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The 'Old' and 'New' Political Economy of Hedge Fund Regulation in the European Union

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This article assesses the 'old' and 'new' political economy of hedge fund regulation in the EU, explaining why the EU has decided to regulate hedge fund managers in the aftermath of the global financial crisis. A Franco-German alliance, with the support of Italy, other Mediterranean countries and some quarters of the European Parliament, has driven the EU's attempt to regulate hedge funds. The new EU rules are explained by institutionally-shaped economic interests rooted in national varieties of financial capitalism – the 'old' political economy of hedge fund regulation. However, 'ideas', in the form of competing regulatory paradigms, are instrumental in explaining why one coalition of actors has prevailed over the other in EU rule-making – the 'new' political economy of hedge fund regulation.

Introduction

Over the last two decades or so, hedge funds have gained economic and political prominence. Economically, hedge funds have grown 50-fold globally in terms of assets under management since 1990. In recent years, trading by hedge funds has accounted for over 50 per cent of the daily trading volume in equities markets. Global hedge fund assets under management reached approximately $2 trillion in 2007. Hedge funds have become crucial providers of liquidity and drivers of price formation in global financial markets (Commission 2008).

Politically, the activity of hedge funds has come into the spotlight due to the role they played in the Asian financial crisis in 1997 and after the failure of long-term capital management (LTCM) in the US in 1998. These two episodes highlighted, respectively, the potential systemic repercussions ensuing from the herding behaviour of hedge funds and from the failure of large hedge funds. In Europe, episodes such as the failed merger between the Deutsche Börse and the London Stock Exchange brought to the fore the

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potentially disruptive effects that hedge funds can have on corporate governance in Continental European countries, first and foremost Germany (*The Economist*, 23 April 2005). Moreover, the large-scale fraud perpetrated by the hedge funds run by Bernard Madoff, who made use of a Ponzi scheme, had considerable political resonance within and outside the US.

In October 2010, the European Union adopted a directive regulating alternative investment funds managers (AIFMs), amongst which managers of hedge funds featured prominently. The adoption of this new legislation was somewhat puzzling for a variety of reasons. First, hedge funds were not the main cause of the global financial crisis that began in 2007 (Brunnermeier *et al.* 2009; de Larosière Group 2009). According to several accounts, they did play a part in worsening it, mainly through a transmission function and notably due to the massive selling of shares and short-selling transactions (Group of Thirty 2009; FSA 2009). However, hedge funds and their managers would argue that they themselves were negatively affected by the crisis, which had been caused by other financial (regulated) institutions such as banks and mortgage lenders. If anything, hedge funds had been part of the solution and not the problem (AIMA 2008).

Second, unlike credit rating agencies, which, prior to the passing of the EU regulation on credit rating agencies in April 2009, were regulated neither at the EU level nor in the member states, hedge fund managers and in some cases hedge funds themselves were subject to national regulation across the EU, even though national legislation differed considerably in certain respects (for an overview, see IOSCO 2006). Existing differences in national legislation across the EU and vis-à-vis non-EU countries, primarily the US, were likely to make harmonisation more difficult because different national standards would need to converge towards common EU rules.

Third, EU legislation on hedge funds managers could have a considerable extraterritorial impact, for example in the US, where a sizeable number of hedge fund managers are located and are therefore subject to US law. Furthermore, EU legislation on this matter could trigger regulatory arbitrage, placing Europe at a competitive disadvantage vis-à-vis less regulated jurisdictions – as claimed, for example, by British policy-makers and the hedge funds industry (House of Lords 2009). Hence, their argument went, hedge fund managers could decide to relocate outside the EU, in particular to Switzerland (*Financial Times*, 14 July 2009; 7 July 2009; 16 June 2009; 4 June 2009). This possibility would be made more likely by the fact that hedge funds are often domiciled outside the EU, generally in tax havens, for tax-related purposes.

Why did the EU decide to regulate hedge fund managers – to be precise, AIFMs[1] –and how were the key features of the legislation decided? The regulation of hedge funds in the EU is an important research topic for three main reasons. First, to a large extent, EU rules provide the framework for national regulatory changes in the member states, and the regulation of hedge funds has been politically contentious in several European countries (Zimmermann 2010). Hence, this research feeds into the debate on the 'clash of capitalisms' (Clift 2009; Callaghan and Höpner 2005) in the EU.

Second, the EU is one of the largest jurisdictions worldwide. It is increasingly active in shaping global financial rules in international fora (Mügge 2011a), and is one of the main interlocutors of the US in the politically charged policy debate on this subject (Helleiner *et al*. 2010; Posner and Véron 2010). Moreover, the proposed EU rules have considerable potential extraterritorial effects. Thus, this article contributes to the literature on the external projection of the EU's regulatory activity, although its main focus is on EU-level dynamics. Finally, this article develops the body of academic works on the EU's response to the global financial crisis.

Theoretical Stock-taking and Research Design

Several theoretically-informed accounts can be put forward to explain why the EU has decided to regulate hedge fund managers in the aftermath of the global financial crisis. They can be articulated at two levels of analysis: the international and the EU level. Explanations situated at the international level can largely be dismissed at the outset, because, as the third section makes clear, there is no empirical evidence to suggest that the pressure to regulate hedge funds in the EU came either from third countries – first and foremost the main player, the US – or from international bodies such as the Basel Committee on Banking Supervision (BCBS) or the International Organization of Securities Commissions (IOSCO).

If anything, pressure was applied in the other direction, in the sense that at the various G20 meetings, EU representatives or national leaders of European countries insisted on issuing statements along the lines that 'all systemic institutions should be regulated'. This commitment was followed up by the IOSCO, the Financial Stability Forum (FSF, later renamed and reshaped into the Financial Stability Board (FSB)) and private sector bodies. Other non-EU countries in the G20 were silent on this issue. The existing regulation of hedge funds in the US prior to the crisis was less strict than the one in place in several EU countries in that the registration of hedge fund managers with the Securities and Exchange Commission (SEC) was basically voluntary. By contrast, in the UK, which together with the US is home to about 85 per cent of the hedge fund assets under management globally – the registration of hedge fund mangers with the Financial Services Authority (FSA) was compulsory, as it was in France, Germany and Italy.

Moving to the EU level, three main explanations could be postulated as to why the EU decided to regulate hedge funds in the way that it did. Some of them can be dismissed at the outset, whereas others will be elaborated on in the following sections. An *interest-based* account would focus on the costs and benefits of hedge fund regulation for the main stakeholders, in particular the large member states (Story and Walter 1997; Underhill 1997). This explanation is largely based on the literature on varieties of capitalism,[2] which argues that financial market regulation in the EU is shaped by the 'battle of the systems' (which is the subtitle of Story and Walter's 1997 book) or 'the clash of capitalism' (Callaghan and Höpner 2005: 307; Clift 2009: 55; see also Bieling 2003; Macartney 2009; van Apeldoorn 2002).

According to this explanation, member states are keen to set in place EU rules that are in line with their domestic regulatory approach and do not create comparative disadvantages or adjustment costs for national industry and the public authorities. It should be noted that although this explanation is classified here as interest-based because it makes reference to material interests rooted in national production regimes, most of the literature on varieties of capitalism has a strong institutionalist component because material interests are shaped by the production regimes in which the actors are embedded (Fioretos 2001, 2010).[3]

The literature on varieties of capitalism has tended to pay limited attention to the financial sector per se (Zimmermann 2010). However, previous research on the Takeover Directive showed evidence of the 'clash of capitalisms' (Callaghan and Höpner 2005: 307; Clift 2009: 55) over takeover liberalisation in the EU, which was promoted by the UK but resisted by Continental countries. This account has implications for the regulation of AIFMs in the EU, given the fact that hedge funds and private equity funds impinge upon corporate governance arrangements and loosen the ties between the financial sector and industry in Continental countries. Hence, it could be postulated that Continental countries have favoured the regulation of AIFMs (or alternative investment funds, AIFs) as a way to limit and control the activities of these funds.

By contrast, this is a non-issue for the British authorities, given the lack of close bank–industry ties in the UK and corporate governance arrangements based on shareholder value (Rhodes and van Apeldoorn 1998). In addition to the implications of hedge fund activity for corporate governance, this segment of the financial industry is a powerful player in its own right, especially in the UK, which hosts four-fifths of the AIFMs in the EU. Furthermore, British authorities have traditionally been sensitive to the regulatory preferences of the financial industry, which plays such a big role in the British economy and makes the City of London one of the main financial centres worldwide. Not surprisingly, the alternative investment funds industry opposed some of the proposed EU rules, and so did the British authorities.

As far as the model of business–government relations is concerned, two assumptions are implicit in this interest-based explanation (Fioretos 2001; Moravcsik 1998). To begin with, the national public authorities are keen to support the model of hedge fund regulation at the EU level which is more in line with their existing domestic political economy institutions and regulatory approaches, so as to preserve the distinctive national varieties of capitalism. Secondly, national authorities are also sensitive to the specific interests of the financial industry, first and foremost hedge funds, especially in the countries where such funds are a substantial component of the financial sector.

An *ideas-based* explanation would focus on the regulatory approaches of the main policy-makers and how policy paradigms (Hall 1993) shape national positions concerning the regulation of hedge funds. Previous research has highlighted the importance of 'ideas' (Grossman 2004) and national discourses about financial regulation (Busch 2004). Other authors have pointed out the 'strategic constructivism' deployed by the European Commission in order to construct the Single Market, including in the financial sector (Jabko 2006) and the 'ascendancy of regulatory liberalism' (Mügge 2011b) as the main paradigm informing EU financial regulation prior to the crisis (see also Posner and Véron 2010). Some of the literature on varieties of capitalism also seems to be aware of the importance of national regulatory approaches (see, for example, Story and Walter 1997), but this is rarely made explicit, and the content of national regulatory paradigms is not spelled out. Feeding into the literature on varieties of capitalism, but with a constructivist take, Donnelly (2010) argues that national policy-makers in the member states have deeply internalised beliefs about the relationship between the state and the market and the legitimate objectives of public policy. Thus, EU policy is shaped and constrained by national norms.

Following this line of reasoning, in the completion of the single market in financial services, Quaglia (2010a, b) points out the competition between the 'market-making' paradigm advocated by the UK and the 'market-shaping' paradigm supported by France, Italy, other Mediterranean countries and, in several instances, Germany. To put it crudely, the market-making approach emphasises the objectives of competition and market efficiency. Hence, the UK has traditionally been keen to promote financial innovation, including the activities of AIFs (interviews, London, May 2007, July 2008, August 2009). By contrast, the market-shaping approach privileges the objectives of financial stability, consumer protection as well forms of veiled protectionism. As for instruments, the market-making approach relies on a light touch, principle-based regulation and private sector governance, as was largely the case for hedge fund regulation in the UK. The market-shaping approach favours prescriptive, rule-based regulation with a strong steering action by the public authorities. In line with this approach, hedge funds and their managers were subject to prescriptive regulation in Continental Europe even prior to the financial crisis (for a survey of hedge fund regulation across countries, see IOSCO 2006). Thus, according to this explanation, Continental countries have been eager to include the activities of AIFs (for example, their level of leverage) in the perimeter of EU re-regulation and to subject them to supervisory oversight (interviews, Berlin, April 2008; Rome, December 2007).

A third, *supranationalist* explanation would focus on EU institutions – in particular the Commission (Posner 2005; Jabko 2006) – as the key players in the creation of financial market integration and regulation. Nonetheless, as detailed in the fourth section, prior to the global financial crisis, the Commission had opposed the regulation of hedge funds by the EU. In the aftermath of the crisis, the Commission was put under a considerable amount of political pressure by some member states, including Germany and France (which held the rotating presidency of the EU in the second semester of 2008), and parts of the European Parliament to issue the proposed rules, as discussed in the fifth section.

Regulating Hedge Funds Internationally

Prior to the global financial turmoil, some research and fact-finding exercises on hedge funds had been undertaken by international financial regulatory fora, generally following policy failures. After the Asian financial crisis and the collapse of the hedge fund LTCM in the US, a set of policy documents were issued by BCBS (1999a, b), IOSCO (1999), and subsequently by the newly created FSF (2000; updated in 2007, when the first signs of the crisis emerged). The US also conducted its own review through the President's Working Group (PWG) on Financial Markets (1999). Basically, all these documents concluded in favour of the indirect regulation of hedge funds, which was indeed strengthened.

In policy discussions in international fora, two different approaches could be detected: one in favour of regulation, sponsored by Germany and France, and one resisting regulation, championed by the US and the UK (interviews, Basel, November 2008; Madrid, March 2009; see also Fioretos, 2010). In 2007, German officials used their presidency of the EU and of the G8 to push for regulation, receiving some backing from the FSF, which the G8 charged with studying the issue.[4] At the outset of the global financial crisis, German finance minister Peer Steinbrück called for a formal code of conduct for hedge funds. The US opposed a code of conduct, while US Treasury Secretary Henry Paulson, Jr. supported a set of principles that informed investors, leaving them to monitor risk (*International Herald Tribune*, 23 April 2007; Bloomberg News, 23 April 2007). An impasse followed, and no action was taken to deal with the problems posed by hedge and private equity funds.

During preparations for the April 2009 G20 summit, the split over how to regulate hedge funds re-emerged. Several European countries, led by France and Germany – as suggested by Sarkozy and Merkel's joint letter (2009) – with the support of Italy (Italian Treasury Minister Giulio Tremonti had vociferously called for the regulation of hedge funds (*Reuters*, 11 October 2008)), pushed for a tougher regulatory regime for hedge funds and wanted the funds to be overseen similarly to banks (*Financial Times*, 23 February 2009). By contrast, the US and UK authorities favoured more disclosure over more regulation, proposing instead that funds be required to register with the government and disclose more information with a view to increasing transparency (*Wall Street Journal*, 14 March 2009). European leaders also wanted to clamp down on tax havens.

In February 2009, German Chancellor Angela Merkel hosted a summit of German, French, Italian, Spanish, Dutch and British leaders in Berlin. The purpose of the gathering was to prepare a common EU policy position in advance of London's G20 summit in April 2009. In relation to hedge funds, the press statement issued after the meeting pointed out that 'all financial markets, products and participants must be subject to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk.'[5]

The consensus reached was seen as a victory for France and Germany, which championed the need for a comprehensive regulatory architecture in the face of resistance from the UK, where many hedge funds are based (*Financial Times*, 23 February 2009). Reportedly, at the meeting, then-British Prime Minister Gordon Brown agreed to restrictions on hedge funds in order to clear the way for an overall accord, which included the call for strengthening the International Monetary Fund (IMF) and endowing it with more resources (*The Daily Telegraph*, 23 February 2009).

A letter sent jointly by Sarkozy and Merkel (2009) to Mirek Topolanek, Prime Minister of the Czech Republic and Jose Manuel Barroso, President of the European Commission, in preparation for the G20 Summit in April 2009 reiterated that:

> The first priority is to build a new global financial architecture. The European Union must assert a common position and take the lead on this. ... On the basis of the achievements of the Berlin preparatory summit in February we are determined to obtain at the London summit concrete results on strengthening international financial regulation. ... The European Union must propose that all hedge funds and other funds presenting a potential systemic risk be subject to appropriate registration, regulation and oversight.

After protracted negotiations, the G20 in London in April 2009 agreed that:

> hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management.

After the crisis and following the G20 recommendations, the IOSCO (2009) put forward some rather general recommendations on the regulation of hedge funds. However, the report that contained such recommendations could not reach an agreement on the fundamental issue of whether the hedge fund or the hedge fund manager should be regulated, as there were different views and national legislation in place in the participating jurisdictions (interview, Madrid, March 2009).

Regulating Hedge Funds in the EU

Prior to the global financial crisis, hedge funds (or fund managers) were not regulated at the EU level. At the national level, hedge fund managers were regulated entities in some member states, though they were not subject to specific legislation concerning hedge fund managers. In other words, they were regulated as 'normal' fund managers. In other countries, such as in France, Italy, Spain and Germany, the fund itself was a regulated onshore vehicle (IOSCO 2006, 2009), although often it could be domiciled in a third country.

Prior to the financial crisis, some member states, most clearly Germany, as well as parts of the EP, had encouraged discussions concerning the regulation of hedge funds at the EU level (for a review of the positions of the different countries on this matter see Fioretos 2010; Moschella forthcoming). Partly to assuage these concerns, the Commission set up a group of experts – the Alternative Investment Expert Group – to discuss the issue. The group, which included several hedge fund managers and other representatives of the financial industry amongst its members, issued a report in 2006, *Managing, Servicing and Marketing Hedge Funds in Europe*, which concluded against EU legislation on hedge funds (Alternative Investment Expert Group 2006). The issue was raised again by the German presidency of the EU in 2007 and during its hosting of the G8 summit (*The Economist*, 26 May 2007). However, at that time there were not many takers for the proposal (interviews, Berlin, April 2008).

In the past, the Commission – notably the Commissioner for the Internal Market, Charles McCreevy – had ruled out EU legislation on hedge funds. According to several interviewees, the Barroso Commission and Commissioner McCreevy in particular displayed a regulatory approach in favour of 'better regulation' of financial services (as elsewhere), which often translated into 'light touch' regulation, or no regulation at all, as in the case of hedge funds and credit rating agencies (interviews, Brussels, June 2007; Paris, July 2007; Rome, December 2007). Yet the global financial crisis shifted the political dynamics in the regulatory milieu in Brussels. The top echelons of the Commission, led by President Barroso, began to display a different pro-regulatory stance, as demonstrated by the decision to propose a regulation on credit rating agencies and AIFMs, which had been ostensibly ruled out by the Commission in the past.

The attempt to regulate hedge funds in the EU was given new momentum by the financial crisis. The EP became particularly vocal on this, producing two reports: the 'Rasmussen' report and the 'Lehne' report (EP 2008a, b). A resolution by the European Parliament issued on 23 September 2008 requested the Commission to submit a legislative proposal or proposals covering all relevant actors and financial market participants, including hedge funds and private equity.

In December 2008, the Commission issued a consultation document discussing regulatory measures on hedge funds. Most respondents to the Commission's consultation believed that an international or global response would be superior to an EU response. However, a small majority of respondents believed that it was nevertheless appropriate to move forward with EU-level action. Many respondents, most notably France and Germany, argued that:

> Europe should play an instrumental role in shaping a global regulatory regime for hedge funds through the creation of a 'European label'. An EU framework could serve as a reference for global regulation of alternative investment management activity. (Commission 2009b: 8)

In June 2009, the European Commission presented its proposal for the draft directive on AIFMs, which includes managers of hedge funds, private equity funds and real estate funds, hence covering quite a broad range of financial entities (Commission 2009a). The directive introduces a legally binding authorisation and supervisory regime for all AIFMs in the EU, irrespective of the legal domicile of the alternative investment funds managed. Hence, AIFMs will be subject to authorisation from the competent authority of the home member state and to reporting requirements of systemically important data to supervisors. The directive sets up a European passport for AIFMs. Hence, an AIFM authorised in its home member state will be entitled to market its funds to professional investors in other member states, which will not be permitted to impose additional requirements.

The directive has potential extraterritorial effects, as it will allow AIFMs to market alternative investment funds located in third country domiciles in the EU only if their country of domicile has entered into an agreement based on the OECD Model Tax Convention and if other regulatory requirements are met. According to the initial draft, non-EU AIFMs could apply for authorisation in the EU, which could be granted only if the regulatory framework and supervisory arrangements in their home country were deemed to be equivalent to those of the proposed directive and if EU operators enjoyed comparable access to that third country market (Commission 2009a). This aspect was seen by some member states – first and foremost the UK – and the hedge funds industry as protectionist, whereas other member states, first and foremost France and Germany, argued that such an approach was necessary to prevent Europe from becoming 'the Trojan horse for offshore funds', as the French Treasury Minister put it (*European Voice*, 29 April 2009).

After intense lobbying from industry, the US and the UK, the draft directive was partly revised during the Swedish presidency of the EU that began in July 2009. Sweden has a significant private equity industry and, like other Nordic countries, has traditionally shared the British market-making approach to financial services regulation. An agreement between the Council of Ministers and the EP was eventually reached in late October 2010, and the directive is due to enter into force in 2013.

Evaluating Theoretically-Informed Explanations against the Empirical Record

Amongst the member states, the main promoters of the directive on AIFMs were France and Germany, with the support of Italy and other Mediterranean countries (*Financial Times*, 30 April 2009; interviews, London, August 2009; Paris, May 2009). This had been a long-standing regulatory goal in these countries (interviews, Berlin, April 2008; Paris, July 2007). Institutionally-shaped economic interests rooted in national varieties of capitalism account for member states' preferences on this matter. Hence, as in the case of the Takeover directive, varieties of capitalism in Europe clashed in the making of EU rules on hedge funds and private equities, which had implications for corporate governance, the links between finance and industry, and the competition between European financial centres. However, the positions taken by the main member states during the negotiations were also in line with their regulatory approaches. The countries embracing the market-shaping paradigm prioritised consumer protection, financial stability and veiled protectionism. The countries adopting the market-making paradigm privileged competition, market efficiency and financial innovation.

Policy-makers in France, Germany and Italy were keen to regulate hedge funds in the EU because they worried about activist investors, such as hedge funds and private equities, threatening to overturn 'cosy corporatism' in their domestic economies (*Financial Times*, 30 April 2009), disrupting established corporate governance arrangements. The activity of hedge funds and private equities also loosens the traditional ties between finance and industry that prevail in large parts of Continental Europe and make long investment horizons possible for manufacturing firms.

In Germany, hedge funds were accused by the outgoing chairman of the Frankfurt Stock Exchange of 'ripping the heart out of the German economy' (*The Independent*, 11 May 2005), whereas the chairman of the Social Democratic Party compared hedge funds and private equity investors to 'plagues of locusts that descend on companies, chew them up and move on' (*The Independent*, 11 May 2005). In France, President Sarkozy articulated his vision of hedge funds and private equity as 'aggressive' gangs of 'speculators', bent on 'snapping up firms, sacking workers and creaming off profits' (*The Economist*, 23 July 2009). At the same time, the financial industry in these countries supported some forms of direct regulation of hedge funds. German commercial banks had expanded in this market in recent years, but were concerned about potentially lax regulation (Fioretos 2010). France hosts the largest share of collective investment schemes in the EU, and the French asset management industry had distinct (competing) interests from that of AIFM (private correspondence, June 2010).[6]

Second, hedge funds were subject to rather strict regulation in the main Continental countries (see IOSCO 2006). This was motivated by policy-makers' beliefs about the potential threat posed by hedge funds to financial stability, the need to protect investors and a deeply ingrained dislike of 'casino capitalism' (Strange 1997), which was seen as serving the fortunes of the City of London (interviews, Berlin, April 2008; Paris, July 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008). This was part and parcel of a 'market-shaping' regulatory paradigm that informed financial regulation in Continental countries (Quaglia 2010a, b).

Third, there were purely domestic political reasons – such as the forthcoming general elections in Germany and President Sarkozy's attempt to increase his political capital in France – that motivated German and French political leaders to be seen as tough in regulating hedge funds and private equity funds. The attempt to appease British public opinion also contributes to explaining why the British government caved in to the EU's desire to regulate hedge funds, which had previously been adamantly resisted by British policy-makers (Helleiner and Pagliari 2010). So, can the political salience of the issue and the populist stance of some national politicians explain the new EU rules imposed on hedge fund managers? As explained above, the regulation of hedge funds had been a goal of French and German policy-makers well before the crisis. It was not a populist move that emerged from nowhere in the wake of the crisis. However, it is true that the latter to some extent silenced the economic interests that had opposed EU rules (first and foremost the hedge funds industry), and gave more prominence, at least temporarily, to public opinion concerns.

The main opponents of the directive on AIFMs were the UK and the hedge fund industry, which is mainly based in London. To be sure, during the consultation phase, they opposed the prospect of EU rules on hedge funds. Once the directive was proposed by the Commission, they focused their criticisms on certain provisions of the draft directive. Private equity funds and real estate funds also criticised the draft directive for different reasons, but this is outside the scope of this research. Lord Myners, a UK Treasury minister, criticised European countries seeking to 'make political capital' from advocating a clampdown on the hedge fund industry, calling their actions 'woefully short-sighted' and 'bordering on a weak form of protectionism' (*Financial Times*, 7 July 2009).

Institutionally-shaped economic interests rooted in the British variety of capitalism explain why the British authorities were critical of the draft proposed by the Commission (for a similar argument, see also Zimmermann 2010). The UK, which hosts four-fifths of all hedge funds in the EU, was concerned about the AIFMs' reaction to the costs of complying with the proposed EU rules and their threat of relocating outside the EU, endangering the primacy of London as a global financial centre. The concern about international 'regulatory arbitrage' has traditionally been at the forefront of British policy-makers' minds,[7] given the fact that London is a leading financial centre which hosts many non-British-owned financial institutions and successfully competes with other financial centres world-wide to attract business (interviews, London, May 2007; July 2008). This is due to their 'market-making' or 'competition-friendly' approach to financial services regulation (Quaglia 2010a, b).

The Socialists in the EP pushed for hedge fund regulation before and after the financial crisis. This political group regarded hedge funds and private equity funds as speculative activities potentially detrimental to the real economy. In December 2008, three leading members of the European Socialists (Rasmussen *et al.* 2008) sent a letter to the President of the Commission, José Manuel Barroso, calling for a Commission proposal on hedge funds and private equity regulation. After the draft AIFMs directive was issued, they argued that it did not go far enough, as reported in a letter sent to Barroso in April 2009 (Rasmussen *et al.* 2009).

The global financial crisis did not substantially alter the configuration of interests concerning hedge fund regulation in the EU. However, it did impinge upon existing regulatory paradigms because it was seen – rightly or wrongly – as implicitly validating the 'market-shaping' approach exposed by the pro-regulation countries, even though several Continental countries, among them the two largest member states, had also been severely affected by the crisis (Hardie and Howarth 2009). By contrast, the crisis challenged the rival 'market-making' (or 'competition friendly') regulatory paradigm. The main supporters of the market-making regulatory paradigm, notably UK policy-makers, did not completely abandon it, but advocated it less forcefully, and some policy-makers began to question it within the market-making coalition. One of the most notable 'conversions' was that of the Commission, which switched to a market-shaping approach.

In the stronghold of the market-making coalition, the UK, alternative views about financial services regulation began to emerge, at least in some quarters. As the Turner Review acknowledged (FSA 2009: 38–39), the global financial crisis robustly challenged – on 'both theoretical and empirical grounds' – the existing 'regulatory philosophy' and the 'intellectual assumptions' of 'efficient', 'rational' and 'self-correcting markets' on which it was based. Specifically on the subject of hedge funds, the Review argued that:

> Regulators and central banks in the performance of the macro-prudential analysis role ... need to gather much more extensive information on hedge fund activities ... and regulators need the power to apply appropriate prudential regulation (e.g. capital and liquidity rules) to hedge funds ..., if at any time they judge that the activities have become bank-like in nature or systemic in importance.

In an overall assessment, economic interests rooted in national varieties of capitalism have considerable analytical leverage in explaining why certain countries and quarters of the EP were eager to strictly regulate hedge funds, whereas others were not. This is the 'old' political economy of hedge fund regulation. Does this suffice to address the research question informing this article – i.e., why the EU has decided to regulate AIFMs in the aftermath of the global financial crisis? The answer is partly negative in that these configurations of interests did not substantially change after the global financial crisis. One is therefore left to explain why the Franco-German alliance, with the support of the 'Club Med' and some political groups in the EP, has prevailed over the preferences of others, namely British policy-makers and a large part of the industry.

This step requires a reference to ideas. This is the 'new' political economy of hedge fund regulation. There were two pathways through which ideas affected the regulation of AIFMs in the EU. To begin with, there was a 'blame game' directed towards the Anglo-Saxon model of financial capitalism and market-friendly financial services regulation. Hedge funds and private equity funds were seen as embodying the 'evils' of such a model. This points to a form of 'strategic constructivism' (Jabko 2006), that is, the political use of ideas by the market-shaping coalition to advance its regulatory preferences. At the same time, there was, at least to some extent, some soul-searching amongst the supporters of the market-making approach challenged by the crisis, which weakened their resolve to oppose the regulation of AIFMs in the EU.

The empirical material presented in this article does not warrant granting independent explanatory power to ideas because, undoubtedly, domestic political economy interests were paramount in triggering and shaping the EU's decision to regulate hedge funds. However, ideas about financial regulation (i.e., regulatory paradigms) explain the shifting balance of power within and outside the EU in the making of rules on financial services. Prior to the global financial crisis, British policy-makers and their regulatory philosophy had been very influential in shaping the EU's regulation of financial services (interviews, Brussels, March and June 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008). However, their model was perceived to be discredited by the global financial crisis (*The Economist*, 2 July 2009; interviews, London, August 2009). As *The Economist* (7 May 2009) put it, a 'new pecking order' emerged (at least temporarily) in the EU, with tangible implications for the redesign of the EU regulatory architecture in financial services.

Conclusion

In the multilevel governance of financial services (Baker *et al.* 2005), the EU has emerged as a prominent player in the aftermath of the global financial crisis, in contrast to its past largely unsuccessful attempt to 'manage globalisation' in financial services (Posner and Véron 2010).[8] Indeed, as noted by Rottier and Véron (2010: 5) the regulatory response of the EU to the crisis has made the EU more 'unilateralist', as the US had been in the past. Reversing its long-standing resolve not to regulate hedge funds and private equities, the EU has adopted a new set of rules on AIFMs, which will potentially have extraterritorial effects. Moreover, the EU has also attempted, with mixed success, to shape the international regulatory initiatives unfolding in this field (Mügge 2011a).

This article presents evidence that suggests that certain member states, backed by some members of the EP, were the driving forces in the redesign of EU regulation. Their actions were motivated by institutionally-shaped economic interests, but were also informed by their 'market-shaping' regulatory approach concerning financial services. The global financial crisis partly discredited what can be labelled as the 'British model' of financial services regulation, which had been in good currency in the EU since the late 1990s and had informed a large part of the EU rules adopted prior to the global financial crisis (Posner and Véron 2010; Quaglia 2010a, b). An alternative regulatory paradigm has gained ground in the wake of the crisis, empowering one coalition of actors and silencing another. Thus, ideas are instrumental in explaining why one set of actors and their interests prevailed over the others in shaping EU rules on AIFMs. This does not mean that they were the 'best' ideas, or necessarily the most suitable to address the shortcomings brought to the surface by the global financial crisis. However, the market-shaping coalition was able to 'bank' on these ideas in the aftermath of the crisis.

From a theoretical point of view, this article has combined insights from the literature on varieties of capitalism with the literature on the role of ideas (in this instance, regulatory paradigms) in financial services regulation in the EU. It is argued that whereas the global financial crisis did not alter the fundamental features of national varieties of capitalism, it partly affected (at least in the short and medium term) national regulatory approaches and the prevailing paradigm in the EU, though it did not bring about a fully-fledged paradigm shift. The findings also highlight the strategic use of ideas (or regulatory paradigms) in policy-making by covering up or reinforcing power-based dynamics, a mechanism often overlooked by ideational approaches.

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Notes

1. In examining the AIFM draft directive, the focus will be on its implications for hedge funds and fund managers, not for managers of private equities funds and real estate funds, which are also covered by the directive.
2. The literature on varieties of capitalism in Europe is extensive; for a comprehensive analysis, see Schmidt (2002), Hall and Soskice (2001), and Hancké *et al*. (2007).
3. I wish to thank one of the anonymous reviewers for pointing this out to me.
4. Previously, in July 2005, the then-Chancellor of Germany, Gerhard Schröder (Social Democrat) had pressed for tighter controls on hedge funds at the G7 Summit in Britain, where it was blocked – as Schröder himself revealed in 'Wall Street and London' (*The Independent*, 16 June 2005).
5. http://www.diplo.de/diplo/en/WillkommeninD/D-Informationen/Nachrichten/090224-1.html (accessed May 2009).
6. For example, the French MEP Jean-Paul Gauzes, who was the rapporteur for the AIFM directive, inserted an amendment that required depositories to be in the same country as the AIF – which is the French stance in Council and also happens to be the business model of the French industry – e.g., onshore depositories.
7. This expression was used very frequently in the policy documents produced by the British Treasury, the FSA and the Bank of England.
8. I wish to thank one of the anonymous reviewers for pointing this out.

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