Regulating investment funds: the power of filthy lucre

The story of the EU's attempts to tackle investment funds

November 2010

In November 2010 the European Parliament is expected to formally approve the new Alternative Investment Fund Managers Directive on hedge funds and private equity funds. This short history of the lobbying war waged by the investment fund lobby shows how hedge funds and private equity funds and their lobby groups managed to fight and win what has been the first really open political battle on financial regulation in the history of the European Union.

Summary

- A long standing battle on regulation of "alternative investment funds", hedge funds and private equity funds, draws to a close this month (November 2010) with MEPs voting on the Alternative Investment Fund Managers Directive. While early in the process ambitious proposals were tabled, the legislation to be adopted is weak and full of holes.
- This is in no small part due to the concerted efforts of the funds themselves and their lobby organisations EVCA and AIMA.
- Thanks to its close relationship with the Single Market Commissioner, the financial industry has been able to hold back legislation for years.
- When a proposal was finally tabled, the financial lobby managed to influence both the European Parliament and the Council of Ministers so effectively that the lobbyists are now drawing a sigh of relief.
- Close cooperation with the British government and their ability to stir up protectionist fears in the US were instrumental to their victory.
- Given that this was the first really open battle on financial regulation - fought out in public and through intense political discussions in Parliament and the Council - the final result bodes ill for future efforts to rein in the power of financial corporations in general, and the financial lobby in particular.

Is the new EU directive on hedge funds and private equity funds, the Alternative Investment Managers Directive, due to be adopted in November 2010, a step forward towards real insight into an otherwise opaque part of the financial markets? Does it open a new era of effective regulation of investment funds, or is it more like a "Swiss cheese", with holes so big that even funds with major fortunes can escape regulation?

When the European Parliament votes on the text on future regulation of hedge funds and private equity funds - the result of a compromise with the Council of Ministers - on the 11th November 2010 it will mark the end of a long and fierce battle. The legislation to-be adopted is a watered down version of a proposal from the Commission, which in turn was a pale shadow of what was previously advocated by a majority in the European Parliament.

A history of financial lobbying

The compromise deal was reached in talks between the EU institutions. When the outcome looked certain in mid-October, the investment fund lobby groups, the Alternative Investment Management Association (AIMA, hedge funds) and the European Venture Capital Association (EVCA, private equity funds) were relieved, while those in Parliament and in the Council who had been advocating tougher regulation either kept a low profile, or muttered restrained disappointment.

The process is interesting for several reasons. For one, the skirmish over the regulation of investment funds provided the first truly open battle between politicians and the financial lobby. And since major political parties and governments put their weight behind relatively ambitious proposals, the case is a good illustration of the power of the financial sector in general and the financial lobby in particular. The change in course that the financial lobby managed to promote is quite remarkable. To fully grasp the extent of the influence of the investment fund lobby, a short walk through the stages of the political process is necessary.

Which funds?

The funds affected by the directive – hedge funds and private equity funds - are two different types of investment funds. Neither is open to investments from the general public. Instead their money comes from "institutional investors", including banks, insurance companies, pension funds, and very rich individuals. Though most people have no clue what they are and what they do, they are important players in the global financial system. Until recently these funds jointly managed approximately 2 trillion euro – that's slightly less than the GDP of Germany, slightly more than the GDP of France[i].

Hedge funds and private equity funds are both practically unregulated. Rules that apply to investment funds open to the public, such as shareholder associations and mutual funds, on for instance transparency, and rules on capitalisation that apply to banks, don't apply to these funds. They also both borrow large amounts of money to make their investments. Their growth, consequently, is associated with the availability of credit at a low interest rate.

Hedge funds mostly invest in financial instruments that pay off in a very short time, including derivatives. Basically, they invest – or speculate - in everything possible. Private equity funds, on the other hand, mostly invest in assets and companies not listed on the stock exchange. They buy companies or buy into them with other investors. To illustrate their size: in 2006 they collected more than 400 billion US dollars for investments. Names like Burger King, Dunkin' Donuts, Hertz and Toys R Us are part of private equity portfolios. A big private equity fund like Blackstone has completed transactions worth 200 billion dollars and its businesses employ more than 300.000 employees.[ii] Some funds may invest in both financial instruments and in companies.

The problem with hedge funds and private equity funds

There are many problems associated with hedge funds and private equity funds, for example:

Financial instability

Funds have drawn heavy criticism for their methods and what many consider to be their irresponsible behaviour. They have run up a series of bills which they have then left for tax payers and workers to pay. On top of this, the amount of money they move around in an almost unregulated environment has helped to create financial instability. And indeed, over the years, the funds have sent shock waves through the global financial system on more than one occasion. As for example during the South East Asian financial crisis in 1997 when hedge funds played a major role - in a crisis that not only made millions of people in the region unemployed, but which also had serious global repercussions. Or when the giant US hedge fund Long Term Capital Management collapsed in 1998, prompting the Federal Reserve Bank of New York to step in and organise a bail-out operation to the sound of 3,635 billion US dollars.

Similarly, during the darkest months of the present financial and economic crisis, investment funds played a part. As when two hedge funds, offspring of Wall Street investment bank Bear Stearns, got into trouble over massive investments in the infamous subprime loans that triggered the financial crisis in 2008, leading to a fraud case and a 30 billion dollar bailout operation by the New York Federal Reserve.

The "regulated" financial sector played the main part in the recent financial crisis, but there is ample evidence that "unregulated" investment funds did their bit, and that they too represent a source of financial instability.

Attacks on economic policies

Funds have also been responsible for a number of large speculative attacks on the economies of whole countries, exploiting weaknesses to their maximum, and causing problems that have forced governments to apply severe austerity programs or other drastic measures. As for example when the speculator George Soros used his Quantum Investment Fund to speculate against the British pound and the Swedish kroner in 1992[iii] . Or when - more recently - speculation against the Greek economy sent shock waves through the European Union in early 2010[iv].

Tax evasion

Many funds are based in tax havens, or use other methods to avoid taxation. This allows them to keep a large share of the profits and avoid giving their fair share to society. On top of this, private equity funds routinely loan large sums of money to buy companies (leveraged buy-outs), and they then let the company in question bear the debt. This allows the company to deduct the repayments from their tax accounts, boosting the profits that go to the private equity fund owners.

Asset stripping and leveraged buy-outs

A well-known and widely applied method to earn money from a newly-bought company is to sell off any assets of any value and let the rest go under. This "asset stripping" is one of many consequences of the "short termism" of private equity funds. A method that has made Franz Müntefering, then Chairman of SPD in Germany, compare the funds to "locusts"[v]. The method has been superficially but effectively described in the Hollywood movie, Wall Street, where financial tycoon Gordon Gekko buys airline Blue Star, officially to save the company. Shortly after the purchase, he sells off the valuable assets for a quick profit, and lets the rest sink.

The "leveraged buy-outs" where a company is bought using borrowed money, can also be a burden on the future prospects of a company. After acquisition using borrowed money, the private equity fund often transfers the debt to the company itself, leaving managers with the job to secure servicing a big debt as well as profits to the fund in question. Such a scenario can be highly detrimental to long term interests of the company, for instance, it can shrink the means available to invest.

A short history

There has been vigorous debate on hedge funds and private equity funds for years. Yet they have remained largely unregulated at the EU level. There has been no set of rules on transparency, capital requirements, investment strategies, leverage etc. The decision on an EU-wide directive, then, was long overdue.

Was it worth the wait? Those seeking effective remedies to the problems associated with the two types of funds (see box) will have to be more patient, it seems. The scale, scope and depth of the new regulation are considerably less ambitious than what was originally outlined. The important question in this article is why this is the case. When putting the spotlight on the role of the financial lobby, it becomes clear they played a significant role, perhaps the key role, in watering down these ambitions, as a quick run through the history of fund regulation reveals.

Strategical plans dominated by industry (1999-2003)

Ten years ago, EU regulation on financial markets was in its infancy. Until the Financial Services Action Plan in 1999, financial regulation was first and foremost a prerogative of Member States. That year saw a major public debate on financial markets, in the aftermath of the 1997 financial crisis in South East Asia. But although hedge funds were seen as partially responsible for the crisis, and although hedge funds had been a matter of heated debate in the US (following the collapse in 1996 of a major hedge fund) the action plan did not address the question of financial stability or any other risk linked to investment funds. The issue was first and foremost to promote the creation of a true EU market for financial services. Although it included 42 separate measures, no regulation of investment funds was considered[vi]. This can in part be explained by the fact that the proposals were all forged in close cooperation with the financial industry that had no economic interest in stronger regulation of investment funds[vii]. Rather the opposite.

The Commissions bias: industry experts help stop initiatives (2003-2007)

Though not included in the first wave of EU financial regulation, the issue was soon to emerge on the agenda, thanks to demands for regulation from some political quarters in the European Parliament. In 2003, Parliament adopted the Purvis report, which warned against “risk of systemic damage to the global financial system if (investment funds) proliferate without quantification or control.” In the report, the Commission was called on to elaborate a number of proposals, but very little happened. In fact, the report seems to have been ignored completely by the Commission. Two years later, in 2006, the issue resurfaced, thanks to another resolution from the Parliament. This made the Commission act. Or so it seemed.

The Commission set up two expert groups at the start of 2006 to provide it with advice. Both groups were made up exclusively of people from the financial industry. Given their composition, it may not come as a surprise that they did not encourage the Commission to introduce new legislation to avoid the risks associated with investment funds. One group reported that existing regulation “served the industry, its investors and the wider market well.”[viii]

The Single Market Commissioner Charlie McCreevy was happy with this conclusion, and decided not to take the matter any further. The privileged access the financial lobby enjoys via the Commission’s expert groups had in this case been used to its maximum, stopping a proposal at the start.

Diluting the Rasmussen report (2008)

This was not the only time the Commission refrained from action, despite requests from the European Parliament. In fact, this pattern was repeated a handful times. This inertia annoyed those in the European Parliament determined to see better regulation of investment funds, not least the PES group of social-democrats.

But the investment fund lobby, aware of the growing importance of the Parliament vis-á-vis the Commission, started to work more with the Parliament. Close relations with a Commissioner and civil servants were no longer enough. Sooner or later there would be a directive, and that would mean good relationships would be needed with the two institutions that would have to agree to adopt it - the Council and the European Parliament.

EVCA was confident it could develop such a relationship. In its 2009 annual report, EVCA wrote: "EVCA's appearances at the European Parliament, workshops sponsored by the European Union and elsewhere are not by chance. They are the results of years of work and bridge-building. Effectively acting on behalf of members, means knowing the true significance of a research paper, committee hearing or set of questions from a member of the European Parliament."

EVCA had serious concerns with the PES group however, and had taken "the unprecedented step" of writing an open letter to all MEPs from that group to counter what EVCA called "misconceptions" about the industry.[ix]

And for good reason. In spring 2008 Poul Nyrup Rasmussen, then chairman of the PES group, managed to get the backing for an “own-initiative” report[x] on the matter, stressing that Commissioner McCreevy had ignored requests for a proposal in 2004, 2006, and twice in 2007. In April 2008 he launched a draft proposal (report)[xi] which included a host of measures to curb the operations of investment funds, addressing major issues, including:

- Transparency, not only for regulators but for the public as well
- Measures to stop tax evasion
- Rules on the capitalisation of funds, limitations on leverage
- Registration of funds through disclosure of a comprehensive list of information on the funds, including information on “past performance”. Such requirements were to be a condition for authorisation.
- Rules on conflict of interest for managers of companies taken over by private equity funds

The Rasmussen proposal was seen by the financial industry as very radical. It covered most controversies around the funds On one occasion, Rasmussen even suggested that investment funds might not be good assets for society. Referring to a report by Lord Turner, the chairman of the UK Financial Services Authority, Rasmussen said: "Turner says some wise things. Is it so that all the trillions of derivatives, hedge funds, asset management, short-selling, is it true that these have all been useful for society? There has been a socially-useless increase in derivatives."[xii] Nevertheless, these were not proposals that would block further development of the investment fund industry. Some parts would support their expansion, though in a different regulatory framework. Hardly radical.

A vigorous debate on the issue followed. The European Trade Union Confederation (ETUC) expressed “deep concern at intense lobbying activities” aimed at watering down the draft[xiii]. And according to the PES, during the summer, the Conservative and Liberal groups in Parliament did their best to stop the proposal altogether.

The European Parliament’s formal discussion and adoption of a proposal took place in September 2008, the very month when the bankruptcy of US investment bank Lehman Brothers was announced, pushing the financial crisis to its climax. These events seem to have changed the mood and the agenda in the right wing parties. They seemed to have accepted that some sort of regulation was necessary. But they would take a price for it. When a compromise was made between the PES, the liberal group (ALDE) and the Christian Democrats/Conservatives (EPP), a large number of ideas were deleted from the proposal:

- Transparency was only for regulators.
- Measures to stop tax evasion had been taken out
- Rules on limitations of leverage, enforced by tax measure, were taken out
- Some parts of the transparency requirements were taken out, including "past performance".
- Rules on conflict-of-interest of managers were deleted.
- On asset-stripping, the text only encouraged the Commission to frame a proposal that would "avoid unreasonable asset stripping".[xiv]

Parts of the fund industry breathed a sigh of relief. The text still included regulation of all funds, but while still expressing "concerns" over for instance the demand to disclose investment strategies, representatives from industry told the Euractiv news portal that the "parts of the text which were too unfavourable to industry have been removed." The EVCA even claimed to have been the victor of the debate: "in the course of Parliamentary ratification, during summer 2008, the reports radically changed their view of private equity, becoming moderate in tone and reducing their demands on our industry. In all, more than 100 revisions were achieved. This major reappraisal represents a significant success for EVCA's public affairs efforts."[xv]

Justin Perrettson of EVCA said in a statement: "The detailed text…is far better for private equity than the industry had initially expected. It incorporates over 200 amendments and a new compromise text, on all of which we have provided advice."[xvi]

McCreevy throws spanner in the works (2008)

Even so, the EVCA immediately started lobbying to influence the next link in the decision process: Single Market Commissioner Charlie McCreevy.

The Commissioner's first reaction to the European Parliament's decision had been to use the privilege of the Commission and ignore Parliament's advice. At the very session where the decision was to be made, he stated as on many previous occasions that he did not: "believe it is necessary at this stage to tar hedge funds and private equity with the same brush" as used for the regulated sector[xvii].

But EVCA was not taking any chances. Having expressed relief about the Parliament's proposal, it immediately started lobbying Commissioner McCreevy against most of the measures in the text[xviii]. McCreevy for his part stated his willingness to cooperate closely with industry on the matter. Known to be a close friend of the private financial sector, the EVCA and the hedge fund industry had good reason to expect close cooperation with McCreevy. In his response to the EVCA, McCreevy emphasised the importance of industry-driven codes of conduct. To help the EVCA make its case on this point, McCreevy wrote: "My services are entirely at your disposal."[xix]

The first big favour to the financial lobby was to slow down the pace considerably. McCreevy did not make a proposal at first but opted instead for a fresh consultation on the regulation of hedge funds. This was announced on the 1st December, a decision that drew heavy fire from the PES and Rasmussen who accused McCreevy of "acting like a paid lobbyist."[xx]

This gave the fund lobby a chance to forward yet another argument to avoid fresh regulation, making a solemn promise to take care of matters without intervention from authorities. In early 2009 both AIMA and EVCA each started advocating "self-regulation", announcing new codes of conduct in a rather obvious attempt to make the Commissioner refrain from tabling a draft directive[xxi]. In response to EVCA's proposal, Rasmussen commented: "It's too late now that everyone – with the possible exception of Charlie McCreevy – agrees that self-regulation has failed and that binding legislation is needed. I am astonished that the ECVA think they can get away with self-regulation. They haven't got the message have they? Maybe they have been badly advised by Mr McCreevy."[xxii]

AIFMD and Trojan horses (2009)

But even if Commissioner McCreevy did not wish to propose regulation, his room for manoeuvre had narrowed considerably by the beginning of 2009. The financial crisis had set a new agenda, and politicians at every level voiced concerns over lax regulation. In November 2008, the European Council decided that "no financial institution, no market segment and no jurisdiction must escape proportionate and adequate regulation or at least oversight."[xxiii] And at the beginning of 2009, the French and German governments spoke out for regulation of investment funds ahead of a G20 Summit on the 1st April. In a statement Angela Merkel and Nicolas Sarkozy underlined "that all hedge funds and private pools of capital that could constitute a systemic risk, should be subject to appropriate regulation and supervision."[xxiv]

In April 2009 the Commission published its proposal on regulation, called the Alternative Investment Fund Managers Directive (AIFMD)[xxv]. While this was a first attempt to rein in hedge funds and private equity funds, it was received with deep disappointment and even anger in the PES group of social-democrat MEPs. They noted 10 major setbacks compared to the Parliament's position, including the fact that the proposal did not stipulate regulation of the funds as such, but only of their managers; that registration was to be a formality without real requirements; and that a high threshold would let many fund managers escape regulation[xxvi]. The latter would even allow major funds to exploit a loophole, by working around regulation by splitting investments up in separate funds. All in all, Rasmussen considered the proposal to be as full of holes as "a Swiss cheese"[xxvii].

PES tried to put their foot down and listed what it called "minimum requirements" for a new directive:
1) An all encompassing approach has to be ensured: no exemption of alternative investment funds should be allowed.
2) Non-EU funds must also be covered.
3) As 'Extreme Leverage' is one of the major causes of this financial crisis, there must be clear limits imposed on this option.
4) Full and real transparency should be central to this directive.
5) Clear penalties for improper conduct should be outlined[xxviii].

By this time, others had criticised the Commission's proposal, including the French government. And the concern of the French government was very fundamental. In its view the proposal could undermine French regulation by introducing an "EU passport", including for off-shore funds. That would allow funds approved in one member state to operate in the entire EU.

This, in French Finance Minister Christine Lagarde's view, could amount to the EU becoming "a Trojan horse for off shore funds". Lax conditions at the EU level would allow funds to operate in countries like France that would otherwise have imposed tougher conditions than the weak measures in the directive. It could even allow, or so Lagarde seemed to say, funds to operate that would otherwise have been barred. Commissioner McCreevy denied this, saying the standards set out in the proposal were in his mind "the reverse of a Trojan horse".[xxix]

This debate continued throughout the whole period.

Scaremongering (Summer 2009)

The AIFMD had other fierce critics – from the other side. Although the draft directive was weaker than the European Parliament's resolution from September 2008, the financial industry reacted with amazement and apparent shock. The private equity lobby EVCA came out with a fundamental critique and far reaching proposals for amendments.[xxx] But the fiercest reaction came from the London-based hedge fund industry – which encompasses 85 per cent of the hedge funds in the EU. The stated goal of the biggest lobby organisation in the field, AIMA, was straightforward: "A total rewrite of the draft directive... We don't think it can be readily salvaged", AIMA Chairman Andrew Baker said[xxxi].

The first step in the funds' offensive was classic: scaremongering. In the months following publication of the proposal, hedge funds were regularly quoted in the media saying that if a directive along the proposed lines was adopted, they would flee the area and seek refuge in less regulated places, such as Switzerland or New York. "If this directive goes through as drafted, large chunks of the industry will be leaving Europe," Ian Wace of hedge fund Marshall Wace said in a statement typical of the moment.[xxxii]

In another attempt to influence the debate, hedge fund managers predicted a sharp response from the US in retaliation against what managers saw as "protectionist moves": "I think that could be one of the untintended consequences, and I think it's a real shame because I think that quicker intervention by the UK government could have stopped this," Stanley Fink, known as "the Godfather" of the hedge fund industry in the UK said.[xxxiii]

Among other players that imagined a scary picture, was a research institution; Open Europe. According to a report[xxxiv] that members of its staff referred to in comments in the media, member states would lose considerable tax income if the Directive were to be adopted as proposed by the Commission. Director of Open Europe Matts Persson, and author of the report, warned that "thousands of jobs and millions in tax revenues could be at stake."[xxxv]

But those kind of "findings" should be handled with caution. Not only did the author not make any attempt to estimate job losses thanks to the modus operandi of private equity funds, nor did he try to estimate losses of tax revenue due to the proliferation of off-shore investment funds. But it should be noted that several members of Open Europe's board in fact represent investment funds that are members of either EVCA and AIMA[xxxvi].

Mobilising governments (Winter 2009-2010)

Mobilising the UK government was the other step taken by financial lobbyists. The then Prime Minister Gordon Brown had actually made cautious promises to move towards regulating investments funds for some time. Even a week before the launch of the draft directive, Brown's comments on investment funds were unusual for a British Prime Minister.[xxxvii] This was to change rapidly. After the publication of AIFMD in April 2009, meetings were held between the leading figures of the London-based hedge funds and the UK government, and they soon paid off. In June, the UK Government City Minister Lord Myners promised to "fight tooth and nail" to revise the directive[xxxviii].

The hedge funds also managed to mobilise the Mayor of London, Boris Johnson on their behalf. In fact the financial sector, including hedge funds and private equity funds had provided half of the funds he had received for his election campaign [xxxix]. So he took a lobbying trip to Brussels to warn against the AIFMD in strong terms.

The main asset, though, was definitely the UK government. From mid-2009, there was close contact between the hedge fund lobbyists and City Minister Lord Myners. The latter was, for instance, briefed by Nickolas Reinhard from the lobbying consultancy hired by the EVCA, Fleishman-Hillard[xl] - "regarded as one of the best European financial services sector lobbyists"[xli] - before joining meetings in Brussels on the AIFMD[xlii].

And Lord Myners did much more than listen. For a while the key lobbying figure for the hedge funds, Andrew Baker of AIMA, tried to stir up opposition at government level to influence the response of the Council of Ministers. And Lord Myners did not hesitate. At a meeting, Lord Myners promised hedge fund managers that the UK was sending officials to lobby “in more than a dozen key EU capitals”[xliii].

And to raise the stakes, Baker also tried to make the issue an international problem. “Global industry centres such as the United States, Canada, Switzerland, Hong Kong, Singapore, Japan, Australia and South Africa, will all be affected by this. This is not just an internal EU matter,” he stated in July. On this matter too, Lord Myners was keen to serve. Officials from the UK Treasury and the City of London were sent to the US in order to raise the issue with the US government[xliv].

Apparently this effort paid off. Months later, in March 2010, the centre of the debate on fund regulation was a remarkably sharp protest over the planned directive from US Treasury Secretary Timothy Geithner. Judging by the wording, the potential conflict with the US that the hedge fund lobby had hoped to drag on to the EU agenda, had made its entry in force. In the letter, Geithner stressed that “we are concerned with various proposals that would discriminate against US firms and deny them the access to the EU market that they currently have. We strongly hope that the rules that you put in place will ensure that non-EU fund managers.. have the same access as their EU counterparts.”[xlv]

This clearly strengthened the UK government’s hand in the negotiations at the EU Council of Ministers on the common position of member states governments.

Astroturfing (Spring 2010)

Meanwhile, the lobby organisation for private equity funds started warming up for the debate in the European Parliament on the AIFMD. Shortly before the big day, MEPs received a letter signed by hundreds of small and medium sized enterprises (SMEs) begging them to work for a weak position from the parliament, at best a complete carve-out for private equity, or at least to scale-down obligations to disclose information on the funds. In the letter they claimed that some proposals would hurt innovative companies which would find it harder to come by the kind of venture capital that the funds allegedly provide. A cry from small companies to appease and guide MEPs on the future of innovative companies, or so it seemed. This kind of statement might leave the impression that private equity funds are a major source of “venture capital”, but reports claim that venture capital only covers five per cent of capital from the funds.

What is more, it was soon revealed that the letter’s origins showed there was a very strong link indeed between the companies in question and the investment funds affiliated to EVCA. An investigation of a sample indicated that the vast majority of SMEs were actually owned wholly or partially by the very funds they were speaking out in favour of. And there was evidence that leading figures in the EVCA secretariat wrote the letter, though EVCA itself did not appear anywhere in the text. Indeed there is evidence that EVCA orchestrated and steered the initiative, not the SMEs[xlvi].

“Managers of the companies wanted to bring the message to the politicians, and the EVCA was the natural body to facilitate”, EVCA secretary general Javier Echarri told a Danish daily newspaper[xlvii].

The Danish daily went out of its way to get the Danish companies on the signatory list to comment, but managed to get statements from only three of them, two of which did not know how the names of their companies had ended up on the list.

Bombardment (Summer 2010)

The big battle in the European Parliament commenced in late 2009 and culminated in May 2010. In the run-up to the debate in May, representatives from the lobby organisations and individual funds were apparently regular guests in the offices of MEPs. One piece of evidence is a report from some of the most staunch opponents of the AIFMD, the British Conservative Party and their group in the European Parliament, the European Conservatives and Reformists Group. In the first six months of 2010, no less than 46 separate meetings on the AIFMD took place between members of this group of MEPs and lobbyists[xlviii].

This whole effort undoubtedly had the single purpose of influencing the votes on the Parliament position on the AIFMD, the climax being the vote in the plenary on a report done by French Conservative Jean-Paul Gauzés. One way to influence this process was by having MEPs present amendments for the votes. And in this particular case there were quite a few. When the European Parliament's Committee on Economic and Monetary Affairs made the most important decisions on the 17th May 2010, they had to deal with no less than 1,600 proposals for amendments[xlix]. Half of these had come from the finance lobby organisations[l].

After the vote, the Parliament was left with a document that bore little resemblance to earlier proposals. On three points, though, the Parliament tried to strengthen the text, including by proposing a deletion of thresholds (allowing smaller funds to escape regulation) and replacing it with a "proportionality principle". That would ensure a wide coverage."[li].

But on major issues the Parliament Committee did not try to strengthen the regulation. On the question of the scope of the AIFMD, the Committee did not try to include the funds (as opposed to just the fund managers), nor did it counter the weakening of measures against tax evasion. Though far below the standard envisaged earlier by the European Parliament, the Committee did not act accordingly. Last but not least, the Committee did not seriously question the easy access to the whole EU market that foreign funds would have, once authorised in one member state.

Months of political pressure and heated opposition in some countries to the AIFMD had apparently taken its toll on the European Parliament. Though the AIFMD was a much less ambitious proposal than what had originally been put forward in September 2008, there was little sign of a recourse to the positions taken when the financial crisis was at its climax.

End game (Autumn 2010)

At the Council of Ministers level, the balance of power was changing swiftly too. In May 2010, the Council of Ministers of Finance and Economy (ECOFIN), met on the same day as the vote in the European Parliament, sidelined the UK minister of finance, George Osborne. Key to the conflict were the rights of foreign funds and the EU passport, and the French position on these matters had set the agenda. But Osborne had no intention of leaving it at that, and saw some light at the end of the tunnel: "I think the combination of the European Parliament vote and the recording in the minutes of the Council of our concerns, particularly around third-country provisions, means there is still much to play for," Osborne said. Importantly, he felt he had support from Single Market Commissioner Michel Barnier[lii]. But while the UK position was initially sidelined, the Council moved to a proposal that met its concerns.

For Osborne had indeed reason to sense a new agenda around the corner. The Council negotiated intensely for the next few months, and little by little the tables turned. The Belgian Presidency of the European Union started advocating the EU passport as a way of finding middle ground, ie. accommodating the UK on a controversial part of the proposal. This played well together with the European Parliament and apparently won over many member states. The change of the debate was all too obvious from the reaction of the French government. In September Lagarde informed the Presidency that the draft would go too far in restricting national authorities leeway in imposing rules on foreign fund managers[liii]. A quite ironic statement, since the whole effort supposedly had been about adopting effective regulation of the funds. Now, it seemed, the directive could even lower standards by weakening national rules. Even so, on 19th October 2010 the Council finally sealed an agreement based on the Presidency's draft[liv]. The way was paved for final approval, pending agreement with the political groups in the European Parliament.

The result: worse than nothing?

In broad terms, the new Alternative Investment Fund Managers Directive shares only few traits with the Rasmussen report from 2008, which started the whole debate. There are no real steps taken against the two forms of tax evasion: leveraged buy-outs and deductions of indebted companies and operations of funds based in tax havens. The rules on transparency prescribe limited transparency for regulators, but no real transparency for the public. And the acceptance of a set of very meagre demands is set to open the door to hedge funds operating more freely in all member states.

In fact, it doesn't meet the minimum requirements phrased by the PES at the start of the debate on the AIFMD:

1) An all encompassing approach has to be ensured: no exemption of alternative investment funds should be allowed.
The AIFMD has numerous exemptions and loopholes in this respect. First and foremost, it doesn't cover the funds themselves, only the managers. Second, it allows fund managers administering funds of respectively 100 million and 500 million euros, depending on conditions, to operate outside the framework of the directive.

2) Non-EU funds must also be covered.
Non-EU funds are indeed covered. But they are exempt from a long list of conditions, including annual reporting and rules on depositaries. As for tax measures, little more than information exchange is required. On the face of it, and given that the passport regime will lead to access to the whole European Union, the Directive might even provide funds with in-roads to member states that would otherwise have blocked their entry.

3) As 'Extreme Leverage' (borrowing heavily to invest) is one of the major causes of this financial crisis, there must be clear limits imposed on this option.
The rules in the directive on leverage are almost exclusively on disclosure to regulators and investors. They do have to argue their case to the Commission under some circumstances, if a systemic risk could be nascent. But leveraged buy-outs (borrowing money to buy companies) do not seem to be affected in any way.

4) Full and real transparency should be central to this directive.
The directive does not require full transparency. It requires partial transparency, and mostly for regulators and investors - not the public.

5) Clear penalties for improper conduct (investment strategies in breach of the directive) should be outlined.

The penalties are not clear. The directive does not impose a harmonised system of penalties.

Triumph for the financial lobby

Those who have advocated a more ambitious set of rules along the way had a hard time showing enthusiasm at the compromise they signed. French Minister of Finance Christine Lagarde noted that "it's indeed a compromise and we probably could have come up with something better."[lv]
And in Parliament Conservative MEP Jean-Paul Gauzés remarked: “The text is not perfect but texts are never perfect.”[lvi]

Taken together, very little was won by those political forces that put their heart to this, and if it had been the small marginal groupings, it would be no surprise. However, since both the PES in the European Parliament, the German and the French governments all put their weight behind it, the case may provide us with a dazzling discovery: the power of the financial lobby and of the financial sector as such, is quite a tremendous power to fight.

The Brussels press were not slow in declaring the deal a victory for the UK.[lvii]

Speaking for the industry, AIMA’s Andrew Baker seemed satisfied: "There is still much in the directive that will be difficult to implement and there will be a heavy compliance burden that the industry will have to bear....But the impact will be far less severe than if something close to the original proposal had been agreed."

As for the off-shore funds of for instance the Cayman Islands, Guernsey and Jersey, they can sleep safe in the knowledge that their concerns were addressed, or so a lawyer connected to these funds, Ben Robins, wrote in an analysis: "In our home jurisdictions of the Cayman Islands, Guernsey and Jersey (the leading offshore fund jurisdictions), there is complete confidence that the islands will meet the minimum criteria attached to EU marketing beyond 2013... To the extent that an EU marketing passport for 2018 and beyond is attractive and requires offshore managers to comply with the full requirements of the AIFMD, our regulators are standing ready to fine-tune our regulatory regimes to ensure continued EU access to our funds and managers."
Ben Robins even foresees an increase in their activities: "We are anticipating that this new clarity will boost fundraising activity using offshore funds and managers."[lviii]

Similarly for the private equity business. A private equity lobbyist conceded to Financial News: "To be honest as it stands now we can live with everything in the text"[lix]. The EVCA too seemed genuinely satisfied: “We are relieved to have reached some legal certainty, which is particularly important for our long-term fund investors. We will now work constructively to ensure that the implementation of these and other relevant initiatives...do not inhibit SMEs and innovative companies’ access to capital or the promotion of long term investment within the EU", chairwoman Uli Fricke said in a statement[lx].

The EVCA certainly had concerns. As in every step of the process in the past years, they keep an eye on future possibilities of pulling another tooth out of the regulation they will face. And they seem to win at every step.

A look back

The story of investment fund regulation in the European Union is partly the story of the power of the financial sector, and its ability to apply this power to effective lobbying. A few years back the financial lobby could rely on its intimate relationship with the Commission, including via expert groups, in their attempt to stop proposals to strengthen regulation. Once a proposal was tabled, it quickly established a multi-pronged offensive - lobbying the European Parliament and the UK government - and managed to set a new agenda in both institutions.

This process is alarming for two reasons: first, it seems that investment funds will be able to continue the kind of activities that has given cause for concern in the past. Second, generally speaking, the financial lobby has won the first open political battle on regulation. While banking lobbyists often manage to influence behind the scenes, they are rarely forced to fight it out in public. Since major political forces, including the PES and the French government were much more ambitious than the fund community could accept, the fund lobby had to get involved in a much more open struggle. The fact that they won bodes ill for the future political debates on financial regulation.

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[i] ITUC; "Where the House Always Wins": Private Equity, Hedge Funds and the New Casino Capitalism", 2007, page 14.
[ii] Ibid. page 13.
[iii] http://news.bbc.co.uk/2/hi/229012.stm
[iv] See for instance Euractiv, 10. November 2010, http://www.euractiv.com/en/euro/barroso-considers-ban-speculation-sovereign-debt-news-325532
[v] See for instance Tagesspiegel, 18. November 2008, http://www.tagesspiegel.de/wirtschaft/in-der-kreditklemme/1372796.html
[vi] On "The Financial Services Action Plan" see http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/l24210_en.htm
[vii] ALTER-EU; "A captive Commission - the role of the financial industry in shaping EU regulation", November 2009, page 12. http://www.greenpeace.org/raw/content/eu-unit/press-centre/reports/a-captive-commission-5-11-09.pdf
[viii] Ibid. page 15.
[ix] EVCA Annual Report 2007, page 10.
[x] An own-initiative report is a text adopted by Parliament initiated by the Parliament itself, and not by the Commission or as a reaction to a proposal by the Commission.
[xi] Poul Nyryp Rasmussen; "Draft report on hedge funds and private equity funds", European Parliament, 18. April 2008, http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&mode=XML&language=EN&reference=PE404.764
[xii] "Rasmussen opens door to change hedge fund directive", Financial News, 11. September 2009.
[xiii] http://www.etuc.org/a/5046
[xiv] See the adopted proposal here: http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A6-2008-0338&language=EN#title2
[xv] EVCA Annual Report 2008, page 10.
[xvi] Euractiv, 11 September 2008.
[xvii] Charlie McCreevy, Speech in the European Parliament, 22. September 2008, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/451
[xviii] EVCA; "Submission by the Private Equity Industry to the European Commission in response to the European Parliament Resolutions INI/2007/2238 and INI/2007/2239", 14. November 2008.
[xix] Letter from Commissioner Charlie McCreevy to Jonathan Russell, chairman of the EVCA, 18. December 2008.
[xx] European Voice 18. December 2008 and letter from the PES to Commissioner McCreevy.
[xxi] On the AIMA "transparency initiative" see "AIMA provides key leadership as industry fights its corner", Eurohedge, March 2009.
[xxii] "Rasmussen calls on Commission to reject EVCA self-regulation", February 2009, http://www.pes.org/en/news/rasmussen-calls-commission-reject-evca-self-regulation
[xxiii] http://www.ue2008.fr/PFUE/lang/en/accueil/PFUE-11_2008/PFUE-07.11.2008/Reunion_informelle_chefs_etat_et_de_gouvernement_de_Union_europeenne_le_7_novembre.html
[xxiv] http://news.xinhuanet.com/english/2009-03/14/content_11008955.htm
[xxv] The draft directive and related documents can be found here: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm
[xxvi] PES; "Second Round (January-May 2009): Influencing the Commission", http://www.pes.org/en/node/37952
[xxvii] http://www.pes.org/en/news/draft-directive-has-more-holes-swiss-cheese
[xxviii] PES; "Second Round (January-May 2009): Influencing the Commission", http://www.pes.org/en/node/37952
[xxix] European Voice, 29. April 2009.
[xxx] EVCA response, June 2009, http://www.evca.eu/BTF/Industry_Common_Position_26_June_2009.pdf
[xxxi] "Lobbying builds on EC draft directive as opposition grows", Eurohedge, June 2009.
[xxxii] Financial Times, 3. June 2009. See also Financial Times 16. June, 7. July and 12. July.

[xxxiii] Financial Times, 7. July 2009.
[xxxiv] Open Europe; "The EUs AIFM Directive. Likely impact and best way forward", September 2009. http://www.openeurope.org.uk/research/aifmd.pdf
[xxxv] Daily Telegraph, 21. September 2010, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6216262/EU-regulation-to-cost-hedge-funds-1.2bn-each-year.html
[xxxvi] Check list of board members at http://www.openeurope.org.uk/about-us/board.aspx. Tisbury Capital Management is a member of AIMA, branches of the Hambro corporation are members of both EVCA and AIMA, JP Morgan is a member of both EVCA and AIMA, Sloane Robinson is a member of AIMA. EVCA members can be found at http://www.evca.eu/toolbox/membersearch.aspx?id=624. AIMA recently disclosed its list of members: http://www.aima.org/en/document-summary/index.cfm/docid/05578081-F000-446A-93617B8188726542
[xxxvii] New York Times, 12. April 2009.
[xxxviii] "Lobbying builds on EC draft directive as opposition grows", Eurohedge, June 2009.
[xxxix] The Guardian, 11. October 2009, http://www.guardian.co.uk/politics/2009/oct/11/boris-johnson-hedge-funds-accusations
[xl] That the EVCA has hired Fleishman-Hillard can be seen in the register for lobbyists of the Commission. https://webgate.ec.europa.eu/transparency/regrin/consultation/displaylobbyist.do?id=56047191389-84. The same register shows that public affairs consultancy Hume Brophy works for AIMA. https://webgate.ec.europa.eu/transparency/regrin/consultation/displaylobbyist.do?id=3843982938-44
[xli] A quote from eFinancial News; http://www.efinancialnews.com/story/2010-02-08/some-of-the-top-banking-industry-lobbyists
[xlii] Lord Myners debated with Poul Nyrup Rasmussen, using an agressive tone against what he described as "protectionism hiding as if it were protection." http://openeuropeblog.blogspot.com/2009/09/rasmussen-v-lord-myners-and-rest-of.html
[xliii] "EU warned hedge fund proposals pose risks", Financial Times, 27. July.
[xliv] Financial Times, 27. July.
[xlv] Letter from US Treasury Secretary Timothy F. Geithner to Single Market Commissioner Michel Barnier, 1. March 2010.
[xlvi] Corporate Europe Observatory; "Venture ventriloquists", June 2010, http://www.corporateeurope.org/lobbycracy/content/2010/06/venture-ventriloquists
[xlvii] Information, 1. September 2010. See also Corporate Europe Observatory; "Fund lobby admits to masquerade", September 2010, http://www.corporateeurope.org/lobbycracy/content/2010/09/fund-lobby-admits-masquerade
[xlviii] European Conservatives and Reformists Group, "Lobbying Contacts Report 1st January – 30th June 2010". Similar information is not available from other groups.
[xlix] See the director of the major lobbying company Burson-Marsteller, David Earnshaw, explain the details of this procedure: http://www.europarl.europa.eu/news/public/story_page/008-72110-096-04-15-901-20100406STO72099-2010-06-04-2010/default_en.htm
[l] According to an estimate done by The Green Group in the European Parliament. See http://blog.brusselssunshine.eu/2010/04/mep-amendments-and-democracy.html
[li] For a comparison between the Commissions proposal and the parliamentary committees amendments, see http://www.europarl.europa.eu/oeil/resume.jsp?id=5774032&eventId=1108839&backToCaller=NO&language=en
[lii] European Voice, 18. May 2010.
[liii] European Voice, 16. September 2010.
[liv] Euractiv 20. October 2010, http://www.euractiv.com/en/euro-finance/ministers-resolve-row-hedge-fund-regulation-news-498949
[lv] Ibid.
[lvi] Hedge Funds Review, 26. October 2010, http://www.hedgefundsreview.com/hedge-funds-review/news/1811137/european-union-aifm-directive-set-november-vote
[lvii] Euractiv, 20. October 2010 and EUObserver, 20. October 2010.
[lviii] Ben Robins; "Safe in the knowledge", The Lawyer, 8. November 2010, http://www.thelawyer.com/safe-in-the-knowledge/1006050.article
[lix] "Alternatives industry escapes the worst from Brussels, Financial News, 20. October 2010.
[lx] http://www.evca.eu/news/news.aspx#anchor