**Europe Proposes to Regulate Hedge Funds and Private Equity Firms**

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The financial press has reported increasing demands in Europe for the regulation of hedge funds due to their purported role in the ongoing and worsening financial markets crisis. Giulio Tremonti, Italy's finance minister, gets our award for the most inflammatory proposal by a leading public official. Bloomberg reports that Mr. Tremonti has called hedge funds "dark and opaque" and "demented," and charged them with not conforming to the "laws of capitalism." He has stated that serious consideration should be given to banning hedge and private equity funds altogether. The most recent proposals for legislation submitted by the European Parliament were relatively tame by comparison.

The European Parliament is the only legislative body with popularly elected members in the European Union. However, as is typical for parliamentary systems, the executive branch – the European Commission – must initiate legislation. On September 23, 2008, Parliament made a formal request to the Commission to initiate legislation dealing with hedge and private equity funds.

As it happens, this is the fifth proposal for regulation of hedge and private equity funds submitted to the European Commission by Parliament. It was based on recommendations by the Committee on Economic and Monetary Affairs, led by Poul Nyrup Rasmussen. The Committees on Legal Affairs and Employment and Social Affairs made comments on Rasmussen's recommendations. The prior four proposals, which called for more stringent regulation, were largely ignored by the Commission, which may explain the rather temperate approach of the current proposal.

Parliament's latest attempt to get the Commission's attention is composed of five sets of detailed recommendations. The first recommendation would impose risk-based capital requirements on all investment firms (including hedge and private equity funds), require organizers of asset-based securities to retain some risk on their balance sheets, impose greater oversight of credit rating agencies, adopt measures to value illiquid securities, require greater disclosure by prime brokers and facilitate cross-border investment by venture capital funds. The second requests legislation to establish a private placement regime, to provide employees the right to object to a takeover of their employer by a private equity fund, and to require pension funds to disclose their investments in hedge and private equity funds. The third requests legislation that would limit leverage by private equity funds through capital requirements and prevent "asset stripping," which refers to the practice of so-called "vulture funds" of acquiring companies so that they can be sold in pieces and liquidated. The fourth recommendation would regulate conflicts of interest by requiring greater disclosure by credit rating agencies and determining whether some existing regulations should be abolished because they have led to unlawful market concentrations in the financial services industry. Finally, Parliament recommends that the Commission examine all existing European legislation to determine whether gaps in existing rules need to be filled to better regulate the financial services industry, including hedge and private equity funds.

Parliament has asked for a response from the Commission by the end of 2008. Given the magnitude of the request, this is a tall order. Nonetheless, the Commission has already acted on one of the recommendations – to impose greater oversight on credit rating agencies. My guess is that the rest of Parliament's proposal, like its four predecessors, will end up in the Commission's dust bin.

The European Union was formed because of widespread concern on the Continent that the economic power of the United States was rendering the economic policies of individual European nations irrelevant. The economic dominance of the United States therefore accomplished what Napoleon, Bismark and other famous European autocrats and visionaries could not. It caused the quarreling European states to yield part of their independent national sovereignties and unite together under one common economic platform. While over the years the European Union has gained more power over the internal affairs of its member states, its primary reason for existence continues to be economic. As might be expected, in things economic, the European Union almost always considers what the United States has done or will do before taking any action.

Rasmussen's proposal, and the European Parliament's recommendations, speak optimistically about the need for a "global regulator." I very much doubt that Asia would need to be included for the time being, but these recommendations implicitly acknowledge that it is pointless for the European Union to impose hedge fund regulation, unless the United States is willing to agree to similar rules.

This is particularly the case with proposals to impose capital requirements on hedge funds. Capital requirements are intended to reduce the amount of leverage that any one firm can create. So, calls to limit leverage are just another way of saying that there should be capital requirements. If Europe imposes capital requirements and the United States does not, hedge funds will do everything possible to locate their business within the United States.

Sadly, the same is true of the United States. The global reach of the financial services industry and the technological ability to move capital across borders in a heartbeat mean that the United States cannot promulgate effective hedge and private equity fund regulation unless the Europeans are willing to hold hands with us. The SEC was forced to accept portfolio margining, despite serious misgivings, in an effort to limit hedge fund capital flight to Europe because the Europeans had less-stringent margining rules. The Europeans also had less stringent customer protection rules, which is why many hedge funds went under when they were unable to get their prime brokerage deposits out of the Lehman bankruptcy. What goes around, comes around.

This global reality is also true of banking and insurance regulation, which is why all of the various regulators seem to be reading from each other's playbook.

Recently, I have heard proposals from so-called "economic patriots," who resent the fact that the United States is subject to the regulatory policies of other nations. In a reheated version of the Monroe doctrine, economic patriots would restrict capital flows so that the economy of the United States is less linked to the global economy. These restrictions could take the form of outright restraints on capital flows. Alternatively, the United States could impose high tariffs on imported goods, thereby imposing derivative capital restrictions.

We tried this once before. In a desire to protect American industry and farmers, and insulate ourselves from Europe's troubles, Congress enacted the infamous Smoot-Hawley Tariff Act in 1930, raising tariffs to record levels. European nations responded with their own tariffs. The free flow of capital was restricted. A severe downturn was thereby transformed into complete economic collapse. Economic patriotism is just another word for isolationism and can only impoverish the nations that adopt it.

So, the only sensible thing for American regulators to do is negotiate with their European counterparts to establish globally consistent standards for hedge and private equity fund regulation. It would be even better if the Chinese would sign up. A few quibbles aside, there is much in the European Parliament's recommendations that we can accept, at least as a basis for discussion. Clearly, Europe and the United States share a common need to understand what is going on in financial institutions, and come up with a mutually acceptable, consistent method of limiting leverage.

The alternatives to cross-Atlantic regulatory cooperation are depressing. At a minimum, the failure to adopt sensible, enlightened regulation in an increasingly global economy will result in periodic financial crisis, taxpayer bail-outs, and recessions, each worse than the last.