerful regulator than anything that Europe can offer at present. The institution of a European SEC potentially would have a profound impact on the regulatory dynamic that currently exists between Europe and the United States.

All of this suggests that we are moving into a new era when, horror of horrors, the United States may be forced to adopt securities regulations for no other reason than to keep up with Europe. One test of this new dynamic will be hedge fund regulation. If Europe adopts registration, capital and disclosure requirements for hedge funds operating in one way or another in Europe, will the United States be forced to adopt parallel regulations?

Should we declare independence? Is it time to put on the war paint and toss the tea into Boston Harbor? Sadly, English tea is no longer shipped into Boston Harbor, and independence of European influence in this the 21st Century probably leads down the primrose path to poverty. Better to deal with the new realities, something every trader that has confronted the cascade of market structure changes in recent years knows only too well.

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