Hedge Fund Regulation Takes a Step Forward in Europe

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On December 18, 2008, the European Commission published a request for public consultation on the regulation of hedge funds. Readers of this column will recall that legislation in the European Union must be initiated by the European Commission, a body that functions as the executive branch of government. The request for public consultation is similar in many respects to the public notice and comment procedure that is required before administrative agencies, such as the SEC, can promulgate rules.

The request for public consultation responds to two reports published by the European parliament, called the Rasmussen and Lehne reports after the chairmen of the committees that prepared them. On the basis of the Rasmussen and Lehne reports, the European Parliament urged the Commission to propose legislation to curb the abuses identified in the reports resulting from hedge fund activity. The public consultation identifies four principal areas of concern and requests public comment on eleven questions. Comments are due on January 31, 2009, and the Commission plans to consider comments it receives in mid-February.

The European Commission did not respond to all of the concerns expressed by Rasmussen and Lehne. The European Parliament was particularly concerned about private equity funds buying operating companies and then liquidating them or shredding their operations, which swells the ranks of the unemployed. Of course, this sort of "creative destruction" also results in more competitive industries. Perhaps for this reason, the European Commission's consultation does not raise this issue as a problem for hedge funds.

In its public consultation, the European Commission points out that before the current financial crisis hedge funds were not thought to require much in the way of regulation. Their investors were wealthy individuals and sophisticated institutions. Regulations intended to protect investors through disclosure, and mandated risk management and asset valuation procedures were not viewed as necessary to shield sophisticated investors who should be capable of protecting themselves from fraud and unwise investments. Hedge funds didn't seem to pose any particular risk to the economy because losses from their failures would fall on well-heeled, sophisticated investors and to a limited extent on the failed hedge fund's immediate institutional counterparties. The seemingly benign nature of hedge funds precluded the need for capital requirements. Hedge funds were thought to contribute to market stability by deepening liquidity and promoting price discovery through short selling and other sophisticated trading techniques. As a result, specific hedge fund regulations intended to protect markets were not considered necessary.

The financial crisis has shaken all of these assumptions.

As demonstrated forcefully by the Madoff scandal, sophisticated investors can be defrauded, suggesting that they also need adequate disclosure and are unlikely to obtain it without regulation. Moreover, frauds that affect only the wealthy nonetheless destroy confidence in the market as a whole.

Many hedge funds were highly leveraged and have therefore been major players in the great deleveraging. In response to redemption requests, hedge funds have rushed to sell assets, leading to a collapse in market prices. The quarterly redemption policies of many hedge funds, rather than delaying market pressures, has led to bulges in sales, as funds all rushed to the exits at the same time. In turn, many hedge funds found it difficult to repay loans, which put lenders in jeopardy and exposed flaws in the economic system.

Finally, hedge funds have been blamed for causing market instability. Their large positions facilitated market manipulation. And, short sales can also be used as a technique to drive prices down, a form of manipulation known as the "bear raid."

These recent experiences all indicate a need for regulation. But, the Commission asks, "Can a purely European response be effective?" To ask this question is to answer it. Probably not.

For students of financial history, this all has a familiar ring to it. The investment trusts of the 1920s, which caused so much trouble for the markets in 1929, were, like hedge funds, investments of the rich and famous. In fact, ordinary retail investment in the stock market by anyone other than the wealthy was relatively uncommon. In its early stages, the financial crisis that began in 1929 was largely regarded as a problem for wealthy people. It wasn't until later, when unemployment rates went off the charts, that the public realized that when the wealthy eat unripe grapes, the teeth of ordinary workers are set on edge.

The new administration taking power this week in Washington is bound and determined to institute new and more powerful regulation of the financial services industry and particularly of hedge funds. The use of taxpayer funds to prevent the complete collapse of financial services, without more, has generated so much public outrage that new regulation is a political necessity. I believe that we are shortly to witness unemployment rates not seen since the depths of the Great Depression. The public pressure for massive reform in the wake of this calamity will be irresistible. It only remains to be seen whether or not hedge funds will go the way of the 1920s investment trusts into oblivion.

In one respect, however, the current financial crisis is much different than the one faced by the highly idealistic administration of Franklin Delano Roosevelt. The financial markets of the 1930s were much more of a local affair than the highly interconnected markets we face today. The Congress that convened in 1934, working with the Roosevelt administration, was not required to consider the extent to which its regulatory initiatives would be frustrated by the actions of European regulators, let alone the Chinese and Indians.

Today's globalized financial markets require us to hold hands with our European and Asian counterparts and construct a unified regulatory system. Otherwise, hedge funds and their advisors will simply relocate their operations, in whole or part, into the most congenial jurisdiction. The inconvenient question is: "Can a purely American response be effective?" Probably not.

For this reason, the proposals to regulate hedge funds that flow from the European Commission's public consultation bear watching. They are likely to be very similar to the reforms generated by the Obama administration.

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