Terms and Conditions of Use of Digitised Theses from Trinity College Library Dublin

Copyright statement

All material supplied by Trinity College Library is protected by copyright (under the Copyright and Related Rights Act, 2000 as amended) and other relevant Intellectual Property Rights. By accessing and using a Digitised Thesis from Trinity College Library you acknowledge that all Intellectual Property Rights in any Works supplied are the sole and exclusive property of the copyright and/or other IPR holder. Specific copyright holders may not be explicitly identified. Use of materials from other sources within a thesis should not be construed as a claim over them.

A non-exclusive, non-transferable licence is hereby granted to those using or reproducing, in whole or in part, the material for valid purposes, providing the copyright owners are acknowledged using the normal conventions. Where specific permission to use material is required, this is identified and such permission must be sought from the copyright holder or agency cited.

Liability statement

By using a Digitised Thesis, I accept that Trinity College Dublin bears no legal responsibility for the accuracy, legality or comprehensiveness of materials contained within the thesis, and that Trinity College Dublin accepts no liability for indirect, consequential, or incidental, damages or losses arising from use of the thesis for whatever reason. Information located in a thesis may be subject to specific use constraints, details of which may not be explicitly described. It is the responsibility of potential and actual users to be aware of such constraints and to abide by them. By making use of material from a digitised thesis, you accept these copyright and disclaimer provisions. Where it is brought to the attention of Trinity College Library that there may be a breach of copyright or other restraint, it is the policy to withdraw or take down access to a thesis while the issue is being resolved.

Access Agreement

By using a Digitised Thesis from Trinity College Library you are bound by the following Terms & Conditions. Please read them carefully.

I have read and I understand the following statement: All material supplied via a Digitised Thesis from Trinity College Library is protected by copyright and other intellectual property rights, and duplication or sale of all or part of any of a thesis is not permitted, except that material may be duplicated by you for your research use or for educational purposes in electronic or print form providing the copyright owners are acknowledged using the normal conventions. You must obtain permission for any other use. Electronic or print copies may not be offered, whether for sale or otherwise to anyone. This copy has been supplied on the understanding that it is copyright material and that no quotation from the thesis may be published without proper acknowledgement.
The Politics of Financial Services Regulation: Reform and Design in a Footloose World

PhD in Political Science
Trinity College Dublin
2009

Nicola Grenham
Declarations

I declare that this thesis has not been submitted for a degree at this or any other university.

[Signature]

I declare that this thesis is entirely my own work.

[Signature]

I agree that the Library may lend or copy the thesis upon request.

[Signature]
Summary

The Politics of Financial Services Regulation: Reform and Design in a Footloose World

This thesis sets out to investigate why, in an increasingly integrated and interconnected world financial system, the design of financial regulatory regimes remains distinctly national. The issue is puzzling for two reasons. First, the state and economic actors within different countries are subject to many of the same pressures. Secondly, the cross national regulatory objectives are very similar. The question to be addressed is what drives regulatory reform and why is such cross national variation in regulatory regime design exhibited.

The lens through which this puzzle is investigated is one of the most global, interconnected and footloose segments within the financial system: the hedge fund management sector. The sector is described as footloose because both the principal economic actors within it, and the activities in which they engage, have substantial freedom of movement. The thesis employs the cross country-single sector comparative case study method and examines the hedge fund sector regulatory regimes in France, Germany and the United Kingdom. Using an actor centred approach the study examines the importance of four variables of explanation postulated in the literature as important drivers of regulatory regime reform and design. Financial crisis, institutional arrangements, globalisation, and Americanisation; each presents the state and economic actors with different opportunities and challenges to which they respond. The analysis of these explanations is guided by two political economy theories of regulation: the public interest and private interest theories of regulation.

The research conclusions support Pagoulatos’s (1999:90) finding that financial crises can be ‘a vital resource in the hands of policy entrepreneurs eager to expand regulatory initiative’. The study’s findings also show that Moran’s (1991:22) thesis that regulatory regimes are ‘powerful sources of comparative advantage’ continues to be extremely valid. The globalisation of markets, and its effect on the economic and state actors, is
shown to be an important determinant of regime reform and design in all three cases. The regulatory reforms in France and Germany, as well as the lack of reform in the UK can be explained by the state and economic actors', response to globalisation. The two theories of regulation are found to underpin the actions of the policy makers and the firms. That the state actors introduced regulatory regime reform in the public interest is not an unexpected finding. However, that private interest theory is alive in such a footloose sector of the economy is an unexpected finding. There is evidence of a policy development whereby the element of regulation focused on financial market stability and systemic risk is being crafted, increasingly, outside the domestic policy arena; while regulation focused on conduct of business and consumer protection remains firmly grounded in the national policy space.
Contents

Acknowledgements
Table of Contents
Tables and Figures
Abbreviations

Chapter 1 – Introduction and Objective of the Thesis

The Puzzle 1
Importance of Financial Services Sector 3
Importance of the Hedge Fund Sector 4
Regulation – Multiple Meanings 9
Hedge Fund Sector Regulation and Regime Variation 13
Regulatory Regimes 19
  Regime Orientation 19
  Regime Organisation 23
  Why Do Regulatory Regimes Matter? 29
Similarity of Objectives in Financial Regulation 32
Literature Lacuna 36

Chapter 2 – Theoretical Framework and Main Variables of Explanation

Introduction 43
Two Theories of Regulation 44
  Public Interest Theory 44
  Private Interest Theory and the Role of Economic and State Actors 46
Variables of Explanation 51
  Financial Crisis and the Role of State Officials 51
  Institutional Arrangements: Economic and State Actors – Accommodation and Mobility 54
  Globalisation and Americanisation – Liberalisation? 58
    Liberalisation 59
    Globalisation 61
  The Literature and the Effects of Liberalisation and Globalisation 67
    Americanisation 72
Different Assumptions 78
Research Design and Method 81
  Case Selection 83
  Sources 89
Chapter 3 – Financial Crisis, Public Interest and the Role of State Actors

Introduction and Objectives 93
Financial Crisis 94
Financial Crisis and Hedge Fund Regulation in France 100
Financial Crisis and Hedge Fund Regulation in Germany 111
Financial Crisis and Hedge Fund Sector Regulation in the UK 122
Conclusion 130

Chapter 4 – Private Interest Theory and the Role of Economic and State Actors

Introduction 134
France 142
  Regulatory Agencies 143
  Interest Associations 145
  Established Incumbent Economic Actors 146
Germany 152
  Regulatory Agency 153
  Interest Associations and Established Incumbent Economic Actors 154
United Kingdom 158
  Size and Significance of Hedge Fund Sector 159
  Regulatory Agency 160
  Interest Associations 162
Conclusion 167

Chapter 5 – Globalisation and Americanisation

Introduction 172
Globalisation 173
  France 176
  Germany 180
  United Kingdom 185
    Finance matters 190
Americanisation 191
  Americanisation and the Role of Economic Actors 193
    US Economic Actors and France 194
    US Economic Actors and Germany 197
    US Economic Actors and the UK 200
  Americanisation and the Regulatory Model 203
    US Regulatory Model and France 206
    US Regulatory Model and Germany 208
    US Regulatory Model and the UK 210
Analysis of Explanations 213
Acknowledgements

There are many people to thank. Starting in Ireland, I would like to thank my supervisor, Raj Chari, for his invaluable guidance, advice and patience. I am grateful to Professor Michael Marsh and Dr Robert Thomson for their knowledge and advice. In France, Germany and the UK I would like to thank Hubert Reynier, Eric Panniez, Jérome Sutour, Bruno Lescoat, Marc Louis Landeau, Pierre Edouard Coiffard, Richard Cross, Fabrice Demarigny, Stefan Seip, Oliver Burkart, Dr Alexander Henner, Dr Bernhard Speyer, Anthony Belchambers, Iain Cullen, Florence Lombard, Mark Fox Andrews, Sheila Nicoll, Angela Knight, Ian Morley, Richard Edwards and the many other experts in Paris, Frankfurt and London who kindly agreed to be interviewed for this research but who requested to remain anonymous.

This thesis is dedicated to Michael.
Abbreviations

AFEI - Association Francaise des Entreprises d'Investissement (Association of Investment Services Firms)

AFG - Association Francaise de la Gestion Financiere (Asset Management Association)

AIMA - Alternative Investment Management Association

AMF - Autorité des Marchés Financiers (Financial Market Regulator)

AML – Anti-money Laundering

APCIMS - Association of Private Client Investment Managers and Stock Brokers

BaFin - Bundesanstalt für Finanzdienstleistungsaufsicht (The Federal Financial Supervisory Authority)

BAKred - Bundesaufsichtsam rab für Das Kreditwesen (Federal Banking Supervisory Office)

BAV – Bundesaufsichtsam rab für das Versicherungswesen (Federal Insurance Supervisory Office)

BAWe - Bundesaufsichtsam rab für den Wertpapierhandel (Federal Securities Supervisory Office)

BCCI - Bank of Credit and Commerce International

BIS - The Bank for International Settlements

BNP – Banque Nationale de Paris

BVI - Bundesverband Investment und Asset Management (Investment Management Association)

CAC 40 - Cotation Assistée en Continu (Continuous Assisted Quotation)

CCSA - Comité de Contrôle de Surveillance de l’Assurance (The Insurance Surveillance Committee)

CDC- Caisse des Dépôts

CDGF - Conseil de Discipline de la Gestion Financière (Council for the discipline of investment managers)
CECEI - Comité des Etablissements de Crédit et des Entreprises d'Investissement (Committee for the establishment of credit and investment firms)

CESR - The Committee of European Securities Regulators

CFTC - Commodity Futures Trading Commission

CME - Coordinated Market Economy

CMF - Conseil des Marchés Financières (Council of the financial markets)

COB - Commission des Operations de Bourse (Commission for the operation of the stock market)

CRBF - Comité de la Réglementation Bancaire et Financière (Committee for the regulation of banking and finance)

DAX - Deutscher Aktien-Index (German stock index)

DP16 - Discussion Paper 16

DTB - Deutsche Termin Bourse (German financial futures and options market)

EEC - European Economic Community

ENA - Ecole Nationale d'Administration

ERM - European Exchange Rate Mechanism

EU - European Union

FCIMT - Fonds Commun d'Intervention sur les Marchés à Termes (Futures investment funds)

FoHFs - Funds of hedge funds

FSA - Financial Services Authority

G7 - The World’s Leading Industrial Countries

GDP - Gross Domestic Product

IMAG - Investment Modernisation Act

IMAUK - Investment Management Association

IMF - International Monetary Fund
IMRO - Investment Management Regulatory Organisation
 IOSCO - International Organisation of Securities Commissions
 IPO - Initial Public Offering
 ISD - Investment Services Directive
 LME - Liberal Market Economy
 LSE - London Stock Exchange
 LTCM - Long Term Capital Management
 MATIF - Marché à Terme International de France
 MFA - Managed Funds Association
 NYSE - New York Stock Exchange
 OECD - Organisation for Economic Co-operation and Development
 SEC - Securities and Exchange Commission
 SFA - Securities and Futures Authority
 SIB - Securities and Investments Board
 SOX - Sarbanes Oxley Act
 SROs - Self Regulatory Organisations
 UAP – Union des Assurances de Paris
 UBS - Union Bancaire Suisse
 UCITS - Undertakings for Collective Investments in Transferable Securities
 UK - United Kingdom
 US - United States of America
Chapter 1

Introduction and Objective of the Thesis

The Puzzle

In an increasingly integrated global financial system, in which the state and economic actors are subject to many similar pressures, financial regulatory regime design remains distinctly national. Why is this so? The last 20 years have witnessed a striking amount of reform in the design of the financial regulatory regimes of France, Germany and the United Kingdom (UK). Yet, despite the almost uniform objectives of regulation which are described later in this chapter, cross national variation in regulation persists. This study seeks to find out what and which actors drive regulatory reform and why the cross national variation continues, particularly in view of the fact that regulatory policy makers in the different nations are subject to many of the same forces. The prism through which this puzzle will be investigated is one of the most global, interconnected and footloose segments of the financial services industry: the hedge fund management sector. The sector is described as footloose because both the principal economic actors within it, and the activities in which they engage, have substantial freedom of movement.

It is the very global and footloose characteristics of the hedge fund industry that make the disparate approach to regulatory regime design even more surprising. In essence we have market globalisation without regulatory globalisation. The globalisation of markets enables buyers and sellers from one location to meet (physically, through...
agents or electronically) with buyers and sellers from any other location to conduct transactions (Braithwaite and Drahos, 2000: 8). Regulatory globalisation ‘involves the spread of some set of regulatory norms … but it does not mean that regulation has necessarily harmonised’ (Braithwaite and Drahos, 2000: 8). What has driven the introduction of hedge fund sector specific regulations in two of the cases under observation, but not in the other? Which actors were responsible for the decision to reform, or not to reform? Why is the regulation of the hedge fund industry different in each of the countries? Why is this interesting? And what does it tell us about trends in regulation?

This chapter proceeds in the following stages. It begins with an overview of the importance of both the financial services sector and its subset, the hedge fund management sector. The next section discusses what is meant by the term regulation, and this study’s application of the term. Following this, the chapter goes to the heart of the puzzle and analyses the cross country variation in hedge fund sector regulation. It then proceeds with a discussion and comparison of the regulatory regimes, followed by a review of the objectives of financial regulation, which are shared by the three cases. The chapter concludes with a discussion of the contribution that the study seeks to make, and an important gap in the literature that this research seeks to fill.
Importance of Financial Services Sector

The financial services sector fulfils a unique and special role in every advanced liberal democracy. The sector has an asymmetric yet symbiotic relationship with every other sector in the economy: ‘all branches of economic activity today are fundamentally dependent on access to financial services. In fact, it is the diversified intermediation and risk management services provided by the financial system which have made possible the development of modern economies’ (WTO, 2001:1). The financial services sector is the conduit through which people’s individual savings flow, and the conduit through which money is allocated around the economy. This money that is distributed to the sectors that need it is people’s savings. Savers and borrowers are brought together bringing finance to business and opportunities for savers to manage their finances for the long term. The sector is defined by intense competition, and is in a state of almost perpetual innovation as economic actors create new products and services to compete in the market, satisfy customer preferences and legitimately get around the rules and regulations that may be deemed to stand in the way of a company’s pursuit of its objectives. One of the consequences is that the regulation often lags the activities of the regulated, a challenging if not frustrating position for those actors entrusted with regulating the sector.

The financial services sector’s unique role means that it is one of the most highly regulated sectors in any economy. The past 25 years have witnessed a veritable revolution in financial services regulation (Moran, 1991: 2) meaning that substantial regulatory reform, whether manifested as de-regulation or re-regulation has taken
place in almost every Organisation for Economic Cooperation and Development (OECD) country. De-regulation refers to the liberalisation of the sector, the reduction or removal of government required constraints on a sector, and the reduction or withdrawal of the government from influence and control. Re-regulation refers to the regulatory reform designed to meet an objective, or series of objectives, that result in an increase in the number of rules with which participating companies in the sector must comply. It may enhance or weaken government control over a sector (Vogel: 1996: 17).

**Importance of the Hedge Fund Sector**

Within the financial services industry, hedge funds today play a vital and increasingly powerful role. Despite being around since 1949\(^1\), it is only in the last 10 to 15 years that the arcane hedge fund sector has emerged to attain its important position within the global financial system. Figure 1.1 shows the growth of the global sector since the 1990 expressed in terms of assets under management. The data show that during the 15 years the sector grew at an average annual rate of over 20% and, as will be explained later in this chapter, the sector shifted from being a very small niche segment in the financial system, to becoming a major participant therein.

---

\(^1\) The first hedge fund was founded by Alfred W Jones in the United States in 1949 (Mauldin, John. 2004:283)
There is no single legal definition of the term ‘hedge fund’ and each jurisdiction in which hedge funds operate has a different perspective on what they are and what they do. The term is used variously to refer to individual investment management professionals, corporations, investment products, and investment strategies. In more detail, the individual investment management professionals are the hedge fund advisers or managers; they are the people making the investment decisions. The corporations are the hedge fund management companies or partnerships within which these advisers or managers work. The investment products are the hedge funds in which certain people can invest. And the investment strategies are the different
investment and trading methods used to extract profit from the financial markets. Unless otherwise specified, this research uses the term 'hedge fund sector' to refer principally to the hedge fund advisers and their corporate entities. There are three defining characteristics of a hedge fund: first it has extensive flexibility regarding the investment strategies that can be used to achieve the investment objective, particularly the ability “to sell short” and to use leverage (gearing); secondly, the hedge fund advisers are compensated primarily through performance related fees, and the greater the performance the greater the fee payout; thirdly hedge fund advisers generally align their interests with those of their investors by investing their own money alongside that of their clients.

The vital role that hedge funds play in the financial markets is twofold. First they have become important liquidity providers to the market. Liquidity providers are to the global financial markets what crude oil is to the global industrial sector (Taylor, 2004). Markets do not function without liquidity providers; in fact they can break down such as when the Russian government declared a moratorium on its rouble debt and domestic US dollar debt in August 1998. All markets need sellers when everyone wants to buy and buyers when everyone wants to sell (Taylor, 2004). And the markets can offer healthy returns to the experienced and talented liquidity providers. Despite having only one and a quarter trillion US dollars under management, representing a little over 2% of the total assets under management in the global fund

---

2 When investing in anything, the usual practice is to buy first, wait for the item to increase in value and then sell it. Short selling is the practice of reversing this standard two step transaction process by selling first in the expectation that the item will go down in value and then buying it back in order to close out the transaction. Most investment managers are not allowed to do this – hedge funds are.

3 Standard performance fee is 20% of the profits: source www.oecd.org/dataoecd/6/15/18474849.pdf

4 Lipper TASS Hedge Fund Database
management industry, hedge funds are estimated to account for between thirty and forty percent of all daily trading volume on the New York and London stock exchanges, and are estimated to contribute up to 30% of the profits of investment banks. As shown in Figure 1.1, since 1990 assets under management in hedge funds have grown at an average rate of over 20% per annum. Secondly, they can provide attractive portfolio diversification benefits to investors. The portfolio diversification benefits that some hedge funds offer investors exist primarily because of the greater flexibility in the types of investment strategies that the hedge fund advisers can use. For example, if an individual is invested in the stock market, when the stock market falls in value, her investment is also likely to fall in value. However, if this investor has some money invested in a hedge fund, when the stock market falls the investment may go up in value thereby providing valuable diversification because the performance is not necessarily correlated with the performance of the stock market.

However, as an important provider of liquidity to the financial markets, the hedge fund sector can have potentially destabilising implications for the financial system. There are a number of reasons for this. First, the opaque manner in which the hedge fund advisers function, which refers to the fact that they are not required by most regulatory regimes to disclose their investment holdings. Secondly, their ability to "sell short" which, in a highly pessimistic economic climate in which the stock markets are falling, may exacerbate this downward trend with potentially severe

---

5 The Economist, July 2005; Securities and Exchange Commission, 2005; Dow Jones News Wires, 2005
6 Lipper TASS Hedge Fund Database
7 Portfolio diversification is the investment practice of not putting all your eggs in one basket and allocating the money across different asset classes and investment strategies
financial consequences for many investors. Thirdly, their ability to use substantial amounts of leverage, which is debt used for investment purposes, and which has a multiplier effect on the potential profits and losses. When the economic and financial climate is stable and optimistic the use of leverage can deliver valuable enhanced investment returns. However, in a negative and uncertain climate the use of leverage can multiply losses and destabilise the financial system.

Not everyone can invest in a hedge fund; as we shall see in the section that compares the different regulatory regimes, many investors are prohibited from investing in hedge funds for reasons of regulation. They may also elect not to invest because the taxation of profits from such an investment may be higher than for other investments. The minimum investment amount for most hedge funds is between five hundred thousand and a million US dollars, well beyond the financial scope of most retail (small) investors. And although hedge fund regulation is neither universal nor homogeneous, regulations in many countries prevent the distribution (financial services jargon for “sale”) of hedge funds to the general public which is deemed too poor or too ill informed to invest in them. This issue is explored in more detail in the empirical chapters.

Having established the critical role of the financial services sector to the economy, and the critical role of the hedge fund sector within the financial services sector, this research will now address the issue of regulation. It will start by defining what is meant by regulation and the regulatory regime.
Regulation – Multiple Meanings

What is regulation? It is a research topic that crosses a number of academic disciplines both within and beyond the social sciences. Regulation is a complex and multi-dimensional topic and has a variety of meanings in the literature, each influenced by the research agendas and theoretical and methodological approaches used by scholars in the academic disciplines such as political science, economics, and law to describe and explain regulation. For example, the economic approach to regulation focuses on the outcome of regulation, usually expressed in terms of the effect of regulation on the performance of a particular sector or on economic growth. The political science literature on regulation, however, is more focused on elements such as which actors have the power to determine regulatory regime design and reform; in whose interests are the policies related to regulation of a sector formulated; and what decision making processes characterise and explain decision outcomes in a particular policy area? Within an actor centred analytical approach, the actors are the causes or the drivers of regulatory reform and the researcher seeks to examine the differential environment in which they respond to certain pressures.

This research uses an actor centred analytic approach and follows the narrowest of Baldwin, Scott and Hood’s (1998) three definitions of regulation. This narrow definition, (a) ‘targeted rules’, refers to regulation as an authoritative set of rules usually in association with an administrative government agency responsible for supervising, monitoring and enforcing compliance of the economic actors with these rules. For example, the regulations may state that only investment companies that are
licensed by the regulatory agency can offer savings and investment products to the public, and that such companies must manage their businesses according to specific rules. In contrast, the next definition (b) refers to ‘all the efforts of state agencies to steer the economy’ (Baldwin et al, 1998:3). For example, banks may be required to provide discounted lending to certain borrowers; or tax incentives may be provided to individuals to encourage them to save. To complete this regulatory canvas, the broadest definition, (c), refers to all forms of social control. Within this meaning any influence on the behaviour of any actors in the state can be deemed to be regulatory (Baldwin et al, 1998:3). Targeted rules are neither created nor reformed in a vacuum; nor are they crafted out of thin air (Rapport Public, 1991). They are discussed, drafted and delivered within the regulatory regimes which are themselves, ‘political creations’ (Moran, 1991:22)

These regulatory regimes can be ‘powerful sources of comparative advantage’ in a highly competitive environment such as the financial services sector (Moran, 1991:6-7). The link between financial regulation and the type and size of financial market that exists is well documented: ‘the legislative and regulative provisions that define permissible spheres of activity for various institutions operating in the financial services sector determine to a great extent the kind of institutions and the kind of financial services industry that develop’ (OECD, 1987). So what is a regulatory regime? And, if regulatory regimes are powerful sources of comparative advantage, then it follows that some regimes will be much more conducive to the development of certain economic activity than will others. Figure 1.2 shows the variation in the size of the hedge fund sector in France, Germany and the UK; at the end of 2004 the
hedge fund sector, defined as money advised by hedge fund advisers, in Germany was 30 times smaller than in France whose sector, in turn, was nearly ten times smaller than in the UK.

Figure 1.2: Cross National Comparison of Hedge Fund Sector Size by Assets under Management (US Dollars)

While it is beyond the scope of this research to examine the causes of this variation in sector size, the data are important to the research question because they clearly show the substantial difference in the size of the sector in each of the countries and it is this very difference that may have prompted the regulatory reforms in France and Germany, and the lack thereof in the UK. The fact that some variation exists is not unexpected; however, the extent of the variation, particularly between France and the

11
UK, is unexpected. It has been informally suggested that the UK’s financial regulatory regime is one of the reasons why the size of the sector in the UK is so much larger than that in France or Germany.

Further, it has been suggested that one of the reasons that comprehensive new hedge fund sector regulations were introduced in France and Germany in the early twenty-first century was because the political and economic actors in both countries wanted to create an environment that would enable and encourage the hedge fund sector in each financial centre to expand. The research will examine the role and interaction of three groups of actors, the economic actors, the elected state actors and the bureaucratic state actors, to try to find out which group or groups had the power to determine regulatory regime design and change. It is possible that this examination may reveal different preferences among the economic actors in each of the three cases, and different levels of influence over one or both sets of state actors; it may also reveal quite different incentives in each of the cases for the elected state actors and the bureaucrats.

The policy outcome that this research seeks to shed light on, namely the radical reform of the regulatory regimes addressing the hedge fund sector in France and Germany in 2003 and 2004 respectively, and no change at all in the UK, as well as the cross national variation in hedge fund sector regulation resulting from the reforms, can be understood by examining the interactions of the actors involved. In order to do this it is necessary to have an understanding of two elements. First the

---

8 Interviews with Senior Executives within Economic Actors in France, Germany and the UK
organisational structure that frames policy creation and implementation within the sector. Secondly, the key actors in the policy process, along with their interests and power to influence or determine change; and thirdly, the interaction between the main sets of actors. The research may find that the dynamic of the relationship between the economic actors and both sets of state actors accounts for the very large differences between the sizes of the hedge fund sectors in France, Germany and the UK.

**Hedge Fund Sector Regulation and Regime Variation**

The regulation of the hedge fund sector has become a hot topic in regulatory debate during the past five years. Policy makers and regulators are concerned about the substantial growth in the sector and its impact in two areas: the stability of the financial system and consumer protection. Hedge fund advisers and their investment products are assumed by these actors to be high risk on both counts. The concern regarding systemic risk stems from the fact that hedge funds are increasingly becoming liquidity providers to the financial markets. In addition to representing up to a third of all trading activity in two of the world’s largest stock markets, New York and London, hedge funds provide a significant percentage of liquidity in the fixed-income markets\(^9\), particularly in certain fixed income products. In the twelve months to April 2006 the hedge fund footprint in the fixed income markets was substantial. They accounted for over 55% of all credit derivatives trading volume, generated 45% of annual trading volume in emerging market bonds\(^10\), 47% of annual trading volume

---

\(^9\) Fixed income markets include securities, such as bonds, that pay interest. These securities are generally issued by governments or companies

\(^10\) Bonds issued by governments or companies in emerging economies such as Brazil or India
in distressed debt\textsuperscript{11}, approximately 30\% in leveraged loans\textsuperscript{12}, and 25\% in high yield bonds\textsuperscript{13}. As Greenwich Associates’ consultant, Peter D’Amario put it ‘in many ways, they have become the market’ (Greenwich Associates, August 2006:1).

The concern regarding consumer protection stems from the fact that hedge fund investment products, once the preserve of the super rich and institutional investors (such as banks, insurance companies, foundations, endowments), are becoming accessible to the small, retail investor both directly and via her pension fund. While hedge funds were accessible only by the wealthy and the institutional investors, the explicit regulation of this sector was not deemed necessary. Depending on the national jurisdiction, hedge funds (the products) and/or their advisers were either exempt from the statutory regulation, or were accommodated within the general framework of investment services regulation. It was assumed that such investors had both the wealth and the knowledge to express their preferences and make sensible investment choices and protect themselves from the risks associated with hedge funds.

In the past few years that has all changed. New hedge fund regulations have been introduced in a number of countries, including two of the cases in this study, in the last five years. In France, in August 2003, the Financial Securities Law (Loi de Securité Financière) introduced new investment vehicles allowing all investors access to French hedge funds for the first time. Although France had introduced a very

\textsuperscript{11} Includes public debt securities (e.g. bonds) of companies that cannot service their debt and therefore are in default, bankruptcy or financial restructuring (Oaktree Capital Management)

\textsuperscript{12} Loans regarded as less credit worthy and therefore more risky

\textsuperscript{13} Source: Greenwich Associates, August 2006
specific framework for regulation of the hedge fund sector in 1988, the regulations that were then introduced were narrow in scope and were targeted to support the relatively new French financial futures market, the Marché à Terme International de France (MATIF). They did this by encouraging the economic actors specialising in this segment of the financial market to create investment products\textsuperscript{14} that would use the MATIF and increase liquidity in this relatively new market. Prior to the introduction of the new regulations in 2003 most hedge fund products were made available to French investors either by creatively interpreting the existing investment services regulations, meaning that loopholes in the extant regulations were used to import foreign investment funds into France, or by packaging the investment products so that they did not look like hedge funds, but rather looked like lower risk investments.

In Germany, in January 2004, the Investment Modernisation Act (Gesetz zur Modernisierung des Investmentwesens und zur Besteuerung von Investmentvermögen), referred to herein as the IMAG, came into force. This allows hedge funds to be established and distributed in Germany for the first time. Until this time Germany did not have any explicit regulations either prohibiting or encouraging the hedge fund sector, which meant that the economic actors who had established hedge fund operations prior to the reform did so within the country’s extant broader investment services regulatory regime. As in France, prior to the new regulations some hedge fund products had been offered to German investors but they were established outside Germany and imported, and were packaged so that they looked

\textsuperscript{14} Fonds commun d’intervention sur les marché à terme (FCIMT)
like low risk bond funds, rather than hedge funds, in order to comply with the then regulations.

The UK has not created a specific regulatory regime for the hedge fund sector, preferring to regulate the economic actors and their activities in this sector as it regulates all other investment services economic activity. In 2002, the Financial Services Authority (FSA), the unitary financial regulatory agency, published a Discussion Paper 16 *Hedge Funds and the FSA* to encourage a discussion of how UK based hedge fund managers are regulated. In the UK in 2005, the FSA published a further paper on the topic Discussion Paper 05/4. To date, the UK regulatory regime has not been amended.

The regulatory policy makers have been busy. But what exactly are they regulating, particularly when one of the few areas of common ground is the fact that not one jurisdiction provides a legal definition of hedge fund? The answer to this question varies quite substantially from jurisdiction to jurisdiction. Table 1.1 summarises four key elements of variation across the three cases, and includes a fifth element on which there is no variation.
Table 1.1: Cross national variation in Prudential and Conduct of Business Hedge Fund Regulation

<table>
<thead>
<tr>
<th>Primary Category of Regulation</th>
<th>Key Elements of Hedge Fund Sector Regulation</th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudential and Conduct of Business</td>
<td>Distinct Hedge Fund Sector Regulatory Regime</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Prudential</td>
<td>Regulation of Hedge Fund Advisers?</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Prudential</td>
<td>Investment Strategy Restrictions?</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Conduct of Business</td>
<td>Regulation of Hedge Fund Products?</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Conduct of Business</td>
<td>Distinction between single &amp; fund of hedge funds?</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Conduct of Business</td>
<td>Investor Type Restrictions?</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
</tbody>
</table>

Source: Adapted from International Organisation of Securities Commissions (IOSCO) Consultation Report, Appendix C, March 2006

What exactly does Table 1.1 tell us? It starts by telling us that in the UK the hedge fund sector does not have its own separate regulatory regime, and is regulated by the investment services regime which also regulates all other investment services activity. This contrasts with the situation in France and in Germany in which a separate regulatory regime is carved out of the investment services regime for the hedge fund sector. It then shows us that in France and the UK the hedge fund adviser is regulated, in Germany it is not. In Germany and France, the hedge fund investment product itself is regulated; in the UK it is not. The hedge fund product is the investment vehicle (fund) in which investors invest; the hedge fund adviser is the company and its personnel which makes the investment decisions with the objective of producing profits for the investors in the hedge fund product. What this means is that in Germany an unregulated firm can set up a hedge fund product, but can only

---

15 A fund of hedge funds aims to reduce risk by spreading the investment across multiple hedge funds, rather than investing in a single fund.

16 Funds of hedge funds (FoHFs) are authorised for institutional not retail investment.
promote that product to investors once the said product has been authorised by the regulator, the Federal Financial Supervisory Authority (BaFin). In France, only firms that are authorised by the Autorité des Marchés Financiers (AMF) under the hedge fund regulations can establish hedge fund products and, with the exception of one type of fund\textsuperscript{17}, the products must be authorised by the AMF if they are to be promoted to investors. In the UK any firm providing investment services must be regulated by the FSA, and this includes hedge fund advisers. The UK based hedge fund advisers are regulated under exactly the same regulations as any other investment services provider; there are no regulations specific to hedge fund advisers. However, the UK does not require hedge fund products to be regulated; in fact, it does not require any investment products to be regulated. The focus is on regulating the adviser, not the investment vehicle which is fundamentally different to the German approach. France requires both the advisers \textit{and} the products to be regulated.

Table 1.1 also shows that the regulatory regimes in France and Germany impose restrictions on the type of investment strategies that can be used by the hedge fund advisers; the regime in the UK does not. Restrictions include the amount of gearing or leverage that may be used, the types of investment securities that may be bought or sold, and the amount of money that can be invested in a single security such as a stock or bond. These restrictions are in place because of concerns relating to systemic risk. Finally, the table shows that while France and Germany distinguish between two different generic types of hedge fund investment products, on the basis that one is

\textsuperscript{17} Contractual funds must file with the AMF, but do not require authorisation from the AMF
deemed to be more risky than the other, the UK regime makes no such distinction. If regulatory regimes can provide the nation state with a formidable competitive edge by enabling the activity of the economic actors, which actors were responsible for the design of the three regimes and what motivated their choice of each regime's distinguishing characteristics? To try to answer these questions, an understanding of exactly what constitutes a regulatory regime is useful.

Regulatory Regimes

The regulatory regime is made up of 'specific constellations of ideas and institutions' (Vogel, 1996:20). In Vogel's framework, ideas refer to regime orientation while institutions refer to regime organisation. Regime orientation is about the political and bureaucratic actors' opinions concerning the appropriate scope, objectives and methods of government intervention in the economy, and about how this intervention affects economic performance. Regime organisation is about the organisation of the political and bureaucratic actors concerned within a specific policy sector and the relationship of these actors with the economic actors (Vogel, 1996:20-21).

Regime Orientation

In the context of the overall investment services sector within which the hedge fund sector resides, regime orientation is about the extent to which the regulation is principles based, prescriptive or a combination of the two approaches. Within the narrower hedge fund sector, regime orientation also includes whether or not to allow
all investors to invest in hedge funds, or to limit access to certain types of investor, the only element in Table 1.1 on which there is no variation. Whether or not to impose investment restrictions such as allowing or prohibiting the practice of short selling, or the use of leverage; and the desirability of placing limits on the practice of either are also important considerations.

At the heart of the variation in regulatory regime design is the degree to which regimes are principles based or prescriptive based. ‘Principles are implicitly understood to be rules which are general in their language, purposive in their content, and non-legal in their effect’ (Black, 1999: 113); they provide flexibility, but not legal certainty because they are open to interpretation. Prescriptive based regulation is almost the mirror image of principles based: it provides detailed rules which offer the regulator and the regulated certainty, predictability and consistency. All three hedge fund sector regulatory regimes are a combination of both; however, the regulations in France and Germany are more prescriptive than those in the UK.

One of the best examples of a fundamental principle common to all the regimes is that of “best execution”. This is the requirement for investment services companies to execute transactions in the best interests of their clients. Best interests may include price improvement, speed of the transaction and anonymity, and clients may prioritise these objectives differently. To some anonymity may be paramount, and the client may be willing to accept that the transaction will not be done at the “best” price. For others, price improvement may be paramount and the speed at which the order is executed is not crucial. In a principles-based regime, the investment services
company uses its discretion in executing the transaction to ensure that each client receives best execution. In a prescriptive-based regime, a rule book tells the company how to execute the transaction, irrespective of the idiosyncratic requirements of its different customers.

Principles based regulation is generally preferred by management, but not by compliance departments\(^\text{18}\) or the firm's lawyers\(^\text{19}\). Management generally prefers it because it offers flexibility and proportionality; compliance departments and lawyers dislike it because of its uncertain, inconsistent and unpredictable characteristics. The industry that is being regulated is not an homogeneous economic actor, which in the context of this study will be demonstrated in the empirical chapters. Further, within particular firms the homogeneity of interests and preferences regarding the more desirable regulatory approach, prescriptive or principles, does not always exist.

This tension goes to the core of the politics of regulation and is one of the biggest challenges facing the regulators, in any sector, as they seek to find the right equilibrium between the conflicting requirements of certainty and flexibility, as well as the conflicting requirements of precision and generality (Black, 1999: 95). Most economic actors want a degree of flexibility, but they also want certainty because they need to know what conduct of business is acceptable and what is not; they do not want to fall foul of the regulations and incur sanctions. The three most commonly cited disadvantages of highly prescriptive regulation are that it can lead to a culture of

\(^{18}\) The compliance department is responsible within the company for ensuring that the company's activities are in compliance with the rules and regulations

\(^{19}\) Interview, Senior Executive at Economic Actor in the UK, 6\textsuperscript{th} February 2006
box ticking in which compliance is all about the process rather than about the outcome; instead of the regulatory goals being the focus, the rules are the focus, the consequence of which is that ‘the letter of the law may be obeyed at the cost of the spirit’ (Goodhart et al, 1998:3). Secondly, regulated firms may be inappropriately treated; and, thirdly, it fosters a culture of ‘creative compliance’ because the very existence of precise rules makes loopholes easier to identify and exploit (Black, 1999; Goodhart et al, 1998).

Prescriptive based regulatory regimes consist of the following: a set of rules drawn up by policy makers and regulators sometimes in consultation with the economic actors and their advisers, but rarely in consultation with the consumer; a single regulatory agency, or sometimes multiple regulatory agencies, responsible for monitoring compliance with the rules and ultimate enforcement thereof. The financial regulatory model used in the United States of America (US) is, perhaps, the original prescriptive model which owes its origins to the crisis generated by the stock market collapse of 1929 and ensuing Great Depression.

One of the issues with which policy makers struggle is designing the regulatory environment to satisfy the preferences of both investors, who seek protection, and economic actors who seek a robust but light-touch regime which does not overburden them with regulatory disclosure and operational requirements and the accompanying costs. In a global financial system in which the market has fewer and fewer boundaries, the economic actors can overcome any regulatory boundaries by moving
to a preferred location. At the core is the debate regarding the relative value of the prescriptive versus the principles based approach to regulation.

**Regime Organisation**

*Regime organisation* is manifested in the institutional structure of the key actors, political, bureaucratic and economic, in the policy space. Organisation includes, *inter alia*, the number of regulatory agencies, the scope of each agency, and how it is funded. For example, the regime may have a single, super regulatory agency like the FSA in the UK or the BaFin in Germany, responsible for all activities within financial services; or, as in France, it may have multiple agencies responsible for specific functions and activities, such as investment management, banking or insurance, and the agencies' funding may come from central government, from the regulated entities or a mixture of both. How the agencies relate to and interact with the political and economic actors and the degree to which the regulatory agencies are independent of government are important institutional factors and influence the size and scope of the regulated sector. Within the narrower hedge fund sector, regime organisation includes whether or not the sector is carved out and regulated separately and distinctly from the rest of the investment services sector, as is the case in France and Germany; or whether the sector is not carved out, and is regulated according to the same principles and rules as all other investment services companies, which is the case in the UK.
Hedge fund sector regime organisation further includes the approach to *prudential* and *conduct of business* regulation. In Germany and the UK both are managed by a single agency; in France, prudential and conduct of business regulation are managed by separate regulatory agencies. These variations in regime organisation create different institutional environments in which the state actors, both elected and bureaucratic, and economic actors act and interact. The actors involved in the introduction of new hedge fund sector regulations in France and Germany had specific interests and preferences that the regulatory reforms sought to fulfil; and the interactions of the different actors, as well as the outcome of their interaction was structured and shaped by distinct characteristics of the French and German institutional settings in which they took place (Scharpf; 1997: 1). The approach to regulation of the hedge fund sector in the UK and the decision not to carve out a distinct regime for it outside the general investment services regime, unlike in the other two cases, is also closely linked to the interests and preferences of the relevant actors, whose interaction too was framed by the domestic institutional setting, as the study will examine in the empirical chapters.

The distinction between prudential and conduct of business regulation sits at the heart of the hedge fund sector regime variation. Prudential regulation refers to the rules that exist to ensure that only companies that meet minimum agreed standards of solvency and soundness are able to offer investment services to consumers both wholesale and retail (Llewellyn, 1999: 10). This prudential regulation is deemed necessary because consumers, especially retail consumers, are not often in a position to judge the quality of a financial organisation and its products because of lack of
information, knowledge and expertise. Furthermore, unlike the purchase of many consumer items, the purchase of the financial product, such as a savings and investment product, is a one-off purchase. It is rare for individuals to purchase multiple investment products, and if you only buy something very occasionally it is difficult to compare and contrast the quality of the product, its price and the after sales service with other products. The consumer is dependent on the integrity and skill of a firm to manage this product and is unlikely to know for many years whether she has bought well or not because the quality of the performance of most investment and savings products can only be evaluated over time. Evaluating the quality of companies, products and services is difficult and costly for the retail consumer who may find that useful information is very inaccessible.

Conduct of business regulation is a primary tool in the regulatory regime for addressing the issue of consumer protection. In the empirical chapters the study will examine whether the state actors' concern for consumer protection has been an important driver of the reforms that introduced new hedge fund sector regulation in France and Germany. Conduct of business regulation refers to the manner in which the providers of investment services are allowed to interact both with potential and existing customers. It dictates how a company may promote products and services to potential clients; for example, cold-calling, or unsolicited email distribution, may be prohibited. It dictates the type of information that can be shared with clients, for example any product performance information may be required to be audited. Conduct of business regulation has rules regarding the manner in which information should be presented to consumers; for example any product sales literature must be
accompanied by the prospectus (legal investment document); and the framework for ongoing communication, for example product performance reports must be provided to investors on a mandated frequency.

The variation in conduct of business regulation relating to investment services between the three cases is quite substantial. With regard to the promotion of investment services and products, in Germany cold calling, including by email and facsimile, is prohibited under both the Unfair Competition Acts of 1909 and 2004\textsuperscript{20}, and the Securities Trading Act, 1995; however, unsolicited letters are allowed. And investment product or service promotional materials need to comply with the restrictions set out in the Unfair Competition Act, the conduct of business rules, the Banking Act and the German Investment Act. In France cold calling is not explicitly prohibited; however companies that promote financial services and products in a misleading or unclear way, may be liable for prosecution either under specific rules covering the financial services industry such as conduct of business rules, or under more general rules applicable to all professionals in France. The regulatory regime in the UK places severe restrictions on any promotion, whether in writing on paper or electronically, or orally, that is classified as an invitation or inducement to make an investment in a service or product. Any financial promotion must be issued or approved by a company that is regulated by the FSA, or the promotion has to fall within one of the exemptions to the regulatory requirements. Failure to comply is a criminal offence.

\textsuperscript{20} The original Unfair Competition Act dated from October 1909. In July 2004 the German legislature passed a completely new statute.
The principle of *best execution* falls within the conduct of business regulation. In France the AMF General Regulations provide precise information regarding the best execution rule and the duty required of companies to execute client orders in the best possible manner; and the French regulations do not allow for any exemptions from this obligation for certain types of client, as is the case in the UK for example. In Germany the best execution provisions under the conduct of business regulations require investment companies to execute orders at the best available price for the size and type of transaction; as in France there is no general exemption from the best execution obligation for certain types of clients. The UK approach to best execution is slightly different. Companies owe a duty of best execution to 'private' and ‘intermediate’ customers, but not to 'market counterparties'\(^\text{21}\).

It is clear from this discussion of conduct of business regulation that the concept of investor protection is not uniform across the three cases. On the basis that a primary reason for the introduction of new hedge fund sector regulations is to provide investors with better protection than that afforded by the previous regulations, one would expect the cross national hedge fund regime variation to be linked to the different national approaches to investor protection.

The final element of regime organisation that is particularly relevant to this study is segmentation of the investment services sector into the wholesale market and the retail market. This distinction, coupled with the size of the wholesale market, is

\(^{21}\) FSA Glossary of Definitions, *FSA Handbook*, Release 049, 2005. Private customer is a private individual who is not an intermediate customer or a market counterparty. A market counterparty is, for example, a central bank, State investment body, financial institution. An intermediate customer is a client who is not a market counterparty or a private investor.
expected to have had a major influence on the national approach to hedge fund sector regulation and the resulting cross national variation; and will be investigated in the empirical chapters. Regulation of the wholesale market concerns the regulation of professional market participants who conduct business with one another. They are assumed to be able to make knowledgeable and informed decisions because they have access to all the necessary information. Information asymmetries are not considered to exist in the wholesale market. Regulation of the retail sector concerns the regulation of individual consumers who are considered vulnerable because of lack of financial market knowledge and expertise. The retail sector can, as a result, be subject to different regulations and scholars and practitioners agree that this is appropriate (Goodhart et al, 1998:7). The balance between the wholesale and retail, and the importance or not, of the wholesale market to the overall sector is reflected in the regulatory regime designs.

The size of the wholesale sectors in France and Germany is small relative to the size of the respective retail sectors which are much larger. This suggests that regulatory policy makers will be more concerned by issues relating to the retail sector. In the UK, however, the size and power of the wholesale market may have a major influence on regime design, and may be an important reason for the maintenance of the regulatory status quo in the UK. The regime in France does not distinguish between the regulation of the wholesale and retail markets; the case studies will analyse whether this characteristic can be linked to the type of hedge fund sector regulation introduced in France. The regulatory regimes in both Germany and the

---

22 Interviews, Senior Executives within Economic Actors in France and Germany, February, March and May 2006
UK treated the wholesale and retail markets as one and the same until substantial regulatory reform was introduced in both cases in 1995 and 1986 respectively and, for the first time, the state actors chose to distinguish between the two markets. As in the French case, this regime characteristic will be examined to find out if the regime organisation which separates the wholesale and the retail sectors is directly linked to the type of hedge fund sector regulatory regimes in the UK and Germany.

Why Do Regulatory Regimes Matter?

Regulatory regimes have a normative role to fulfil. One of the main objectives of regulatory regimes is to induce minimum behavioural standards and practices by the suppliers of financial products and services. This is important because the financial services sector plays a critical role in the economy because it is the conduit through which investors’ savings are intermediated. The standards of legitimacy of any financial services regulation are decided, to a significant degree, by normative issues (Gilligan, 1999: 106). This is because the state actors are deemed to have a responsibility to serve the public interest by designing a financial regulatory regime that can meet the desired objectives. Secondly, it is well established that there is a strong correlation between economic growth and the structure of the financial sector. Both advanced industrial as well as developing economies review and analyse other countries for ideas and policy models to identify optimal solutions to policy problems.
Increasing financial market globalisation and integration are having an effect on regulation to the extent that regulatory models and approaches are being re-thought at both national and international levels, by both economic and state actors. Although to date there is no international financial regulatory authority, there are international bodies, for example, the Bank for International Settlements (BIS), the International Organisation of Securities Commissions (IOSCO), and the Committee of European Securities Regulators (CESR) that influence regulatory debate and seek to establish international standards and guidelines. This re-thinking is driven by having to deal with the consequences of trans-national economic activity (McCrudden, 1999: 3). The financial regulatory regimes in some of the world’s most wealthy countries are not homogeneous: those seeking to learn from and, possibly, imitate or emulate the regulatory regime of one or more of the successful economies, have extensive choice.

There is a third reason why regulatory regimes matter and it relates to one of the biggest policy challenges facing governments today. This is the very present and growing problem, in advanced liberal democracies, of the provision of pensions and long term financial security to an increasingly elderly population: the so-called pension time bomb. The pension time bomb refers to the fact that people are living longer and fertility rates are declining. This means that the ratio of tax paying workers to pension-receiving retirees is declining. At the beginning of this century the ratio of working tax payers to non-working pensioners in the developed world was approximately three to one. By 2030, without reform, this ratio is expected to fall to one and a half to one and, in some countries such as Germany and Italy, it is expected to drop to one to one or even lower (Petersen, 2000).
This demographic trend provides state actors in advanced liberal democracies with a substantial policy challenge, how to provide long term financial security to their citizens, 90% of whom rely almost totally on public pensions when they retire (Business Week, 2005). In response to this concern, in the late 1980s and early 1990s governments started encouraging individuals to save for themselves by purchasing pension and other investment products, including shares in newly privatised companies. One of the effects of this is that pension funds, on behalf of individual savers, as well as the individuals themselves, have been increasing their exposure to hedge funds (Casey, Quirk & Acito and the Bank of New York 2004). And this development has raised concerns because the hedge fund sector is regarded by some as the investment equivalent of the “wild west”, a sector with little regulation populated by “locusts” in the pursuit of financial reward at any cost (Parades, 2006: 6).

The importance of the sector to the state actors was highlighted when hedge funds topped the agenda at the meeting of the world’s leading industrial countries, the so-called G7, in Essen in Germany in February 2007; the German political actors were concerned about the risk the hedge fund sector may pose to the stability of global financial markets and the economy, and to the growing number of individual investors accessing the sector. As noted earlier, the hedge fund sector has the potential to destabilise the financial markets for two key reasons: its use of leverage, or gearing, and its role as an important liquidity provider to these markets. These two

---

21 In 2005 Franz Muentefering, then Chairman of Germany’s Social Democratic Party, described hedge funds as locusts. In February, 2007 he repeated the statement as Vice Chancellor of Germany: “German vice-chancellor stands by his call to tackle ‘locusts’”, Financial Times, 15 February, 2007
factors, coupled with the fact that the hedge funds are not generally required to report all the content of their portfolios to the regulators, have given some policy makers cause for concern. The nationally designed regulations display quite a strong variation in the state actors' assessment of these risks, an issue to which the study will return later in the research.

The designers of financial regulatory regimes have two primary issues to address. First, the objectives of the regulation and, secondly, the selection of the model of regulation that will be the vessel through which the objectives can be achieved. The research now proceeds with an analysis of the objectives of regulation.

**Similarity of Objectives in Financial Regulation**

All regulation is designed to deliver a particular outcome. Regulation, in effect, requires firms to operate and manage their activities in a particular way; if the government simply wanted to encourage firms to behave in a particular manner, it would induce them with other incentives such as taxes and subsidies (Sappington and Stiglitz in Bailey, 1987: 5). Despite the heterogeneity of many financial regulatory regimes, including the three under analysis in this research, they share five common objectives. First, the maintenance of a stable financial system through the prevention of financial crises and related systemic risk. Systemic risk refers to a scenario in which a serious problem in a company, in a market sector, or to a settlement system. Settlemen

---

*Settlement is the completion of a transaction: the seller transfers securities or financial instruments to the buyer and the buyer transfers money to the seller. Settlement, or payment, systems provide the*
could cause a "domino effect" throughout the financial markets resulting in the failure of one company after another (IOSCO, 1998:7). It can also refer to a crisis of confidence among investors which creates illiquid conditions in the financial market (IOSCO, 1998:7). Secondly, the assurance of the integrity, safety and soundness of financial institutions which is known as prudential regulation. Thirdly, the protection of the consumer, explicitly the retail consumer. Fourthly, the maintenance of consumer confidence in the financial system as a whole, and in the financial institutions that operate within the system. Finally, the prevention of fraud and financial crime including money laundering and terrorist financing.

The overall financial system includes the circulation of money, banking services, credit granting services, insurance services, securities broking services, as well as savings and investment services. If the financial system or a financial institution is at risk, the economic and social, not to mention political, consequences may be substantial. By way of example, in the savings and loan crisis in the United States of the 1980s and 1990s, an estimated 50% of all savings associations, holding between them total assets of over US $500 billion, failed resulting in a 'clean up' cost to the taxpayers of approximately US $124 billion, as well as a cost to the savings industry of US $29 billion (Curry and Shibut, 2000). In France, the Credit Lyonnais scandal in the mid 1990s is estimated to have cost the French taxpayers US $20-30 billion as the government bailed out the bank in 1994, 1996 and 1997. These three bailouts were the equivalent of total government expenditure on Housing and

channels through which funds are transferred among financial institutions to fulfil payment obligations arising in the financial markets

25 US Savings associations with explicit insurance provided by US government agencies
Community Amenities over the same period\textsuperscript{26}. While these two financial crises were very different in profile and scope and had very different causes, they are examples of events that financial regulatory regimes aim to prevent.

The consequences of neither protecting the consumer, nor of maintaining her confidence in the financial system, can be great. For example, if consumers are concerned about the integrity of a particular bank and, as a result, decide to take out their money, other customers of other banks may follow suit. The effect of such action is to reduce the amount of money available in the financial system thereby forcing the banks to reduce their lending activities which will negatively impact their corporate and private customers alike by making it difficult for them either to re-negotiate existing borrowing facilities, or to take out a new loan.

One of the primary reasons that protection of the consumer is included in the objectives of most financial regulatory regimes is the issue of asymmetric information. Investment and savings products are manufactured and promoted by professional financial services companies and their representatives. These professionals generally have considerably more knowledge and expertise than their retail clients. Small investors are considered to be vulnerable to an information asymmetry; the rigorous evaluation of the integrity of both financial institutions, and the products and services that are offered, requires a degree of knowledge and expertise that is often absent on the demand side of the retail market. A particularly acute example of this is the personal pension’s “mis-selling” crisis in the UK during

\textsuperscript{26} OECD country reports 1994, 1996, 1997
the late 1980s and early 1990s which, by the end of June 2002, resulted in total compensation of over US $18 billion being paid to people who had been wrongly sold personal pensions between April 1988 and June 1994\textsuperscript{27}. The crisis was an unintended consequence of a government policy initiative to reduce future social security costs. This initiative offered individuals an incentive to opt out of state run pensions and to buy a personal pension. The government also abolished the compulsory membership of occupational pension funds. It is estimated that 500,000 individuals were persuaded by commission driven sales people to leave occupational funds and that 90\% of these individuals received inappropriate advice (Davis, 2004: 16).

This pensions mis-selling scandal highlighted the need for effective regulation to protect the consumer, and was a major cause of the substantial reform of the UK financial regulatory regime announced by the state actors in 1997 and completed in 2001. It is relevant because, as will be discussed in the second chapter, financial crisis is one of the possible causes of regulatory reform that will be tested in this study. A financial crisis functions as a ‘focal point around which the behaviour of actors converges’, and it can be a valuable resource for the policy entrepreneurs who are keen to reform or expand the regulatory regime (Pagoulatos, 1999: 90).

\textsuperscript{27} www.sharingPensions.co.uk (accessed April 2007)
Literature Lacuna

Most of the literature on financial regulation is focused on the banking sector. Scholars agree that banks are special, and that they are special for two reasons. First they are the only source of finance for most borrowers; and, secondly, they manage and control the payments system (Bernanke, 1983; Goodhart et al, 1998). If the banking system is at risk, the probable financial disruption to the economy is likely to be more serious than would be the case with other sectors of the financial system.

Banks have mismatched assets and liabilities: their assets are illiquid long term loans, their liabilities are short term deposits which can be withdrawn on demand. The failure of one bank could have a contagious effect on the health of other banks, and the whole financial system, as lack of consumer confidence results in a “run” on the banks.

The rationale for regulation and the format of regulation differs between banking and non-banking financial services. Systemic issues whereby the failure of a single entity can have a contagious effect on the whole system, are paramount in the regulation of banks; but systemic issues are less significant in the area of non-banking financial services such as investment management where ‘consumer protection issues are comparatively more important’ (Goodhart et al, 1998: 10). However, as the boundaries between financial markets become blurred and as the hedge fund sector expands, the concern about systemic risk spreads beyond the regulation of banks. This happens because of the particularly unique features of the sector’s approach to investment management.
As has been noted earlier, hedge funds have extensive flexibility with regard to how they invest and can buy or sell assets and securities that more traditional investment managers may not; hedge funds use gearing (leverage) which means that they have to borrow from a third party financial institution such as a bank to obtain the gearing. If something goes wrong, both the financial institution and the hedge fund could face the risk of loss; this is not the case with so-called traditional funds, such as mutual funds, where only the mutual fund would be at risk.

An examination of financial system regulation through the lens of hedge fund sector regulation has not been done and is useful for a number of reasons. The sector is one of the fastest growing segments in the financial system. It has become an increasingly important provider of liquidity to the financial markets raising concerns about the impact of the sector on the stability of the global financial system. Added to this, the sector intermediates an increasing amount of investor savings around the world. Further, the sector is both dynamic and footloose which means that its actors and activities can move from one regulatory regime to another with relative ease. The characteristics of the hedge fund sector raise concerns for policy makers that cut to the core of how they best meet the regulatory objectives of preventing financial crises and protecting the consumer.

Until the early twenty first century, the hedge fund sector functioned, in the main, within the existing national regulatory frameworks for investment services. This is
no longer the case, evidenced by the carving out and creation of explicit hedge fund sector regulatory regimes within broader national financial regulatory environments. Understanding why and in whose interests the regulatory reforms took place, which actors were responsible for the policies that determined the reforms and the regulatory regime design, and how the three sets of actors - the economic, the state elected and the state bureaucratic - interacted should shed useful light on a number of elements of regulatory policy.

Financial regulation is justified by policy makers for the following reasons. One of the aims is to facilitate the maintenance of a healthy and robust national financial system in which both economic actors and the public have confidence. A second aim is to protect the public from rogue economic actors, and from the potential risks derived from the asymmetric characteristics of information and knowledge distribution in the sector. Thirdly, the policy makers aim to prevent systemic failure of the domestic financial system. The fourth justification for financial regulation is to obtain what economists call a positive externality which, in the context of this study, results in the purchase by the consumer of savings and investment products and services (Bentson, 2000: 9). Policy makers are charged with achieving these objectives in the most global of global markets (Brathwaite and Drahos, 2000: 8) in which both capital and economic actors can move freely rendering national borders either porous or almost non existent.
This study is concerned with the drivers of regulatory reform and regime design. A unified theory of regulation does not exist. Within the political science and political economy literature several theoretical explanations have been developed to explain 'how and why regulations evolve as they do and what forces can lead to their durability as well as their potential for change' (Kroszner, 1999: 5). Two theories of regulation, as will be examined in detail in chapter 2, guide this research; the public interest and private interest theories of regulation. Scholars who have examined and explained regulatory reform and variation in financial services regulation include: Cerny (1989); Coleman (1996); Laurence (1996); Lütz (1996); Moran (1991); Vogel (1996); and Westrup (2006).

These scholars have examined some of the challenges faced by national regulatory regimes in an increasingly seamless world financial market, and identified variables that can serve as catalysts for regulatory reform. Chapter 2 will discuss these scholars' arguments and findings. It is intriguing that in spite of the globalisation of the markets, international economic activity and competition remains powerfully conditioned by national regulation (Vogel, 1996), a finding with which all scholars above agree. This issue is at the heart of this research study. The hedge fund sector represents one of the most footloose segments of the financial system and the state actors in France, Germany and the UK have each adopted a different model of regulation for the sector. Why did they do this? Following the literature, the study will apply three explanations to the puzzle: globalisation; Americanisation; and the relationship between the domestic economic and bureaucratic actors which is influenced by the institutional setting in which these actors function. The study will
add one additional explanation, financial crisis. The rationale for the selection and inclusion of the four variables will be explained in detail in chapter 2. By way of summary, despite being considered a determinant of regulatory reform, financial crisis has not been empirically tested in the literature. Further, as will be examined in the next chapter, globalisation and Americanisation are theoretically distinct variables which share a common theme, namely liberalisation. By unpacking their distinct characteristics from this common theme it is hoped that the study can identify the extent to which each variable may have driven reform and design.

As developed above, a key objective of this thesis is to examine why, in an increasingly integrated global financial system the design of financial regulatory regimes remains distinctly national. The issue is puzzling because the state and economic actors in France, Germany and the United Kingdom, are subject to many of the same pressures. The study seeks to find out what drives regulatory reform and why the cross national variation in regulatory regime design is exhibited. The research may find that the regulatory reforms in France and Germany were driven by the elected state actors in the interest of enhancing or strengthening the national regulatory regime. The actors may have been motivated by the desire to maintain and reinforce state sovereignty in the face of market globalisation, and to use the regulatory regime as an institutional filter to the pressures presented by market globalisation; the incentive may also have been to make the domestic financial market more competitive on the basis that regulatory regimes can be powerful tools of competitive advantage. Alternatively, the study may find that the regulatory reform and the national regulatory regime design were determined by the interests
and actions of the economic actors, both the domestic and the foreign, either as a result of direct interaction with the state actors, or indirectly as a result of the actions of firms in the sector. By identifying the role played by each of the actors in the regulatory reform and regime design process, the rationale for their actions and the interaction between the actors that produced the policy outcome, this study may provide useful knowledge to policy scholars and practitioners focusing on policy making in other sectors of the economy which are faced with market characteristics and challenges similar to the ones experienced by the regulators of the hedge fund sector.

The drivers of reform, and the variation in the hedge fund sector regulations, raise interesting questions about optimum regulatory methods and regime design. The financial services sector is one of the most highly regulated and dynamic sectors in the policy space providing regulatory regimes with significant challenges as they struggle to adapt to market developments (Goodhart et al, 1998; Moran, 1991; Steil, 1994; Vogel, 1996). Public policy in the financial sector concerns itself with fundamental issues such as whether the regulatory distinction between investment services companies, banks and insurance companies is meaningful, whether the distinction between hedge fund managers and other fund managers is meaningful, whether principles based regulation is more appropriate than prescriptive regulation, and whether the current boundaries within the financial system, and their accompanying regulations, are still valid (Goodhart et al, 1998; Mayer, 1995; Steil, 1994). Public policy also affects the size and configuration of the financial sector and, as has already been noted, can have profound economic and social
consequences. Any financial regulation is, implicitly, also economic and social regulation (Francis, 1993); the fact that the financial services sector affects every aspect of economic activity in society makes it so. By systematically examining regulatory policy across France, Germany and the UK through the prism of the hedge fund sector, this cross national comparative research aims to help understand the actors and factors that shape both the regime design and the outcomes. The research seeks to find ‘generic knowledge’ (George and Bennett, 2005: 272, italics in the original) that may contribute to existing regulatory theory, or may lead to a better explanation of the causal links that affect regulatory regime design.

Although the identification of useful evidence to help explain variation in regulatory regime reform and design is the primary objective of this research, a secondary objective is to analyse the evidence and identify trends, if any, in the politics of regulation. The next chapter will present a critical review of the competing theoretical explanations posited in the literature for the rationale behind regulatory regime reform and design. Chapter 2 will proceed in the following way. It will start with a closer examination of two political economy theories of regulation that may underpin the actions of the three sets of actors being analysed in this study. It will then turn to an examination of the four variables of explanation that this study sets out to test, and discuss the use of the variables in the literature and the conclusions drawn. It will conclude with a discussion of the research design and method, including explanation of the case selection and identification of the data sources.

28 Generic knowledge is defined by George and Bennett (2005 as ‘a useful label for a form of theory that is of recognisable interest to policy specialists’. George and Bennett refer to middle-range theories which ‘are more likely to constitute useable knowledge for policy than broad, general theories’ (272-275).
Chapter 2

Theoretical Framework and Main Variables of Explanation

Introduction

This chapter discusses the theoretical explanations in the literature that have been used to explain regulatory regime reform and design, and describes the theoretical underpinnings of this research. Using an actor-centred approach, the study is guided by two theories of regulation, the public interest theory and the private interest theory, both of which will be discussed in detail in the next section of this chapter. The study seeks to identify whether the policy outcome, which is defined as the decision in France and Germany to reform the regulation of the hedge fund sector and the decision in the UK not to engage in any reform, resulted from the action of a principal actor, or from the strategic interaction among different actors. In doing this the study seeks to determine the effect on the elected state actors (the government), the appointed state actors (the bureaucrats) and the domestic economic actors of four main variables of explanation: financial crisis, the institutionally conditioned relationship between the economic and bureaucratic actors, globalisation, and Americanisation. Using the public interest and private interest theories of regulation as guides, the study seeks to identify the link between each variable of explanation and the behaviour of the different sets of actors and the regulatory outcome.

This chapter will proceed in the following way. The next section will start with a discussion of the two theories of regulation. The chapter will continue with a review
of the four explanatory variables and a description of how each will be applied to the puzzle. The chapter concludes in two stages. First by discussing the research designs and methods employed by scholars in the examination of financial regulation; and moving on to describe this particular study’s research design and method and case selection. The second stage provides a summary of the primary and secondary data sources.

Two Theories of Regulation

Public Interest Theory

‘Producing outcomes that are in the interests of everyone (the ‘public interest’) is the traditional aim of regulatory policies’ (Hix, 1999: 212). The concept posits that regulation exists for the protection and the benefit of the public. The objective of regulation is to protect the consumer through the implementation of specific legislation, compliance with which by the economic actors is managed, generally, by a specific regulatory agency. In effect the state officials act in the public interest to control the behaviour of the private sector (Baldwin and Cave, 1999). It has been noted that public interest theory has no known author in the political economy literature (Hantke-Domas, 2003). Richard Posner (1974) is the first scholar credited, within the literature, with attributing the rationale for regulation to a theory based on the concept of public interest (Hantke-Domas, 2003:165). However, the normative underpinnings of the public interest theory of policy making date back over two thousand years. In the Republic (Plato, c.360 B.C.E.) an ideal state is presented in
which those responsible for governing do so 'with a view to maximising the happiness of the state as a whole' (Bostock, 1995: 685). Therefore, in an ideal state, policy makers should design and craft policies that are in the public interest. Public interest theory assumes that the purpose of regulation is to promote public values and that the state actors, acting in the public interest, establish a legal framework to achieve a specific set of regulatory objectives (Francis, 1993: 7; Stone, 1977). However, what is the public interest; how is it determined; and by whom? It is not possible to understand the variation in regulatory regime design without understanding how governments in different countries define the public interest (Vogel, 1996).

The public interest can be considered 'part of an ideological posture about the aims of the state, or the government' (Hanke-Domas, 2003: 187). Ideology not only influences whether or not, or the degree to which, the state may intervene in the economy, it also influences the type of regulation that may result from such intervention (Coleman, 1996; Moran, 1991; Vogel, 1996). At one end of the spectrum the state may own everything, in which case the need for a separate financial sector regulator and its accompanying rules and regulations is non-existent. At the other end, the market may be left to organise and police itself motivated by the fact that consumers will not invest if they do not have confidence in the soundness and integrity of the market, and that for the economic actors supplying the products and services a good reputation is a competitive advantage. One of the determinants of the chosen regulatory model is the state actors' desire to regulate the sector in the public interest.
Private Interest Theory and the Role of Economic and State Actors

The core of the private interest theory of regulation²⁹ is the relationship between the economic actors and the state actors. Using private interest theory as a guide, the question to which an answer is sought is whether the relationship between the economic and bureaucratic actors can explain the hedge fund sector regulation in each case, particularly in the context of the domestic economic actors persuading the state actors to give them the regulations that they, these economic actors, want. The private interest theory of regulation can be sourced to a particular scholar, Stigler (1971). The theory’s principal hypothesis is that regulation benefits, and is therefore sought by the regulated industries that, in essence, “capture” the state actors. The contention is that the interests of the economic actors, particularly big business, and the state actors are so closely connected that the bureaucracy ‘almost acts as servant of private interest’ (Vogel, 1996: 266). In his seminal article in 1971, Stigler defined what has since become known as the capture theory of regulation. In this theory, on the assumption that political actors always need votes and will offer favours for both the likelihood of getting votes, and the resources to assist the vote getting process, he predicted that politically influential industries would be able to obtain from the government and its agencies at least four anti-competitive protective measures. First, government subsidies, such as the US government financing of oil related research and development projects through the US Department of Energy. Secondly, control over entry to an industry by new rivals; for example, the established incumbents in the investment services sector could support more regulation, such as a proposed

²⁹ Also referred to as the Economic Theory of Regulation, and the Capture Theory of Regulation (Stigler, 1971: 1)
increase in the capital adequacy requirements\textsuperscript{30} for all licensed firms, thereby making it more difficult for small, new firms to enter the market. Thirdly, the suppression of ‘substitutes and complements’, an example of which is the big pharmaceutical companies with their patents acting to limit or even prevent the distribution of generic drugs. The fourth anti-competitive protective measure put forward by Stigler is favourable price fixing; an example of this is a regulation that mandates the maximum sales expenses that can be charged in the promotion of a product and solicitation of customers, such as an investment fund; this would limit the growth of small firms and reduce competition, and reduce the sales costs of larger firms thereby potentially enhancing their profitability (Stigler, 1971: 5-6).

Stigler’s theory of capture was critiqued for failing to explain why certain industries demonstrated ‘capture’ and benefited from anti-competitive regulation while other industries did not. In an article in 1974 Posner, another scholar from the Chicago School posited that if an industry is unofficially organised as a cartel, the necessity of courting and capturing the regulator in order to maximise profits does not exist because the very organisation of the industry will deliver the desired ends. However, industries that are not tightly organised will need the assistance of the regulator to achieve their objectives. He therefore suggested that regulation ‘should be positively correlated with non-homogeneous and non-concentrated industries’ in which cartels did not exist (Hägg, 1997: 344). Non-homogeneous and non-concentrated industries are sectors of the economy with multiple economic actors offering multiple and varied products and services such as the investment services sector.

\textsuperscript{30} The minimum capital required by a firm to meet prudential regulatory standards
Both Stigler and Posner made the assumption that the concept of capture was binary: the relationship was between a single industry group and its regulator. In 1976 a third eminent Chicago based scholar, Peltzman, developed an alternative model and concluded that the symbiotic distribution of favours between the economic and political actors is less clear cut than suggested by Stigler and Posner because both sets of actors, particularly the political actors, will spread their patronage, meaning their favours and resources, among multiple interests so that no single interest group receives all the favours.

Despite the variation in these private interest theories of regulation, all three share a central analytic core: the theory is actor based and the political and economic actors are assumed to be self-interested utility maximisers and interest groups are presumed to be able to influence the outcome of the regulatory process by providing financial or other support to politicians or regulators (Peltzman, Levine and Noll, 1989: 1). The extent to which the economic actors were able to influence and design the regulatory outcomes in France, Germany and the UK will be examined in the empirical chapters.

Capture, however, can also work in the other direction with the favours going from the economic actors to government and its agents, the bureaucratic actors. This variant of the economic theory of regulation is often referred to as Leviathan. Scholars who have examined the Leviathan as a theoretical explanation for regulation have done so, primarily, in the Public Choice literature and include Brennan and Buchanan (1977) and Tullock (1967). According to the Leviathan hypothesis, political and bureaucratic actors are a distinct interest group concerned with
expanding their size and influence (Kroszner, 1999; Noll, 1989). Were the new regulations introduced in France and Germany by the political bureaucratic actors in order to deepen and strengthen their role?

The private interest theory of regulation suggests a close and symbiotic relationship within the regulatory regime in which the organised economic actors give to the political actors and vice versa; each group, thereby, endeavouring to maximise its position and power. The relationship can be described as a policy community which facilitates the intermediation of the interests of the economic and the political actors. Following Coleman, ‘a policy community is defined to include all actors or potential actors with a direct or indirect interest in a policy area or function who share a common “policy focus”, and who, with varying degrees of influence shape policy outcomes over the long run’ (Coleman, 1996: 11). Further following Coleman’s typology, the relationships between the private and state actors within a policy community can be described as policy networks, the characteristics of which may vary from pluralist, to corporatist or state-directed (Coleman, 1996: 12). These relationships between the different state and private actors suggest that certain factors in a policy community can encourage a strategy of mutual cooperation between the professional state elected and appointed policy makers and the economic actors, resulting in a relationship that has been described as ‘bureaucratic accommodation’ (Jordan and Schubert, 1992: 16).

Defining regulatory capture is one thing, empirically identifying and measuring it is quite another. From the regulator’s perspective, it may be difficult to capture hedge
funds because the sector is extremely footloose and hedge funds do not need regulatory largesse in the way that the established, incumbent financial institutions do. This is because hedge funds were originally structured outside the ambit of financial regulation and were not sold to the public in the form of small investors. For these two reasons there may be few incentives that the regulators could offer hedge funds, or vice versa. It is possible that the regulatory developments that have taken place in France and Germany to explicitly regulate the hedge fund sector may be explained more by other factors such as public interest or the impact of globalisation rather than private interest theory and regulatory capture. If an ‘accommodative’ relationship between the economic and bureaucratic actors is a valid explanation of the regulatory reform and variation in regulation, the study will expect to find evidence of the following. There will be limited evidence of the economic actors exercising the “exit option” and engaging in regulatory and operational arbitrage, for there will be little need for them to do this. There will be evidence of recruitment by the hedge fund sector of personnel from the regulatory agencies, particularly senior level regulatory officials whose knowledge and relationships are likely to be valuable. The study would also expect to find evidence of established, incumbent firms accepting additional, prescriptive regulations; the motivation for which is to raise the cost of being an active economic practitioner in the sector and, thereby, cement the incumbents’ position in the sector and make it more difficult for new comers to enter the sector thereby reducing competition.

Taking ideas raised in the public and private interest theories of regulation, along with ideas raised and conclusions noted in the literature by scholars such as Cerny,
Coleman, Laurence, Lütz, Moran and Vogel which will be discussed later in this chapter, there are different theoretical explanations that may help explain the hedge fund sector regulatory reform in France and Germany, and the lack thereof in the UK.

Variables of Explanation

Financial Crisis and the Role of State Officials

Reform and change in regulatory regime design trails the developments of ever more sophisticated and complex financial markets, products and services. Some of the literature posits that a key catalyst for regulatory change is a financial crisis or scandal (Bishop et al, 1995; Goodhart et al, 1998; Pagoulatos, 1999). Financial crises are associated with regulatory reform because they upset the existing equilibrium and alter the relative position of competing interests. The literature on financial regulation consistently and extensively emphasises the desire to prevent a financial crisis as one of the primary justifications for regulation; yet the same literature is surprisingly void of any explicit definition of a financial crisis. As Foot (2003) put it ‘most authors seem to assume that what constitutes a crisis is so obvious that it doesn’t need definition’. This study uses Aizenman’s (2007: 9) definition of financial crisis which ‘refers to a rapid financial disintermediation due to financial panic ... the ultimate manifestation of financial crises includes bank failures, stock market crashes, and currency crises, occasionally leading to deep recessions’. Disintermediation is described as a “flight to quality” meaning that investors try to remove their money from firms and investments that they perceive to be suddenly
more risky and move their savings to investments that are perceived to be much safer (Aizenman, 2007: 9).

Further, there is no common understanding regarding the cause of financial crises, how to measure a financial crisis or, indeed, how to prevent one (Currie, 2003). This lack of clarity concerning a primary driver of regulatory reform suggests the potential for a mismatch of regulatory objectives and regulatory methods. The financial crises during the last 15 years such as the Mexican crisis in 1994-1995, the Asian crisis in 1997-1998, the Russian debt crisis and the failure of one of the world’s largest hedge funds in 1998, the crash of the world’s equity markets caused in part by the collapse of companies such as Enron and WorldCom between 2000 and 2003, have resulted in the enactment of an increasing amount of financial services regulation despite the fact that the primary sources of the events have not been identified.

When a financial crisis upsets the equilibrium, it upsets both the financial sector and the private sector-public sector equilibrium. The worse the economic consequences of a financial crisis, the greater the public interest in and political saliency of having an effective regulatory regime, and the greater the likelihood of regulatory reform led by the state officials in the aftermath of a crisis. Financial services regulation is about public interest because of the sector’s critical role in providing fuel for the economy and mediating people’s savings; so too is hedge fund sector regulation. As was noted in chapter 1, the common objectives of financial regulation include maintaining a stable financial system, protecting the consumer and maintaining her confidence in the sector, and preventing financial crises. The stability of the financial system can be
upset by a financial crisis such as when the failure of one firm has a negative impact on economic activity in the financial sector; for example, the Northern Rock crisis in the UK in 2007. Consumer confidence in the sector can be affected by inappropriate market practice; this is defined herein as behaviour, on the part of the firms active in the investment services sector, that may be considered underhanded or is even prohibited thereby favouring some investors over others. Examples include insider dealing and market manipulation. Insider dealing takes place when an individual or firm buys or sells shares of a company based on price sensitive information that is not in the public domain, in the expectation of profiting from the expected change in the share price when the said information becomes available in the market (Moran, 1991: 48). Market manipulation takes place when the ‘price setting mechanism of financial instruments is distorted or when false or misleading information is disseminated’ (Directive 2003/6/EC of the European Parliament and the Council of 28th January, 2003). The integrity of the sector, its related stability and consumer confidence therein can be affected by the asymmetric distribution of information (Bentson, 1999:21; Goodhart et al, 1998:45-46). This results in the suppliers of savings and investment products being far better informed and more knowledgeable than the consumers of such products. Without comprehensive information, ill-informed decisions may be made by the consumers which may result in the selection of sub-optimal financial products or services. Unlike many goods and services, the quality of investment and savings products cannot be determined fully until many years after the purchase. Furthermore, unlike many goods and services, investment and savings products are rarely purchased on either a consistent or regular basis, the consequence of which is that the consumer is not able to compare and contrast the quality and price
with other similar products. Protecting consumers from a financial crisis is a major objective for any financial services regulation in the public interest. When people lose their savings there is often a cry of "something must be done" in the public interest to try to better protect the investor and prevent future crises.

The study will test the effect of financial crisis on regulatory reform. If financial crisis is an important variable of explanation this study would expect to find evidence of regulatory reform in the aftermath of a financial crisis. The state actors, mindful of the political saliency of taking action to reassure the public that such a crisis will not happen again, and to restore the public’s confidence in the financial system, will introduce new prescriptive regulation. It will be prescriptive because the fundamental principles on which most financial regulatory regimes are based, such as companies must conduct their business activities with integrity and must treat their customers fairly, do not change.

Institutional Arrangements: Economic and State Actors - Accommodation and Mobility

This explanation posits that there is a link between regulatory regime reform and design and the relationship between the domestic economic actors and the regulators. The institutional setting in which the actors operate defines their strategy options and the type of interaction between the different sets of actors within the setting (Scharpf, 1997: 12). For example, if the domestic regulatory regime is more restrictive than the regime in an alternative country it is possible that some of the domestic economic actors will exit the home regime in favour of establishing operations in the alternative
regime. Alternatively, these economic actors may endeavour to operate within the domestic rules, or seek to change these rules.

Laurence’s (1996) research is alone in specifically identifying the behaviour of the economic actors as the principal driver of regulatory reform. His study aims to explain the paradox of two trends in regulation: de-regulation (withdrawal of state imposed restrictions on economic activity in the sector), and increased regulation (continued if not greater involvement in the financial sector by the state through the imposition of new rules and regulations).

A key question that he addresses is why governments with very different regulatory traditions make similar policy choices. He does this by examining the impact that the ‘internationalisation’ of the financial services sector had on the regulatory reform in Japan and the UK of the domestic securities markets during the 1980s. While Laurence does not define internationalisation, his usage of the term suggests that is used as a synonym for market globalisation. Laurence concludes that the reforms were primarily for the benefit of a particular constituency of economic actors whose ability to influence the policy making process was strengthened by their ability to ‘exit’ the domestic marketplace when another regulatory regime provides a more desirable environment in which to operate. Exercising feet rather than voices, which means that instead of lobbying for change in the domestic rules, the economic actors prefer to establish their operations in other national regulatory regimes, is shown to be a powerful bargaining tool (Laurence, 1996: 311). Laurence’s main conclusion is
that globalisation ‘will result in regulatory reforms which will systematically favour the most mobile economic actors’ (Laurence, 1996: 335).

Policy initiatives that ‘systematically favour’ the economic actors can be linked to the theory of the structural dependence of the state on a well functioning economy. Policies that can result in negative incentives for economic activity limit the potential tax receipts and thereby undermine the policy makers’ likelihood of achieving various policy goals (Block, 1977: 15). The neo-Marxist theory that underpins the state’s relationship with the economic actors is not homogeneous. Instrumental Marxists such as Ralph Miliband (1969) posit that when the state makes public policy it does so with the direct participation of the economic actors. This suggests that actual policy outcomes will always reflect the desires of and promote the interests of the economic actors’ interests and, following Miliband, that ‘the state is an instrument that is used by capitalist actors’ (Chari and Kritzinger, 2006: 55).

Structural Marxism (also known as structural functionalism), however, stresses the relative autonomy of the role of the state. According to structural functionalism the state acts autonomously, but always in the interests of capital and the economic actors (Poulantzas, 1973). It is not necessary, however, for the economic actors to participate directly with the state actors. According to Poulantzas ‘whatever the state does is by definition functionally beneficial to the interests of the capitalist class’ (Bernhagen, 2007: 47). This is because in a capitalist economy the ability of the state actors to pursue their policy goals is constrained by, and structurally dependent
on, the economic actors’ ability to pursue their business objectives and produce the
desired tax revenues (Chari and Kritzinger, 2006: 56).

Laurence’s conclusion that the action of the mobile economic actors exiting a regulatory regime because it constrains their activities, rather than engaging in dialogue with the state actors to change the regime, is a catalyst for the state actors to introduce regulatory reform, lends support to Poulantzas’s thesis. To encourage the return of the economic actors, policy reform is introduced. As will be shown in the section on globalisation below, Laurence’s study agrees with all of the scholars of regulation referenced in this chapter that the globalisation of markets will result in regulatory reform at the national level. He contends that this reform will particularly benefit the ‘mobile economic actors’. This is not because the state actors reform the regulations at the direct bidding of these economic actors; but rather, because the state actors want to discourage these economic actors from exiting the regime, they act autonomously.

The study will test to what extent, if any, an accommodating relationship between the domestic economic and bureaucratic actors determined regime reform and design. It will further examine whether the actions of the economic actors acted as a catalyst for regulatory reform in France and Germany, but led to no change in the UK. If the institutional setting and an accommodating sector-bureaucracy relationship is an important variable of explanation this study would expect to find evidence of one or more of the following. First, regulatory and operational arbitrage in which the ‘mobile’ economic actors opt to exit the domestic regime in order to establish their
business activities in a different country in which the regulatory regime is more flexible and less restrictive. Secondly, lobbying of the bureaucrats for regulatory change by the domestic economic actors, with the objective of strengthening their position in the sector. Thirdly, recruitment of individual bureaucrats by the economic actors to enhance both knowledge and the economic/bureaucratic actor relationship.

*Globalisation and Americanisation – Liberalisation?*

Globalisation and Americanisation are linked, but theoretically distinct concepts that place pressures on the state and economic actors to which they respond. The two concepts, which will be discussed below, are connected by a common theme which is *liberalisation*. Both can be considered a product of liberalisation, as is demonstrated in Figure 2.1.

Figure 2.1: Liberalisation, Globalisation and Americanisation

![Diagram showing the relationship between Liberalisation, Americanisation, and Globalisation]

Why then does the study not just use liberalisation as an explanation? The reason is that on its own liberalisation is only expected to provide a rough explanation of the puzzle. Employing liberalisation as an explanation without considering the impact of
globalisation and Americanisation runs the risk of painting an incomplete and fuzzy picture. By using globalisation and Americanisation, which are composite parts of liberalisation, in the analysis it is expected that the study will produce a finer grained picture. This section will proceed in the following way. It will start by defining liberalisation and identify the clear link between liberalisation and each of the other two concepts; it will then discuss in more detail the characteristics of globalisation and Americanisation. The objective is to clarify the theoretical distinction between each and liberalisation.

**Liberalisation**

Liberalisation, as was noted earlier in chapter 1, is the reduction of government intervention in markets through the removal of government restrictions on the cross border movement of resources, namely capital, goods, services and people. Liberalisation is linked to globalisation because is has the effect of encouraging or facilitating the latter. As will be discussed below, globalisation refers to *inter alia* the increasing extent of financial, economic and other interaction between nations and across borders. One of the main sets of actors in this interaction is the economic actors whose activities are facilitated by the liberalising actions of governments and state officials.

Americanisation, which will also be discussed below, and liberalisation are also linked. Within the financial services sector it was the decision of the US state actors in 1975 to liberalise their markets, through the abolition of fixed rate brokerage
commissions, which served as a catalyst for the global ‘financial services revolution’ (Moran, 1991). One of the effects of this market liberalisation, coupled with the US state actors’ embrace of neo-liberalism a few years later\(^\text{31}\), was the development of deeper, more liquid markets and an expansion in the export of American financial sector practices and expertise to other financial centres. The export of American expertise was manifested through the establishment of corporate operations outside the US by American financial firms, particularly banks, a practice that had begun in the two decades after the Second World War as the firms sought new business opportunities (Braithwaite and Drahos, 2000: 102). These US banks with overseas branches became international and ‘had helped to create international markets and in turn had to devise organisational strategies for survival in those markets’ (Braithwaite and Drahos, 2000: 102). The American economic actors have long been on the cutting edge of innovation in the financial markets, particularly through the development of secondary markets in US dollar denominated securities\(^\text{32}\), and in the process have transferred knowledge and skills to non-US economic actors.

The interrelation between liberalisation and globalisation, and liberalisation and Americanisation, can in some exceptional cases result, counter intuitively, in an increase in domestic government regulation, or in supranational governance standards. The liberalisation of market regulations, which started in the US, that has enabled the globalisation of the financial markets, has resulted inter alia in the

\(^{31}\) Neoliberalism is a theory of political economy ‘that proposes that human well being can best be advanced by liberating individual entrepreneurial freedoms and skills with an institutional framework characterised by strong private property rights, free markets and free trade’ (Harvey, 2005, p.2). In July 1979 Paul Volcker became chairman of the US Federal Reserve and, with the objective of crushing inflation, used neoliberalism ‘as the central guiding principle of economic thought and management’ (Harvey, 2005, p.2).

\(^{32}\) For example, both listed and over-the-counter derivatives
increasingly mobile movement of capital across countries and around the world. One of the many beneficiaries of this development is terrorist groups whose ability to launder money has been facilitated by financial market liberalisation and market globalisation (Napoleoni, 2008). With the objective of combating money laundering and terrorist financing, policymakers have introduced substantial anti-money laundering (AML) policy reforms during the past ten years. For example, on 26th October, 2001 the USA Patriot Act was signed into US law. The legislation was introduced in the aftermath of the terrorist attacks in the US on 11th September, 2001. Title III of the Patriot Act is focused on AML; it amended the existing AML legislation by placing greater demands on banks, investment management firms, insurance firms and other financial institutions, of client and financial transaction knowledge, record keeping and disclosure. The rules apply to all companies, both American and foreign, with operations in the US. Further, in December 2001 the European Union (EU) introduced Directive 2001/97/EC which extended the scope of its first AML directive to include the financing of terrorism. Liberalisation reduces barriers and facilitates globalisation and Americanisation, which can result in increased regulation and the subjection of the economic actors to more national and supranational governance standards.

Globalisation

Globalisation is a complex term, the definition of which is itself a topic of debate amongst scholars around the world. At the risk of being accused of flagrant selection

33 Directive 91/308/EEC
bias, a selection of the multiple definitions is herein presented. Globalisation has been defined as ‘...a widening, deepening and speeding up of interconnectedness in all aspects of contemporary social life from the cultural to the criminal, the financial to the spiritual’ (Held, McGrew, Goldblatt and Perraton 1999: 2). Giddens (1990: 64) highlights the interactive characteristics of the globalisation process defining it ‘... as the intensification of worldwide social relations which link distant localities in such a way that local happenings are shaped by events occurring many miles away and vice versa’. Gilpin (2001: 364) defines it more simply as ‘the integration of the world economy’. A financial market practitioner, philanthropist and scholar defines globalisation as the ‘development of global financial markets, growth of transnational corporations and their growing dominance over national economies’ (Soros, 2002: 13). In a similar vein with the emphasis on the globalisation of business and economics, Holm and Sørensen, (1995: 5) define it as ‘...a qualitative shift toward a global economic system that is no longer based on autonomous national economies but on a consolidated global marketplace for production, distribution and consumption’.

Scholte (2002: 8-22) in his wide ranging review of the globalisation literature identifies five predominant definitions of globalisation. The first four are dismissed as modish re-packaging or re-branding of longstanding, accepted concepts. The fifth, however, is considered distinct. First he identifies globalisation as internationalisation wherein globalisation ‘refers to a growth of transactions and interdependence between countries’. From this perspective an increasingly global world is one in which more ideas, people, goods, services, capital, messages and so
forth cross borders between national-state-territorial units (Scholte, 2002: 8).
Secondly, Scholte identifies globalisation as liberalisation which refers to a process of removing officially imposed restrictions on the movement of resources between countries with the objective of forming an ‘open’ and ‘borderless’ global economy (Scholte, 2002: 10). Within this definition, globalisation happens as political actors reduce or abolish regulatory measures such as trade barriers, foreign currency restrictions, capital controls or visa requirements. Thirdly, he identifies globalisation as universalisation which means that globalisation is a process that disperses goods and services and policies to people all over the world. Examples include Mercedes, Marlboro, Coca Cola, and environmental legislation. Globalisation is, in effect, a synonym for ‘worldwide’ and ‘everywhere’ (Scholte, 2002: 11). Fourthly, he identifies globalisation as Westernisation which defines globalisation as a variant of universalisation. Westernisation refers to the political, economic and social structures of advanced liberal democracies which are spread across the globe resulting in the destruction of ‘pre-existent cultures and local self-determination’ (Scholte, 2002: 12). Fifthly, Scholte conceptualises globalisation ‘as the spread of transplanetary and, in present times more specifically, supraterritorial social relations’ (Scholte, 2002: 4). Conceptualised in this way, globalisation is about changing the way social space is understood. Social space and social connectivity should no longer be conceived of from the perspective of a territorial schematic with tangible borders and places; ‘supraterritorial’ social relations are connections that are ‘relatively’ de-coupled from territory (Scholte, 2002: 17). Manifestations of ‘supraterritorial connectivity’ include the Internet, instant worldwide television broadcasts, jet travel, and global credit cards (Scholte, 2002: 21).
While there is variation in the theoretical interpretations of globalisation, they share a fundamental parameter, namely liberalisation (Ladi: 2007: 6). It is the liberalising activity of state actors reducing barriers to the movement of people, capital, goods and services that enables the globalisation of markets, which is a distinct type of globalisation (Braithwaite and Drahos, 2000:8). And it is the globalisation of markets that this study employs as a variable to explain regulatory regime reform and design;

'markets are where buyers and sellers meet. In the case of global markets, buyers or sellers from any one territory can meet (physically through agents or electronically) with buyers and sellers from any other territory to conduct transactions. Financial markets are the standard example of genuinely global markets' (Braithwaite and Drahos, 2000:8).

Measuring financial market integration and globalisation can be done in a number of ways. Financial integration initially manifested itself through capital flows among developed countries and, as capital controls were removed, and technological and financial innovation advanced, it has spread to emerging market countries (Andersen and Moreno, 2005). The foreign exchange markets are the primary conduit for these capital flows; Table 2.1 summarises the global foreign exchange market turnover for the 15 year period to April 2004 and shows a substantial increase in total turnover suggesting greater market integration.
Table 2.1: Global Foreign Exchange Market Turnover: Daily Averages in April, in billions of US dollars\(^{34}\)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover at April exchange rates(^{35})</td>
<td>650</td>
<td>840</td>
<td>1,120</td>
<td>1,590</td>
<td>1,380</td>
<td>1,880</td>
</tr>
</tbody>
</table>


In addition to the integration observed in the foreign exchange markets, financial market integration is also in evidence in other asset classes exemplified by the increasing correlation between asset yields and prices, such as those between different types of bonds and equities in global markets as can be seen in Figure 2.2 and Figure 2.3.

Figure 2.2: Trend in Global Stock Market Correlation

![Figure 2.2: Trend in Global Stock Market Correlation](source)

Source: HSBC Navigator Report, 2 March 2007, page 6

---

\(^{34}\) Adjusted for local and cross-border double counting

\(^{35}\) Non-US dollar legs of foreign currency transactions were converted from current US dollar amounts into original currency amounts at average exchange rates for April of each survey year and then reconverted into US dollar amounts at average April 2004 exchange rates
Figures 2.2 and 2.3 show that despite temporal volatility, the trend in both global equity and bond markets since the early 1990s has been towards higher correlation, suggesting that the markets are more integrated. This development makes it easier for the economic actors to operate globally; but provides the regulatory policy makers with significant challenges as they seek to meet their objectives and fulfil their responsibilities.

It has been noted earlier in the study that the hedge fund sector is a major, if not critical participant, in these increasingly integrated global financial markets. This situation is not likely to change for two main reasons: first, hedge funds provide a valuable liquidity service to the global markets and this role is not expected to diminish; and secondly, assets under management in the sector are expected to continue to grow at a healthy pace. Of the one and a quarter trillion US dollars
currently estimated to be invested in hedge funds\textsuperscript{36}, one third of this, three hundred and sixty one billion US dollars, is sourced from institutions such as pension funds, charitable foundations, endowments and insurance companies. By 2010 institutions of this type are expected to invest five hundred and ten billion US dollars of new investment in hedge funds which will represent approximately 50\% of the total projected flow of money into the sector over the period\textsuperscript{37}.

\textit{The Literature and the Effects of Liberalisation and Globalisation}

The effects of liberalisation and globalisation on financial regulatory regimes have been examined by the aforementioned Laurence and Moran, as well as by Coleman (1996), Lütz (1996), Vogel (1996) and several years earlier by Cerny (1989). Through the lens of the financial services sector in Canada, France, Germany, the UK, and the USA, Coleman examines the effect of the globalisation of the financial services sector on the convergence of economic and political structures. He poses two interrelated hypotheses on the effects of \textit{globalisation} on domestic policy change: first, globalisation will encourage considerable convergence in economic structures; secondly, convergence in economic structures will favour, in turn, increasing similarities in political structures (Coleman, 1996: 227). Evidence in his research suggests that both hypotheses are credible. Coleman uses the term globalisation to mean liberalisation which, following Scholte, this researcher defines as ‘a process of removing government imposed restrictions on movements between countries in order to create an “open”, “borderless” world economy’ (Scholte, 2000: 16). Coleman

\textsuperscript{36} These data are as at the end of 2005
\textsuperscript{37} Casey, Quirk & Associates. “Institutional Demand for Hedge Funds 2”. October 2006

67
refers to three developments within the financial services sector that are evidence of globalisation: ‘the growth of international banking and securities markets, the strengthening of the linkages between domestic banking and securities markets, and the deepening of these same domestic markets’ (Coleman, 1996: 5). Like Lütz (1996) he finds evidence of a strengthening of national structures; and like Vogel (1996) Coleman finds evidence of reform in accordance with a distinctly national pattern.

In her examination of the effect of ‘economic internationalisation’ on the reform of the stock exchange sector in Germany, Lütz concludes that, contrary to the hypothesis that globalisation reduces the influence of the state and its political actors because ‘policies are increasingly formulated in supranational or global arenas’ (Lütz, 1996: 2), the role of the nation-state is enhanced. By looking through the lens of financial services regulation, explicitly stock exchange regulation, in Germany her study analyses the effect on the actors in the domestic market, of policies that are increasingly crafted at a supranational level outside the national policy making institutional framework. She comes to the conclusion that market globalisation was a catalyst for ‘structural shifts in the architecture of domestic governance systems’ (Lütz, 1996: 30) and that these shifts had the effect of reinforcing the role of the state actors; one of the main reasons for this was that the German self regulatory model was strained by this market globalisation.

Lütz uses the terms internationalisation and globalisation interchangeably and the theme of liberalisation runs through them; both terms refer to greater cross border economic integration generally, and greater financial market integration in particular.
For Lütz, globalisation indicates the process of blurring boundaries between formerly separated domestic product and capital markets (Lütz, 1996: 9). This financial market globalisation, in which markets become increasingly interconnected and seamless is, she argues, driven by two factors which are 'structural market changes' and growing 'interstate collaboration' with regard to securities regulation. One of the effects of this globalisation, and the related market competition, on the German market was regulatory reform which enhanced rather than reduced the influence of the German state. Lütz identifies two factors that contributed to the enhancement of the state's power: first, because the economic actors were no longer able to regulate themselves to acceptable 'international' standards, the state had to make the necessary institutional adjustments to meet these standards in order that the German financial market and economy would not be unduly handicapped; and, secondly, the state was now interacting with other states through international financial market bodies such as International Organisation of Securities Commission (IOSCO) which imposes responsibilities on its members and, thereby, can enhance the role of the state in fulfilling these duties (Lütz, 1996: 30).

Vogel, in his analysis of regulatory reform in the financials services and telecommunications sectors in the UK and Japan, identifies three 'common forces for change'. First, market change, driven mainly by technological developments, undermines existing models of regulation; secondly, the principle and theory of deregulation, 'backed up by economic and political power of the United States, have diffused internationally' (Vogel, 1996: 25); and thirdly, macro economic trends

---

38 Germany became a member in January 1995
made de-regulation an attractive political programme’ (Vogel, 1996: 25). A central thesis of Vogel’s analysis is that de-regulation is not synonymous with liberalisation; the empirical evidence indicates that de-regulation can be more synonymous with re-regulation. Intuitively de-regulation and liberalisation are the same; both terms suggest the reduction of barriers to economic activity and the withdrawal of the state from its role in controlling the behaviour of the economic actors in the market. The objective is to enhance economic activity and social welfare by encouraging the development of a more open and competitive marketplace, in essence a more liberal marketplace with fewer regulations restricting the activities of the economic actors. The reality, however, is that in order to encourage such a liberal and competitive market, the political actors have had to introduce many new regulations; they have had to re-regulate to achieve their objectives leading to the paradox ‘freer markets, more rules’ (Vogel, 1996). The results of Vogel’s analysis concur with all of the scholars discussed in this study that regulatory reform was ‘powerfully shaped’ by the state actors (Vogel: 1996: 265).

Cerny’s analysis of the ‘Little Big Bang’ in Paris in 1986, which refers to the liberalisation of the French financial market, concludes that regulatory reform was initiated by the elected state actors. His central thesis posits that the reform was caused by both external and internal forces: external forces exemplified by the de-regulation taking place in countries such as the UK and the USA and the effect of this de-regulation on the activities of the economic actors; internal forces in the form of the French government responding to increased competition and a desire to ‘replace the state led credit based system with an arms length financial market system’ (Cerny,
1989: 169). These reforms were led by the state actors, rather than the economic actors, and were in response to pressure in the form of increasingly competitive markets.

Globalisation acts as a stimulus to which both the state and the economic actors respond. The pressures posed by greater market competition, particularly on more restricted national systems, can result in policy change (Pagoulatos, 1999: 75). The study will test the effect of globalisation on these actors and, if it is an important variable of explanation, this study would expect to find the following evidence. Evidence of the national economic actors, be they French, German or British, exiting their domestic territory and choosing, instead, to establish operations in an alternative political economy with preferred rules, regulations and institutional characteristics. It would also expect to find evidence of the relevant national economic actors expanding their business activities by establishing operations in one or more foreign territories in addition to their home country base. Further evidence of the impact of globalisation on national level regulation would be the reform of the regulatory regime by the state actors with the objectives of discouraging domestic economic actors from engaging in regulatory and operational arbitrage by, effectively, ‘choosing the exit option’ (Lütz, 1996: 9) whereby firms opt to relocate their operations in an alternative regime, encouraging those who have exited to return, and making the domestic market more attractive to all economic actors. The theory guiding such action from the state actors is the public interest. It is in the public interest to have a competitive and vibrant financial sector which can service all other sectors of the economy thereby enhancing economic and social welfare.
Regulatory arbitrage is a result of regulatory competition. The effect of globalisation on financial markets has put regulatory competition in the forefront of the debate on financial regulatory reform because the primary consequence of regulatory competition is regulatory arbitrage. In order for arbitrage to work, it is essential to have a significant degree of transparency and information regarding the different regulatory regimes; and to have the right balance between the desire for a light regulatory touch, thereby providing flexibility, and the need for an institutional context and level of staff expertise that will enable the company to meet its objectives (Radaelli, 2004). Economic actors are unlikely to move to a jurisdiction simply because the financial regulations are considered better. Other factors are taken into account such as the employment law, availability and expertise of staff and services, and levels of taxation. However, the globalisation of the financial market within multiple, diverse regulatory regimes suggests an opportunity for the economic actors to take advantage of this regulatory competition in order to meet their objectives. The extent, if any, of this will be explored in chapter 5.

**Americanisation**

Americanisation as a theoretical explanation of regulatory regime change is associated, particularly, with Moran (1991) and has been described briefly earlier in this chapter. Americanisation is used to refer to market liberalisation and free market capitalism. The thesis contends that there are measurable American influences on financial markets and financial regulatory policy. These influences stem from the fact that American economic actors are significant participants in the global financial
system as well as being formidable product innovators in this financial system, and that elements of the American financial regulatory model, developed since the 1930s and 1940s, have been adopted by other regulatory regimes.

Moran defines Americanisation as an ‘American creation and a response to American circumstances’ (1991: 266). In his analysis of the financial regulatory regimes of Japan, the UK and the US the Americanisation of regulation is ‘deep and pervasive’ (Moran, 1991: 132-133). His thesis contends that the power of the American regulatory model which combines a flexible principles-based with a prescriptive rule-based approach, and the significance of the American economic actors was a key determinant of the substantial reform of financial services regulation in the UK introduced by the Financial Services Act of 1986: ‘the agenda of regulatory change in Britain was an agenda set by American events and American influences’ (Moran, 1991: 312).

Laurence refutes the hypothesis of Americanisation as a determinant of regulatory reform. In his study he contends that the hypothesis suggests that increased internationalism and liberalisation of financial markets will provide the US, as the most powerful state in the international system, with new opportunities and incentives to try to influence financial sectors and their related regulatory regimes in other countries (Laurence, 1996: 315). The thesis contends that because of the role of the American economic actors, and because the US had developed a formidable

---

39 The Glass-Steagall Act of 1933, which separated commercial and investment banking, was repealed in 1999 eventually leading to what proved to be a disastrous accumulation of risks in the investment banking sector.
financial regulatory regime dating back to the 1930s, as the financial markets became more liberal and integrated, in the event of regulatory conflict between the US and another country, the US had the means to force other countries to adopt American standards. Laurence posits that there is limited evidence of the US state actors applying direct pressure on other countries to reform; there is, however, more evidence of indirect US influence through the actions of the American economic actors. The crux of his refutation of the Americanisation hypothesis is the shift from functional separation of markets, such as banking, insurance and securities (investment services), towards “universal” forms of financial intermediation in which one firm may be active in at least two of these sectors. This, he argues, is a ‘shift away from American standards’ (Laurence, 1996: 316) which required at that time the separation of different financial services activities such as banking and investment services.

The significant role played by the American economic actors in the financial sector is evidenced by the fact that at the end of 2006 four of the world’s ten largest financial services firms by revenues were US firms; four of the world’s five largest securities firms by revenues were US firms; and seven of the world’s ten largest global investment managers, measured by assets under management, were US firms. It was noted in chapter 1 that the financial markets are highly competitive; although this study has not been able to identify any independent rankings from which it can source the relevant data, as material players in the financial markets it is intuitive to assume that the US economic actors are at the vanguard of financial innovation. By financial

40 Italics in the original
41 2007 Financial Services Fact Book, Insurance Information Institute: New York, NY
innovation the study refers to ‘...the act of creating then popularising new financial instruments as well as new financial technologies, institutions and markets’ (Tufano, 2003). Examples of innovations include derivatives and other securities and products for transferring risk, enhancing liquidity or reducing transaction costs.

The hedge fund sector is both a consumer and supplier of innovative financial products. The sector’s origins are in the USA and over 75% of all assets under management in the sector are advised by hedge fund economic actors based in the USA. If Americanisation is a cause of the regulatory reform, as well as a cause of hedge fund sector regulatory regime design, the study will expect to find evidence of the following. Transformations of the financial system effected by US economic actors, in the form of hedge fund advisers, acting as financial entrepreneurs in their private interest in their efforts to identify opportunities, drive change and reshape the system (Kaufman, 1994: 6). The adoption of an American model of regulation, in response to pressure from the American economic actors, as national level regulatory regimes are modified by the political actors to accommodate US regulatory characteristics and, thereby, encourage a greater number of US economic actors to establish or expand their operations in the particular country. And the study would expect to find evidence of an increase in the number of American economic actors within the hedge fund sector in the relevant country. The size and influence of the US economic actors in the financial sector broadly and the hedge fund sector specifically provide the French, British and German economic and political actors with competitive challenges, but does this mean that we can identify the reform and

---

42 Lipper TASS Hedge Fund Database
43 The American model of regulation is described in detail in Chapter 5
variation in regulation with the thesis of Americanisation? Or are other variables more powerful at explaining the regime design?

The studies discussed in this chapter shed valuable light on a number of theoretical explanations for regime design and reform. The evidence of the economic and political changes in the financial services sector leads Coleman to conclude that globalisation has resulted in a degree of economic and political convergence. But he also stresses 'that domestic markets in financial services have not only persisted in the global era, but have also strengthened and become more important to their respective states' (1996: 227-228). Lütz’s analysis of reform of stock exchange regulation in Germany in an era of globalisation also concludes that the authority of the state actors in crafting national level regulation has been enhanced by the pressure of globalisation. It is intuitive to suggest that as financial and economic system boundaries become blurred, so too do the regulatory demarcations. However, the evidence presented in the ensuing empirical chapters in this study may point to support for Lütz’s thesis, as the regulation of the hedge fund sector has developed along distinctly national lines in each of the three cases, France, Germany and the UK, despite similar external pressures.

Vogel’s complex research study explains both the determinants of regulatory change, as well as the outcome of regulatory reform. He stresses the role of distinct national patterns in influencing the regulatory regime design, pointing out that ‘pre-existing ideas and institutions powerfully shape the basic direction of regulatory change’ (Vogel: 1996: 256) which will explain regime variation. What he means by this is
that countries with an historic custom of government intervention in the economy and close sectoral networks, designed regulatory reform to maintain the government’s role and preserve favoured institutional arrangements; whereas countries with a more laissez-faire approach to intervention and looser sectoral networks used regulatory reform ‘as an exercise in disengagement’ (Vogel: 1996: 256). However, he also identifies significant variation across sectors, measured by whether change in the regulation of a sector results in the state’s disengagement from the sector, or reinforcement of its role in the sector, which is not necessarily linked to a distinct national pattern.

Cerny’s study explains the 1980s reform of financial market regulation in France as the conscious effort of the political actors to re-institute Paris as a leading financial centre. The regulatory reforms of the early 2000s in France and Germany may too be shown to have been led by elected state actors with the objective of regaining national prominence on the global financial stage. Westrup reinforces the role of the political actors in driving regulatory reform in the public interest with his analysis of why Germany and the UK decided to abandon their respective multiple regulatory models in favour of a single financial regulator in each country.

Laurence’s work stands out among the studies referenced in this research because it is alone in pointing directly to the behaviour of the economic actors as the primary determinant of regulatory change. However, the economic actors did not drive regulatory reform in accordance with the private interest theory of regulation; they
drove it by engaging in regulatory and operational arbitrage which acted as a catalyst to the state actors to reform.

**Different Assumptions**

Each of the variables of explanation makes different assumptions about the determinants of regulatory regime reform and design. The three sets of actors, state elected, state appointed and economic, do not have uniform motivations and may respond to similar pressures in diverse ways and for different reasons. Table 2.2 provides a summary of the explanation for regulatory reform, the actors involved and the primary regulatory theory guiding their actions. Although this study uses the primary regulatory theory identified in Table 2.2 as the guiding influence on the behaviour of the actors, it is possible that the effect of the explanations on the state and economic actors results in the related action being guided by a secondary theory of regulation. For example, the Americanisation thesis also makes sense under a public interest assumption as regulatory reform is implemented in order to attract US firms to the foreign regime. Further, the financial crisis thesis can also operate under a private interest assumption of state actors seeking to expand their scope and power in the aftermath of a financial crisis.
Table 2.2: Explanatory Variables, Actors and Theories

<table>
<thead>
<tr>
<th>Explanation</th>
<th>Action</th>
<th>Primary Guiding Theory of Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial crisis</td>
<td>State actors introduce regulatory reform in the public interest</td>
<td>Public interest</td>
</tr>
<tr>
<td>Institutional influences</td>
<td>State actors introduce regulatory reform in response to direct pressure from economic actors OR in response to indirect pressure from economic actors</td>
<td>Private interest</td>
</tr>
<tr>
<td>Globalisation</td>
<td>State actors introduce regulatory reform in response to pressures created by market globalisation and behaviour of economic actors</td>
<td>Public interest</td>
</tr>
<tr>
<td>Americanisation</td>
<td>Behaviour of US economic actors acting as financial entrepreneurs effects change in financial market and influences regulatory policy AND/OR elements of US regulatory model adopted</td>
<td>Private interest</td>
</tr>
</tbody>
</table>

The investment services sector is characterised by intense market competition and technological innovation, forces to which national regulators have to adapt in order to defend their turf (Jabko, 2004: 201). A financial crisis may act as a catalyst for the elected state actors to introduce regulatory reform in the interest of restoring public confidence in the financial sector and, in so doing, to restore confidence in the government. Major financial crises ‘become a vital resource in the hands of policy entrepreneurs eager to expand regulatory initiative’ (Pagoulatos, 1999: 90).

The institutional setting and its influence on the behaviour of the domestic economic actors may have one of two effects: direct lobbying of the regulator resulting in
regulatory reform; the decision by the domestic economic actors to exit the regime and in so doing act as a catalyst to the elected state actors to introduce regulatory reforms with the dual objective of persuading those who have exited to return, and dissuading those who have yet to exit from so acting.

It is not just the institutional setting that may provide the catalyst for the economic actors to engage in regulatory arbitrage. Globalisation provides opportunities for the economic actors both to exit their national regulatory regime as well as to establish operations in multiple regulatory regimes. The behaviour of the economic actors can place pressure on the state actors to engage in reform of their respective regulatory regimes. Americanisation involves the transfer of knowledge and expertise from the American economic actors to the local economic actors in financial centres outside the US. It also involves the adoption, by the state actors in other countries such as France, Germany and the UK, of institutional characteristics of the US regulatory regime.

Despite the fact that the three regulatory regimes under analysis in this study are in countries that are members of the EU, and that an estimated 80% of economic and financial regulation applicable in member states is adopted through the EU policy process (Hix, 1999: 211), the study does not include Europeanisation as an explanatory variable. The reason for this is that the hedge fund sector is not included in any of the Single Market Directives focused on investment services during the time period of the study.
In the ensuing empirical chapters the study will seek to identify the independent effects, if any, of each of the explanations, on the regulatory reform and regime design in the three cases. There can be a large lag between the structural changes and developments in the financial markets and policy responses. The expansion of the hedge fund sector, as noted in chapter 1, is a structural change in the investment services sector that has been documented for some 20 years; however, it has taken the policy makers time to appreciate the impact of the sector on their respective savers and investors, and the cross national variation in their responses is an issue that the study endeavours to explain.

Research Design and Method

Following the research and design methods of some of the leading empirical studies of financial regulation in the political science literature, which are usually small-N case studies, this study uses the cross country-single sector comparative case study method. The objective of this research is to try to explain the cross national regulatory reform and variation in regulation in France, Germany and the UK in one of the most footloose and increasingly integrated sectors of the world’s financial system, the hedge fund management sector.

The case studies within the literature generally fall into one of the following categories: single country-single sector; single country-multiple sectors; cross country-single sector; or cross country-multiple sectors (Levi-Faur, 2004:179). In chapter 1 and earlier in this second chapter, the study made reference to a select
group of scholars who have examined financial regulatory regime design and reform, each using a variant of the case study method. A brief overview of the research methodologies used by these scholars provides us with an interesting snapshot of the variation in research design in the comparative analysis of financial regulation.

Cerny’s (1989) study of financial market deregulation in a *dirigiste* system uses a single country-single sector case study analysis of the French financial services sector. Lütz’s (1996) study also uses the single country-single sector case study method for her analysis of regulatory change in the financial services sector in Germany. Coleman’s (1996) research is designed as a cross country-single sector case study of the financial services sector in Canada, France, Germany, the UK and the USA. Laurence (1996) also uses the cross country-single sector case study method in his examination of financial services sector regulation. He focuses particularly on the sector in Britain and Japan. Moran’s (1991) comparative analysis of the financial regulatory regimes of Japan, the UK and the US is a cross country-single sector case study of financial services sector regulation and the determinants of reform. Westrup’s (2006) investigation of the rationale for the creation by the state actors of two new unitary financial regulators is a cross country-single sector case study of financial services regulation in Germany and the UK. Westrup’s study examines the question of regulatory reform being the result of a determined electoral strategy by centre-left parties.

*Italicics in the original*
Vogel's (1996) approach is more complex than the aforementioned research studies. His analysis of regulatory reform in advanced industrial countries is, on the surface\textsuperscript{45}, a cross country-cross sector comparative case study of the telecommunications sector and financial services sector in Japan and the UK. However, as one explores the study, three additional sectors are included (broadcasting, transport and utilities), and three additional countries are included (France, Germany and the USA), although these additional cases are not studied in as much depth as the primary cases. In total, Vogel counts 25 cases in his study; however, if one classifies different time periods (before and after an event) as different cases, the number increases to 30 cases (Levi-Faur, 2004).

The chapter now proceeds to an explanation of the rationale for the selection of the three cases, France, Germany and the UK.

Case Selection

France, Germany and the UK have been selected to investigate the regulatory reform in hedge fund sector regime design and variation because they exhibit intriguing similarities and differences. All three countries are advanced liberal democracies with similar sized economies which, measured on the basis of nominal Gross Domestic Product (GDP), represent 15%, 20% and 16% of total world GDP\textsuperscript{46}. The financial services sector is an important constituent of all three cases, although its contribution to each of the economies varies. In the UK the sector accounts for nearly 9% of

\textsuperscript{45} The only sectors and countries noted in the Contents page

\textsuperscript{46} Source: International Monetary Fund, World Economic Outlook Database, October 2007
GDP\(^{47}\), in France it accounts for 4.6% of GDP\(^{48}\) and in Germany it is also 4.6% of GDP\(^{49}\). In this study, GDP excludes services such as consulting, legal and accounting. Each country is classified as a different type of political economy. The UK is classified as a Liberal Market Economy (LME) in which competitive market mechanisms and arrangements coordinate the activities of the economic actors (Hall and Soskice, 2001: 9). Germany, alternatively, is classified as a Coordinated Market Economy (CME) in which the economic actors depend more heavily on non-market relationships to coordinate their activities with other actors and to develop their core strengths (Hall and Soskice, 2001: 9). It should be noted, however, that Germany under the leadership of Gerhard Schroeder from 1998 to 2005, made some steps towards the capital-market based model. By way of example, in December 1999 the Germany government announced that it would repeal the longstanding 50% capital gains tax charged on the sale of corporate crossholdings, thereby encouraging companies to sell shares and reinvest the capital. And in 2001 major reforms to the pension system were implemented which included, for the first time, the introduction of personal pension plans (Vitols, 2005). France, however, does not fit neatly into either category; her political economy shows characteristics of both the LME and the CME (Hall and Soskice, 2001: 21).

The overarching financial regulatory regimes, not just the hedge fund segment thereof in France and Germany, have undergone substantial reform in all three countries during the past twenty years. The role of the three central banks in each of the three

\(^{47}\) Office for National Statistics Yearbook 2005  
\(^{48}\) France: Financial Services Profile, The Economist Intelligence Unit, 2007  
\(^{49}\) Minister of Finance, Address to the Euromoney Capital Markets Forum, Berlin, 28 April 2005
countries has been substantially reformed as monetary policy responsibility was removed from the Banque de France and the Deutsche Bundesbank, but given to the Bank of England; and financial system supervision responsibilities were modified as part of the substantial financial regulatory regime reforms that all three cases have experienced during the same period.

The three cases differ on the dependent variable: both France and Germany have introduced regulatory reform explicitly targeted at the hedge fund sector, and while these new regulations share common objectives, they exhibit some fundamental differences as noted in chapter 1. The UK, on the other hand, has designed no explicit hedge fund sector regulatory regime and continues to regulate the hedge fund advisers as it regulates other investment services firms. The three cases differ in terms of the size of their hedge fund sectors as noted in Figure 1.2. It is possible that this variation in sector size relates directly to the influence of the relevant economic actors; an issue which will be explored in the empirical chapters. The three cases also exhibit large variance in the values of the key causal explanatory variable, the instance of financial crises and their impact on the actions of state officials. In a small-N study the larger the variance of the values of the key causal explanatory variable, the fewer the observations that are needed to achieve a fixed level of certainty regarding a causal inference (King, Keohane, Verber, 1994: 215). It is possible that in France and Germany the rationale for separate hedge fund sector regulations is the fact that hedge funds are considered more risky, both to individual investors and to the financial system, than other investments because they use highly flexible investment strategies and techniques, which so-called traditional investment
advisers are prohibited from employing. The different approaches to the regulation of this fast growing, important and increasingly global sub-sector of the investment services industry raise interesting questions relating to the model of regulation that is most likely to fulfil its objectives.

While the selection of the cases for analysis as well as the selection of the analytical approaches has been done with the objective of meeting at least minimum standards of integrity and robustness, the researcher is all too aware that 'in non-random comparative research strategies not all cases can be methodologically or theoretically equal' (Levi-Faur, 2003: 12). While the financial regulatory regimes of France, Germany and the UK have been examined in the literature through the lens of banking or financial services regulation broadly, none has been examined through the lens of the hedge fund sector. This is important because the financial sector is not homogeneous and the characteristics of the hedge fund sector raise concerns for policy makers that cut to the core of how they best meet the regulatory objectives of preventing financial crisis and protecting the consumer. Financial crisis is referenced in the literature as a likely cause of financial regulatory reform and design, but has not been empirically tested. The notion of an accommodating relationship between the economic actors and bureaucrats, as state actors, in which there is evidence of "capture", has not been empirically tested in the political science literature; it has been tested neither in the financial services sector nor its offspring, the hedge fund sector. Americanisation has been empirically tested in the financial services sector, with positive (Moran, 1991) and negative (Laurence, 1996) results, but it has not been
tested in the hedge fund sector, which was founded in the US over fifty years ago and is still a very “American” phenomenon.

Regulation of the hedge fund sector is, in the main, a twenty first century development. Until the beginning of this century, explicit hedge fund sector regulation was almost non-existent; the sector either operated within the overall framework of investment services regulation, such as in the UK, or via exemption there from, such as in the US. However, during the last five years the regulatory authorities in a number of countries, including France and Germany, have been busy designing new hedge fund sector regulation. Why regulation is now being considered and introduced, and why there is evidence of such cross national variation, raise interesting policy related questions to which this study seeks to provide some answers.

The analysis of the evidence in the following empirical chapters could lead us to a number of possible conclusions. It is possible that one of the variables is significantly more powerful than the others in explaining the regulatory reform and variation. It is also possible that a combination of the variables convincingly explains the puzzle presenting the research with the problem of observational equivalency. To manage this potential methodological problem, the study endeavours to identify the conjunctural relationship, if any, between the variables. Globalisation and Americanisation may each influence the behaviour of the three sets of actors in this analysis, and while each phenomenon has distinct characteristics, they share a common vein which is liberalisation. Does the impact of financial crisis,
globalisation or Americanisation best explain the regulatory reform in France and Germany, and the lack of change in the UK? Or perhaps the behaviour of the economic actors and an accommodating relationship with the state actors provides an answer to the puzzle. It is possible that a combination of two or more explanations may provide the answer. And, if a link is found between one or more of the variables and one of the cases, how applicable is this link to the other cases under examination? The observable implications that flow from each of the hypotheses have been outlined in this chapter and the detailed evidence from the case studies will be presented in the ensuing empirical chapters (chapters 3, 4 and 5).

Unravelling this puzzle will, it is hoped, provide valuable information to both scholars and practitioners of financial regulation alike. Despite the almost uniform overall objectives of financial regulation, and the increasingly global and interconnected nature of the investment services sector, from a formal regulatory perspective the global financial market does not exist. The global financial market can be described as ‘a loose coalition of national markets with different regulatory traditions’ (Gilligan, 1999: 43). The economic actors may behave as if the market is relatively seamless, but each national regulatory regime continues to make regulatory policy according to its preferred national approach. An investigation of regulation is an investigation of public policy. By examining regulatory regime variation through the lens of the hedge fund sector, one of the fastest growing and dynamic segments of the global financial services sector, this research seeks to provide a better understanding of financial sector policy making as regulatory regimes struggle to adapt to market developments. As was noted in chapter 1, public policy in this
sector concerns itself with fundamental issues such as whether the regulatory
distinction between hedge fund advisers and other investment services companies is
valuable, whether one style or type of regulation is more appropriate than another,
and whether the current boundaries within the financial system, and their
accompanying regulations, are valid (Goodhart et al, 1998; Mayer, 1995; Steil, 1994).
In addition, it is hoped, that by enhancing the understanding of public policy making
in the hedge fund sector of the financial services market, this study may contribute
specifically to the existing literature on financial regulation and, more broadly, to the
wider literature on regulation, by explaining regime variation and identifying material
patterns and trends in the politics of regulation.

Sources

The data used in this study are from a combination of primary and secondary sources.
The first primary source consists of regulatory “rule books”; regulatory consultation
and discussion papers; trade association guidelines, research papers and reports;
speeches by economic, political and bureaucratic actors within the financial services
sector; conference transcripts; and government documents such as the Code
Monétaire et Financier in France and Hansard in the UK. The second primary source
consists of data gathered from 42 semi structured personal interviews primarily with
members of the economic elite, but also with senior bureaucratic actors in all three
countries. The goal of the interviews was to inform the study by providing the
researcher with information on what the different actors think and how they interpret
particular events (Aberbach and Rockman, 2002: 673). Table 2.3 provides a
breakdown of the number of interviewees within each set of actors. The study focused on interviewing actors in each of the three cases France, Germany and the UK.

Table 2.3: Interviewees by Actor Categorisation

<table>
<thead>
<tr>
<th>Type of Actor</th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic – Firms</td>
<td>12</td>
<td>7</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Economic – Interest Assocs</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

The economic elite were divided into two groups; the firms, and the leading interest associations for investment services. The firms included large and small investment services organisations including hedge fund advisers, investment banks, asset management companies, securities houses, large financial conglomerates, and law firms specialising in the sector. Interviewees were selected on the basis of their senior positions within the different organisations; the majority are board level executives, two are senior compliance officers and three are mid-level executives. Within the interest associations, interviews were conducted with either the Chief Executive or the Deputy Chief Executive. The interviews with members of the bureaucratic elite were conducted with high ranking executives within the AMF in France, the BaFin in Germany, the FSA in the UK, the Committee of European Securities Regulators (CESR) based in Paris, and one EU Commissioner. At some organisations, more than one person was interviewed.

50 One of these associations, the Alternative Investment Management Association (AIMA), is headquartered in the UK but is a global interest association.
All but two of the interviews were conducted face to face; the two exceptions were conducted by telephone. Each interview lasted approximately one hour; the shortest interview lasted just under 30 minutes, and the longest lasted just under two hours. The interviewees were asked a limited number of the same questions which were open-ended; the questions were structured as such in order to provide the interviewees with flexibility and latitude in their responses without being circumscribed by the researcher’s preconceived notions concerning the importance of particular themes (Berry, 2002: 679). In some interviews additional questions were asked as the ‘conversation’ progressed. Table 2.4 notes the open-ended questions that were common to all interviews. Twenty nine of those interviewed agreed to be recorded and transcripts were then made. In the other interviews extensive notes were taken and subsequently written up within 24 hours.

Table 2.4 Open-Ended Questions asked in Elite Interviews

<table>
<thead>
<tr>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>What drives financial regulatory reform?</td>
</tr>
<tr>
<td>Which actors drive financial regulatory reform — the economic actors; the politicians; the bureaucrats; the public?</td>
</tr>
<tr>
<td>To what extent is the regulatory regime an instrument of comparative economic advantage?</td>
</tr>
<tr>
<td>How much influence do external institutions such as the EU, the US regulatory regime, and IOSCO have on national regulatory regime design?</td>
</tr>
<tr>
<td>To what extent is regulatory change driven by a financial crisis or scandal?</td>
</tr>
<tr>
<td>How would you define a financial crisis?</td>
</tr>
<tr>
<td>How cosy is the relationship between the financial elite and the policy makers?</td>
</tr>
</tbody>
</table>
Most of those interviewed have requested to remain anonymous; although the Acknowledgements section in the introduction to this research contains the names of those interviewees who agreed to be identified. The author is extremely grateful to all interviewees for the valuable information imparted and insights shared. The secondary data sources include the print and electronic media, review articles and journal articles. The study will now proceed to an investigation and analysis of the effect of financial crises on the role of the state actors in financial regulatory regime reform and design.
Chapter 3

Financial Crisis, Public Interest and the Role of State Actors

Introduction and Objectives

Chapter 1 set the stage for the puzzle which has two pieces: why did France and Germany introduce comprehensive new hedge fund sector regulation for the first time within 12 months of each other in 2003/2004, while the UK maintained the status quo; and why such cross national variation in hedge fund sector regulation is exhibited. This is surprising when all three countries are subject to the common pressures of an increasingly integrated and competitive financial services system which suggests the convergence, rather than divergence, of financial regulatory regimes. In the first chapter the importance of financial services sector broadly, and the hedge fund sector more specifically to the world’s financial and economic systems was discussed. The chapter also discussed the definition of regulation, the objectives of regulation which include the prevention of financial crises, the different types of financial regulatory regimes, and described the cross national variation in the hedge fund sector regulation.

Chapter 2 described two theories of regulation and four variables of explanation that may help us to understand the regulatory reform and variation. This chapter will examine financial crisis and the role of elected state officials in determining regulatory reform and regime design. A common objective across all regulatory
regimes is the prevention of financial crises. A financial crisis may compel the state actors to respond and take action in the public interest to restore confidence in the financial system, protect the consumer against future crises, and provide support for the government. The examination of financial crisis as an explanation of regime reform and design is effected by the comparative analysis of the three cases; France, Germany and the UK.

Financial Crisis

As noted in chapter 2, a financial crisis is defined as a widespread panic in the financial sector and can result *inter alia* in stock market crashes, currency crises and bank failures as economic actors and consumers seek to switch their money from investments perceived to be risky into safer places. Financial crises can act as 'catalysts that transform the politics surrounding a set of regulatory policy alternatives' (Pagoulatos, 1999: 90). In order to explore the possible link between a financial crisis and regulatory reform and variation, this research has selected the domestic financial crises that occurred in each case from 1990 to 2002, as well as the only major hedge fund crisis. Although the hedge fund sector, exemplified by the establishment of hedge fund advisory companies, was in evidence in the UK in the mid 1980s, the sector was not in evidence in France until 1991 nor in Germany until 1994. On the basis that this possible explanation of regulatory variation assumes policy action in the aftermath of a crisis and that the rewards to the state actors from such action may diminish over time, the start date for any crisis is 1990. During the

---

51 The Lipper TASS Hedge Fund Database
15 year period there were four financial crises in France; one in Germany; and nine in the UK.

The hypothesis that new regulation is introduced in the public interest after a financial crisis requires a definition of the public interest. This issue has challenged and vexed scholars of regulation and public policy for many years. Is it valid to assume that the public interest is common across all three countries; or does it vary from France to Germany to the UK? It is generally assumed that regulation in the public interest seeks to protect and benefit the public at large, particularly from market failure (Hankte-Domas, 2002: 165). A financial crisis, such as the collapse of a firm that requires a bail out, or the sharp fall in value of a stock market is deemed to be a market failure because ordinary members of the public can lose their savings. This research study assumes that the French, German and British state actors share a common interest to protect their respective publics from such an outcome. The analysis is, therefore, approached by seeking to identify any link between hedge fund regulation and a financial crisis. Financial crises are a form of market failure and within the literature on financial regulation there is a relatively commonly held view that regulatory reform often follows in the wake of a financial crisis (Currie, 2003; Goodhart et al, 1998; Pagoulatos, 1999). Among the best known examples of this financial crisis driven regulation were the introduction, in the United States, of the Securities Act in 1933 and the Securities and Exchange Act in 1934 in the aftermath of the Wall Street Crash of 1929; and, more recently, the introduction of the Sarbanes Oxley Act (SOX) in 2002 in the aftermath of the corporate accounting scandals in a

52 Also known as the Public Company Accounting Reform and Investor Protection Act
number of large US firms including Enron and WorldCom. Before turning to the cross national examination of the effect of financial crisis on regulatory regime reform and design in the three countries, a brief discussion of the introduction of SOX in the US is pertinent to the study on three levels. First, the legislation was brought in by the elected state actors in the aftermath of a financial crisis with singularly little consultation with the economic actors. Secondly, the new rules are highly prescriptive and are intended to bolster the credibility of the US regulatory regime and provide the consumer with better protection. Thirdly, an unintended consequence has been the reduction in the competitiveness of the US financial activity covered by SOX, as economic actors have elected to engage in regulatory arbitrage to the benefit of other regulatory regimes, and to the detriment of the US regime and a sector of the US economy.

SOX was enacted by Congress in a year of mid term congressional elections in the aftermath of the spectacular failures of two companies, Enron and WorldCom, which filed for bankruptcy in December 2001 and July 2002 respectively in the wake of revelations of fraudulent accounting practices and executives’ self-dealing transactions (Romano, 2005: 1523). America had experienced corporate failure before resulting in both wealth and job destruction; but it had experienced nothing on the scale of these bankruptcies. At the beginning of 2001 Enron was ranked seventh in Fortune Magazine’s ranking of America’s top 500 companies; at that time 62% of the Enron pension fund for employees was invested in Enron shares which the market valued at around 80 US dollars per share. By January 2002 the market valuation had fallen to 70 cents per share; the investment and job losses were substantial and many
of the employees’ pension funds were wiped out (Jickling, 2003: 4). Until July 2002 Enron was the largest failure in US corporate history; then WorldCom filed for bankruptcy which dwarfed Enron’s filing. Corporate fraud seemed rife; investors had been grossly misled and the elected state actors acted swiftly to attempt to redress the information asymmetries, improve investor protection and restore confidence in the market. SOX was introduced very speedily before the mid term elections, and it was widely perceived in the media that members of Congress were motivated by re-election concerns (Romano: 1525).

The origins of a crisis may be local, but the implications for regulatory reform are often regional or global (Clark, W. and I. Demirag, 2006: 75). Although SOX was a US regulatory reform designed to address a US issue, it applied also to foreign companies listed on a US stock exchange, irrespective of the quality of a foreign firm’s home country financial regulatory regime and investor protection regulations. The effects of SOX’s introduction have been examined in a number of empirical studies. The costs of regulatory compliance, most notably audit costs, have increased (Asthana, Balsam and Kim, 2004; Eldridge and Kealey, 2005); and smaller companies have elected to de-list and exit the public market (Block, 2004; Kamar, Karaca-Mandic and Talley, 2005). SOX has been shown to be more positive for firms with weak home country regulations and investor protection, than for firms with strong home country investor protection rules (Litvak, 2007). One of the unintended consequences of SOX is the increase in the number of foreign companies seeking to raise capital on the London Stock Exchange (LSE) and the decrease in such listings on the New York Stock Exchange (NYSE); in 2006 for the first time new company
listings on the LSE exceeded\textsuperscript{53} new company listings on the NYSE by almost 50\%\textsuperscript{54}. The UK is deemed to have a ‘lighter touch’ more principles based regime than the US’s more prescriptive model. As will be demonstrated in the coming sections, regulation introduced in the aftermath of a financial crisis is prescriptive. It is so because the fundamental principles of a market, such as treat all consumers equally and fairly, do not change.

In 1998 the global financial markets experienced the first major hedge fund sector crisis. This was the collapse and subsequent bail out of one of the largest hedge fund companies at that time, Long Term Capital Management (LTCM) which was based in the US. The LTCM crisis highlighted the global reach of the hedge fund sector’s activities and the potential weaknesses in the market-based approach to regulation of the sector that was used by the American and, to a lesser extent, UK regulators. This approach imposes specific responsibilities on four sets of actors: hedge fund investors, creditors and other counterparties (counterparties)\textsuperscript{55} to the hedge funds, the regulatory agencies and the hedge fund actors themselves (Bernanke, 2007). With LTCM this approach failed. What went wrong and what impact, if any, did this regulatory failure have on the French, German and UK regulatory regimes and their approach to the hedge fund sector?

\begin{itemize}
\item Measured by the amount of money raised
\item \textsuperscript{53} LSE Press Release, “London Stock Exchange Leads Global IPO Market”, 31 December 2006
\item \textsuperscript{54} Creditors and counterparties are financial firms such as banks and brokers through which the hedge funds conduct their business of buying and selling securities. As described in Chapter 1, hedge fund investment strategies often involve borrowing from the creditors in order to place larger bets
\end{itemize}
Starting with the first set of actors, the investors, they are responsible for thoroughly assessing the investment proposition offered by the hedge fund to determine the suitability of making an investment; if they make a bad decision, it is their responsibility. In the case of LTCM, which was the case for most hedge funds at that time, the investors were presumed to be knowledgeable and sophisticated financial institutions and extremely wealthy individuals. Retail investors, such as those who could have accessed the product promoted through Carrefour in France a few years later, could not invest in LTCM directly (although they may have had exposure via a pension fund). In the absence of any comprehensive data listing LTCM’s investors, and on the basis that LTCM was, in 1998, one of the largest hedge fund advisers in the sector\textsuperscript{56}, one can only presume that the investors in LTCM did their homework and came to the conclusion that the opportunity was compelling and that an investment therein would produce profitable results over the long term.

Moving on to the counterparties, their responsibility is to enable the hedge fund actors to convert investment ideas into reality in the financial markets by achieving a delicate equilibrium. The core of this equilibrium is risk: the hedge fund actors may desire to take on increasing amounts of risk to implement their ideas and achieve their investment objectives; a desire that can place the counterparties in a tricky situation of conflicting incentives. On the one hand the preference of the counterparties is to give the hedge funds what they want, for this can result in greater economic gain for both sets of actors as well as the investors; on the other hand, the counterparties have an obligation to constrain the hedge funds from excessive risk taking in order to

\textsuperscript{56} Interview with Editor, \textit{InvestHedge}, London, 7\textsuperscript{th} June 2006
prevent substantial losses that may impact other actors in the financial system and threaten the financial system itself. Restricting the activities of hedge funds in a highly competitive market is less economically rewarding for the counterparties if everything goes according to plan; however, it is more rewarding if this action prevents a financial crisis. The obligation of the hedge fund actors is to manage their firms and their investment products to satisfy their investors’ expectations without acting in a manner that could put the financial system at risk.

What responsibility do the regulators have in this market-based approach? To encourage the economic actors, both the counterparties and the hedge fund advisers, to operate responsibly by balancing the preference for substantial economic gain against the risk of a financial crisis. In the case of the LTCM crisis the counterparties and the hedge fund adviser failed in their responsibility (Bernanke, 2007). Was this failure and resulting crisis linked to the hedge fund sector regulatory reform in France and Germany? The study will proceed as follows. The first section examines the issue of financial crises and the regulation of hedge funds in France. The second section then examines the issue of financial crises and hedge fund regulation in Germany. The third section turns to an examination of financial crises and the distinct lack of any explicit hedge fund sector regulation regime in the UK.

Financial Crisis and Hedge Fund Regulation in France

Wealthy investors have always been able to access hedge funds. Until relatively recently, the less affluent have not. In 2002, Carrefour, the French supermarket
company, started making a particular type of hedge fund investment product, which had been created by one of France’s leading financial institutions Société Générale, available to its customers for a minimum investment of less than €1,000. The regulators were not happy. According to Frédéric Cezard, who worked at Société Générale when the Carrefour product was launched, ‘two months after its launch, the regulator realised that it had made a mistake in terms of providing protection for small investors’ (HedgeFundIntelligence, 2006). Although a particular type of hedge fund product had been available in France since the late 1980s, prior to the Carrefour product launch they had never been explicitly available to the public at large. As long as hedge funds were not accessible by the general public, the regulators seemed happy enough to leave the sector alone. In August 2003 the Loi de Securité (Financial Security Act) was introduced. Its objective was to simplify and strengthen the supervision of financial services in France by streamlining the complex financial regulatory regime that comprised multiple regulators each with their own rules and regulations, to bring about a more unified regime under a single umbrella, the Autorité des Marchés Financières (AMF). The Financial Security Act also introduced extensive new hedge fund regulations. Why? Was this a response from the state actors to a financial crisis?

There were four financial crises in France during the period under observation. Table 3.1 links these crises to the regulatory concerns.
Table 3.1 France: Financial Crises and Regulatory Concerns

<table>
<thead>
<tr>
<th>Crisis</th>
<th>Systemic Risk</th>
<th>Investor Protection</th>
<th>Investor Confidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Lyonnais</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Currency</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Stock Market 1994</td>
<td></td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Stock Market 2000-2002</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The Credit Lyonnais scandal is estimated, between 1992 and 1997, to have cost the French taxpayer approximately 25 billion US dollars, equivalent to half the French government’s budget deficit for the year 1997\(^{57}\). The government rescued the company three times: in 1994, 1996 and 1997. In 1993, during the unfolding of the Credit Lyonnais crisis, France experienced a currency crisis. The European Exchange Rate Mechanism (ERM) had been under serious pressure since 1992 and by the summer of 1993 was very near collapse. The French Franc was under substantial pressure as the government vacillated between defending the currency’s peg to the Deutsche Mark or not. The crisis for the ERM was so severe that in August the band, within which currencies were allowed to fluctuate, was expanded from 2.25% to 15%. The first of two stock market crises happened in 1994 when the CAC 40\(^{58}\), the reference index for the performance of the French stock market, lost 17%. In percentage terms this was hardly a catastrophic drop in the value of the stock market. However, in the early 1990s the French stock market experienced much greater participation from both domestic and foreign investors explained partly by the government’s privatisation policy started in the mid 1980s (Gordon and Meunier,

---

\(^{57}\) Source: OECD Country Report 1997
\(^{58}\) CAC 40 is the abbreviation for Cotation Assistée en Continu (Continuous Assisted Quotation) and is the stock market index of the 40 major companies in France
This expanded participation meant that the sharp fall in the value of the market in 1994 affected a greater number of French investors than previous market falls. By the end of 1994 the share prices of some of the newly privatised companies such as Union des Assurances de Paris (UAP), Elf Aquitaine and Renault had fallen below the privatisation offering price. The second stock market crisis was much more severe. Between June 2000 and September 2002 the value of the main French stock market declined by 57%; while the value of the Nouveau Marché, the new stock market founded in 1996 to trade the shares of young, up and coming European companies that sought capital investment, declined by nearly 90% during the same period. During the late 1990s many small investors had invested in the French stock markets for the first time, either by buying shares directly or through savings and investment products. In 1999 the flow of euro into the main French stock market was 1.4 billion; in 2000 the asset flow increased ten times to 14 billion euro. This coincided with a doubling in the value of the French stock market as represented by the CAC 40 which can be seen in Figure 3.1, and a quintupling of the smaller market, the Nouveau Marché, which is evidenced in Figure 3.2. ‘When the bubble burst many of these investors suffered substantial financial loss; and the market suffered from the ensuing loss of public confidence and trust’\(^{59}\). Perhaps the most high profile corporate loss during the market crash was that of Vivendi Universal which lost over twenty three billion euro in 2002; this brought the company close to bankruptcy and was the largest loss in French corporate history up to that point. Not only did Vivendi’s near demise hit investors’ pockets, it also raised questions about the integrity of the company’s management. Between 2001 and 2003 asset flows into

---

\(^{59}\) Interview, 20th April 2006, Senior Executive at Regulatory Agency AMF, Paris
savings and investment products reduced substantially: in 2001 there was a small inflow of 210 million euro; in 2003 there was a net outflow of 1.3 billion euro\textsuperscript{60}. 'In France you need a crisis and then you get progress'\textsuperscript{61}. How valid is this statement?

Figure 3.1:

\begin{figure}
\centering
\includegraphics[width=\textwidth]{equities_purchases_cac40}
\caption{Equities purchases by households and trends in the CAC40}
\end{figure}

Bars: annual flow of assets into stocks held directly and indirectly in millions of euro.
Line: movement of CAC 40 in points.
Sources: Euronext and Banque de France\textsuperscript{62}

\textsuperscript{60} 'Report on the marketing of financial products', published by the AMF and presented by Jacques Delmas-Marsalet, Board Member of the AMF, to Thierry Breton, Minister of Economy, Finance & Industry on 21\textsuperscript{st} November 2005
\textsuperscript{61} Interview, Senior Executive at Economic Actor, Paris 20\textsuperscript{th} April 2006
\textsuperscript{62} From 'Report on the marketing of financial products', published by the AMF and presented by Jacques Delmas-Marsalet, Board Member of the AMF, to Thierry Breton, Minister of Economy, Finance & Industry on 21\textsuperscript{st} November 2005

104
The hedge fund sector has been in existence in France since the late 1980s. In late December 1988 a new law transposed the European Union (EU) Directive 85/611/EEC into French law. Among many of the changes to the investment services regulatory canvas, investment products that specialised in trading futures and options were now allowed to be created in France and sold to investors. Experts generally agree that the regulations allowing these new investment products, called Fonds Communs d’Intervention sur les Marchés à Terme (FCIMT), were designed to provide support to the relatively new French futures exchange, the MATIF. This new

---

63 Also known as the UCITS (Undertakings for Collective Investments in Transferable Securities) Directive
64 Exchange listed derivative securities
FCIMT investment product was, in effect, the first French hedge fund. Although legislation introduced between 1988 and 2003, particularly the Financial Activity Modernisation Act of 1996, reformed regulations concerning the provision of investment and portfolio management services, none of the revised or new regulations explicitly addressed the hedge fund sector. The Financial Security Act of August 2003 changed all that by introducing a framework that enabled the development of comprehensive and far reaching hedge fund regulations.

It had always been possible to manage money in France using investment strategies generally associated with the hedge fund sector. The difficulty lay in being able to solicit money from the thousands of French investors who outsource their investment and savings requirements to professional experts. The 2003 Financial Security Act changed this. The new regulations allowed the creation of new savings and investment products that were designed to permit investors access to a range of different hedge fund strategies on an 'on shore basis'. The distinction between 'off' shore' and 'on shore' is important. Because the previous regulations had made it so difficult for hedge funds to be established in France (on shore) and accessible by the public, many firms had sought to get around these restrictions by establishing hedge fund investment products off shore, in regulatory regimes such as the Cayman Islands or Bermuda, and then 'packaging' these products in such a way that they could be promoted and made available to investors in France. This special packaging generally followed one of two forms. The investment product could be listed on an EU recognised stock exchange, the preferred exchanges being the Irish Stock

---

65 Interview, Senior Executive at law firm, Paris, 28th February 2006
Exchange and the Luxembourg Stock Exchange, and once listed the investment product looked like any other company listed on the stock exchange. Investors could buy shares in what was, in effect, a hedge fund, in the same way that they could buy shares in their favourite telecommunications company. The other form of packaging ‘dressed up’ a hedge fund investment product so that it looked like an investment grade bond. This was the type of product created by Société Générale and distributed through Carrefour. The new regulations are designed, in part, to thwart this practice of manufacturing the product off shore and finding creative ways to make the product available to French investors on shore in France.

As was noted in chapter 1, the French regulations are an intriguing blend of the principles-based and the prescriptive. The new regime under the AMF offers both flexibility and uncertainty: ‘you never know whether something that we are doing is compliant or not’. It is beyond the scope of this research to discuss the detail and merits of the French hedge fund sector regulations. The question at this stage of the study is to determine to what extent, if any, the state actors responding to a financial crisis was the main determinant of the new regulatory regime.

During the last twenty five years, France has experienced a number of financial crises which provided the state actors with considerable cause for concern. Looking at the evidence it is possible to identify a link between the 2000-2002 stock market crash, with the introduction of new hedge fund regulations in the way that one can, for

---

66 A bond is a debt instrument created in order to raise money; it guarantees the investor a particular return over a particular time period. An investment grade bond is a bond which is relatively safe
67 Interview, Senior Executive at Economic Actor, Paris, 28th February 2006

107
example, between the high profile corporate failures in the US during the same period and the introduction by Congress of the Sarbanes Oxley legislation. The introduction of the Financial Security Act, within which the new hedge fund regulations were contained, was directly linked with the shocking loss of wealth suffered by many individuals in the stock market fall out at the beginning of this century and which affected confidence in the financial sector. In a speech to the Club de la Bourse\textsuperscript{68} on 20\textsuperscript{th} January 2003 to mark the organisation’s tenth anniversary, Francis Mer the Minister of the Economy, Finance and Industry told the audience that ‘we are living in a crisis which is both a financial crisis and a regulatory crisis’\textsuperscript{69} (Mer, 2003, January). He went on to say that a critical review of the financial regulatory regime was required and was being undertaken to better understand how the regime could be improved to function better in a more complex and global economic and financial environment, which financial market actors should regulate themselves and their activities outside the regulations, and which actors and activities should be regulated by the regulator.

This market crash provided fuel to the many individuals in France who are suspicious of the financial markets and the people that work in them: ‘in France there is a lot of left wing analysis which believes that people who have power and money will try to rip off the public, and therefore there need to be lots of regulations regarding investor protection’\textsuperscript{70}. The press release issued by the Ministry of the Economy, Finance and

\textsuperscript{68} Stock Exchange Club
\textsuperscript{69} ‘Nous vivons en effet une crise qui est à la fois une crise financière et une crise de la régulation’
\textsuperscript{70} Interview, Senior Executive at Economic Actor, Paris, 28\textsuperscript{th} February 2006

108
Industry on 5th February, 2003 which announced the forthcoming reforms, is entitled ‘Restoring Confidence’ and states that the Financial Security Act

‘is intended to respond to the crisis of confidence affecting the financial sector and the business community. It provides for a sweeping reform of the financial activities’ supervisory authorities, strengthens the protection provided to small investors and the insured, and reforms the supervisory mechanisms for corporate accounting and governance’.

State actors can be highly sensitive to what can affect the public’s trust and confidence in the market. The political salience of taking action to restore confidence in the financial services sector increased as the market continued on its downward path from June 2000 to September 2002. Meanwhile, during this time, one of the few segments of the global investment services market that was producing profits for its investors was the hedge fund sector which is demonstrated in Figure 3.3.

2002 was the year in which, as noted earlier, the supermarket company Carrefour launched the first hedge fund product in France aimed at the general public. And according to one of the economic actors involved in the project, the regulators were concerned about this particular market development because at that time most of the economic actors in the sector operated legitimately in France but outside the regulatory regime. The very public promotion of the new Carrefour fund\textsuperscript{72}, as well as the acute and sustained drop in the value of the stock market provided the state actors with ample justification to amend the regulatory regime in the interest of better protecting the public, and improving the efficiency of the French financial regulatory system. The LTCM crisis, which had shaken the global financial system in 1998,

\textsuperscript{72} The fund was advertised in the company's supermarkets
hovered in the background as the hedge fund crisis that no regulator wanted to see repeated. Three of the 15 banks involved in the private sector bailout of LTCM were French\textsuperscript{73}, and although there is no evidence of any formal action taken by the regulators and other state actors in the aftermath of the LTCM event with the specific objective of assessing the integrity of the French regulatory regime and its ability to fulfil its goals regarding systemic risk and investor protection., the fear of such a crisis taking place in the future as more and more members of the French public invested in the hedge fund sector, formed part of the rationale for the new regulations. These new hedge fund sector regulations, introduced in the summer of 2003, were part of the overall reform of the regulatory regime which was completely restructured and streamlined from multiple agencies into a single agency, the AMF. This financial policy was driven by the state actors in the aftermath of what Mer (2003, January) referred to as a financial and regulatory crisis.

Financial Crisis and Hedge Fund Regulation in Germany

Sweeping reform of the German regulatory regime relating to investment services came into effect in January 2004 with the Investment Modernisation Act (IMAG). The IMAG reformed Germany’s ‘heavily criticised and outdated’ public investment fund law(s) and fund taxation law(s) (MacHarg and Hey, 2003: 1). Among the substantial changes that were introduced to the German investment market law were new hedge fund regulations. For the first time, the hedge fund sector became regulated by German law; although the law does not use the term ‘hedge fund’ opting

\textsuperscript{73} Banque Paribas, Crédit Agricole, and Société Générale
instead for the expression ‘Sondervermögen mit zusätzlichen Risiken’ (investment scheme with additional risks) (Lang, 2004:672). Prior to the introduction of the new hedge fund sector regulations in the IMAG there was no specific legal framework for the sector, and the sector was not prohibited per se. In fact, the hedge fund sector was virtually non-existent in the country. As was demonstrated in chapter 1, there were very few German hedge fund advisers, and the amount of money invested in hedge fund products, whether home grown or foreign, was among the lowest in Europe. But it was possible for the economic actors to create and offer hedge funds, through careful and creative interpretation of the regulations that existed for the broader investment services sector. The lack of home grown hedge fund product can, partly, be attributed to the fact that the investment product manufacturer, such as an investment management firm, needed imaginative and resourceful product design and packaging skills to develop a product within the overall investment services regulatory framework that would be accessible to investors and, in the process, ran the risk of designing a product that, from an investment perspective, was a pale imitator of a hedge fund because of the investment strategy restrictions.

Furthermore, while hedge fund investment products could be accessed by German investors, the punitive taxation rules often associated with investing in these funds made them unattractive to investors. This meant that there was a financial regulatory regime and a related taxation environment that while neither explicitly prohibiting the establishment of either a hedge fund adviser or a hedge fund product, nor the ability of investors to access such investment products, did little to encourage the

---

74 The Lipper TASS Hedge Fund Database
development of the domestic hedge fund sector. The very different treatment by the German financial regulatory and taxation regimes of domestic and foreign funds meant that it was difficult and expensive to design products that could appeal to a broad range of investors.

However, one economic actor’s obstacle is another’s challenge and some of the investment services companies handled the regulations and the taxation issues by manufacturing their hedge fund products abroad as investment grade bonds\(^{75}\) which could be distributed to the investing public without the risk of punitive taxation on any financial gain, and without having to water down the investment approach in order to comply with the investment restrictions which limited some of the hedge fund investment strategies that could be employed. In October 2000 Deutsche Bank, one of Germany’s leading financial institutions, launched the first such product aimed at the German investor; it was called Xavex Hedge Select and it raised nearly two billion Euro from both small retail as well as large institutional investors. The product was complex in structure and expensive in terms of the fees that it charged the investors; but at the time it was the only product offered by one of the country’s leading financial institutions that enabled German investors to obtain exposure to the new and innovative hedge fund sector. Following Deutsche Bank’s successful launch, similar savings and investment products were launched by other investment services companies and by early 2004 the German investment market had over 50 such products (MFA Reporter, 2004: 2).

\(^{75}\) Considered low risk investments by the regulator
Although the particular interest of this research study in the IMAG is the introduction of new hedge fund sector regulation, one of the act’s objectives is to standardise the treatment of all German and foreign investment funds. The IMAG harmonises the taxation treatment of foreign and domestic funds; it requires improved transparency of information about investment funds for investors, thereby endeavouring to reduce the problem of asymmetric information between the promoters (insiders) and the consumers (outsiders) of investment products; and it makes it easier to create and distribute investment products in Germany. If a financial crisis can be put forward as a determinant of regulatory reform, to what extent are the IMAG and its new hedge fund rules explained by the state actors responding to a crisis?

With one substantial exception, financial crises were conspicuous in their absence in Germany during the observed period. The single financial crisis to which this study refers is the stock market crash between March 2000 and March 2003. Table 3.2 links this crisis to the regulatory concerns.

Table 3.2 Germany: Financial Crisis and Regulatory Concerns

<table>
<thead>
<tr>
<th>Crisis</th>
<th>Systemic Risk</th>
<th>Investor Protection</th>
<th>Investor Confidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Market 2000-2003</td>
<td></td>
<td>Y</td>
<td>Y</td>
</tr>
</tbody>
</table>

The main stock market in Germany, the Deutsche Börse, lost 55% of its value; however, the Neuer Markt which, since its launch by the Deutsche Börse in 1997, had become the dominant stock exchange for small European growth and technology companies, lost a staggering 95% of its value between its peak in the spring of 2000
and September 2002. And in March 2003 the decision was made to abolish the Neuer Markt; it had become regarded as a scandal ridden stock market serving the interests of insider dealers and other market manipulators. The German stock market was not alone in crashing; after the bursting of the so-called Dot Com bubble\textsuperscript{76} in the spring of 2000, the Dow Jones World Stock Market Index, a summary measure of the performance of the world’s stock markets, fell nearly 45\% during the same period (Dow Jones, 2007). In order to understand the effect of this crisis on both the public and the policy makers in Germany it is necessary to sketch the radical reforms and developments that had taken place in the German investment services sector in the preceding ten years. This is because these reforms were among the first steps taken by the state actors to foster the development of a more market and less bank-based financial sector. As a political economy classified as a CME in which non-market relationships had long played a dominant role in economic governance, Germany’s financial system was dominated by the banks. The stock markets played a less important role. Some of the reforms that were introduced by the state actors in the decade before the IMAG were designed to enhance the role of the stock markets as providers of both capital and liquidity to Germany’s financial sector.

Since the late 1980s the state actors, with the support of the economic actors, had been engaged in a strategy of ‘risk privatisation’ (Westrup, 2006) as they fostered the development of an equity market culture, in part through a programme of corporate privatisations. This strategy had started in the UK in 1981 and was adopted by both

\textsuperscript{76} Speculative enthusiasm for new companies whose business models depended on the Internet
France, which executed its first privatisation in 1986, and Germany which executed its first privatisation in 1987\textsuperscript{77}.

Although there was limited participation from the small investor in early privatisations in Germany, the privatisation of Deutsche Telekom in 1999 was regarded as the first major step towards the creation of an \textit{Aktienkultur} (share holding culture) in Germany (Posen, 2003). The ultimate sanction of this policy is the purchase of shares by the public; and if the public is going to buy shares, it needs to have confidence in the financial sector. In 1994 the Second Financial Market Promotion Act was passed which did two things that were designed to help convince investors, both in Germany and abroad, that the German stock market was sound and fair. It prohibited insider trading which, until this point, had not been illegal; and it established a totally new regulator for investment services, the Bundesaufsichtsamt für den Wertpapierhandel (BAWe)\textsuperscript{78}.

These reforms were necessary because prior to their introduction, a self regulatory regime existed which suffered from ‘widespread accusations of market manipulation and exploitation of small shareholders’ (Kenyon and Vitols, 2005: 24). The responsibility of the BAWe was to ensure that the securities and their related derivative markets functioned fairly, and this would be achieved by pursuing three objectives; investor protection, market transparency and market integrity. In 1995 a shareholding culture did not yet exist; at this time households (individual investors)

\textsuperscript{77} Privatization Barometer \url{www.privatizationbarometer.net/database.php}. Accessed 10 July 2007

\textsuperscript{78} Also called the Federal Securities Supervisory Office
had almost no money invested in the stock market on a direct basis through the purchase of shares in companies, and only €10 billion invested on an indirect basis through investment in savings and investment funds. Within five years this situation had dramatically changed. By early 2000 household direct investment in the German stock market had grown to €20 billion, and household indirect investment had grown to nearly €60 billion (Kenyon and Vitols, 2005: 26).

This five year period had also seen the establishment, in 1997, by the main stock exchange, now called the Deutsche Börse, of a new subsidiary exchange, the Neuer Markt. The rationale for the creation of the new exchange was simple. The Deutsche Börse was dominated and controlled by banks which had strict criteria concerning the size and profitability of companies that could be listed on the exchange. This meant that many of the young companies that had been privately established and which needed to raise money in order to invest in the development of the firm were unable to list on the exchange and were unable, therefore, to gain access to the enlarging pool of equity finance. The German economic and state actors had decided that if the financial sector was to be more competitive, and the potentially high growth German companies were to have the opportunity to develop, then a new approach was needed and the Neuer Markt was born. It was set up to enable small, and very often unprofitable, companies to raise money from investors by being listed on a stock exchange.

The German investor’s enthusiasm for investing in the stock market was abruptly challenged by the stock market crash which seriously damaged both wealth and
investor confidence. According to a survey conducted by the financial services firm UBS Warburg in 2002, 40% of retail investors stated that the two years of market declines since the spring of 2000 would permanently change the amount they invested in stocks in the future\(^9\). In September 2002, a German investment analyst told the *Financial Times* 'the market has been burnt badly ... retail investment in Germany has been wiped out for a generation' (Taylor, 2003: 156). Figure 3.4 shows the rise and fall of the Neuer Markt as defined by the exchange’s NEMAX share index.

Figure 3.4: Performance of the Neuer Markt March 1997 to November 2002

\[\text{Deutsche Boerse AG NEMAX All Share Performance}\]

\[\text{Source: Bloomberg (2006 (2))}\]

Having had no hedge fund sector regulation, to what extent were the new regulations included in the IMAG introduced by the state actors in response to the substantial loss of people’s savings in the stock market crash, and the accompanying loss of consumer confidence? Is there evidence that the LTCM crisis in 1998 influenced the decision of the state actors to introduce these new regulations? The evidence in Figure 3.3 shows that during the prolonged stock market fall out, on average hedge funds were making money for their investors. The evidence also shows that the number of foreign based funds and hedge fund type investment products launched for distribution to German investors increased during the same period\textsuperscript{80}. Hedge fund investment products have always been perceived by financial sector policy makers to be more risky than other types of savings and investment products for three principal reasons. The first thesis promulgated by supporters of the ‘hedge funds are more risky’ group relates to the extremely flexible and dynamic characteristics of many hedge fund sector investment strategies and that while this flexibility can increase the opportunities for achieving positive performance for investors, in can also increase the potential for losses. The second thesis relates to the opaque and secretive manner in which many of the economic actors in the sector manage their firms and their investment products giving rise to concerns regarding asymmetric information. The third relates to the fact that while the majority of hedge fund advisers are located in the US and to a lesser extent the UK, the investment funds that they offer to investors are, generally, domiciled in offshore centres such as Bermuda and the Cayman Islands presenting German, as well as French and UK, regulators with a regulatory

\textsuperscript{80} Bundesverband Deutscher Investment-Gesellschaften (German Association of Investment Funds and Asset Managers) "Investmentstandort Deutschland: Trendwende bei der Wahl des Auflagelandes", May 2006
mismatch. This mismatch relates to the goal of protecting the domestic investors but without having any regulatory authority over the foreign domiciled investment funds.

All three theses provide ammunition to those concerned about the potential risk generated by the twofold issue of asymmetric information. It is twofold because of its effect on consumers, and because of its effect on the financial system. If consumers do not know exactly what they are buying, how can they make informed decisions? And if one of the principal guardians of the financial system, the regulator, does not know what the hedge funds are doing, how can it fulfil its obligation to prevent a financial crisis? The regulatory reform which took place in the wake of the trend of increased investor interest in the hedge fund sector and the stock market and LTCM crises may be evidence of correlation; but does this suggest a direct link between financial crisis and the ensuing reform? Did the political actors opt for a change in the regulatory regime in the public interest in response to societal pressure, or were other political and economic dynamics at work that better explain the reform?

The IMAG states that its main objectives are to standardise the treatment of German and non-German (foreign) funds, to improve transparency in the investment services sector, and to make it easier to manufacture and distribute investment and savings products in Germany. As a senior executive of one of Germany’s leading investment services firms has noted,

‘the express purpose of the new law was to make Germany a viable competitor to Europe’s leading investment fund centres in Luxembourg,
Ireland and the UK. The goal is to attract foreign investment funds and managers and avoid further migration of investment fund business out of Germany\(^81\).

The IMAG goals suggest that the logic behind the reform was the creation of a more competitive domestic financial services market. Following this logic, the inclusion in the IMAG of the new hedge fund sector regulations suggests that the policy makers recognised the growing importance of the sector to the financial markets and its interest to investors, and therefore made the decision to bring it formally within the regulatory regime. Both the public interest and Germany’s economic interest would be better served by reforming the regulatory regime. Hedge funds are perceived to be more risky than so-called traditional investment and savings products and the evidence that growing numbers of German investors were accessing hedge fund investments gave the state actors cause for concern\(^82\). However, none of these hedge fund products suffered substantial losses in the stock market turmoil which suggests that the government was more concerned about improving the overall regulatory environment for investment funds, than with targeting its response to this financial crisis.

As already noted, one of the goals of the IMAG was the standardisation of the treatment of domestic and foreign funds and to discourage the practice used by many economic actors of establishing investment products in a foreign market and then selling them into the German market. The hedge fund products that were being

\(^{81}\) Interview, Senior Executive at Economic Actor, Frankfurt, 16\(^{th}\) May 2006
\(^{82}\) Interview, Senior Executive at BaFin, Frankfurt, 15\(^{th}\) May 2006
offered to German investors prior to the new regulations were all created outside the
domestic regime; they were foreign funds. It follows that if the rules governing the
treatment of domestic and foreign funds were to be standardised, that hedge fund
sector products would be included. The financial crisis of the lengthy and acute stock
market crash that resulted in substantial losses for many investors, who had *inter alia*
supported the Neuer Markt and the Deutsche Telekom privatisation by investing in
shares, is linked to the introduction of the new hedge fund sector regulations. The
effects of the crisis contributed to the government’s desire to modernise the
regulatory regime and make it more attractive to domestic and foreign economic
actors alike. While there was little direct effect of the LTCM crisis on the German
retail investors, despite the fact that one of the 15 banks involved in the “rescue” of
LTCM was Germany’s largest bank\(^{83}\), the fear of a similar crisis happening in the
future and the desire to protect the consumer there from, influenced the designers of
the new regulations\(^{84}\).

**Financial Crisis and Hedge Fund Sector Regulation in the UK**

The insights so far into the introduction of hedge fund sector regulation in France and
Germany show that financial crises played a meaningful role by putting the state
actors under pressure to reform the regulatory regime in an effort to restore public
and investor confidence in the respective financial systems and, at the same time,
chose to include regulation of the hedge fund sector. Financial crises can create an
environment in which the promotion of the public interest becomes politically

---

\(^{83}\) Deutsche Bank AG

\(^{84}\) Interview Senior Executives at BaFin 15\(^{th}\) May 2006; CESR 20\(^{th}\) April 2006
important and the state actors have the incentive to change the regime. In the UK, however, despite experiencing multiple financial crises during the period, the state elected and bureaucratic actors chose to maintain the status quo with regard to the regulatory regime that applies to the hedge fund sector, although substantial reform of the financial sector regulatory regime did take place. In order to better understand the possible causal interaction between financial crisis and changes in the regulatory regime in the UK, it is useful to review the catalogue of financial crises that took place from 1990 onwards and the impact that these events and their consequences had on regulatory reform. If, as all the UK interviewees claimed, regulatory systems are borne out of crisis, the research should find empirical evidence of reform as a consequence of a crisis. The financial crises in the UK and the related regulatory concerns are presented in table 3.3.

Table 3.3 UK: Financial Crises and Regulatory Concerns

<table>
<thead>
<tr>
<th>Crisis</th>
<th>Systemic Risk</th>
<th>Investor Protection</th>
<th>Investor Confidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Levitt Group</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>BCCI</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Maxwell</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Currency</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barings</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Deutsche Morgan</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Grenfell</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equitable Life</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Split Capital</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>Investment Trusts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock Market</td>
<td>Y</td>
<td></td>
<td>Y</td>
</tr>
<tr>
<td>2000-2003</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the late 1980s the state actors initiated substantial reform of the provision of pensions. This reform meant that individuals were allowed to opt out of the state
provided pension schemes and choose alternative, market-based solutions to their long term savings requirements; further it was no longer mandatory to be a member of the pension scheme that was provided by the company for which an individual worked. The policy was part of the state led programme to encourage the privatisation of savings and investment, and within four years of its introduction in 1988 approximately 25% of the workforce elected to invest in a personal pension (Disney, Emmerson and Smith, 2003: 4). The first financial crisis to which this research refers was the collapse of the Levitt Group in December 1990 with the loss of £24 million of clients’ money, much of which had been given to the firm to invest as a result of the government’s new pension policy. 1991 witnessed the collapse of Bank of Credit and Commerce International (BCCI), whose ‘primary commercial activity turned out to be money laundering’ (Clarke, 2004: 156), in which £13 billion was found to be missing, and which resulted in some creditors of the bank trying to sue the Bank of England for £1 billion, raising questions about the central bank’s supervisory role. The year also experienced the Robert Maxwell scandal in which approximately £400 million was stolen from the Mirror Group Newspaper pension fund. In 1992 the state actors, while trying to manage a political economy that was in a debt induced recession, had to deal with the ignominy of the national currency being forced out of the European Exchange Rate Mechanism (ERM) through the action of a host of economic actors, the most high profile of whom was the hedge fund adviser, George Soros. Through their speculative activity the economic actors calculated, successfully, that the elected state actors did not have the political will to compel the electorate to accept the price of fulfilling the rigorous convergence criteria

85 Source: former Executive Director of the Levitt Group 1985-1990
for European monetary union agreed in the Maastricht Treaty which had, while sterling was in the ERM, forced the UK ‘to follow the tight monetary policy adopted by Germany and had witnessed the increasing demands on the public sector’s finances’ (Bank of England, 1992).

In 1995 one of the UK’s oldest financial institutions, Barings Bank, collapsed. Although the losses to clients and investors were de minimus because the firm was sold quickly to a large Dutch financial institution which agreed ‘to pay all our customers and clients in full’\(^{86}\), the bank’s collapse once again raised serious questions about the quality and integrity of the supervision provided by the Bank of England as the principal regulator. In 1996 investors were once again on the receiving end of an investment scandal, this one perpetrated by Peter Young, an investment manager at Deutsche Morgan Grenfell. His fraudulent activities cost the parent company, Deutsche Bank, approximately £300 million in fines and compensation to some 180,000 investors; a reassuring action for the investors, less so for the Deutsche Bank shareholders. After three crisis free years, 2000 saw the near collapse of Equitable Life in which over one million holders of savings and pension products in the UK, and another 15,000 investors in other EU member states, lost substantial amounts of money\(^{87}\). The next crisis happened in 2002 and involved a particular segment of the investment services sector which centred on an investment product type called Split Capital Investment Trusts. In this instance 25,000 investors were deemed eligible for compensation amounting to £142 million. The problem with Split Capital Investment Trusts had come to light because of the sharp fall in the

\(^{86}\) Aad Jacobs, chairman of ING, quoted in the International Herald Tribune, 7th March 1995.

value of the stock market, which dropped nearly 50% between 2000 and the beginning of 2003. If financial crisis is a determinant of regulatory reform, the empirical implication is that the UK regime is likely have experienced the introduction of a significantly greater amount of regulatory change than either France or Germany, on the basis that more crises had taken place. However, in the context of trying to explain the UK preference for maintaining the status quo with respect to hedge fund sector regulation, despite ample opportunity to do otherwise with the substantial regulatory reform introduced by the elected state actors in 1998 and 2000, it is helpful to consider the possible link between the financial crises and the overall regulatory reforms of 1998 and 2000.

From 1986 until 1997 the UK regime was one of self regulation within a statutory framework. There existed a multiplicity of self regulatory organisations (SROs), each serving a particular segment of the financial services sector, which were authorised by the Securities and Investments Board (SIB) acting as the overarching regulator. The system had been created by the Conservative government in 1986 as part of their programme of risk privatisation with the dual objectives of providing protection for the consumers of financial services, and providing a regulatory framework within which the UK based economic actors and the UK financial sector could operate as they competed in an increasingly global and integrated market. The series of financial scandals in the 1990s ‘led the Labour party in opposition to
conclude that the current system of self regulation was not working and that something radical needed to be done.\textsuperscript{88}

Once in power in 1997 the new Labour government acted swiftly and the radical action included stripping the Bank of England of its supervisory responsibilities, and dismantling the complex, self regulatory, multi-agency financial services regime and replacing this with a new unitary regulator for the whole sector, the FSA. While other factors undoubtedly played an important role in this radical policy initiative, and it is beyond the scope of this study to examine them, there is clear evidence that there is a causal relationship between financial crises and regulatory reform in the UK. In the parliamentary debate on the Bank of England Bill in November 1997, the proposed reform of the central bank’s role was linked directly to the collapse of both BCCI and then Barings; and the replacement of nine regulatory agencies with a single agency was directly linked to the pensions mis-selling crisis of 1990s. The latter crisis had shown the self regulatory regime to be an inadequate protector of the consumer:

‘part of the problem with the self regulatory system ... was that, in many cases, the regulators turned a blind eye to what was going on. Certainly in the case of pensions mis-selling, the industry knew what was going on, but the regulators chose to do nothing about it.’\textsuperscript{89}

\textsuperscript{88} Interview, February 2006, with an adviser to the Front Bench Treasury team in both houses of parliament on the reform of the financial regulatory regime
\textsuperscript{89} Alistair Darling, Chief Secretary to the Treasury, recorded in Hansard 11 November, 1997 Vol. 300, c721
This link between crisis and reform in the UK applies, based on the evidence, to domestic financial crises caused by economic actors that negatively impact domestic consumers. To what extent is there a link between the single hedge fund sector crisis noted earlier and any ensuing change in the regulatory regime? This is a question to which the study now turns.

It was the failure of LTCM and the shockwaves that this event sent through the financial system that first caused the regulators in the UK to seek a deeper understanding of this hitherto arcane and opaque sector and its potential to cause a systemic crisis. The relatively recently formed FSA has four statutory objectives which include maintaining confidence in the financial system and protecting the consumer; being caught off guard by the hedge fund sector was unlikely to enhance the new agency’s reputation with either the economic actors that it regulates, or the political actors on whose behalf it operates.

Although the hedge fund adviser to the LTCM fund was US based and, therefore, operating within the framework of the US regulatory regime, the global systemic issues that were raised as a result of LTCM’s and its counterparties’ mismanagement propelled the UK regulators to take action. The activities of LTCM, and other hedge fund firms, are a material contributor to the wholesale financial market in the UK; suddenly, there was a political imperative to better understand the sector and its effect on the wholesale financial system, as well as on the consumer. To this end the regulators actively sought communication with and information from the hedge fund sector’s leading interest association, the Alternative Investment Management
Association (AIMA). The pre LTCM equilibrium that existed between the sector and the regulators, in which the economic actors had found getting access to the regulators somewhat difficult, 'you had to use a canon to shoot the door down to get them to listen; they really did not want to know', was radically altered. Meetings were arranged between the regulators and the sector, information shared and a dialogue commenced that culminated four years later with the publication by the FSA of Discussion Paper 16 (DP16), the first formal communication issued by the regulator about the sector. The LTCM crisis had brought the issue of systemic risk once again to the forefront of the agenda, particularly in the UK for two main reasons. First there are many more hedge fund advisers located in the UK than in France or Germany; and secondly, the wholesale financial market, in which the hedge fund sector is a major actor, is much larger in the UK than in France or Germany (Clifford Chance, 2005). The LTCM crisis did not, however, generate renewed concerns about investor protection because only large financial services institutions and other investors who were deemed to understand the risks were invested; small investors were not at risk directly because they did not have access.

The FSA issues two types of policy papers, discussion papers and consultation papers. There is one fundamental difference between the two which is that consultation papers result in action, meaning regulatory reform; discussion papers, however, do not result in policy action and are issued to encourage debate between the regulators, the financial sector and other interested parties about a particular topic. Discussion papers, however, often precede consultation papers. DP16 was concerned

90 Interview, Executive Director of AIMA, London, 6th February 2006
91 Financial Services Authority Discussion Paper 16 "Hedge Funds and the FSA", August 2002
with two primary issues: first, whether the current model for regulating the UK based
hedge fund sector is appropriate; and secondly, whether the rules relating to the
promotion of hedge fund products and, in particular, the prohibition of the sale of
hedge fund products to small investors continues to be appropriate. FSA discussion
papers and consultation papers invite response from interested parties within a
defined time frame. The overwhelming response to DP16 was agreement with and
acceptance of the status quo; although there was recognition from the regulator that
the situation, particularly in relation to the lack of accessibility of hedge fund
products to small investors, should be kept under review with the potential for future
discussion or consultation.

Conclusion

The goal of this chapter has been to try to determine the effect of financial crisis on
regulatory regime reform and design. There was a major hedge fund sector crisis
prior to the reforms in France and Germany. This LTCM crisis shook the global
financial system and resulted in substantial losses for many of the investors in the
fund. British, French and German banks were among the banks involved in the
private sector bailout of the fund organised by the New York Federal Reserve\textsuperscript{92}. The
regulatory agencies in all three cases are more than familiar with the event and claim
that one of the primary objectives of their regulatory regimes is to ensure that the
financial system cannot again be put at such risk\textsuperscript{93}. Neither the French, nor the
German nor the UK regulatory authorities have extra-territorial powers to impose

\textsuperscript{92} Barclays, Crédit Agricole, Deutsche Bank, Paribas, Société Générale
\textsuperscript{93} Interviews: Senior Executives at AMF 20\textsuperscript{th} April, 2006; BaFin 15\textsuperscript{th} May 2006; FSA 6\textsuperscript{th} April 2006
regulatory requirements on non French, German or UK economic actors that do not carry out regulated activities within their respective regimes.

The public interest theory of regulation suggests that state actors respond to a crisis by introducing regulatory reform in the public interest. From the analysis in this chapter how valid is to suggest that regulatory reform is best understood as an outcome of a financial crisis? Financial crises can be ‘a vital resource in the hands of policy entrepreneurs eager to expand regulatory initiative’ (Pagoulatos, 1999: 90) providing the state actors with the justification to implement change. During the period under investigation there was only one hedge fund sector crisis, LTCM; and this affected the global financial system. In France the prospect of such a crisis taking place in the future provided the policy makers with justification for reforming both the overall investment services regulatory regime as well as the specific hedge fund sector regime. This justification was to provide better protection for investors, particularly the small investors, who were increasingly gaining access to hedge fund sector investments. However, other factors are also linked to the reform, as will be demonstrated in the ensuing empirical chapters.

In Germany, despite very public anti-hedge fund rhetoric from individual state actors in the years post the regulatory reform94, it is not possible to state that the new hedge fund sector regulations were introduced explicitly as a result of the LTCM crisis. However, this crisis loomed in the background and fear of a similar event happening

94 17th April, 2005. Interview with Franz Müntefering, then chairman of the Social Democratic Party, in Die Bild Zeitung in which Müntefering said that some financial investors, such as hedge funds, “attack companies like swarms of locusts, demolish them and move on”.

131
in the future that might dislocate the German financial market, and result in substantial losses for investors, influenced the regime designers. The state actors were responding to other pressures and, as will be shown particularly in chapter 5, did not need to use what was then the world’s largest hedge fund crisis as justification for regulatory reform. Their motivations for reform were the competitiveness of the Germany financial market and the protection of the domestic economic actors. The decision of the regulators in the UK, after consultation with the hedge fund sector actors, not to introduce any regulatory reform despite the shockwaves that the LTCM crisis had sent through the global financial system, suggests collective understanding that the extant regime fulfilled the regulators’ goals for maintaining systemic stability and investor protection with the economic actors’ preference that the regime need not be changed.

Moving beyond the hedge fund crisis and its effect on the specific hedge fund sector regimes to other financial crises and their effect on the overall financial regime, the link with regulatory reform is more clearly demonstrated in all three cases. Although it has been observed that the extent to which change is made is not proportional to the breadth or depth of crises. For example, the UK experienced substantially more crises than France and Germany combined, yet the regulatory reforms in the UK which resulted in the creation of the unitary regulator, the FSA, were no more radical in scope than the similar reforms undertaken in Germany that produced the BaFin in 2001, and the reforms undertaken in France that resulted in the streamlining of regulatory agencies and the creation of the AMF in 2003. Financial crises provide the state actors with both the justification and the incentive to introduce policy
changes that they may desire for other reasons; what the financial crisis does is to provide almost foolproof legitimacy for the reforms on the basis that they are being introduced in the public interest. The combination of a financial crisis hovering in the background, as well as the prevention thereof being a major focus of regulatory regime design means that there is always a link between crisis and reform as policy makers may use the past or prospect of a crisis to introduce change.

This study now moves on to an examination of the relationship between the economic actors and the state actors to consider the extent, if any, to which the private interest theory of regulation is a useful guide in analysing the roles of the different actors in the regulatory regime reform and design that the study seeks to explain.
Chapter 4

Private Interest Theory and the Role of Economic and State Actors

Introduction

Having set the stage for the puzzle in chapter 1, the second chapter described two theories of regulation and four explanations that have been posited in the literature as determinants of regulatory regime reform and design. In chapter 3 financial crisis, one of the explanations, and the role of elected policy makers acting in the public interest was examined. This chapter will examine the role and actions of the economic actors, particularly the domestic economic actors in France, Germany and the UK, and the relationship between the economic and appointed state actors in influencing, or even determining regime reform and design. It will seek to determine the effect of the institutional relationship between these two sets of actors on the hedge fund sector regulatory regimes in each of the three cases.

Political scientists have put forward two explanations to support the market driven model of regulatory change, and both rest on the economic actors. The first are the ‘coordinated economic actors’ who actively strive for reform; the second are the ‘uncoordinated economic actors’ who prefer to exit the regime (Perez, 1998: 760). The economic actors who wish to push for reform in order to reduce or remove national barriers, open up markets and improve their ability to compete internationally will coordinate with each other to achieve their objectives (Cohen,
1989; Dollar and Frieden, 1990). Both formally and informally, directly and through relevant interest associations they will lobby the elected and appointed political actors to make changes to the regime. The other economic actors will operate unilaterally in what they consider to be in the best interest of their organisations. If the regulatory regime does not enable them to manage their businesses efficiently and competitively they will exit and establish operations elsewhere. Within this group there is no coordinated action; if one of the purposes of exiting is to achieve a competitive advantage, sharing the plan of action with other economic actors is an unlikely approach. For footloose economic actors based within the EU, the act of exiting their national market and relocating to a different country within the EU single market means that they will not be excluded from their original national market despite having exited (Coen, 1998: 77). The action of exiting the regime and the effect of this on the domestic market causes the political actors to reform the regulatory regime in order to persuade the economic actors who have left to return and to dissuade others from leaving (Laurence, 1996).

In order to examine the possible link between regulatory regime reform and design and the relationship between the domestic economic and bureaucratic actors, this research seeks to find the following empirical evidence in each of the cases. First, a push from the incumbent economic actors for regulatory reform which, while potentially more burdensome and costly, may restrict the ability of other economic actors whether foreign or domestic to successfully enter the market thereby enabling the incumbents to maintain their dominant market position. Secondly, limited evidence of the practice of regulatory and operational arbitrage. Regulatory and
operational arbitrage can be manifested in a number of ways. The economic actors can exit the domestic regime and establish their businesses in a foreign regulatory regime with the goal of achieving a comparative competitive advantage. Economic actors engaging in this form of regulatory arbitrage may have done so as a result of the pressure of the globalisation of markets, an issue that will be explored in the next chapter. An alternative course of action is to establish business operations in foreign regimes while maintaining operations in the domestic regime. Thirdly they can create investment products in foreign regulatory regimes to avoid the restrictions of the home regime, and package these products in such a way so that they can be sold to consumers in the home regime. A quasi 'back door' approach to product distribution which, following the use of this phrase in computer programming, means that access to the domestic based investors can be achieved by by-passing the domestic regulations. The behaviour of the economic actors, by engaging in regulatory and or operational arbitrage acts as a catalyst to the state actors to change the domestic regime.

It is intuitive to suggest that if the economic actors are satisfied with the domestic regulatory environment, they are less likely to go to the trouble and expense of setting up a new operation in a different country. Fourthly, an employment trend whereby individual bureaucrats quit the regulatory agency and take up employment in the financial sector suggesting the transfer of useful knowledge concerning the operations, strategy and preferences of the agency to the firms that it regulates, thereby enabling the firms to adjust their approach to better get what they want from
the bureaucrats. This section seeks to find out the extent, if any, to which the economic actors drove the change or maintenance of the status quo.

The relationship between the economic and bureaucratic actors, and the outcome of this relationship, differs across all three cases and is shaped and conditioned by the characteristics of the institutional setting in each country (Scharpf, 1997:1). The institutional setting is important because public policy is likely to result from the strategic interaction between a few or multiple policy actors, and each set of actors has its own opinion regarding the policy issue and the desirability and feasibility of particular responses; each set of actors also has its own 'individual and institutional self interest as well as its normative preferences'; and finally each set of actors has its own 'capabilities or action resources that may be employed to affect the outcome' (Scharpf, 1997: 11).

There are several key characteristics that make up the institutional setting and that influence the strength of the economic actors in their ability to drive regulatory reform. The number of regulatory agencies is a characteristic and has particular effect: it determines the degree to which the regime is centralised and, therefore, the extent to which the economic actors need to collaborate in order achieve the desired outcome. The greater the number of agencies the greater the possibility of multiple preferences regarding regime design as agencies, and their regulatees, compete to maintain or strengthen their positions relative to the other bureaucratic and economic actors. Germany and the UK each have a single regulatory agency; France, however, has a primary agency, the AMF, for the fund management and hedge fund sectors,
but continues to maintain a role for other agencies within its broader investment services regulatory regime\textsuperscript{95}.

The number of interest associations and the nature and density of the membership is a second characteristic and there is significant cross national variation. Germany has a single interest association for the whole investment sector, and membership is voluntary. The UK has three interest associations, and membership of each is also voluntary. In France, however, membership is mandatory and regulated companies must choose to join one of two associations. Table 4.1 identifies the principal interest associations in each of the cases.

Table 4.1: Investment Services Interest Associations

<table>
<thead>
<tr>
<th>France</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFG - Association Francaise de la Gestion Financiere</td>
<td>BVI - Bundesverband Deutscher Investment-Gesellschaften e.V. (Also known as Bundesverband Investment und Asset Management e.V.)</td>
<td>IMA – Investment Management Association (herein after referred to as IMAUK to avoid confusion with IMAG)</td>
</tr>
<tr>
<td>AFEI - Association Francaise des Entreprises d'Investissement</td>
<td>AIMA – Alternative Investment Management Association\textsuperscript{96}</td>
<td>APCAIMS – Association of Private Client Investment Managers and Stock Brokers</td>
</tr>
</tbody>
</table>

\textsuperscript{95} For example the Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI) which is responsible for issuing the licences, after consultation with and approval from the AMF, to credit institutions and broker dealers that want to engage in fund management activities; and the Comité de Contrôle de Surveillance de l'Assurance (CCSA) the insurance supervision committee with a similar role for insurance firms engaging in fund management activities.

\textsuperscript{96} AIMA is a global interest association representing the hedge fund sector with members in 47 countries. It has chapters in many countries. It is not allowed to operate in France and does not operate in Germany.
A key question in relation to the interest associations is how effective they are in representing the interests of their members and delivering the optimal supply of a collective good which, in the context of this study, is the desired regulatory model. An important consideration in order for an association to be effective is for it to know which public institutions should be lobbied (Coen, 1997). To what extent, if any, is a single association representing the vast majority of economic actors in the investment services sector, who have joined the association voluntarily, more powerful and successful in representing the interests of its members than multiple associations representing different segments of the sector? Following Olson’s (1965) thesis, a large, single, and probably national, association will be less effective than small groups. The latter are easier to organise and, therefore, should stand a much better chance of achieving the desired objective. To what extent does mandatory membership of an interest association affect the association’s ability to deliver on behalf of its members? The three cases exhibit variation in the number of associations and the type of membership which, when analysed, should provide useful clues regarding the nature of the relationship between the economic and bureaucratic actors.

The third characteristic of the institutional setting is the density of the economic actors in the investment services sector and the extent to which a small number of large incumbent firms dominate the sector. A highly concentrated group of dominant firms has greater chance of either driving or resisting regulatory reform than a more diverse and fragmented collection of economic actors. As Table 4.2 shows, the investment services sector, as defined by the number of companies offering
investment products (funds), in Germany is twice as concentrated as the sector in the UK which, itself, is twice as concentrated as the sector in France. The effect, if any, of this on the regulatory outcome is explored later in this section.

Table 4.2: Comparative Number of Investment Services Firms

<table>
<thead>
<tr>
<th>Date</th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>62</td>
<td>18</td>
<td>39</td>
</tr>
<tr>
<td>1991</td>
<td>70</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>1992</td>
<td>81</td>
<td>17</td>
<td>25</td>
</tr>
<tr>
<td>1993</td>
<td>58</td>
<td>10</td>
<td>24</td>
</tr>
<tr>
<td>1994</td>
<td>67</td>
<td>20</td>
<td>37</td>
</tr>
<tr>
<td>1995</td>
<td>58</td>
<td>19</td>
<td>44</td>
</tr>
<tr>
<td>1996</td>
<td>72</td>
<td>17</td>
<td>30</td>
</tr>
<tr>
<td>1997</td>
<td>82</td>
<td>22</td>
<td>33</td>
</tr>
<tr>
<td>1998</td>
<td>108</td>
<td>21</td>
<td>40</td>
</tr>
<tr>
<td>1999</td>
<td>100</td>
<td>23</td>
<td>69</td>
</tr>
<tr>
<td>2000</td>
<td>118</td>
<td>33</td>
<td>47</td>
</tr>
<tr>
<td>2001</td>
<td>132</td>
<td>27</td>
<td>49</td>
</tr>
<tr>
<td>2002</td>
<td>137</td>
<td>23</td>
<td>52</td>
</tr>
<tr>
<td>2003</td>
<td>128</td>
<td>23</td>
<td>46</td>
</tr>
<tr>
<td>2004</td>
<td>114</td>
<td>21</td>
<td>53</td>
</tr>
<tr>
<td>2005</td>
<td>96</td>
<td>28</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: Lipper Hindsight Database

It is intuitive to suggest that the more concentrated the number of economic actors, such as in Germany, the greater the likelihood that they have an ‘accommodating’ relationship with the regulator. This will benefit them in a particular way; the regulations are designed to sustain their established position in the market by making it difficult for new firms to enter. The greater the number of economic actors, the less
likely an accommodating relationship will be exhibited; unless, of course, other factors are at work that facilitate the development of such a relationship.

The fourth characteristic of the institutional setting that may influence the relationship between the economic and state actors is the size of the hedge fund sector, and the contribution made by the broader financial services sector to the economy. This research has already established the importance of both the financial services sector, and its hedge fund sub-sector, to the economy. Were the new hedge fund sector regulations in France and Germany introduced at the behest of their respective economic actors in order to enable them to take a larger slice of this fast growing sector from their domestic bases? And did the regulatory regime in the UK remain unchanged because it had enabled the development of the largest hedge fund sector in Europe, defined by the number of hedge fund advisers and the amount of money that they ‘managed’, and second largest sector in the world resulting in a substantial contribution to the UK economy? The next section of this chapter explores the link between the characteristics of the institutional setting and the impact of these characteristics on the interaction of the economic and bureaucratic actors in each of the three cases France, Germany and the UK, commencing with France. The objective is to seek to determine whether an accommodating relationship between the two sets of actors is responsible for regime reform and design.
France

The institutional setting in France has been framed by a unique relationship that exists between the political, bureaucratic and economic elite. The Grandes Ecoles operate as a training ground for the French elite in the civil service, business and politics. The highly exclusive nature of the Grandes Ecoles, such as the Ecole Nationale d'Administration (ENA) and the Ecole Polytechnique, has resulted in a strong network of well established relationships forged between graduates of these elite academic institutions. For these graduates (Enarques), moving fluidly between the civil service and business sectors is an accepted practice and has served the historically strong partnership between the state and the economic sector (Thoenig, 1996). An examination of the curriculum vitae's of the executive committee members of the three largest financial services companies in France, BNP Paribas, Crédit Agricole and Société Générale shows that while the percentage varies across the firms, at least 65% are graduates of the Grandes Ecoles. On the basis that the Grandes Ecoles absorb the brightest 10% of France's school graduates (Riché, 2008) and that less than 5% of French students study at the Grandes Ecoles (Sciolino, 2006), it is reasonable to suggest the existence of a healthy network of solid relationships amongst senior professionals within the French financial system. Further, it has been noted that the Enarques share a common mind-set one of the effects of which is to approach policy issues and problems in the same way (Elgie, 2003: 161). The examination also showed that 39% of the executive committee members of these three firms have worked in the civil service, predominantly in the

Ministry of Finance or the Treasury. This suggests a valuable resource of information within the economic actors at two key levels: first knowledge of the preferences and motivations of personnel within relevant ministries and regulatory agencies; and secondly, knowledge of how these ministries and regulatory agencies function. The ‘Enarques network’ coupled with inside knowledge of the bureaucracy, is likely to have been very useful to the economic actors prior to the passage of the law in 2003 that both streamlined the number of regulatory agencies and allowed the introduction of comprehensive hedge fund sector regulation.

Regulatory Agencies

Before the reform there were five regulatory agencies responsible for investment services and the regulatory landscape was complex. The Commission des Operations de Bourse (COB) was responsible for protecting investors and for ensuring the integrity of the financial markets. It had been established in 1967 and was modelled on the US Securities and Exchange Commission (SEC). The COB established the conduct of business rules for the investment services industry and could impose administrative sanctions; and while it did not grant licences to investment companies, it approved the authorisation framework. Licences for firms to engage in investment services activities, or exemptions from requiring a licence, were granted by the Comité des Etablissements de Crédit et des Entreprises d’Investissement (CECEI). The third agency is the Comité de la Réglementation Bancaire et Financière (CRBF) which contributes to the development of regulatory standards and establishes the

98 Interview with Senior Executive at AMF, 20th April 2006
general regulations applicable to credit institutions and investment companies. The CRBF had very broad statutory powers to determine general regulations applicable to all credit institutions which include banks providing investment services. The Conseil de Discipline de la Gestion Financière (CDGF) was a disciplinary commission for pure investment management companies only; credit institutions such as banks that offered investment management services as part of their overall portfolio of financial services, were not subject to the CDGF. The CDGF had the power to impose disciplinary sanctions against both firms and investment products. If the COB identified a breach of the law and regulations and wanted a disciplinary sanction imposed, it would report the case to the CDGF.

The fifth agency in the pre-2003 regulatory landscape responsible for investment services was the Conseil des Marchés Financières (CMF). This body set out the rules that applied to firms providing investment services, such as stock brokers, that were neither pure investment management companies nor credit institutions. The CMF also set out the regulations aimed at ensuring that all participants in the French financial markets are treated equally and that the markets are transparent and free from manipulation.

Prior to the reform that streamlined the four agencies with supervisory and enforcement functions into a unitary agency the AMF, the complicated landscape provided ample opportunity for regulatory competition and regulatory arbitrage within the regime and suggests an interesting institutional configuration. The multiple agencies with their different preferences could have made any co-ordinated activity
among the economic actors within the whole sector quite difficult; yet the binding ‘agent’ in the form of the Enarques network suggests an environment in which the challenges of collective action within such an institutional setting could be overcome. There is evidence that this was the case; there is also evidence, which will be shown towards the end of this section on France, that the Enarques network enabled the interaction between the elected and appointed state actors and the economic actors to collectively decide upon the outcome. The institutional setting is much less disparate than it may appear on the surface.

*Interest Associations*

In France all investment services companies are required to join one of two interest associations, the AFG or the AFEI. The AFG is the most dominant and claims to have market coverage of ‘almost 100%’⁹⁹. An Enarques network coupled with mandatory membership of a high density interest association suggests an economic group with formidable ability to achieve its goals regarding regulatory regime design and reform. To what extent was this the case with the introduction of the new hedge fund regulations? A look at the AFG members who are active in the organisation’s various committees, for example Crédit Agricole, Société Générale and BNP Paribas, and an assumption that these active members are an important driver of the AFG’s agenda, suggests that the organisation’s preferences were formulated by the large economic actors; which, in turn, suggests that these actors desired reform of the regulatory regime relating to the hedge fund sector. According to interviews with

⁹⁹ Interview with Senior Executive at AFG, 28th February 2006
senior executives within both small and large economic actors, as well as at the AFG and the AMF, this was the case. The dominant economic actors were very aware of the success of the hedge fund sector in the UK as well, of course, in the USA. They wanted the regulations in France reformed in order for the domestic financial market to become more competitive. The AFG was asked by some of the leading economic actors to organise a committee dedicated to the subject of hedge fund sector regulation with the objective of pressing the regulator for change\textsuperscript{100}.

\textit{Established Incumbent Economic Actors}

France has more economic actors in the investment services sector than Germany and the UK together. However, the large incumbent firms dominate. These large financial institutions, such as Société Générale, BNP Paribas, Crédit Agricole and La Caisse des Dépôts (CDC), have the resources to operate anywhere; if the domestic regulatory environment impedes their ability to operate as freely as they would like, they can simply exit and establish operations in a different country with a more advantageous regulatory regime. Alternatively they can use their financial, legal and intellectual resources to work within the existing regulations without having to exit the regime. They do not necessarily need to commit resources to forcing change in order to run their hedge fund sector activities.

\textsuperscript{100} Interviews with Senior Executives at three separate Economic Actors, Paris, 28\textsuperscript{th} February 2006
The evidence shows that many French companies, both the large and the small\textsuperscript{101}, had successfully found ways to create hedge fund investment products outside France and package them in such a way that these products could be bought by consumers in France. A review of the larger financial firms that were active as investment managers in the hedge fund sector also finds limited evidence of these firms exercising the exit option, but evidence of them establishing operations outside France in addition to maintaining their Paris based operations. Only one large company had moved a substantial portion of the asset management component of its hedge fund operations out of France\textsuperscript{102} prior to the introduction of the new regulations. Despite the fact that the larger economic actors had found ways to work within and around the pre-2003 regulations, they committed resources to pushing reform of the regime in order to enhance and expand their activities.

For the smaller companies the situation was somewhat different. A number of the smaller economic actors had opted to establish their hedge fund businesses outside France primarily in the UK\textsuperscript{103}. While regulation was a factor in this decision, there were other factors that influenced the choice. The hedge fund sector was much larger and far more developed in the UK than in any other country in Europe. This was partly because of the regulatory regime, but other political, economic and social factors were important. The UK employment and taxation regulations made it more attractive to establish a new business in London than in Paris. Furthermore, London

\textsuperscript{101} Firms include Olympia Capital Management, La Compagnie Financière Edmond de Rothschild, HDF Finance, Exane, Altigefi, Athena Alternative Asset Management, Société Générale, BNP Paribas, Crédit Agricole and CDC

\textsuperscript{102} Crédit Agricole Alternative Asset Management

\textsuperscript{103} Lipper TASS Hedge Fund Database
was a repository of the diverse expertise needed by the hedge fund sector; lawyers, accountants, portfolio managers, traders, skilled administrators and many other experts in the sector were plentiful; and as more and more hedge fund companies were set up, the segment of the economy dedicated to servicing the hedge funds expanded as well. Finally, the legal system in the UK, unlike the legal system in France, did not prohibit rehypothecation thereby enabling a highly diverse sector to develop. In France, the regulations meant that the small number of domestic hedge fund advisers that were established before the regulatory reform, were limited to using investment strategies that bought and sold exchange-listed derivative securities because the issue of rehypothecation did not apply to these investment strategies.

For the French financial entrepreneurs seeking to be part of the fast growing hedge fund sector, being based in Paris was not an advantage; and while the large financial firms maintained operations in multiple locations, including Paris and London, the smaller economic actors without the resources, or the desire, to establish multiple offices, settled on London. Of the approximately 350,000 French working in the UK in early 2006, 70% worked in London and half of these individuals were working in financial services including the hedge fund sector.

The introduction of the new regulations was influenced directly and indirectly by the activities of the large economic actors, and indirectly by the small French economic

---

104 Rehypothecation is the reuse of collateral that has already been posted to secure an obligation. When a customer, such as a hedge fund, deposits securities as margin with a broker instead of cash she hypothecates the securities with the broker. She is basically obtaining a loan on these securities. With permission from the customer the broker may repledge (rehypothecate) the collateral for one of its own obligations to a third party (International Swaps and Derivatives Association, Inc. 2005 Collateral Guidelines).

105 Futures and options

106 French Consulate quoted in Special Report on France by Ashley Seager and Angelo Balakrishnan, 8 April 2006. "Young exiles embrace the Anglo model". The Guardian
actors. The influence of the established economic actors was two fold. First they engaged in regulatory and operational arbitrage by establishing operations in the UK, and by creating investment funds outside France and then "importing" them into France using the extant domestic regulations. Secondly, they co-ordinated their preferences through the AFG to press the regulator, AMF, for change. The activities of the small economic actors also functioned as a catalyst for the reforms; one of the reasons for the introduction of the sweeping new regulations was to stem the flow of talent and capital out of France. Both the economic and state actors wanted to improve the competitiveness of the French financial sector, and enable France to benefit from one of the fastest growing segments of the global financial sector. The hedge fund sector had been growing at 20% per annum, although France experienced little of this\(^7\); and talented French financial professionals were moving to London seeking opportunity and fortune. The actors coordinated effectively to produce the new regulations, helped by the institutionalised and close relationship fostered by the Enarques network.

The economic actors wanted greater flexibility that would benefit themselves and Paris as a financial centre. The approach from the economic sector was two pronged. On one level there was extensive communication between the AMF and the AFG through consultation and working groups populated with functionaries from the two organisations as well as compliance personnel and lawyers from the larger economic actors; and on another level senior executives from these large firms, armed with the knowledge of the potential benefits and risks to their businesses of regulatory reform.

\(^7\) Lipper TASS Hedge Fund Database
directly, although discretely, lobbied state actors. The economic actors contacted the regulators, both through the AFG and directly through senior executives, requesting reform; the regulators ‘engaged’ the services of sector experts to act as liaison between the regulators and the industry and to help prepare the presentation to the Ministry of Finance; after discussion and debate the Financial Security Act was introduced\textsuperscript{108}.

The economic actors wanted to be able to expand their activities in France; and to protect the French market from foreign competition. Prior to the new rules, the incumbents had the market pretty much to themselves and while they desired much greater latitude in the types of investment products and services that they could offer, they did not want to make it easy for foreign economic actors to move on to their turf.

The AMF board members, all of whom are appointed by the Ministry of Finance and the majority of whom are career civil servants, wanted to serve their political masters and avoid events, such as a financial scandal related to the hedge fund sector, which might put these masters into the firing line. The AMF board, whose decisions are made by majority vote with the chairman having the casting vote in the event of a tie, includes representatives from economic actors who make up one third of the board; they are proposed by the sector and appointed by the Ministry of Finance. The interaction between the economic actors and the bureaucrats happens at three levels\textsuperscript{109}. First is at the board level. The second level is through the consultative

\textsuperscript{108} Interviews with two Senior Executives within two separate established economic actors, 28\textsuperscript{th} February and 20\textsuperscript{th} April, 2006

\textsuperscript{109} Interview with Senior Executive at AMF 20\textsuperscript{th} April, 2006
committees, of which there are five\textsuperscript{110}, that are populated by two members of the board and different representatives selected from the sector. These committees meet approximately once a month and review all the issues that will be presented to the board. The third level of interaction is through the unofficial day to day communication that takes place in working groups and other discussion groups that include economic actors as well as organisations that represent the retail or small investors.

The economic actors had opportunity as well as incentive to place reform of the hedge fund sector regulation on the agenda. And according to all French interviewees, the regulators were keen drivers of the changes, once the issue was on their agenda. The large economic actors got what they wanted and it has been said that the bureaucrats did the bidding of these incumbent firms\textsuperscript{111}. The influence of small firms in the discussion process was limited and, while there is no evidence of an official policy, the French authorities would prefer that fewer small investment services companies exist 'because they do not see the value of these small firms'.\textsuperscript{112}

On the basis that the incumbents obtained what they wanted from the regulatory agency, it would be easy to infer that the regulator was 'captured'. However, such an inference is misleading. The regulator in France is filled with 'fonctionnaires' who are professional civil servants. They work at the AMF for between two and five years before being sent to another ministry or agency. These professional civil servants are

\textsuperscript{110} Listed companies; market intermediaries; market infrastructure (clearing and settlement); investment management; retail investors and individual shareholders

\textsuperscript{111} Interviews with three separate Senior Executives at three separate Economic Actors 20\textsuperscript{th} April 2006

\textsuperscript{112} Interview with Senior Executive at AFG, 28\textsuperscript{th} February 2006
not exclusively part of the financial regulatory regime; they are part of the broader civil service. They have a safe career and social status. The opportunity of being ‘captured’ by the economic actors is very limited, and the Enarques network through which an accommodating relationship between the state actors and the economic actors is soft-wired into the institutional setting, makes the practice somewhat unnecessary on the basis that the members of this elite network are, by definition, in a strong position to request and provide favours to fellow Enarques in order to enhance position and career prospects.

Germany

The institutional setting in Germany is framed by the federalist system which means that the government has a more fragmented political structure than France or the UK. Federalism has forced the German state actors to rely more on informal networks to co-ordinate policy change, and this in turn implies a greater reliance on private sector economic actors (Vogel, 1996: 254). In the context of this research study, this implication suggests that the economic actors could have played a major role in the introduction of the new hedge fund sector regulation contained in the IMAG. And the characteristics of the institutional setting in Germany also point to an environment in which the preferences of the different actors, the firms, the bureaucrats and the politicians, could be aligned in the interest of achieving regulatory reform.
Regulatory Agency

The country has a unitary financial regulatory agency, BaFin, which was established in 2002. BaFin resulted from the merger of three separate regulatory bodies responsible for the supervision of different segments of the financial sector: Federal Banking Supervisory Office (BAKred); Federal Insurance Supervisory Office (BAV); & Federal Securities Supervisory Office (BAWe). Bureaucratic actors may drive regulatory reform in order to entrench their position within the sector in the knowledge that more regulation means more monitoring and supervision and, therefore, probable improved job and career security. In Germany, however, the evidence does not show that the bureaucratic actors were drivers of the decision to introduce the new hedge fund sector regulations; they were simply responsible for the implementation of the new policy. In the same way that the radical reform of the financial regulatory regime in 2002, which created the BaFin, had been driven by the politicians without formal consultation with either the economic or bureaucratic actors, so too were hedge fund regulations introduced. The German economy was flailing and radical change was required and the state actors had a mandatory EU obligation concerning the transposition of UCITS III which could be used as a vehicle through which to introduce the reforms. Once the regulatory reforms were announced, the economic actors were supportive. And while their preferences or goals were not the cause of the reforms, the behaviour of the domestic economic actors which is explored later in this chapter, was a powerful catalyst.

113 Law on Integrated Financial Services, 22nd April 2002
114 Interview with Senior Executive at BaFin, 15th May 2006
The investment services sector in Germany has a single interest association with 99% coverage of its market\(^{115}\), and a group of six incumbent economic actors accounting for over 75% of the market\(^{116}\). Was the introduction of the new regulations determined by the incumbent economic actors’ desire to further strengthen their position and their use of an accommodating regulatory agency? New regulations bring with them opportunities for both the economic and the bureaucratic actors, as well as costs for the economic actors which are generally passed on to their customers. The economic actors are able to develop new and different investment and savings products for the market, and they accept the costs associated with complying with the new rules. Further, additional regulations can act as a barrier to entry to entrepreneurs. The large companies have the financial, legal and personnel resources to cope with regulatory reform; the cost of taking advantage of the new regulations and complying with them is accepted as a cost of doing business.

There is no evidence that the new hedge fund sector regulations in Germany were driven \textit{directly} by the economic actors; neither the BVI nor individual economic actors overtly lobbied for the change\(^{117}\). However, there is evidence that the economic actors \textit{indirectly} influenced the reform. The status quo prior to the reform suggests that the investment firms had found ways to create and offer hedge fund

\(^{115}\) Interview with Senior Executive at BVI, 16\(^{th}\) May 2006

\(^{116}\) Allianz Dresdner, Cominvest Asset Management (a subsidiary of Commerzbank), Deka, DTZ Asset Management, DWS Investments (part of the Deutsche Bank Group) and Union Investment; source: interview with Head of Research at Deutsche Bank

\(^{117}\) Interviews with Senior Executive at BaFin on 15\(^{th}\) May 2006 and Director General of BVI on 16\(^{th}\) May 2006
investment products to the German investor using a blend of regulatory arbitrage and creative product packaging which, indirectly, served as a catalyst for regulatory reform. Many firms had exercised their ability to exit the German system and establish operations in alternative jurisdictions. Luxembourg and Ireland were the preferred locations for the creative manufacture of more innovative and flexible investment products which, on the surface, did not look like hedge funds and which were brought back into Germany and distributed to German investors under an EU 'passport'. Further, London was the preferred location for the hedge fund activities of German financial companies, such as Deutsche Bank, that sought to provide a host of financial services to and within the global hedge fund sector.

One of the features of the German financial market is the very strong position of the incumbent firms, particularly the banks. For example, at the beginning of 2001 the four large universal banks (Commerzbank, Deutsche Bank, Dresdner Bank and HypoVereinsbank), as well as the savings banks (Sparkassen) and the credit cooperatives (Genossenschaften) accounted for some 80% of investments under management and owned most of the German investment management companies (Maurer, 2004: 126). There is very little competition from either foreign investment companies or domestic based smaller companies. And the fact that most of the investment products produced by the large incumbents are distributed to investors either via branch networks or via sales people with a close working relationship with the large firms meant that the status quo was preserved. 'The structure of the market favours the incumbents and because of this the incumbents favour the structure'\textsuperscript{118}. If

\textsuperscript{118} Interview with Senior Executive at Deutsche Bank, 16\textsuperscript{th} May 2006
neither the bureaucratic nor the economic actors directly drove the reform, then who was responsible? In support of Pagoulatos's finding that financial reform is not always explained 'in terms of interest group pressure' (2003: 172), the evidence points to the elected state actors rather than the economic actors, although once hedge fund sector regulation was on the agenda the policy was supported by the economic actors.

The elected state actors were concerned that hedge fund investments which, as has been noted, are deemed by many commentators to be high risk investments, were being made available to investors disguised as low risk savings and investment products. This development raised concerns about investor protection and the question of whether investors would be better protected with the introduction of explicit hedge fund sector regulation. The state actors, particularly the Minister of Finance, concluded that they would, but there was a much broader reason for incorporating hedge funds into the IMAG; a factor which is explored in detail in chapter 5.

If the reform was driven by the elected state actors, then the concept of the changes being caused by an accommodating 'capture' style relationship between the economic and bureaucratic actors is somewhat misplaced. Unless of course there was such a cosy relationship between these two sets of actors which, in the eyes of the state, was hurting the economy that the state had to take action. This was not in fact the case. A primary indicator of the evidence of capture is the movement of staff, particularly senior officials, from the regulatory agency to companies that are regulated by the
agency. Further, a primary reason for any such personnel movement is financial incentive and career advancement; employees of private sector financial services firms are generally better paid than employees of government agencies. However, in Germany there is very little staff movement between regulator and companies; there is no trend, unlike in the UK, of the financial sector poaching people from the regulator. One of the reasons is that although the firms may offer greater financial reward, this is accompanied by reduced job security; 'almost all staff [at BaFin] are civil servants and they want jobs for life'. The working relationship between the firms and their regulatory agency was one of accepted co-existence; both parties interacted with each other according to the rules of the game and got on with their business.

There is no evidence in the form of overt lobbying by the economic actors endeavouring to leverage the relationship in order to pursue an agenda of reform with the objective of boldly bringing the hedge fund sector to Germany. Nor is there evidence of the economic actors lobbying to maintain the status quo once the proposed changes were presented by the elected state actors, which suggests support for the reforms in the expectation that the new regulations would provide opportunity for continued, if not improved, market position and economic reward. At the time both sets of actors, the economic and bureaucratic, had much with which to contend. The regulators were dealing with the severe and unexpected shake up of the regime caused by the government's decision in 2002 to streamline and merge three major regulatory agencies into a single agency; while the economic actors were managing

119 Interview with Senior Executive at FSA, 6th April 2006
120 Interview with two Senior Executives at BaFin, 15th May 2006
the severe disruption to their businesses caused by the lengthy and sharp decline of
the equity markets between 2000 and 2003. This study now turns to the UK and the
extent to which maintenance of the status quo was determined by the economic actors
with or without an accommodating relationship with the regulator.

**United Kingdom**

The characteristics of the institutional setting in the UK share similarities and
variation with the settings in France and Germany. Like Germany, but unlike France,
the UK has a single, super-regulatory agency. Like France, and unlike Germany, the
UK’s investment services sector is not dominated by a handful of firms. There are
three interest associations representing specific segments of the investment services
market, and membership to all three is voluntary. The other characteristics of the
institutional setting have already been documented in this study; the hedge fund
sector in the UK is the largest in Europe by a substantial margin over France and
Germany combined, and the contribution of the financial services sector to the UK
economy at 9% is almost double the contribution of the sector to the German and
French economies. What does this mean and what, if any, evidence do these data
show that the role of the economic actors and their relationship with the bureaucrats
was critical to the maintenance of the status quo?
Size and Significance of Hedge Fund Sector

The economic actors had a substantial incentive to keep the regulatory regime as it was. A thriving and expanding hedge fund sector continues to develop and this fuels corporate revenues and profits. The growth in the number of hedge fund advisers results in the growth in the number of financial services companies, such as banks, establishing divisions dedicated to servicing these advisers. This requires greater investment in technology and skilled personnel as these financial firms compete to satisfy the demanding and often complex requirements of the hedge fund advisers. The growth of the sector in the UK was, and still is, the sector's most formidable promoter; as the expertise to service the sector both broadens, in terms of the number of companies providing legal, accounting, research, broking, and financial engineering services, and deepens in terms of the calibre of these services, so the UK became an obvious place in which to establish a hedge fund management business in Europe. While the regulatory regime, which is more flexible and accommodating to the hedge fund sector than the regimes of France or Germany, provided the investment products are not made available to the general public and are limited to so-called professional investors, is an important factor, the ready availability of essential expertise to service the hedge fund sector, such as legal, accounting, and broking is also an important factor.
The UK has had a unitary financial regulatory agency, the FSA, since 2000. The hypothesis that an accommodating relationship between the economic and bureaucratic actors results in regulations favoured by the economic actors suggests a close relationship between the two groups involving more frequent communication than that required by the regulator in order to fulfil its supervisory obligations. Hedge fund companies are relatively newly established, entrepreneurial businesses. They are, in the main, private businesses that are notoriously low profile and secretive. Communication with the regulator is limited to the necessary form filling and ensuing meeting when the firm is in the process of obtaining its licence to operate as an investment company, and thereafter to the submission of written reports to the regulator to comply with the regulations. After obtaining the licence to operate, meetings between the firm and the regulator are rare and are generally limited to the occasions when the regulator decides to conduct an on site inspection; inspections take place on average every three years.

Approximately 29,000 firms are regulated by the FSA. The regulatory agency focuses its attention on visiting and inspecting approximately 3% of the firms on the basis that the market is highly concentrated and that this 3% represents about 85% of the whole financial services market. Quarterly written reports and triennial meetings, rarely with the same individuals from the regulatory agency on basis that staff

---

121 On 20th May 1997 the government announced the policy to merge multiple financial regulators into a unitary regulatory agency. The FSA became operational in name in October 1997 but only received its statutory powers in the Financial Services and Markets Act, 2000

122 Interview Senior Executive at FSA, 6th April 2006
turnover at the ‘lower levels’ of the FSA is high\textsuperscript{123}, are factors which do not point to a relationship in which the regulators are ‘persuaded’ to do the bidding of the hedge fund firms in return for some favour or opportunity. As long as hedge fund advisers do not promote their investment products to the general public, the UK regulatory regime allows them extensive flexibility in how they manage their businesses and their investment portfolios. Further, few hedge fund firms want to access the savings of the general public; small investors are perceived to be financially unsophisticated, lacking in knowledge and, as a result, more demanding of service and support. However, the FSA’s strategy of targeting its supervision and monitoring activities on a very small percentage of regulated companies considered by the regulator to be the most dominant and important actors in the market, suggests an institutional arrangement that can and may facilitate capture between the regulator and these high priority firms.

In August 2002 the FSA published its first Discussion Paper, DP16, on the hedge fund sector\textsuperscript{124}. The objective of this paper was to establish whether or not the current regulatory regime for the sector was appropriate, and whether any reform was required. The profile of the economic actors who responded to DP16 is diverse\textsuperscript{125}. Respondents (excluding those who asked for their responses to remain confidential) included hedge fund actors, established so-called traditional institutional investment management firms, as well as firms and individuals in the retail and private client

\textsuperscript{123} Interview with two Senior Executives at separate Economic Actors, 28\textsuperscript{th} February and 13\textsuperscript{th} March 2006
\textsuperscript{124} Financial Services Authority Discussion Paper 16 “Hedge Funds and the FSA”, August 2002
\textsuperscript{125} Financial Services Authority “Hedge Funds and the FSA: Feedback Statement on DP16”, March 2003
segments of the marketplace. The aggregate consensus was that no change to the extant regime was required.

*Interest Associations*

The economic actors within the UK investment services sector are represented by three separate interest associations. The Investment Management Association (IMAUK) represents the established institutional investment management companies and claims high density membership with coverage in excess of 90% of potential members\(^{126}\). The Association of Private Client Investment Managers (APCIMS) represents, as the name suggests, investment management firms that are focused on the private investor; it too asserts coverage of more than 90% of potential members\(^{127}\). Thirdly, the Alternative Investment Management Association (AIMA) represents economic actors in the hedge fund sector. As the study has noted, neither France nor Germany has a separate interest association for the hedge fund sector; further, Germany has a single interest association dealing with all investment services companies, and France has two associations to represent the varying interests of the firms involved in investment services.

Each of the interest associations in the UK has a close and symbiotic relationship with the regulator\(^{128}\). Although both the IMAUK and the APCIMS had had lobbying functions for many years, AIMA did not create a lobbying function within its

\(^{126}\) Interview with IMA Deputy Chief Executive, 6th April 2006
\(^{127}\) Interview with APCIMS Chief Executive, 20th February 2006
\(^{128}\) Interviews: Senior Executive at FSA, 6th April 2006; three Senior Executives at separate Economic Actors 6th February, 13th and 21st March 2006
organisational structure until 2003. Despite having a close working relationship with the regulator, the three interest associations do not, however, have a close working relationship with each other; in fact, the inter interest association relationship has been described as both ‘tense’ and ‘competitive’.\(^{129}\) Tense and competitive relationships suggest diverse preferences which, when presented to the unitary regulator, could result in ‘inaction’ on the basis that the investment services sector is regulated, from the prudential perspective, as a single unit within the financial system. The conduct of business element of the regulations does not, however, treat all savings and investment products as a single unit and the regulations vary depending on the type of product and its perceived degree of risk. Products that the regulator deems low risk can be sold to the general public; products deemed to be high risk, such as hedge funds, cannot.

The IMAUK did not want the status quo changed because its members, many of which are the established, incumbent firms such as Aberdeen Asset Management, AXA Investment Managers, Barclays Global Investors, Henderson Global Investors and Schroders Investment Management, dominated the UK investment services sector and at the time regarded the hedge fund advisers as upstarts who needed to be kept on the fringe of the sector.\(^{130}\) The established firms were restricted by regulation from adopting many hedge fund investment methods, they regarded the enthusiasm for the hedge fund sector as a passing fad, and at that time they had not appreciated the financial benefits to be gained from embracing the new sector’s methods. In short the incumbents had no incentive to lobby for regulatory reform. Their concern was

\(^{129}\) Interview with Senior Executive at APCIMS, 20\(^{th}\) February 2006

\(^{130}\) Interview with Senior Executive at IMAUK, 6\(^{th}\) April 2006
that regulatory reform may have made it easier for the hedge fund sector to expand its activities beyond its core investor base and compete more effectively with the so-called traditional investment management firms that the IMAUK represents.

The AIMA did not want the status quo changed because the current environment enabled their members, the hedge fund economic actors, to establish and develop their businesses within a light touch regulatory regime away from the spotlight of the intense regulation associated with providing services to the general public. The hedge fund advisers had neither the incentive to change the regulatory status quo, nor an accommodating relationship with the regulator that could be leveraged to ensure the maintenance of the status quo. And while the APCIMS members, who work with the smaller investors, may have desired greater access for their clients to hedge fund products, without support for change from the other two groups of economic actors, the status quo was maintained.

Regulatory reform rarely happens in the UK that does not suit the large financial services firms which, by definition, are also the incumbents. The established economic actors have more influence with the regulators than the smaller actors. This is in part because they have the resources in the form of in house lawyers and compliance personnel to get access to the regulators to achieve the desired objectives. Large, established firms are self interested and there is no evidence that they fear the increased competition that may result from reform; what they fear is a regulatory regime that restricts or prevents them from doing what their shareholders,  

131 Interviews: two Senior Executives at separate Economic Actors, 20th February 2006
management and employees expect which is making money. If the status quo enables them to do this, they are unlikely to support changes that may result in additional regulatory costs.

Capture between the established incumbents and the regulator is alive and well in the UK; and in both directions suggesting a regulatory regime designed to accommodate both sets of actors\textsuperscript{132}. This did not come about because of lack of staff rotation at the regulatory agency, a policy that can result in capture as the regulator and the regulated become more knowledgeable of and familiar with one another. The professionals within regulated firms prefer interacting with the same people who understand their business; they do not like having to deal with new regulatory personnel who need to be educated and trained each time they meet. Regulatory capture among the established incumbents came about because of staff turnover at the FSA; and turnover is sufficiently high that a policy on job rotation is not needed\textsuperscript{133}. The clearest evidence of this turnover is the prevalence of former regulatory personnel working for large financial firms, particularly investment banks. According to a senior officer at the FSA, all the major investment banks and other large financial institutions have former FSA personnel on their staff and meetings between the regulator and the Compliance Officers Group ‘was just like an SFA\textsuperscript{134}, FSA reunion\textsuperscript{135}. The investment banks are critical service providers to the hedge fund sector, and their profitability is increasingly dependent on the sector. They are,

\textsuperscript{132} Interviews: FSA, April 2006; three Senior Executives at separate Economic Actors February and March 2006
\textsuperscript{133} Interview with Senior Executive of FSA, 6\textsuperscript{th} April 2006
\textsuperscript{134} Securities and Futures Authority
\textsuperscript{135} Interview with Senior Executive of FSA, 6\textsuperscript{th} April 2006
therefore, unlikely to push for any change in the regulatory regime which may upset this equilibrium and the relative position of the different actors. The motto 'if it ain't broke, why fix it' runs through the interviews for this study that were conducted with the economic actors in the UK; and the regulators were not in the habit of proposing reform of the regulations without a catalyst such as lobbying from the economic actors, a financial scandal or an EU directive that had to be implemented.

There was no lobbying from the economic actors to change the regime and there was not a scandal involving a UK based hedge fund adviser. Further, the UK did not have to contend with a development that vexed policy makers in France and Germany. This study has already established that in France and Germany the practice of regulatory and operational arbitrage, engaged in by the economic actors, is linked to the reforms that included the introduction of new hedge fund sector regulations. Not only is regulatory regime arbitrage not an issue with which the UK regulator has to contend, analysis of the number of foreign individuals and organisations which have established financial services businesses, including hedge fund firms, in the UK shows that the UK has been a beneficiary of regulatory arbitrage at the expense of the other regimes\textsuperscript{136}, meaning that economic actors from France, Germany and other nations chose to establish hedge fund sector operations in the UK.

\textsuperscript{136} Lipper TASS Hedge Fund Database
Conclusion

This chapter has attempted to answer two principle questions: did a special and accommodating relationship exist between the economic actors and the regulators and, if it did, was the regulatory regime reform and design driven by such a relationship? The evidence observed in the analysis of the role of the economic actors and their relationship with the appointed state actors is mixed. Table 4.3 summarises the evidence as well as the institutional characteristics noted in the study’s analysis.

Table 4.3: Observable Evidence and Institutional Characteristics

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic actors engage in regulatory &amp; operational arbitrage</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Economic actors lobbied for reform</td>
<td>Y</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Economic actors employ former bureaucrats</td>
<td>Y&lt;sup&gt;137&lt;/sup&gt;</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Number of regulatory agencies</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Number of interest associations</td>
<td>2</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Concentrated investment services sector</td>
<td>N</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Global hedge fund sector ranking&lt;sup&gt;138&lt;/sup&gt;</td>
<td>5&lt;sup&gt;th&lt;/sup&gt;</td>
<td>25&lt;sup&gt;th&lt;/sup&gt;</td>
<td>2&lt;sup&gt;nd&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

The evidence from the German case is, perhaps, the clearest cut. The highly concentrated group of established incumbents in the investment services sector did not appear to have an unusually accommodating relationship with the regulator. Nor did they seek to change the regulatory regime by pressing for new hedge fund sector

---

<sup>137</sup> The custom of bureaucrats moving to and from economic actors is part of the unique Enarques system in France

<sup>138</sup> Lipper TASS Hedge Fund Database. Ranking defined by assets managed by hedge fund advisers in each country
regulations. They were able to develop their hedge fund sector activities quite effectively by engaging in operational and regulatory arbitrage. They did not lobby the regulator, nor did they seek to strengthen their respective positions vis-à-vis the regulatory agency by recruiting personnel from the BaFin. Further, the small size of the hedge fund sector in Germany suggests that the domestic hedge fund advisers, who, by definition, were not part of the established incumbents, lacked either the economic or political influence to push for regulatory reform.

The evidence from the French case is not as straightforward. Both large and small economic actors used regulatory and operational arbitrage to pursue their business objectives. This was an activity which acted as a catalyst for reform in both France as well as Germany, an issue that will be explored in more detail in chapter 5. However, the evidence shows that economic actors also wanted and pushed for reform. Theoretically, both the large and small French economic actors lobbied for regulatory reform on the basis that membership of an interest association is mandatory. Practically, as has been noted, the drive for change was done mainly by the established incumbents rather than the smaller entrepreneurial firms. The contents of the end regulations also suggests that the large incumbent firms were involved in their design, through participation in consultative committees and working groups, because the regulations are highly complex, and have made it more, not less, difficult for the smaller entrepreneur to establish a hedge fund advisory business in France.

Such complex regulations impede the ability of additional economic actors, domestic and foreign, to establish hedge fund sector businesses in France which reinforces the
position of the incumbents. The unique institutional arrangement of the French political economy, namely the Enarques network, can certainly be considered ‘accommodating’ and points to a close relationship between the two sets of actors. However, a particular factor renders it weak as evidence of the private interest theory’s notion of ‘capture’. Not only are the civil servants moved by their political masters every few years from one company to another, they are also moved across sectors within the economy.

The evidence from the analysis of the UK produced mixed results. The examination found no empirical evidence of the use of regulatory or operational arbitrage by the economic actors, suggesting that they were satisfied with the regime and had no reason to exit. With regard to lobbying for either reform or maintenance of the status quo, the study found evidence that the economic actors did not want change, as demonstrated in their response to the FSA’s discussion paper DP16. The hedge fund sector’s dedicated interest association, AIMA, did not have a lobbying capability until 2003; the organisation had deliberately stayed away from regulatory policy and any lobbying activity on the basis that its members’ preference was for the sector to remain away from the regulator’s radar screen. The other economic actors in the sector, such as the incumbent institutional investment firms, were satisfied with the regulatory equilibrium provided by the regime and no evidence has been found that they demanded change.

139 Interview with Senior Executive of AIMA, 6th February 2006
Career movement of personnel from the regulator to the economic actors is, however, in evidence in the UK suggesting a close relationship between certain segments of the regulatory agency and its 'clients'. According to both economic and bureaucratic actors interviewed who pointed out this evidence, the instance of a regulator joining an economic actor is not occasional. It is fairly systematic and is driven by the firms' desire to enhance their ability to navigate, as well as to influence, the regulatory regime, and the individual regulators' desire to enhance their career prospects, particularly from a financial perspective. The fact that the regulator targets most of its supervisory and monitoring responsibilities on 3% of the regulated firms also points to a more knowledgeable and accommodating relationship between the two sets of actors.

Does this evidence suggest that bureaucratic accommodation and the private interest theory of regulation help to explain the relationship between the state and economic actors and why there was no sector regulatory reform in the UK? For bureaucratic accommodation to exist both parties need incentives; at the heart of the concept is the symbiotic relationship between the firms and the regulators. The economic actors within the investment services sector are not homogeneous; the sector has three interest associations each representing the interests of its particular members: the hedge fund actors; the incumbent, institutionally focused investment firms; and thirdly, those firms specialising in the private client and small investor segment of the overall market. The collective response to DP16 was that no regulatory reform was required. No change in the regulation satisfied the preferences of the economic actors; but it also satisfied the bureaucrats. If the latter had not been satisfied with the
status quo it is likely that they would have taken the next step and followed the discussion process of DP16 with a consultation paper which would have resulted in regulatory reform. The evidence does not demonstrate that the hedge fund sector had a capture-style relationship with the regulator at the time. But the evidence of the movement of personnel from the regulator to the regulated, as well as the absence of the practice of regulatory arbitrage by the economic actors, suggests a regulatory regime designed by two sets of actors with an accommodating relationship.

The study will now proceed, in the next chapter, to explore and analyse the strength of globalisation and Americanisation as explanations of financial regulatory regime reform and design.
Chapter 5

Globalisation and Americanisation

Introduction

Having set the stage for the puzzle in chapter 1, the second chapter described two theories of regulation which guide this study and four explanations of financial regulatory regime reform and design that have been posited in the literature. In chapter 3 the research examined the impact of financial crisis on the role of elected state actors and regulatory reform. Chapter 4 went on to examine the institutional influences, particularly the relationship between the economic and bureaucratic actors and the extent, if any, to which this relationship guides the design and reform of the regulatory regime. This chapter will examine the effects of globalisation and Americanisation on the different groups of actors and explore how the state and economic actors responded to the different pressures. The next section will commence with a cross national comparative analysis of the effect of globalisation on the state and economic actors. The chapter will then proceed with an analysis of the influence of Americanisation on regime reform and design in France, Germany and the UK as a result of the pressure it may place on the state and economic actors.

As was noted in chapter 2, globalisation and Americanisation as determinants of regulatory reform, share a central analytic theme which is liberalisation. Liberalisation is the reduction or removal of government restrictions on the cross
border movement of resources such as people, capital and services. Within the world’s economic and financial systems, liberalisation has taken place in three distinct areas during the past 30 years: liberalisation of the current account; liberalisation of the capital account; and the unification of the exchange rate (Simmons and Elkins, 2003: 2). Liberalisation of the current account refers to the increasing commitment of governments not to meddle in the foreign exchange markets thereby allowing the market to determine the level of each currency relative to other currencies. Liberalisation of the capital account means the removal of taxes, quotas and other rules that may discourage the free movement of investment funds into and out of a country (Quinn and Inclan, 1997). Liberalisation in the context of the unification of the exchange rate, means that governments have moved away from multiple or tiered exchange rate systems on the basis that such systems ‘can be used to discriminate against particular kinds of transactions or particular trading partners’ (Simmons and Elkins, 2003: 2). However, liberalisation does not equal globalisation or Americanisation. Each concept, as will be demonstrated in the forthcoming sections, is theoretically distinct and places different pressure on the state and economic actors to which they respond.

Globalisation

Globalisation is defined in this study, as noted earlier, as the globalisation of the financial markets. What this means is greater financial market integration and interdependence as a result of declining technology and communication costs. Globalisation presents opportunities as well as threats to both the state and
economic actors. ‘For political economy, the principal issue raised by globalisation concerns the stability of regulatory regimes and national institutions in the face of heightened competitive pressure’ (Hall and Soskice, 2001: 55). Each set of actors may respond differently to these pressures on the basis that their preferences are not homogeneous and are shaped by the specific institutional setting in which they act and interact (Scharpf, 2000: 36-37). Further, as noted in chapter 4, these institutional settings vary cross nationally, and include rules, both formal and informal, that structure the course of action that a particular set of actors may choose (Scharpf: 2000: 38). In this section the study seeks to evaluate the impact of globalisation on the state and economic actors in order to determine the extent to which the hedge fund sector regulatory reform in France and Germany, and the lack of change in the UK, were influenced by the effects of globalisation.

The state actors’ response to the influence of globalisation on the economic actors is the adoption of a policy of regulatory reform as they seek to make their domestic financial markets more open and competitive to all economic actors, both the indigenous and the foreign. The state actors are driven by the desire to give their respective national financial sector a comparative institutional advantage, one of the benefits of which can be a more competitive economy. The increasing interconnection between markets and the growing innovation of financial firms means that there is a political imperative to introduce regulatory reform if the domestic financial market, and by definition the economy, is not to lose out to other financial centres. Globalisation acts as a catalyst to which the economic and the state actors react.
Empirical evidence of the effect of globalisation on the economic actors is their use of regulatory and operational arbitrage. If the domestic regulatory regime is considered comparatively less accommodating to business activity than a foreign regime, the firms can leave the home regime and set up operations in a foreign regime. Firms may also choose to have operations in both the domestic and foreign regimes. Rather than physically exit the domestic regime, the economic actors may choose to create and domicile their investment products in a foreign regime which has more flexible regulations, and then import these investment products to the home regime effectively through the back door.

If national regulatory change is driven by the pressures of globalisation, one would expect to find particular empirical evidence. First is evidence of an expanding cross border financial and economic sector from which some countries are benefitting while others are not. Secondly, on the basis that the domestic regime makes it difficult for the economic actors to develop their activities in this sector, the economic actors exercise the exit option and establish operations in foreign jurisdictions in order to participate more effectively and fully in this expanding sector. And thirdly, if the rules at home restrict the actions of the economic actors it is probable that they will find ways around these rules; an alternative to exiting the domestic regulatory regime is to find a back door approach that will enable the companies to offer the prohibited or restricted investment products to consumers in the domestic market.

The existence of an expanding cross border financial services sector has already been well established in this study. The hedge fund sector has been growing at the average
rate of 20% per annum since the early 1990s and the sector’s contribution to both the volume of activity in the global financial markets, as well as to the profitability of many economic actors, has been clearly documented in chapter 1. It has also been clearly established that the UK has benefited far more from the growth of the sector than either France or Germany: over 80% of all assets managed by hedge fund advisers in Europe are managed by firms based in the UK; the US hedge fund advisers who have decided to establish operations in Europe have selected the UK over France and Germany; and the UK is the European home for the majority of firms providing services to the sector in Europe. What evidence is there of domestic economic actors using the exit option and, or, the back door to be actively involved in the sector? This section will proceed with an investigation of these phenomena in each of the three cases starting with France.

France

The French case exhibits evidence of both phenomena. Prior to the regulatory reform of 2003, the majority of hedge fund advisers active in France were those who chose to operate within the narrow and limited regulations that were introduced in 1988. French economic actors who did not want to have to operate within these regulations based themselves outside Paris, primarily in London. The individual hedge fund advisers were not alone in establishing businesses outside Paris to take advantage of growing enthusiasm for the sector. Some of France’s largest financial institutions including Crédit Agricole, BNP Paribas and Société Générale established substantial

140 Lipper TASS Hedge Fund Database
investment services operations in London to enhance their overall businesses including the segments of the company active in the hedge fund sector. In parallel with these developments, economic actors in France, some of which also had hedge fund sector related operations in the UK, researched and created hedge fund type investment products for distribution to French investors via the back door\textsuperscript{141}. While these products were not illegal, they were designed outside the limited hedge fund sector regulations, effectively by identifying and taking advantage of one or more loopholes in the broader rule book. Evidence of the active use of regulatory arbitrage either in the form of establishing operations in an alternative regime, or in the form of creative investment product development, posed two challenges to the policy makers in France.

The expansion of the economic actors’ activities outside France raised the issue of financial market and broader economic competitiveness. Since the regulatory reforms of the 1980s the French State has, step by step, tried to reduce its once highly influential role in the financial sector; and while dirigisme is not a feature of the past, the French economy, and the financial sector that serves it, has become a significantly more liberal, market driven economy than it is a directed or coordinated market economy. The elected state actors recognised that while there were likely other reasons for the economic actors to set up in the UK and elsewhere, a key factor that encouraged the French economic actors to engage in both regulatory and operational arbitrage was the financial regulatory regime in France. If the regulations are too

\textsuperscript{141} Examples include listing the investment product on the Irish or Luxembourg stock exchange the effect of which classifies the product as an EU listed company in which almost anybody can invest
stringent, footloose companies can and will move their operations\textsuperscript{142}. Hence one of the challenges was to help Paris as a financial centre, and a positive consequence of this would be to help the French economy which, in the early twenty first century, was not showing signs of robust health. The second challenge was providing better protection for investors who were able to access hedge fund investment products that had been created in foreign regimes away from the authority of the French regulator. The fact that investors were not necessarily at any greater risk of financial loss from these products than from many other investment products was not the point; the point was that the state actors wanted greater control over the design and distribution of these products in order to better protect the French public.

The regulatory reforms introduced by the Financial Security Act (2003) were driven by the state actors who had three objectives with regard to the type of regulatory regime that they sought to create. In his speech presenting the proposed Financial Security Act to the National Assembly on 29\textsuperscript{th} April, 2003 Francis Mer, the then Minister of the Economy, Finance and Industry stated the three objectives very clearly. First, to strengthen the surveillance of the markets. Secondly to strengthen the protection of the consumers who are defined specifically as the savers and investors, as well as the insured. The third objective is to strengthen or reinforce shareholder democracy; what was meant by this was to create a regime in which all shareholders would be equal and have access to transparent accounting and other information that had been prepared by independent auditors and other professionals. The final text of the legislation is structured in accordance with the three objectives:

\textsuperscript{142} Interviews with three Senior Executives at three separate Economic Actors in France, 28\textsuperscript{th} February and 20\textsuperscript{th} April 2006

178
the first section is entitled ‘Modernisation of the Supervisory and Monitoring Authorities’\textsuperscript{143}; the second section is entitled ‘Protection of the Investors and the Insured’\textsuperscript{144}; the third section is entitled ‘Modernisation of the Rules addressing Company Accounts and Transparency’\textsuperscript{145}. However, the regulatory reforms in France also had an additional goal, as Mer (2003) made clear towards the end of his speech; this was the strengthening and repositioning of Paris as a competitive and attractive financial centre.

By including new hedge fund sector regulations in the legislation the state actors made a number of statements. They recognised the importance of this footloose sector to the financial markets and they wanted France to become a major location in which this fast growing and dynamic sector of the global financial markets could blossom. They also wanted to encourage those domestic economic actors who had left France to return, as well as to discourage those who were thinking of leaving from so doing, ‘the authorities want to make Paris more competitive, they want business to pick up and they want to retain people in France – they do not like people moving to London’\textsuperscript{146}. Finally, they wanted to ensure that the new regulations provided protection for the investors.

The globalisation of the financial markets and the opportunities that this presents for the economic actors to engage in regulatory and operational arbitrage was a causal factor in the introduction of new hedge fund sector regulations in France.

\textsuperscript{143} Titre I Modernisation des Autorités de Contrôle

\textsuperscript{144} Titre II Sécurité des Épargnants et des Assurés

\textsuperscript{145} Titre III Modernisation du Contrôle Légal des Comptes et Transparence

\textsuperscript{146} Interviews with two Senior Executives at two separate Economic Actors in Paris, 20\textsuperscript{th} April 2006
Regulatory and operational arbitrages are consequences of market globalisation which provide the economic actors with incentives to seek comparative competitive advantages in foreign regimes. The practice of these forms of arbitrage is also in evidence in Germany. As in France, it is manifested in the form of the economic actors choosing the exit option and establishing operations in alternative countries with more flexible regulatory regimes, such as Luxembourg and Ireland, as well as in creative investment product development and the introduction of these products to German investors via the so-called back door. By the beginning of 2004 83% of the investment funds sold to German investors were manufactured in a foreign jurisdiction. Companies set up operations in foreign regimes for two main reasons. First, the alternative regimes selected offered greater flexibility regarding investment product design. Secondly, the time period from idea generation to product creation and registration was much shorter in these countries than in Germany. These manifestations of regulatory and operational arbitrage concerned the state actors on two levels: they were concerned about the strength and competitiveness of the German financial sector and by association the German economy. They were also concerned about investor protection on the basis that investors were able to access investments such as hedge fund type products that while totally legal, had been innovatively constructed to get around the specific regulatory hurdles of the German regime.

147 Interview with Senior Executive at BVI, 16th May 2006 in which internal BVI documents demonstrated this evidence
The regulatory reforms introduced by the IMAG (2004), including the hedge fund sector regulations, were ‘politically driven for economic reasons and national pride’. Globalisation had facilitated the substantial growth and development of the hedge fund sector which in Europe became centred in the UK. Prior to the regulatory reforms, the hedge fund sector in Germany was very small. The legislation of 2004 was, like the legislation that introduced the new unitary regulator BaFin in 2001, driven by the state actors’ desire to make Germany more attractive as a financial centre and to enable the country to have a role in the global financial markets ‘which is equivalent to its weight in Europe and the world’.

The elected state actors were aware of the growing importance of the investment services sector, and its subset the hedge fund sector, to the economy. In 2001 the government had announced the Riester reform. This was a policy to encourage individual citizens to take greater responsibility for their savings and investment needs and rely less on the State; unfunded public pensions were to be supplemented with funded private pensions (Krahnen and Schmidt, 2004: 489). One of the objectives of this transition towards funded pensions was to boost the German capital markets, the non-banking part of the financial sector, and thereby weaken the role of the banks. The role of the banks would be weakened because if firms need to raise money they are able to use the capital markets rather than being dependent on borrowing from the banks. Such a strategy should result in an increase in the number and diversity of investment products as the economic actors, both domestic and foreign, compete to attract new business.

148 Interview with Senior Executive at BaFin, 15th May 2006
149 Interview with Senior Executive at BVI, 16th May 2006
Globalisation meant that the economic actors, domestic and foreign, could select the
regime with the most desirable institutional characteristics in which to operate. Prior
to the IMAG’s introduction it is reasonable to suggest that Germany was not a
desirable place in which to establish and manage a hedge fund operation; the small
number of firms in the sector as well as the small amount of assets under
management, in comparison with both France and the UK, provides evidence of this,
particularly as there were no regulations that prohibited the foundation and
management of such organisations. The elected state actors recognised the
importance to the economic actors in the sector of being able to function in a well
designed regulatory regime and sought to create such a regime; they also recognised
the importance of investor protection, particularly since the introduction of the
Riester reforms. If the state actors were encouraging private individuals to access and
use the investment services market to manage their savings and investment needs, the
political imperative of having a robust regulatory regime was somewhat compelling;
‘a financial system can perform its main function of channelling funds from savers to
investors only if it offers sufficient assurance to the providers of the funds that they
will reap the rewards which have been promised to them’ (Krahnen and Schmidt,
2004: 50). Globalisation of the markets put pressure on the state actors to introduce
reforms that would strengthen the position of the German financial sector. With the
new hedge fund sector regulations they sought to achieve an equilibrium that
balanced the economic actors’ desire for creativity and flexibility with the state’s
concern for investor protection and financial stability.
With the regulatory reform included in the IMAG the state actors were determined to reinforce Germany's status as a financial centre which meant achieving three targets; 'modernising the regulatory framework and promoting innovative financial products, but also enhancing and where necessary restoring investor confidence' (Eichel, 2005). The innovative financial products to which Eichel, the then Federal Minister of Finance, refers are hedge funds. The sector's growing and critical role in providing liquidity to the financial system, economic strength and reputation to a financial centre, as well as investment opportunities for a more diverse universe of investors that included the public, was recognised by the politicians and action was taken to try to help Germany both catch up and keep up with the developments in the financial markets. In an increasingly global and competitive financial system it is essential to have a strong and internationally recognised financial regulatory regime in order to compete; such a feature 'is good for business and good for Germany'.

Diverse and strong financial markets 'make an invaluable contribution to economic growth ... it is clearly evident that countries with well developed financial markets grow faster than others' (Eichel, 2005). The then Federal Minister of Finance, Hans Eichel, was of the opinion that while the development and expansion of financial markets was, predominantly, market driven, there was an important role for the state actors to play. This role included ensuring that an appropriate and adaptive regulatory regime existed to ensure that Germany was a beneficiary of the economic actors' participation in the rapidly evolving financial markets. Despite being the largest economy in Europe, the contribution of financial services to the economy was, at

---

150 Interview, Senior Executive, Deutsche Bank, Frankfurt, 16th May 2006
4.6% of GDP, much smaller than the contribution of the sector to the country’s two main European competitors, France and the UK. And in the years before the regulatory reform, GDP growth in Germany had been uncharacteristically low. Between 1995 and 2001 the economy had grown at an average annual rate of 1.6% which was nearly half the average growth rate of the Euro zone countries\textsuperscript{151}. This economic environment placed the state actors under a lot of pressure: unemployment rose to 9.5%, taxation revenues fell and social security spending increased, in part to pay the benefits of those made jobless (Wallace, 2002). Germany was caught up in a ‘vicious circle of low employment, which leads to higher claims on the welfare state, which raises wage costs, which leads to higher unemployment’\textsuperscript{152}.

The relationship between economic growth and a dynamic and flexible financial services sector is well documented; a major goal of the regulatory reform introduced by the IMAG was to ‘fundamentally improve the underlying conditions for Germany as a location for productive investment’ (Eichel, 2005). A further goal was to enable the transparent introduction of the hedge fund sector to the German market and give ‘German investors direct access to this innovative product’ (Eichel, 2005). The state actors recognised the importance of the hedge fund sector on two levels; the sector’s growing importance as a liquidity provider to the financial markets, and the sector’s increasing popularity as a provider of savings and investment products. The state actors’ two pronged goal with the new hedge fund regulations was to provide a


\textsuperscript{152} Schumacher, Dirk. Economist at Goldman Sachs, Frankfurt, quoted in Time, 3 November 2002
framework that would attract financial services activity to Germany, and introduce greater competition as well as provide greater choice to German investors.

The globalisation of the financial markets had exposed the German and French economies to a particular inadequacy of their respective regulatory regimes. This inadequacy had the double effect of encouraging the domestic economic actors to shift certain business activities to other nations to gain access to the advantages provided by the institutional frameworks in these countries, particularly the more flexible and accommodating regulatory environments; as well as discouraging foreign economic actors from entering the domestic market. The regulatory reforms in France and Germany at the beginning of the twenty first century were a manifestation of the state actors’ desire to reverse these trends. The behaviour of the domestic economic actors, engaging in regulatory and operational arbitrage, was a catalyst for regulatory reform.

United Kingdom

The research so far suggests that globalisation and the pressure that its impact imposed on the domestic financial market is an important variable in explaining the regulatory reform that introduced new hedge fund sector regulation to France and Germany in 2003 and 2004 respectively. The degree, if any, to which globalisation can be linked to the UK’s lack of explicit hedge fund sector regulation is an issue to which this study now turns. The effect of financial market globalisation on the economic actors in the UK was different to the effect that it had on those in France
and Germany. Instead of witnessing the exit of firms engaging in regulatory and operational arbitrage in pursuit of innovation, opportunity and efficiency, the UK financial services sector was a beneficial recipient of French, German and other economic actors. Not only did London attract foreign firms and individuals, it experienced substantial growth both in the number of domestic economic actors as well as in the range of financial services activities in which they engaged.

One particular area of growth was in the hedge fund sector. From fledgling beginnings in the 1980s this sector had developed into a formidable financial force by the turn of the twenty first century. Assets under management by the hedge fund advisers based in the UK exceeded the amount of money managed by the German hedge fund and mutual fund sectors combined (Cookson, 2005). A primary determinant of the non existence of a special regime for the hedge fund sector is the economic actors’ desire to maintain the institutional status quo, the characteristics of which had fostered the growth of the hedge fund sector. Evidence of this preference can be found, as noted earlier, in the response of the economic actors, both direct response from individual firms and indirect response from interest associations representing different segments of the financial market active in the hedge fund sector, to the FSA’s first discussion paper on the sector published in August 2002, DP16: ‘Hedge Funds and the FSA’. In clause 1.6 of the response document the regulatory agency states that according to the respondents the current regulatory regime, which treats hedge fund managers as it treats other investment managers, is ‘appropriate’ and does not need to be changed. The FSA did not propose any reform and the status quo was maintained.
A principal issue raised by globalisation concerns the stability of regulatory regimes and national institutions in the face of greater competitive pressure (Hall and Soskice, 2001: 55). All three regimes in this study experienced radical reform in response to the competition unleashed by the liberalisation and trending integration of the financial markets. The UK regime underwent fundamental reform in 1986, slightly ahead of the reforms in France and nearly a decade ahead of the first major reforms in Germany. This reform to the UK regime was driven by the state actors (Coleman, 1996; Moran, 1991; Vogel, 1996) and the timing and content of Big Bang, as the policy was known, laid the foundations for the ensuing dominance of London in Europe in the financial services and hedge fund sectors. The timing gave the UK a huge first mover advantage; but it was the content that allowed foreign companies to buy British firms that was critical to London’s expansion as an international financial centre.

To achieve their objective to turn London into an international financial powerhouse, the state actors’ deemed it neither desirable nor necessary to protect domestic firms from being bought by foreign firms. This contrasts strongly with the approach especially in France, but also in Germany, where the state actors have sought to build their respective financial centres around the domestic economic actors. In responding to the competitive pressures enhanced by globalisation France has been a strong exponent of such a policy, not to create world beating national champions, but simply to protect the domestic market (McGuire, 2006: 887). To quote a senior director of a leading French firm ‘protection of the domestic players is part of the French approach
and the new regulations aim to do this\textsuperscript{153}. The acquisition of many independent UK firms by foreign economic actors helped develop the institutional characteristics that not only enabled incumbent actors to compete and bloom, it fostered the growth of new domestic economic actors (such as hedge fund advisers), and also persuaded other foreign actors to establish operations in London. Having sunk extensive resources into buying British firms\textsuperscript{154} and building up the operations, these foreign firms would have needed a compelling rationale to move the operations to an alternative financial centre. The institutional characteristics that dissuaded them from so doing were plentiful. They included the financial regulatory regime; the ready availability of professional expertise in the form of both employees and service providers; the close connection and access to foreign markets facilitated by the influx of foreign nationals who brought with them knowledge, alternative perspectives, innovative ideas and established business networks; and taxation. Being an early mover in the liberalisation of its financial sector and welcoming foreign companies with their idiosyncratic methods meant greater opportunities for individuals both in terms of the number of jobs available and the type of work in which to engage. And once a sufficiently deep pool of expertise had developed, its continuation became self reinforcing; ‘other financial centres [in Europe] simply didn’t have the necessary staff, or at least not very many of them; and they still don’t’ (Cookson, 2005).

\textsuperscript{153} Interview, Senior Executive at Economic Actor, Paris 28\textsuperscript{th} February and 20\textsuperscript{th} April 2006
\textsuperscript{154} Examples include: Chase Manhattan’s acquisition of Simon & Coates, Laurie Milbank, and Robert Fleming; Citicorp’s acquisition of Scrimgeour Vickers; Dresdner Bank’s acquisition of Kleinwort Benson; Swiss Bank Corporation’s acquisition of Savory Milln; Union Bancaire Suisse’s (UBS) acquisition of Phillips & Drew; Merrill Lynch’s acquisition of Smith Newcourt, and Mercury Asset Management
While the regulatory regime introduced in 1986 was radically changed in 2001 as multiple regulatory agencies were streamlined into a unitary agency, its philosophical underpinnings remained invariant and had important practical consequences. British firms have the flexibility to manage their businesses as they see fit provided, of course, that they operate within the spirit of the rules; they do not, unlike their competitors in France, have to seek permission from the regulator if they wish to engage in an activity hitherto untried. In addition as described earlier in the study in chapter 1, regulation in the UK has in the main been based on broad principles, rather than on extensive and detailed prescriptive rules. This appeals to entrepreneurial economic actors because it enables them to be more innovative, and it reduces the cost of regulation because there is less ‘form filling’ and ‘box ticking’ to be done which means that fewer experts have to be dedicated to the compliance function of the firm.

The effects of globalisation on the financial markets have been perceived in the UK by the state and most of the economic actors as an opportunity, not a threat. There was an early awareness that good regulation and supervision provided a competitive edge and that the regulator has to be alert to the economic consequences of its actions because of the significant impact that these can have on the market. Globalisation and the response by both the state and economic actors to its pressures has resulted in the UK benefiting from important network effects that have developed as increasing numbers of foreign companies have established roots in its financial centre. The greater the number of economic actors that use the country’s investment managers,
hedge fund advisers, lawyers, accountants, bankers and markets, the deeper, more efficient and linked these markets and their users become.

Finance matters

The notion that finance matters was a primary stimulant for the reforms in France and Germany, as well as the decision not to alter the regulation of the hedge fund sector in the UK. The effects of the globalisation of the financial markets had been responded to by both state and economic actors for over a quarter of a century as domestic markets in each of the cases were liberalised to varying degrees, through both de-regulation and re-regulation.

Globalisation of markets is market driven and, within the political science literature, market driven models of regulatory reform identify the state actors as the drivers of the reforms responding to the actions of the economic actors (Perez, 1998; Vogel, 1996). The French and German cases clearly confirm this finding; the elected state actors in both countries were motivated by the competition from alternative regulatory regimes and the goal of strengthening and repositioning their respective financial centres in Paris and Frankfurt. The decisions concerning the hedge fund sector regulation in all three cases were driven by national interest in the face of inter regime competition that was caused by globalisation.

In the French and German cases the consequences of international and trans-national financial and economic activity were a primary determinant of regulatory reform as
the respective state actors re-considered the design of their regulatory models and the
effect that these models had had on each domestic financial sector and its position
within the global market. With the goal of making their markets more competitive
and attractive to the economic actors, the French and German authorities engaged in
comprehensive re-regulation; however, with the goal of maintaining its dominant
position in the European financial services sector, the UK authorities elected to keep
the status quo. The German state actors were not subject to the direct pressure of any
'coordinated economic actors' to reform their regulatory regime. The French state
actors, as noted in chapter 4, were subject to a degree of lobbying from the large
established firms. However, French and German state actors were subject to
extensive indirect pressure from the 'uncoordinated economic actors' whose active
embrace of regulatory and operational arbitrage, both through use of the exit option
and the back door option, were an important driver of the reforms. In the UK, one of
the reasons for keeping the status quo was the satisfaction of the economic actors
with the institutional setting and the advantages that it offered for business creation
and development; the firms had made it clear, formally through their response to
DP16, and informally by simply getting on with their business activities. In essence,
'informal' coordination gave them what they wanted.

Americanisation

Americanisation refers to the measurable influences of the US economic actors on the
financial services sector broadly and, more specifically, on the hedge fund sector and
related regulatory policy. Influence is the capacity of one set of actors to modify the
behaviour of another set of actors. It has already been established in this research that
the US economic actors wield considerable power in the world’s financial markets. It
has also been noted earlier in the study that the first hedge fund was set up in the US
in 1949, and that the country is home to at least 75% of the world’s hedge fund sector
both in terms of assets under management and in terms of the number of hedge fund
advisers. In addition, the three leading organisations that operate as the primary
counterparties to the world’s hedge fund advisers are headquartered in the US and,
between them, account for over 50% of that market155. The hedge fund sector, one of
the most dynamic and entrepreneurial sectors of the financial markets, is dominated
by US economic actors. To what extent was the regulatory reform that introduced
new hedge fund sector regulations in France and Germany caused by
Americanisation? And to what extent does Americanisation explain the variation in
hedge fund sector regulations in France, Germany and the UK?

The empirical evidence that will support the Americanisation hypothesis, and noted
in chapter 2, is measurable American influence on the regulatory regime design
manifested in two ways. First the role of the US economic actors and their
relationship with the domestic economic actors and regulatory policy makers;
secondly, the adoption of the US regulatory model or elements thereof. This section
will proceed in the following steps. It will commence with an analysis of the US
hedge fund actors and the type and extent of their activities in each of the three cases.
Secondly, it will analyse the behaviour of other US economic actors, such as prime

155 Banc of America Securities, Goldman Sachs and Morgan Stanley. 2006 Alpha Awards™,

192
brokers and lawyers, whose business activities are focused on providing services to the hedge fund sector; and this too will be done across the three cases. Thirdly, it will review the US regulatory model as it relates to the hedge fund sector and consider whether elements of this model have been adopted by the regimes in any of the three cases. If the Americanisation hypothesis is supported the study would expect to find the following evidence. The presence of US hedge fund advisers in the country under examination; the presence of other US economic actors who specialise in providing services to the hedge fund advisers; interaction between the economic and state actors influencing regime design; and the adoption of elements of the US approach to regulation of the sector.

Americanisation and the Role of Economic Actors

Until the 1990s, the US hedge fund advisers were very US centric. They focused their investment activities within their domestic financial markets, and most of their investors were US based. However, as the regulatory barriers to international economic activity were removed during the 1980s and 1990s such as the abolition of foreign exchange controls in the UK in 1979, in France and Germany in 1990, and as advances in technology made it easier both to gather information and intelligence from foreign markets, and to invest and trade in foreign markets, a trend began that saw a growing number of US hedge fund advisers actively participating in non US financial markets such as those in Europe, and establishing business operations outside the US. In 1990 it is estimated that the US hedge fund advisers accounted

156 The principal market counterparty to a hedge fund
for a de minimus volume of activity in the European stock and bond markets on the basis that fewer than an dozen were known to be active in these markets\textsuperscript{157}. By the end of 2005 it is estimated that their activity had expanded to represent over 25\%\textsuperscript{158}. As the largest and most liquid of the European financial markets, France, Germany and the UK are likely to have been the primary beneficiaries of this activity. In 1992 the first European based office was established by a US hedge fund adviser\textsuperscript{159}; and by 2005 this number had expanded to an estimated 30\textsuperscript{160}. All of these operations were set up in the UK; not one has been established in either France or Germany. And although in numeric terms the actual number of operations is underwhelming, these US hedge fund advisers account for an estimated 10\% of total assets under management in the global hedge fund sector\textsuperscript{161}. Why did the US advisers select the UK, rather than France or Germany, and what can this tell us about the potential validity of the Americanisation hypothesis? The study proceeds first with a discussion of the presence of the US economic actors in each of the three countries, it then turns to an analysis of the influence of the US regulatory model on the hedge fund sector regulations in each of the three countries.

**US Economic Actors and France**

The institutional characteristics of the environments in France and Germany were quite different to those in the UK. Despite undergoing its own radical regulatory

\textsuperscript{157} Interviews, Senior Executives at Economic actors and AlMMA, 6\textsuperscript{th} and 20\textsuperscript{th} February, 13\textsuperscript{th}, 17\textsuperscript{th} and 21\textsuperscript{st} March 2006  
\textsuperscript{158} Calculated by making the following assumption: US hedge fund advisers represent 75\% of the sector; hedge fund advisers account for 30-40\% of market activity  
\textsuperscript{159} TASS Hedge Fund Research, now part of the Lipper TASS Hedge Fund Database  
\textsuperscript{160} Interview, editor, HedgeFund Intelligence, 7\textsuperscript{th} June 2007  
\textsuperscript{161} Interview, editor, HedgeFund Intelligence, 7\textsuperscript{th} June 2007
regime reform during the 1980s with a major objective of making the French financial market and the French economy significantly more competitive (Cerny, 1989), France was not an attractive location for US, or other non French hedge fund advisers, in which to establish businesses for a variety of reasons. The French financial sector was dominated by domestic firms, particularly banks and other credit institutions, many of which in the early 1990s were still part owned by the State. Dirigisme may have been weakened by the regulatory reforms of the 1980s, but it was not dead (Cerny, 1989) and although foreign financial firms were not prohibited from entering the market, France’s hybrid market economy, which was neither an LME nor a CME, contained enough barriers to give US hedge fund advisers, and other foreign economic actors, pause for thought.

Paris at that time, unlike London as will be discussed later in this chapter, did not have an incumbent group of US economic actors blazing a trail for the US style financial services market activity and fostering in its wake the development of prime broking, accounting, legal and administrative expertise and resources to provide the necessary support to businesses in this area. This meant that there was not an established and deep network of US expatriates, knowledgeable in both the French and US approaches to business creation and development, to which the hedge fund advisers could turn for either simple advice such as where to locate the office or which legal advisers to select, or comprehensive assistance such as the provision of banking and broking services to the new entity.
Two other barriers had an influence on the decision of US hedge fund advisers not to establish operations in France. In 1996 the Financial Activity Modernisation Act was passed. This implemented the transposition of the Investment Services Directive (ISD)\textsuperscript{162} into French law and the Act provided for a single institutional framework for all types of investment service providers in France. The regulatory reform introduced by the Act simplified the regime and, at least for the domestic economic actors, facilitated the development of a more diverse and competitive investment management sector. It did little, however, to encourage foreign economic actors to set up investment management businesses in France. Articles 12 and 15 in the Act contain six and seven requirements respectively that must be met by investment firms. In both Articles the first requirement states that a firm's registered office and headquarters must be in France, suggesting pre-eminence of the French regulatory regime over a business that may have been active in multiple jurisdictions. This was not the situation in the UK where a US hedge fund adviser could establish an operation that was a branch or subsidiary of the main US corporate entity; and depending on the scope of the UK firm's activities, the US hedge fund adviser could either continue to operate under the exemptions of the US regime, or its UK entity was obliged to register with and comply with the local regulations.

The other barrier to entry to which this study refers is the legal system in France, especially as it relates to the issue of ‘custody’ and the role of a particular economic actor, the prime broker. Almost all hedge fund advisers’ investment products/funds are legally required to have a counterparty relationship with a prime broker. The

\textsuperscript{162} Directive 93/22/EEC of 10/05/1993
prime broker, which is usually either a bank or an investment bank, provides a range of services including safe custody of the assets in the fund. French law requires that a domestic bank authorised by the Banque de France fulfils the role of custodian and this legal requirement makes it difficult, if not impossible, for a prime broker to fulfil its obligations. The vexing issue relates to the sharing of liabilities between French custodians and foreign prime brokers (the latter have to act as sub-custodians). While from a practical point of view this issue is not insurmountable, it presents a hurdle to the economic actors that does not exist in other regimes and therefore discourages foreign participation in and the development of the sector in France. Despite extensive discussion between the regulators in France and the hedge fund sector, both indirectly with interest associations such as the AFG and AIMA, and directly with specific economic actors, at the time of writing the rules regarding this issue have not been clarified.

The regulatory reform in France cannot be explained by Americanisation. The physical lack of presence of the US economic actors, particularly the prime brokers and other hedge fund sector specialist service providers, together with some of the specific requirements of the 1996 legislation, as well as the French rules relating to the custody of assets means that the Americanisation hypothesis is not confirmed.

US Economic Actors and Germany

An analysis of certain political and institutional characteristics of Germany in the early 1990s shed useful light on why the first US hedge fund advisers to establish
operations in Europe did not choose to locate these operations in Germany. A primary barrier to entry was the financial regulatory regime; or perhaps it would be more accurate to say the inadequacies thereof. While the Deutsche Bundesbank was fiercely independent and its reputation for managing the dual responsibilities of monetary policy as well as the prudential regulation and supervision of the banking sector was exemplary, the reputation of the investment services sector (securities sector) outside Germany was not so highly regarded. Prior to regulatory reform induced by the Securities Trading Act which was a core part of the Second Financial Markets Promotion Law of 1<sup>st</sup> January, 1995, this sector was not subject to any explicit Federal level regulation and was not supervised by a dedicated regulatory agency. The sector had operated within a model of self regulation which had generated little confidence outside Germany (McDonald, 1996).

Laws that had first been enacted against insider dealing in France in 1967, in the UK in 1980 and in the US in 1934 were not enacted in Germany until 1995 and allegations of fraud in the German market were commonplace. Insider dealing violations rarely led to sanctions, and the lack of prosecution of such flagrant market abuse was not well received in other financial centres (McDonald, 1996). In fact, the perception that the regulator tolerated market abuse led regulatory regimes in other countries to prohibit access to certain segments of the German securities market. The regulators in France and the UK refused to allow either the Frankfurt Stock Exchange, the largest of Germany’s eight stock exchanges, or the Deutsche Termin Bourse (DTB), the German financial futures exchange, to set up terminals for their electronic trading systems in France and the UK. While in the US the SEC refused to
allow products based on the main German stock index, the DAX\textsuperscript{163}, admission to the country and the US economic actors were not allowed to access any DAX based products.

With the new Act the Federal Government sought to restore external confidence in the German market and provide better protection for investors; among other things, it established a new Federal Securities Supervisory Office (Bundesaufsichtsamt für den Wertpapierhandel - BAW\text{e}{}) and prohibited insider trading. This research has already established that the hedge fund sector is one of the most footloose in the financial services community; it has also identified cross national regulatory regime variation and the potential for economic actors to engage in regulatory arbitrage. The US hedge fund advisers were not going to set up shop in a financial centre whose regulatory regime lacked credibility to the extent that US investors had been banned from accessing certain financial products. To do so ran the risk of becoming tarred with the same reputation.

Despite such powerful rationale for not establishing a business in Germany, other characteristics of the financial services sector played their part. The hedge fund sector was almost non-existent; the first hedge fund adviser was not established in the country until December 1994\textsuperscript{164} in spite of the fact that there were no regulations that prohibited such a development. This meant that there were few service providers, such as prime brokers, accountants and lawyers, with expertise in the sector, and few

\begin{footnotesize}
\textsuperscript{163} Deutscher Aktien Index consisting of the 30 major companies listed on the Frankfurt Stock Exchange
\textsuperscript{164} Lipper TASS Hedge Fund Database
\end{footnotesize}
potential employees with the relevant skills. Furthermore, Germany’s Coordinated Market Economy exhibited structural features that had the effect of impeding the activity of foreign economic actors in its stock market. Inter company cooperation was institutionalised by the prevalence of cross shareholdings, whereby firms owned shares in each other establishing a ‘quasi cartel’ that was internally organised and protected the economic actors against influence from the outside (Höpner and Krempel, 2003). Although the cross shareholdings were particularly prevalent in the financial sector (Höpner and Krempel, 2003) their existence meant that outside investors had greater difficulty determining the value of a company as a potential investment, presenting another hurdle to external participation in the market. Further, prior to the regulatory reforms of 2002\footnote{Fourth Financial Market Development Act}, unequal voting rights existed; the standard, common in liberal market economies, of one-share-one-vote was a relatively late introduction to the German regulatory regime. Finally, as in France, the German financial centre was not host to a large number of American financial services firms which meant that the business norms, practices and networks of the professionals that accompanied these firms were absent.

**US Economic Actors and the UK**

Investment companies generally establish additional operations in other countries for one of two reasons. To gain better access to sources of information and market counterparties in order to improve and expand the quality of their investment management services; and to gain better access to potential investors. When the first
US hedge fund advisers started establishing operations in the UK in the early 1990s they were not primarily motivated by getting better access to investors. If this was the main objective then they would have chosen Switzerland, or even France, where at the time there were much larger pools of investor money, mainly from very wealthy individuals and institutions, with an appetite for hedge fund products. The goal was to be able to take better advantage of the investment opportunities available in non-US markets, and having a presence in Europe helped achieve this. The increasingly capable and powerful technology that has made it possible to invest around the globe from a single office can be enhanced by information gathered and ideas generated from local knowledge. The hedge fund sector is highly competitive and being able to access and interpret information ahead of the crowd can be extremely valuable. The UK was chosen for several reasons.

London’s well developed wholesale financial markets ensured a supply of expertise and an availability of market liquidity essential to attracting the participation of new economic actors. At the time that the first US hedge fund adviser set up shop in the UK, the UK was already home to over 90% of the European based hedge fund advisers\(^\text{166}\) suggesting an environment with political and institutional characteristics that enabled if not encouraged the establishment of entrepreneurial financial firms. The important institutional characteristics include ready access to experienced professionals including lawyers, accountants, market counterparties and employees; a regulatory regime based on principles that does not restrict the hedge fund advisers’ investment management activities, and that allows firms to operate with flexibility in

\(^{166}\) Lipper TASS Hedge Fund Database
the fast changing financial markets; an ‘entrepreneur friendly’ policy approach to business and employment; and a legal system recognised for being both robust and fair.

The political influence on the financial services sector was an equally important contributor to the evolution of the UK’s hedge fund sector. In 1986 the Conservative government had introduced radical reform of the regulatory regime with the objective of making the financial services sector of the UK much more dynamic and competitive. One of the consequences of the reforms was a wave of corporate takeovers of most UK financial services firms by foreign financial companies, particularly by US companies. Further one of the effects of these takeovers was a substantial increase in the number of Americans working in the financial services sector in London bringing with them knowledge, skills, norms and networks of professional contacts. Post 1986 the UK developed a vibrant, diverse and expanding American community within its financial centre which had the effect of attracting other US economic actors, including hedge fund advisers, to London. Of the leading US financial services companies providing prime brokerage services, all but one headquarters its non-US prime brokerage services in London; the exception does not provide the service outside the US. Of the leading US law firms specialising in the hedge fund sector, 66% have operations in the UK; 11% have operations in France and 22% in Germany\textsuperscript{167}. What this means is that the influence of the American economic actors on the sector in the UK, meaning their capacity to modify the behaviour of the economic actors in the sector in the UK, is likely to have been much

\textsuperscript{167} www.institutionalinvestor.com
greater than in the other two cases because of the greater number of American economic actors present and active in the market in the UK.

The study refers particularly to the influence on the British economic actors. The mechanism through which this influence is wielded is the specialist services provided to hedge fund advisers and without which these advisers would have difficulty operating. One of the most important of these services is prime brokerage. The first provider of this service in Europe was the US firm Morgan Stanley, which had had operations in London since 1977 and which established its hedge fund platform in London in 1989; Goldman Sachs, another US firm, established its European based prime brokerage platform in London in 1996 (Natarajan, 2001). While many other firms, both US and non-US, have set up similar operations in the UK since 1996, the two original organisations continue to top both the popularity and market share rankings (Gangahar, 2002; Natarajan, 2001). Access to prime brokerage services is critical to the management of a hedge fund and the development of the sector.

Americanisation and the Regulatory Model

This section will now proceed with a review of the US regulatory model as it relates to the hedge fund sector to determine whether there is a measurable American influence on the hedge fund sector regulations in any of the three cases. The US model has two regulatory agencies, the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) which are responsible for
regulating different segments of the financial markets\textsuperscript{168}. This differentiation is defined by the types of assets and derivatives that can be invested in or traded by all economic, state and individual actors who participate in the markets. Although there are some notable (and confusing) exceptions, the CFTC oversees all the futures markets while the SEC oversees the equity and bond markets. As in France, Germany and the UK, there is no legal definition of the term hedge fund in the US. In the main providing no exemptions are being used, if an investment firm is active in the stock and/or bond markets, it will be regulated by the SEC; if an investment firm is active in the futures markets, it will be regulated by the CFTC. And if the firm is active in all these markets, it may be regulated by both.

Both agencies regulate the economic actors. Neither agency regulates the investment products as long as they are not being offered to the general public investors. However, the CFTC does require registration of investment products that are offered to the general public; while the SEC does not require such registration. The majority of hedge fund advisers do not offer products to the general public. A hedge fund adviser active in the futures markets has to register with the CFTC whether or not the firm offers any products to the public. A hedge fund adviser active in the stock or bond markets is exempt from registration with the SEC provided the company meets the necessary requirements of exemption, probably the most important of which is that only very wealthy individuals\textsuperscript{169} and institutional investors, such as pension funds, may access in the adviser’s investment product. A company that is exempt

\textsuperscript{168} The US financial regulatory regime includes multiple agencies. However in the context of this research only the CFTC and SEC are directly relevant

\textsuperscript{169} The regulations quantify the minimum net worth required
from SEC registration is prohibited from offering investment product to the public. Neither the SEC nor the CFTC imposes investment restrictions on the hedge fund advisers.

A final aspect of the US regulatory model to consider relates to the manner in which the regulatory regime is designed and reformed, rather than to the particular detail of the regulations. The US model has been described as highly adversarial and the judiciary is very important (Vogel, 1996: 133). In addition to being fragmented across multiple independent regulatory agencies, the US regime is fragmented between the Federal and State levels and regulation is often shared between the Federal and the State agencies. The regime is highly prescriptive and challenges by the economic actors regarding how the rules should be interpreted is very much part of the adversarial system of regulation in which the courts play a central role in the process of regulatory reform (Vogel, 1996: 230). The introduction of new hedge fund sector regulations in 2004 which were subsequently withdrawn in 2006 provides a very recent example of this adversarial approach to regulatory design.

Until July 2004, most hedge fund advisers in the US operated under various exemptions from the general investment services regulations. In July 2004 the SEC, the primary regulator of investment services firms in the US, required most hedge fund advisers to register under the Investment Advisers Act, 1940, by February 2006\textsuperscript{170}. This new requirement was influenced by two factors; first, small private (retail) investors were gaining exposure to hedge funds both directly and indirectly

\textsuperscript{170} Exemptions existed depending on the number of clients, assets under management, and the duration of the clients' investment
through their pension funds, and secondly the hedge fund sector was becoming an increasingly important component of the financial markets. However, less than six months after the introduction of the new regulations, a three judge panel of the US Court of Appeals for the District of Columbia Circuit ‘unanimously struck down the SEC’s hedge fund adviser registration rules under the Investment Advisers Act’ (SEC, 2006). This meant that hedge fund advisers could continue to operate under the agreed exemptions as before, and the status quo was restored.

Hedge funds have existed in the US since 1949 and in Europe since the early 1980s. Until the early years of the twenty first century they had, in the main, operated within the existing investment services regulations in each country. This was the case in the UK and Germany and, to a lesser extent, in France. What this means is that there was no specific hedge fund sector regulation in Germany prior to 2004 and in France prior to 2003; France’s very specific pre-2003 regulations notwithstanding.

What similarities and differences are there between the US regulatory model and those in France, Germany and the UK? The study will now analyse the similarities and differences between the US model and the regulatory model in each of the three countries.

**US Regulatory Model and France**

Although comprehensive hedge fund sector regulation was not introduced in France until 2003, regulation of a particular subset of the sector had been in existence since

---

171 The first hedge fund adviser was established in the UK in 1983. Source: Lipper TASS Hedge Fund Database
1988. This specific subset refers to the economic actors who use the futures markets, rather than the stock and bond markets, as the financial medium through which to implement their investment management activities. The far more comprehensive hedge fund sector regulations that were introduced in France by the Financial Security Act (2003) show little evidence of being modelled on the US hedge fund sector regime.

This can be seen by considering some of the major elements of the regulations, although substantial variation in the minutiae of the regulations is also evident. A comparison of the main elements is shown in Table 5.1. The US, as has already been noted, has two regulatory agencies and although hedge fund advisers active in the futures markets must be regulated by the CFTC, those active in the stock and bond markets do not necessarily have to be regulated by the SEC. In France it is different; all hedge fund advisers have to be regulated by a single agency, the AMF. Unlike in the US, it is not possible for a hedge fund adviser in France to operate by way of exemption from the regulations. The AMF imposes strict rules regarding the operational roles within the firms that must be fulfilled and the number of individuals required to perform certain functions; there are no such requirements by either of the regulators in the US. The French regulations require the companies to register each investment product with the AMF for approval before it can be offered to investors; the US regulations make no such demand on the economic actors, regulating only the economic actors, not their investment funds. Fourthly, the regulations in France impose investment restrictions on the hedge fund advisers, for example the amount of leverage that may be used, while the US regulations do not.
Table 5.1: Similarities and Differences between US and French Hedge Fund Sector Regulation

<table>
<thead>
<tr>
<th>Key Elements of Hedge Fund Sector Regulation</th>
<th>US</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Regulatory Agencies</td>
<td>2</td>
<td>1\textsuperscript{172}</td>
</tr>
<tr>
<td>Regulation of Hedge Fund Advisers</td>
<td>CFTC: Y, SEC: N</td>
<td>Y</td>
</tr>
<tr>
<td>Regulation of Investment Products offered to non-General Public Investors</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Regulation of Investment Products offered to General Public Investors</td>
<td>CFTC: Y, SEC: N</td>
<td>Y</td>
</tr>
<tr>
<td>Investment Strategy Restrictions</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Investor Wealth Restrictions</td>
<td>Y</td>
<td>Y</td>
</tr>
</tbody>
</table>

Source: Adapted from IOSCO Consultation Report, Appendix C, March 2006

US Regulatory Model and Germany

Germany had no specific hedge fund sector regulations until the beginning of 2004. Although a comparison of the German and US regulatory regimes finds evidence of some similarity, as can be seen in Table 5.2, the extent to which this can be classified as Americanisation is limited. The German regime has a unitary regulatory agency, the BaFin, responsible for the whole financial services sector including the hedge fund component. As this research has already pointed out, the US regulatory regime includes two agencies that inter alia cover the hedge fund sector. German hedge fund advisers do not have to register with the BaFin.

This is similar to the US regime in which the advisers who fall under the jurisdiction of the SEC do not have to register; the difference, however, is that the US hedge fund advisers do not have to register with the BaFin.

\textsuperscript{172} While the AMF is the principal regulatory agency with responsibility for conduct of business regulation, monitoring and supervision, hedge fund advisers are licensed by the CECEI
actors operate under explicit exemptions from the SEC regulations which for example limit the types of investors that can access their products and the number of investors that they may have in their funds. German advisers function under no such exemptions. And the lack of a requirement to register with the BaFin contrasts with the US CFTC’s requirement that all firms active in its markets be registered. Unlike in the US where only certain hedge fund products have to be approved by the regulator, all German hedge fund investment products, even if they are offered by unregulated firms, must be approved by and registered with the BaFin. The German regime imposes investment restrictions on the type of securities these products are allowed to own and what they are allowed to do; the US regime does not constrain the investment activities allowing the hedge fund actors extensive flexibility in the management of their investments.

Table 5.2: Similarities and Differences between US and German Hedge Fund Sector Regulation

<table>
<thead>
<tr>
<th>Key Elements of Hedge Fund Sector Regulation</th>
<th>US</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Regulatory Agencies</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Regulation of Hedge Fund Advisers CFTC: Y</td>
<td></td>
<td>N</td>
</tr>
<tr>
<td>SEC: N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation of Investment Products offered to non-General Public Investors</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Regulation of Investment Products offered to General Public Investors</td>
<td>CFTC: Y</td>
<td>Y</td>
</tr>
<tr>
<td>SEC: N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Strategy Restrictions</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Investor Wealth Restrictions</td>
<td>Y</td>
<td>N</td>
</tr>
</tbody>
</table>

Source: Adapted from IOSCO Consultation Report, Appendix C, March 2006

The evidence observed and examined in this research suggests that the design of neither the French nor the German hedge fund regulations can be explained by
Americanisation. The study will now consider the effect, if any, of American influence on the UK regime and its approach to regulation of the hedge fund sector.

**US Regulatory Model and the UK**

The UK financial regulatory regime that existed in the early 1990s when the first US hedge fund advisers started to establish operations in the UK had been established by the 1986 Financial Services Act. It has been suggested that the liberalisation and reform of the UK regime at that time was heavily influenced by the American approach to regulation of the financial sector (Moran, 1991). The similarity between the two regimes, particularly as they relate to the hedge fund sector, can be seen in the regime organisation and the existence of two regulatory agencies which, like the two US agencies, had regulatory responsibility for the economic actors according to the asset class in which they were active.

In the UK the Investment Management Regulatory Organisation (IMRO) covered all investment managers, including hedge fund advisers, active in the stock and bond markets; while the Securities and Futures Authority (SFA) covered all investment managers active in the futures and derivative markets.\(^{173}\) There was, however, a fundamental difference in the regime orientation; the UK regime was self regulatory within a statutory framework and both IMRO and the SFA were self regulatory organisations; the SEC and CFTC on the other hand are federal regulatory authorities and their commissioners are ‘appointed by the President with the advice and consent

\(^{173}\) Exceptions did exist. It was possible for an investment adviser active in the stock and bond markets to be regulated by the SFA rather than by IMRO
of the Senate\textsuperscript{174}. The regulatory reforms in the UK that were introduced by the Financial Services and Markets Act which came into effect in November 2001, drastically changed both the regime organisation and the orientation. Regime organisation shifted from multiple agencies in favour of a single agency covering all financial services activities; and the self regulatory approach was abandoned. Before considering what the similarity, and subsequent variation in regime organisation, and the variation in regime orientation means for the Americanisation hypothesis, we need to look in more detail at the UK approach to hedge fund sector regulation and consider the impact, if any, of the US approach.

To recapitulate, there are two regulatory agencies in the US; in the UK there is a single agency, the FSA. The US approach separates the hedge fund advisers into those who choose to register with the SEC, those who operate under exemption from SEC regulation and do not have to be registered, and those who must register and comply with the CFTC regulations. In the UK while there is no explicit hedge fund sector regulation, all economic actors acting as hedge fund advisers must be registered with the regulatory agency as investment managers\textsuperscript{175}; there are no exemptions. Both the UK and the US regimes regulate the economic actors and, unlike the regimes in France and Germany, do not require the investment products to be registered with the regulator. The UK and US regimes share another similarity; neither model places investment restrictions on the economic actors which as noted in Table 1.1 differs from the French and German models which do place investment restrictions on the hedge fund advisers.

\textsuperscript{174} www.cftc.gov/opa/opacommissioner.htm accessed August 2007

\textsuperscript{175} This was also a requirement in the self regulatory regime with its multiple regulators
There is a difference between the US and the UK models regarding certain characteristics that the consumers must possess before the hedge fund adviser may approach them. In the UK, the investors with whom the hedge fund adviser may communicate and gain as customers are defined by their knowledge and expertise. What this means is that an investor’s ability to qualify for investment in a hedge fund product is demonstrated by having sufficient knowledge and experience to analyse the proposed investment and determine its suitability for her portfolio. In the US the investors with whom the hedge fund adviser may communicate and gain as customers are defined, generally, by their wealth. An American investor who is able to meet the minimum wealth criteria is deemed to have enough money to afford the losses if the investment goes wrong. The common theme as far as the regulators is concerned, and not just those in the US and the UK, is that hedge fund investment products are more risky than many other types of investment product and protecting the investor is a primary goal. The UK and the US regulators approach their obligation to provide a regime that *inter alia* protects the investor with different regulatory requirements.

The comparisons made earlier in this chapter of the French and the German regulatory models with that of the US found little support for the made-in America thesis. A comparison of the key elements of the US and UK regimes, which is summarised in Table 5.3, concurs with these findings. Although the US and UK models share common ground regarding the issues of investment restrictions and whether or not an investment fund has to be regulated in order to be offered to non-general public hedge fund investors, the variation in the number of regulatory agencies is the important institutional characteristic that does not support the
regulatory model aspect of the Americanisation hypothesis. Before the substantial financial sector, but not hedge fund specific, reforms in the UK in 2001, the regulatory regime shared more characteristics with the US regime, particularly the existence of two regulatory agencies, the SFA and IMRO. The scope and responsibilities of these two organisations were similar to those of the CFTC and SEC, and although it is beyond the scope of this study to explore, an examination of the effect of Americanisation on the regulatory model that existed in the UK post the reform of 1986 and prior to the 2001 reform will likely show much greater support for this hypothesis.

Table 5.3: Similarities and Differences between US and UK Hedge Fund Sector Regulation

<table>
<thead>
<tr>
<th>Key Elements of Hedge Fund Sector Regulation</th>
<th>US</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Regulatory Agencies</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Regulation of Hedge Fund Advisers</td>
<td>CFTC: Y</td>
<td>SEC: N</td>
</tr>
<tr>
<td>Regulation of Investment Products offered to non-General Public Investors</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Regulation of Investment Products offered to General Public Investors</td>
<td>CFTC: Y</td>
<td>SEC: N</td>
</tr>
<tr>
<td>Investment Strategy Restrictions</td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td>Investor Wealth Restrictions</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Investor Knowledge Restrictions</td>
<td>N</td>
<td>Y</td>
</tr>
</tbody>
</table>

Source: Adapted from IOSCO Consultation Report, Appendix C, March 2006

Analysis of Explanations

This chapter has attempted to examine two explanations of financial regulatory regime design and reform, globalisation and Americanisation. The first section
analysed the effects of globalisation on the economic and state actors and found significant evidence in all three cases to support the hypothesis that the regulatory reforms in France and Germany as well as the lack of change in the UK were caused by the effects of market globalisation on the behaviour of the economic actors. Globalisation helps to explain the reform, the design of the regulatory regime as it relates to the sector in each country, and it also helps explain the cross national variation in the regulations as each set of policy makers sought to design regulations that would facilitate the growth of the sector while protecting national authority.

An effect of globalisation is to put pressure on the elected state actors to make their respective markets more competitive. If regulatory regimes are comparative sources of economic advantage, then designing the regulations to be the same as those in other nations will likely result in the footloose economic actors using other institutional criteria to identify and select their preferred location of operation. Both France and Germany exhibited institutional characteristics independent of their financial regulatory regimes that acted as impediments to the development of vibrant hedge fund sectors within their financial systems. The state actors, therefore, had to create what each group regarded as a ‘superior’ regulatory regime in order to appeal to both their domestic economic actors as well as the foreign firms that were so integral to the development of this fast growing and increasingly important segment of the world’s financial markets.

Examining the impact of globalisation with a focus solely on the role of the state actors, however, fails to explain the maintenance of the status quo in the UK. It also
fails to acknowledge the critical role played by the economic actors in France whose use of regulatory and operational arbitrage, as well as lobbying, put pressure on the state authorities to take action. It also fails to acknowledge the influence of the German firms' use of regulatory and operational arbitrage on the state actors in Germany. In the UK the fact that the economic actors neither exited the regime nor lobbied for change meant that the regime was not subject to reform; in France and Germany uncoordinated, self serving action by the economic actors contributed to the introduction of substantial regulatory reform.

The second section investigated the explanatory power of Americanisation as a driver of regulatory reform and regime design. The study has defined the observable implications of Americanisation to be the presence of US economic actors and direct transfer of knowledge and expertise from the US economic actors to the French, German and British economic actors; as well as the adoption of meaningful elements of the US model of hedge fund sector regulation by each of the national regulatory regimes. With regard to the first element, the evidence from the French and German cases provides very little support for the thesis. The institutional settings in both countries exhibited characteristics that discouraged the US hedge fund advisers, and other economic actors, from establishing operations therein. One of the effects of this lack of US presence was the reduced ability of the domestic firms to expand their knowledge either directly, through formal business engagement and information sharing, or indirectly through informal observation and concomitant learning.
Nevertheless, the evidence from the UK brings the study to a different conclusion concerning the impact of the transfer and diffusion of expertise from the US firms to the British firms. The size, scope and profile of the hedge fund sector in the UK are clearly linked to the activity of the US economic actors and the observed evidence suggests that Americanisation is a powerful and valid explanation. However, its strength is questioned when the second element of the variable is considered.

The regulatory regimes governing the hedge fund sector in each of the three cases show limited US influence in design. What does this mean for determining the credibility of Americanisation as an explanation? The study has shown that there is no determinant link between Americanisation and the regulatory regime reform and design either in France or in Germany. In the UK the evidence to dismiss the explanatory authority of Americanisation is not quite so clear cut. As in France and Germany the study has demonstrated no determinant link between the UK regulatory regime approach to the hedge fund sector and Americanisation. But the study has demonstrated an important relationship between the US and British economic actors which has resulted, among other things, in extensive knowledge sharing and dissemination. The influence of the US economic actors active in the UK market is demonstrated by the size, scope and profile of the hedge fund sector in the UK. This influence is not new; the financial sector in London was exposed to the business expertise and approach of the US economic actors long before the sectors in either France or Germany.
American economic actors had been active in the sector in the UK since the 1960s, a trend that was started by a number of US firms engaging in regulatory arbitrage because of two specific US regulations (Cookson, 2005). First, Regulation Q which is a US Federal Reserve Board regulation that limits the interest rate that US banks can pay on savings deposits which meant that any bank that wanted to offer market interest rates on their US dollar deposits had to set up accounts outside the US; and London was the major beneficiary. Secondly, the 1963 decision by the US government to introduce a 30% withholding tax on interest payments to foreigners resulted in the creation in London of the so-called Eurobond market as the thriving US based foreign bond market moved from New York to London almost over night.

This had important implications for the type of financial services market that evolved in the UK; from the early beginnings the US firms contributed to the development of the substantial wholesale market in London in which, as has been noted earlier in the study, the hedge fund actors are major participants. Also noted earlier in the study is the fact that the wholesale financial markets in France and Germany are small; this characteristic of these two financial centres acted as one of the impediments to the development of a hedge fund sector in each of the cases because it discouraged many US economic actors from establishing operations in either centre. This lack of presence had an impact on the ability of the French and German economic actors, based in their respective domestic financial centres, to network with and gather knowledge from the US economic actors. A characteristic of the market that was more readily available to the economic actors in the UK.
In the next chapter the study moves on to a presentation of the conclusions and implications drawn from this research project. It starts with a comparative analysis of the strength of the four explanations in explaining the puzzle, and the merit of the public and private interest theories of regulation in guiding the research. It then proceeds to synthesise the main elements of the research in the context of the study of regulation and public policy, and draws attention to particular trends and themes that have been identified. It concludes by signalling the broader implications of the research and what these may mean for academic scholars and policy makers alike.
Chapter 6

Conclusions and Implications

The objective of this research is twofold. First, to examine the power of four explanations postulated in the literature as important drivers of financial regulatory reform. Secondly, to attempt to explain the different responses, in the context of regulatory regime reform and design, of the state and economic actors in France, Germany and the UK to common challenges; and to explain why cross national variation in regulatory regime design endures. Within the analysis the study has been guided by two political economy theories of regulation; the public and private interest theories of regulation. There is a school of thought that as the world becomes more economically interdependent and its financial markets more integrated the heterogeneity of national rules and regulations gives way to homogeneity as unique national regulatory regimes are regarded as impediments to obtaining the enhanced economic and social rewards that greater integration make possible. In essence, economic growth is good, asymmetric national barriers can prevent a country from fully participating in this growth, therefore the removal or redesign of the barriers is important to enable full and fair participation for all. The inference is that the authority of the state in controlling access to, and activity in, its share of this global financial system is diminished.

An alternative hypothesis suggests that an increasingly integrated and fluid market provides the state actors with the rationale for reinforcing their authority by, for
example, introducing new rules in the interest of safeguarding the citizens and economic actors from what are perceived to be the negative effects of the external forces. This study is about regulatory change and variation in three countries subject to many of the same pressures.

The lens through which the research has been conducted is the hedge fund sector which, over the last fifteen years, has been one of the fastest growing and has become one of the critically important segments of the world’s financial services system. The sector fulfils two economic and social functions; it provides valuable liquidity in the form of risk capital to financial markets which, without liquidity, break down in the same way that cars, ships, aeroplanes and factories break down without oil. It also intermediates the savings of an increasing number of investors around the world. Once virtually ignored by regulators, the sector has in recent years been shifted onto the regulatory radar screens with cross national variation in the outcome from this policy development. What was the causal interaction between the introduction of new hedge fund sector regulations in France and Germany and the lack of new regulations in the UK, and any of the explanatory variables?

Comparative Analysis of the Explanations

Four explanations have been examined in each of the three cases: financial crisis; the institutional arrangements, particularly the relationship between the economic and bureaucratic actors; globalisation; and Americanisation. Each explanation was selected because of its capacity to determine regulatory reform and regulatory regime
design. Table 2.2 earlier summarised these four explanations, each of which places different pressure on both the state and economic actors, and the expected action of the different actors whose actions may be guided by one of the two theories of regulation. The research has shown that the relationship between the four explanations and the dependent variable varies as can be seen in Table 6.1.

Table 6.1: Cross national comparison of explanations

<table>
<thead>
<tr>
<th>Explanation</th>
<th>France</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial crisis</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Institutional arrangements and accommodating relationships</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Globalisation</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Americanisation - influence of economic actors</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Americanisation - influence of regulatory model</td>
<td>N</td>
<td>N</td>
<td>N</td>
</tr>
</tbody>
</table>

Starting with the first explanation, the study finds evidence in all three cases of a link between financial crisis and financial regulatory regime reform as state actors respond to a crisis in the public interest. The equilibrium that is achieved by using regulation to carefully balance the preferences of investors and investment firms is disturbed by financial crises and an expected consequence is regulatory reform. A financial crisis often results in financial loss for investors. It is an unwelcome event that reduces public support for the state and the economic actors, as well as reducing consumer confidence in the financial system, and provides the incentive to promote reform in the public interest.

In France the then Minister of Finance, Francis Mer, stated clearly that reform of the regulatory regime was important because of the ‘regulatory’ and ‘financial’ crises of
the time (Mer, January 2003). He was not referring to the LTCM hedge fund sector crisis; he was referring to the acute loss of wealth suffered by many small and large French investors alike as a result of the stock market crash in the wake of the bursting of the so-called Dot Com Bubble. In Germany too, the failure of LTCM in 1998 cannot be directly linked to the regulatory reforms of January 2004. What is linked was the shocking 50% plus reduction in the value of the German stock market in the early twenty first century, as well as the emerging German stock market culture which bore witness to insider dealing and bribe taking. These events in France and Germany affected investors both large and small, shook investor confidence and led to a breakdown in public trust, which acted as a catalyst to the elected state actors to engage in substantial reform of the financial regulatory regimes. In the UK the financial services regulatory regime had also been subject to radical reform as a consequence of three domestic financial crises, BCCI, Barings and the pensions misselling scandal, but its regulation of the hedge fund sector was not amended in the aftermath of either the acute stock market fall in the first few years of this century, or the LTCM failure. That financial crises can drive regulatory change is not contested by this study; however, the explicit hedge fund sector reform in France and Germany is linked to fear of a future financial crisis, rather than a particular hedge fund crisis.

This fear of a crisis within the sector is linked to concerns for the protection of the general public investors. In both countries small investors had been able to access hedge fund investments, creatively produced and promoted by innovative economic actors, for some years before the regulatory reform. From an investment perspective these products were deemed too risky for unprofessional investors; and from a
regulatory perspective the authorities worried that the investment firms’ practice of engaging in operational and regulatory arbitrage, in order to produce the products, put the investors at risk by exposing them to investments created in foreign centres which were not deemed to have sufficiently robust and respected regimes. The French and German investors were potentially exposed to foreign regulatory regime risks which the regulators in the two countries were neither in a position to monitor nor control.

Crises provide policy makers with the incentives to initiate change in the public interest on the basis that the public controls the state actors through elections. None of the cases experienced a domestic hedge fund crisis; the financial markets in all of the cases experienced the waves generated by a foreign hedge fund crisis. The different action of the policy makers in each of the three countries suggests different priorities which are shaped by the structure of the domestic financial market. In the UK the wholesale market is substantial presenting policy makers with institutional conditions and incentives that vary from those in France and Germany, where the wholesale markets are much smaller. The rules and fiduciary responsibilities that apply to wholesale economic actors are generally different to those applied to firms offering savings and investment products to the general public. Investors and other participants in the wholesale market are professionals with the necessary resources to gather and analyse market, firm and product related information in order to make informed decisions. However, investors from the retail market need more regulatory protection because of the inherent information asymmetry, and because they can no longer depend on the economic actors’ reputational self interest as a method for maintaining investor confidence in the integrity of the financial services market. In
the UK, unlike in France and Germany, small investors had very limited access to the hedge fund sector and the policy makers, after ‘discussion’ with a cross section of economic actors, found no reason to amend the rules.

The principle objectives of financial regulation are shared by the three regulatory regimes under observation. Prevention of a financial crisis, preservation of a sound financial system and protection of the consumer encompass the general goals and fall into two regulatory categories, prudential regulation and conduct of business regulation, which were described in chapter 1. The trend that had begun in all three cases in the mid 1980s, and which continued through the 1990s and into the twenty first century, towards privatising savings and investments, resulted in structural shifts in the market and placed regulatory reform firmly on the policy agenda as state actors sought to design regimes that would ensure protection for the investor and maintenance of consumer confidence in the financial system through, *inter alia*, prevention of crises.

Turning now to the institutional arrangements and the relationship between the economic and bureaucratic actors. The study seeks to find out if an accommodating and symbiotic relationship exists, and the extent to which such a relationship can explain the variation in regime reform and design in each of the cases. The results of the analysis, summarised Table 6.1, show that accommodating relationships help to explain the hedge fund sector regulatory regime in France and the UK, but not in Germany. The analysis finds no evidence in Germany that the economic actors, either the small number of hedge fund advisers or the large incumbent investment
firms, lobbied for reform; nor does it find any evidence of the movement of personnel from BaFin to companies, or vice versa; and there is substantial evidence of regulatory and operational arbitrage suggesting the preference for getting around the extant domestic regulations, rather opting to lobby for change.

In the French case, the situation was quite different. The economic actors used a two pronged approach to press for reform. They both engaged in regulatory and operational arbitrage, and lobbied for change. The incumbent economic actors lobbied the regulators through the AFG; they also used the institutional arrangement of the Enarques network to engage in discrete communication with state actors, both the elected and the appointed, to press for a new hedge fund sector regulatory regime. The interests of the state and economic actors were aligned: both sets of actors believed that a revised regime would provide the French financial market, and the domestic economic actors, with comparative economic advantage going forward. Both sets of actors had incentives to introduce new hedge fund regulations, and France's unique institutional arrangement, the Enarques network, facilitated the policy by providing a common foundation for the development and maintenance of accommodating relationships between the economic and state actors.

In the UK the decision not to reform the hedge fund regime and maintain the regulatory status quo was desired by the economic actors and accepted by the bureaucrats. The study concludes, on balance, that this was the result of an accommodating relationship between the economic and bureaucratic actors. This conclusion is in spite of the fact that the hedge fund sector's interest association only
established a lobbying function in 2003, that the sector had evolved successfully within but on the fringes of the regulatory regime, and that there was no obvious business rationale to request changes to the rules. As noted earlier, the contribution of the financial system and its economic actors to the UK economy is substantially larger than in either France or Germany. The UK has a large wholesale market, and is home to a significantly larger number of hedge fund actors than France and Germany combined. The country is also a beneficiary of the practice of regulatory arbitrage. These financial and economic developments had taken place within the exiting regulatory regime.

Like the hedge fund actors, the established incumbents did not want the regime changed. It was believed inter alia that keeping extant regulation would discourage, or even prevent the newer hedge fund advisers from encroaching on the incumbents’ territory and thereby increasing competition. The FSA’s practice of focusing its supervisory attentions on what it regards as the most important 3% of the regulated entities provides opportunity for the development of close relationships between the regulators and certain economic actors. The evidence of personnel moving from the regulatory agency to its ‘clients’, and the absence of the practice of regulatory arbitrage by the domestic economic actors, points to a regime designed by two sets of actors with an accommodating relationship.

Moving on to the third explanation globalisation, explicitly globalisation of the financial markets, the study finds evidence in all three cases of the link between globalisation and regulatory regime reform and design. Globalisation increases
competition and this raises concerns about the stability of domestic regulatory regimes. Globalisation had exposed the deficiencies of the French and German regulatory regimes to the state actors for two reasons: the domestic economic actors were engaging in regulatory and operational arbitrage, and foreign economic actors were not entering the respective regimes to set up operations therein. The hedge fund sector matters and globalisation is shown to be a strong explanation of why the UK engaged in no reform of its hedge fund sector regulatory regime, as well as why the state actors in France and Germany introduced substantial reforms.

The competition between different regulatory regimes creates opportunities for the nimble, entrepreneurial economic actors to engage in regulatory and operational arbitrage in order to manage their businesses more efficiently and competitively. Both France and Germany experienced the phenomenon as the ‘uncoordinated’ economic actors either exited the regime, or created investment and savings products in foreign regimes and subsequently made these investments accessible to consumers in their respective home countries effectively via a back door. In France the practice of regulatory and operational arbitrage was a cause for concern for the elected state actors for two reasons. Economic activity that should have been taking place in France was being conducted in foreign regulatory regimes. Secondly, the general public and other investors were able to access hedge fund investment products created outside France and over which the French regulators had limited authority and control.
In Germany too, the elected state actors were concerned that the country did not have a financial market that was representative of the country’s position in the world economy, and concluded that the existence of a vibrant domestic hedge fund sector was important to their economy. Further, these policy makers were concerned about protecting the consumers from the risks of investing in hedge fund products that had been created in other regimes and over which the German authorities had limited control. The UK, on the other hand, did not experience the ‘exit’ phenomenon and was a net beneficiary of this activity as foreign economic actors chose to establish operations within the UK regime. Further, it was home to the largest hedge fund sector in Europe and the second largest in the world, a characteristic which contributed to the fact that neither the economic nor the state actors saw reason to change the regulatory regime. This public interest rationale for encouraging and sustaining a vibrant domestic hedge fund sector, namely the importance and value of the sector to a national economy, could however be disputed on a number of grounds, especially in the face of the sector’s potential contribution to the accumulation of systemic risk as noted earlier. One basis for disputing the value of the sector is the potential limited tax revenue, because many of the actual investment funds are established in offshore jurisdictions with low taxation. Another basis for dispute is the number of jobs created, because the majority of firms are small relative to the so-called traditional investment management companies.

Nevertheless, policymakers always have to balance the potential risks and rewards of public policies. Systemic risk may be mitigated, if not prevented, with access to both information and the material economic actors in the financial system. The hedge
fund sector's role as an important liquidity provider to the financial markets, and the
globalisation of these markets which means inter alia that a problem in one country
can quickly spill over into another, suggests that if policymakers want to influence
the behaviour of the economic actors in the sector, they need access to the hedge fund
firms and their counterparties, as well as to an agreed amount of information
concerning their investment activities. It is more difficult to have this access and
information gathering capability if there is not a domestic hedge fund sector. With
regard to one of the policy rewards, job creation, the majority of hedge fund firms
have a policy of outsourcing many of the tasks required to maintain a sound business.
For example, while the investment management activities are done internally by
partners and employees, other requirements such as legal, accounting, compliance,
information technology and marketing are delivered by specialist external service
providers. Moving on to another policy reward, taxation, each economy taxes the
hedge fund firms and the investors in their funds according to the national taxation
code. And for some firms and investors, the opportunities for tax arbitrage are
extensive. However, it is the responsibility of the state actors to devise public
policies that provide incentives for the economic actors to establish and develop
businesses, which do not impair and, ideally, will enhance the government's ability to
achieve its economic and social welfare objectives.

All three countries responded to the pressures brought about by globalisation with the
same objective, but by using different policy tools. The objective of the policy
makers is to promote each national financial centre and strengthen its
competitiveness. In the UK they opted to maintain the existing approach to hedge
fund sector regulation; in France and Germany, on the other hand, the policy makers, particularly the elected state actors, opted to introduce extensive regulatory reform. The world’s financial markets have long been characterised by competition among economic actors, and tension between increasing global market integration and national policies of regulation. Political and financial market borders which, until the reforms that began in the 1970s in the aftermath of the collapse of the Bretton Woods agreement, were one and the same, have progressively diverged in the face of globalisation presenting policy makers with substantial challenges.

The state actors’ authority and legitimacy derive from being elected by individuals whose right to vote is defined, *inter alia*, by their residency and/or domicile in a nation defined by physical borders. Financial market borders are indistinguishable from political borders in the context of a regulatory regime’s objective to protect the investor. However, when it comes to the objective of protecting the market from systemic risk, the cross border activity of the economic actors render the financial market borders permeable and can expose each set of national policy makers to unexpected challenges. Unexpected challenges result from the fact that increased integration of financial markets may increase systemic risk through contagious financial crisis that originates in a foreign financial centre over which the domestic regulator in France, Germany or the UK has no authority; ‘the efficiency of global financial markets, engendered by the rapid proliferation of financial products, has the capability of transmitting mistakes at a far faster pace throughout the financial system

---

176 The Bretton Woods agreement fixed the exchange rates for major currencies against the US dollar and restricted the movement of capital. In 1971/73 the Bretton Woods agreement collapsed and a new financial world order emerged.
in ways that were unknown a generation ago’ (Greenspan, 1997). The footloose hedge fund sector has been both creator and beneficial user of many of the structural changes and developments that have taken place in the markets which in turn have resulted in the proliferation of new financial products to which Greenspan refers.

The final explanation analysed in the study to try to resolve the puzzle is Americanisation. One of the elements of Americanisation as an explanation is the behaviour of the American economic actors. To this researcher it is curious that, outside the UK, this variable is of very limited value as an explanation. It is curious because the hedge fund sector is an American creation and continues to be dominated by American economic actors. Since its inception in the US in 1949 with a single entrepreneurial economic actor, the sector has grown considerably to become a vital segment of the world’s financial services system and US based hedge fund advisers account for 75% of the sector. It is, therefore, not unreasonable to suggest that there will be considerable American influence on both the practices of the economic actors in the sector and on the rules and regulations that govern activity in the sector.

Analysis of the empirical evidence regarding the practices of the economic actors suggests that Americanisation has been a strong influence on the development of the sector in the UK. Business practices were transmitted from the US to the UK primarily because of the powerful position of US firms in the UK financial market brought about by the regulatory reforms of the mid 1980s, and because almost all of the American hedge fund advisers, and their related service providers, that have chosen to establish operations in Europe have done so in the UK. However, there is
no proven link between regime design and Americanisation in the form of either copying or taking elements from the US regulatory model.

Contrary to the findings in the UK, the regulatory changes in France and Germany cannot be explained directly by the actions of the American economic actors. Although a perfectly healthy hedge fund sector had developed in France prior to the reforms, few American firms opted to set up operations in France; and many of the country’s domestic economic actors opted to establish their main hedge fund operations in the UK. The practices of the French firms may have been subject to Americanisation on the basis that the hedge fund investment approach is an American phenomenon and was adopted by many French companies, but the regulatory regime and its reform were not influenced by the American economic actors.

Further, as the data in chapter 1 show, the size of the hedge fund sector in Germany was (prior to the regulatory reform), and still is, de minimus. The small number of American economic actors in the German sector and the size of the asset base that they serve do not suggest a strong American influence. Had the American hedge fund advisers and their economic apostles selected Paris and/or Frankfurt as their European location of choice, this element of the variable may have carried more weight.

The second element of the Americanisation hypothesis, the influence of the US regulatory model on the national regulations in each of the three cases, is weak. This situation is somewhat incongruous particularly because the evidence in the empirical
chapters shows that one of the main reasons for introducing radical new hedge fund sector regulations in France and Germany was to enable and encourage the sector to develop and expand in each case. As the US financial markets have the largest and most successful hedge fund sector, it is not unreasonable to suggest that the designers of the regulations in France and Germany would seek to incorporate some or all of the elements of the US regulatory regime into their respective regimes. This did not take place.

Financial crisis and globalisation have been shown to be the most powerful of the four explanations. Both are linked to regulatory regime reform and design in all three cases. This is not that surprising because globalisation of financial markets results in greater integration which, in turn, means that a financial crisis that originates in one financial centre can spread, like a contagious disease, to other financial centres. The economic actors took advantage of the opportunities offered by the market globalisation, and the state actors responded. The varied responses of the state actors were underpinned by the public interest: the public interest in having a vibrant and competitive financial centre which would benefit not just the financial sector, but the broader economy as well; the public interest in trying to achieve the twofold objectives of protecting the domestic economic actors while encouraging the participation of foreign economic actors; the public interest in protecting the consumer, both her wealth and confidence in the system; and the public interest in preserving systemic stability by preventing financial crises.
In the course of conducting this study, a number of interesting patterns and themes about the politics of financial regulation have emerged, and it is to these findings that the study now turns.

Patterns and Themes

The investigation of this regulatory regime puzzle has identified three distinctive patterns and one particular theme that are likely to be of interest to scholars and practitioners in the field of regulation, particularly financial regulation, and policy making. The first of the patterns is the evidence of the tension between principles based and prescriptive rules based regulation which shows a possible shift towards the former approach. The second is the continued strength of national level regulation in the face of external pressures; evidence of continuing divergence in conduct of business regulation, but convergence in prudential regulation. Thirdly, there is a pattern of closer inter regulatory regime cooperation through formal communication and information sharing. The theme to have clearly revealed itself is the value of carving out the hedge fund sector from the rest of the investment services regulatory regime. The study will proceed with an analysis of each pattern and the theme and consider the implications of each. It will then turn to the lessons that can be taken from this study that may be of value to students of regulatory policy and to comparative political scientists, and conclude with some suggestions regarding avenues for further research.
Principles versus Rules

The tension between principles based and prescriptive regulation cuts to the core of how regulatory regimes can be designed to best meet their objectives. Should the state actors assume that all economic actors in the investment services sector are potential cheats and therefore devise a rule book with multiple volumes listing what can and cannot be done and if it can be done, how it should be done? Or, should they assume that, on balance, the large majority of economic actors are honest and will operate with integrity within the framework of a regime based on the principle of fair play? The debate is multidimensional; neither the regulators, which includes the elected and bureaucratic state actors, nor the regulated firms can be categorised as unitary actors each with its aligned preference. Within each group the preferences diverge. The principal cause of this divergence is the issue of who takes responsibility in the event that something goes wrong.

Starting with the economic actors, the front line personnel charged with the task of creating and managing investment products, and of finding investors for these products want as much flexibility as possible to achieve their goals. They prefer to be guided by broad principles the interpretation of which may vary across firms. However, the firms’ compliance personnel and the firms’ legal advisers generally prefer rules based regulation which provides certainty and is not ambiguous and open to interpretation.
This stress between rules and principles exists also among the architects and managers of the regulatory regimes. None want to be liable in the event of a scandal or crisis; and in the risk averse culture that is exhibited across the regimes, the easiest method of prevention is not to allow 'it' to be done. The regime designers are challenged with finding the right balance between protecting the investor and sterilising the sector. If the economic actors are not able to engage in their desired business activities there will, by definition, be no scandals and investors will be safe. Too much regulation, however, can stifle innovation and market competitiveness which is a concern for policy makers across many sectors of the economy, not just the financial sector. Too many rules also provide excellent opportunities for the more ingenious and creative economic actors. The more prescriptive the nature of the regulation the easier it is to get around.

The study confirms that it is virtually impossible for a rules based regulatory regime to fulfil its objectives. This is because in a fast changing and increasingly global and integrated financial market place the regulations simply cannot keep up with the innovative product development and related activity perpetrated by the economic actors. This has led to an interesting development in some regulatory regimes. Regulators need to know where to focus their resources because they do not have the resources to focus on all aspects of every regulated firm's activities. This policy challenge is resulting in a gentle shift away from prescriptive, rules based regulation to a more principles based approach. In the UK, and to a lesser extent in Germany, there is a shift to more of a risk based approach to regulation which is focused on the outcome rather than on the process. This involves prioritising the sectors of the
financial market and their related economic actors, and allocating information gathering and surveillance resources accordingly. The prioritisation is done on the extent to which the economic actors in a given segment of the financial market pose risks to the regulator in meeting its objectives.

This means that the regulator focuses its resources specifically on certain firms rather than equally on all firms. As noted earlier, the regulators in the UK focus their attention on some 3% of the regulated firms whose activities are deemed to represent an estimated 85% of the overall financial services market. Using such a risk based approach is not as straightforward in France because the legal system derived from the Napoleonic code, means that the regulators cannot legally differentiate between one firm and another. Each firm must be treated with the same regulatory intensity irrespective of its size and share of the market.

The implications are considerable and affect the type of regime that is created and its ability to serve as a tool of competitive economic advantage. A highly prescriptive regime requires formidable human and financial resources to register and supervise all the economic actors, small and large, on an equal basis. The bifurcation between principles and rules is related to the distinction between prudential regulation, which is increasingly principles based, and conduct of business regulation, which continues to be heavily rules based.

This distinction draws our attention to two important issues for the politics of regulation. The study addresses inter alia the extent to which the powers of national
regulatory regimes are, or are not, being reduced in the face of external pressures such as globalisation. Principles based regulation is increasingly being initiated outside the national regulatory regimes, a trend which started in the banking sector with the Basel Capital Accord in July 1988 (Basel I) and which is expected to continue in the broader financial services market including the hedge fund sector. Conduct of business regulation, on the other hand, is still very much grounded and designed within national regimes.

Since Basel I the prudential regulatory standards for the banking sector have not been determined at the level of the national regulatory regime. Conduct of business regulations, however, continue to be crafted at the national level. These developments have important implications at the macro level for the scope and authority of national regulatory agencies, and at the micro level for hedge fund sector regulation. The study will now turn to address both of these issues starting with the effects of challenges to national regulations.

National Regulations and Challenges

The three cases under observation in this study are subject to many of the same pressures. This study has identified market globalisation as a major factor in explaining hedge fund sector regulatory regime reform and design, and it is against the pressure of globalisation that this section considers the position of national regulation. It is intuitive to expect national regulatory regime convergence in the face of common pressures. However, the study has shown clearly that there is continuing
pride in distinct national regulatory regime design in spite of this external pressure. A high quality national regime should be a boon to both the financial services sector and the economy as it fosters competitive activity from domestic and foreign economic actors alike. Quite simply, a well respected regulatory regime is regarded as an economic advantage. But the rationale for the maintenance of distinct national regulatory regimes is based on more than prestige and designing an institutional competitive edge. Political self-interest also plays its part.

A survey of French citizens at the turn of the twenty first century found that in the face of globalisation and the effects of the phenomenon on the French economy, the French government should be responsible for designing and implementing the rules and regulations needed to protect France (Sofres, 2001). François Hollande, at the time leader of the French Socialist Party, quoted in the survey’s findings sums up the tension between globalisation and national regulation and its broader policy and political implications;

‘at a time when the nation state is supposedly unable to face the challenges of globalisation, it is still invested with responsibility to regulate a phenomenon which lies beyond its reach. The contradiction poses a formidable problem for political decision makers ... neither Europe nor international institutions, however relevant their framework might be for such regulation, are considered sufficiently effective or democratic’ (Sofres, 2001).
The maintenance of unique national regulatory regimes serves to maintain state sovereignty and democratic legitimacy. The state actors are able to use the regulatory regime to act as an institutional filter to globalisation thereby enabling them to control the impact of this pressure on their political economy and, in so doing, claim to champion the interests of the citizens. National institutions, both the political and the economic, as well as national characteristics can function as powerful filters of globalisation by providing restrictions and opportunities for domestic and foreign economic actors alike. Academic analyses of the effect of globalisation on the state fall into two distinctive groups. On the one hand the state’s authority is restricted and undermined; on the other its authority suffers no material negative impact. The theoretical economic rationale for those who argue that globalisation diminishes the power of the state is simple; as markets become more integrated, the competition between the economic actors increases resulting in firms exiting the home regime and opting to locate in an alternative regime with preferred institutional characteristics such as regulation. But, as this study has demonstrated, the very action of the economic actors engaging in such regulatory and operational arbitrage was a prime catalyst for regulatory reform in France and Germany. Further the evidence shows that the state actors in both cases were motivated inter alia by the desire to create first class national regulatory regimes, and to create hedge fund sector regulations that would enable the growth of the sector in each country and provide investors with well protected access to one of the most innovative groups providing investment products. Within the sphere of financial policy making and regulation, the nation state seems to be alive and well.
The introduction of hedge fund sector regulations in France and Germany was, in part, supposed to modernise the respective regulatory regimes and provide investors, who are being encouraged to use the private market to invest and save, with more choice. It was also about providing better investor protection. Although at this stage it is too early to draw any firm conclusions regarding the outcome of the regulatory reform, a preliminary examination of the hedge fund sector in each country since the introduction of the new regulations shows little change concerning the size of the sector in terms of money under management and the number of economic actors, despite continued growth in the sector worldwide. This study argues that this is, to an extent, a function of the specific regulations. Other institutional characteristics that may influence the economic actors' incentive to establish or expand operations in a particular country, such as taxation and the ready availability of skilled personnel and expertise, cannot of course be ignored; the size of the sector in the UK is a function of both regulation as well as additional institutional characteristics. However, the highly prescriptive nature of the regulations in both France and Germany has had two unintended consequences.

It is more difficult for the small, domestic entrepreneurial firms to establish as hedge fund advisers than before the reforms, and few foreign firms have elected to establish operations in either country. The rules that were designed by the state actors to enable a vibrant and competitive domestic market in the sector and thereby provide French and German investors with access to home grown innovative investment products, have fallen short of their objectives. The hedge fund economic actors are nothing if

177 Lipper TASS Hedge Fund Database
not opportunistic, dynamic and mobile; the growth of the number of foreign economic actors in the sector in the UK is evidence of this. If the new French and German regulations enhanced the possibility of hedge fund advisers expanding their businesses, many of them would have set up shop in Frankfurt or Paris. In fact, the regulations in Germany are so prescriptive that it is unlikely that any premier league hedge fund actors will establish businesses in the country with the net result that the German investors will suffer from less choice. While it has been observed that France now has the most advanced hedge fund sector regulations in Europe, the minimal growth in the size of the sector since the reform suggests that the regulations are too onerous and prescriptive. In both countries the state actors have delivered a double protectionist policy with the regulatory regimes that have been created; protection of the consumer, and protection of the domestic economic actors.

Globalisation of markets can be good for economic and social welfare because it has the potential to make an extensive range of products and services available to individuals all over the world. However, differential access, which is generally determined by national regulation, can create inequalities. This is not limited to whether an individual has a broad choice of savings and investment products that may or may not include hedge funds. Differential access is evident in other sectors of an economy such as health care, whereby drugs and medical devices for diagnosing

---

178 Lipper TASS Hedge Fund Database
179 One of the requirements of the regulations is that hedge fund advisers provide the regulators with total portfolio transparency. Premier league advisers are able to maintain and grow their businesses without needing to establish operations in a regime with regulations that could undermine their financial standing and market position. If the market knows how an adviser’s portfolio is positioned, the adviser no longer has the same edge
180 Interviews in Paris: AMF, 28th February 2006; AFG, 28th February 2006 and Senior Executives at multiple Economic Actors, 28th February, 20th and 27th April 2006

242
and curing illness are available only to individuals whose governments allow access to the ‘technology’. Globalisation of markets, whether it is in the financial sector or the health care sector, inherently pushes for regulatory consistency and harmonisation; yet national governments must have the freedom to regulate as they see fit. One of the many challenges to policy makers is to find the right balance between the two competing goals in order to best serve the interests of their respective publics.

What does this challenge mean for regulation of the hedge fund sector? The study has established that all national regulators have the same fundamental objectives. They seek to protect the consumer, to prevent financial crisis and to maintain confidence in the financial system. A healthy and vibrant financial services sector benefits the whole economy because every other sector in the economy is dependent upon it. The hedge fund component of the financial services sector has become very important because not only is it intermediating an increasing amount of people’s savings, it has also become a substantial and growing provider of liquidity to the world’s financial system.

The evidence evaluated in this study suggests that the regulation of the hedge fund sector is likely to both converge and diverge. Variation in the element of regulation that is focused on conduct of business and consumer protection is expected to continue as each nation devises its own rules to best safeguard its citizens and its perception of their best interests. The net result is likely to be continued cross national differential access to the sector which may or may not exhibit related
variation in social and financial welfare in the future. The element of regulation that focuses on systemic risk issues, however, has started and is expected to continue to converge. This type of regulation is not expected to be created exclusively at the national level; it is being created, in the style of Basel I and its successor Basel II\textsuperscript{181}, extra territorially through the cooperative collaboration of national regulatory agencies.

\textit{State Actors, Knowledge Diffusion and Inter Regulator Co-operation}

The study produced evidence that shows a pattern of growing communication between different national regulators. An effect of this closer communication is the sharing of information, diffusion of knowledge and more regulatory consensus. This inter regulator communication is not accidental or informal; it is state sanctioned. In 1983 the International Organization of Securities Commissions (IOSCO) was founded. IOSCO’s members are financial market regulators from over 100 countries. The organisation aims to enhance the prudential regulation of financial markets at both the domestic and international levels by encouraging information sharing and cooperation\textsuperscript{182}. In June 2001 the Committee of European Securities Regulators (CESR) was established. CESR has three main objectives\textsuperscript{183}. The first is to improve coordination among EU member states’ securities (investment services) regulators; secondly, to act as an advisory group in assisting the Commission; and thirdly, to

\textsuperscript{181} Basel II was implemented in 2006
\textsuperscript{182} www.iosco.org accessed July 2007
\textsuperscript{183} www.cesr-eu.org accessed July 2007
work to ensure more consistent and timely day to day implementation of EU financial services sector legislation in the member states. All of the members of CESR are also members of IOSCO.

Both organisations recognise that inter regime cooperation and information sharing should strengthen their ability to promote and maintain efficient and sound markets with high regulatory standards, and to prevent market failure. The overarching focus of the standards and guidelines is on regulatory principles and the prudential aspect of regulation. IOSCO standards are gaining broader recognition and national regulatory regimes are increasingly being examined against them. For example, when the International Monetary Fund (IMF) reviews the adequacy of financial supervision and enforcement in certain national regulatory regimes it uses IOSCO standards as a benchmark against which to make the comparison. Like the Basel standards and guidelines, the standards published by IOSCO are neither legally binding nor enforceable, but the evidence shows that they are increasingly being acknowledged and accepted by both policy makers and national regulators.

One of the effects of inter regulator co-operation is likely to be a shift in the established relationships at the national level between the bureaucratic and economic actors. One of the long standing drivers of these established relationships is the information asymmetry that exists between the regulated and the regulator, which means that the regulator needs to communicate with and consult the economic actors in order to reduce the knowledge imbalance. As national regulators share information

184 Interview with Senior Executive at FSA, 6th April 2006
and cooperate with one another on an international level, it is possible that their need to establish close relationships with their regulated entities at home is reduced.

The rationale for this pattern of closer communication between national regulatory agencies, consequential knowledge diffusion and cross national coordination, take us back to the goals of regulation and the challenges presented by financial crises, market globalisation and other pressures. The study has shown that the variation in hedge fund sector regime reform and design has been determined to a large extent by the state actors’ fear of a financial crisis, as well as their response to the effects of globalisation on their respective financial markets. The issue of globalisation and its effect on the domestic political economy is not a hedge fund sector specific phenomenon; it is driving regulatory developments across the whole financial services market. The study now moves on to discuss an important theme that has been raised in the course of conducting this research.

*Regulatory Carve-outs*

It has been noted earlier that one of the levels of cross national variation in the hedge fund sector regimes is whether or not the sector is regulated separately from the rest of the investment services sector. France and Germany have separate regimes, the UK does not. During the course of the interviews conducted to gather data for this study, this issue was raised frequently. What are the public policy benefits of distinguishing between similar but different types of economic activity within the investment services sector? How relevant and meaningful is it to separate hedge fund
investments from other, more so-called ‘traditional’ investments such as mutual funds? The goal of all investment managers is to generate positive investment returns for their consumers. As in any open and competitive market, there is considerable variation in the methods used by these economic actors to achieve this goal. It is possible to argue that the hedge fund sector regulations, variable as they have been shown to be, as they currently stand generally discriminate against a particular group of consumers, in this case the general public. The policy makers have fostered the privatisation of risk but they have controlled access to a legitimate sector of the investment services market on the grounds of protecting the consumer, the rationale for which is the perception that one type of investment is more risky than another type. It is well beyond the scope of, and relevance to, this study to comparatively examine the multiple variant investment products to which the public is allowed access or is prohibited from accessing. The study’s concern lies with the logic, and the actors that support this public policy, of carving out a segment of the investment services sector for specific regulation. This is an issue that has policy implications beyond the sector under analysis.

As this study has described, the hedge fund sector evolved on the fringes of the more established investment sector within the different national financial centres. In France and Germany the hedge fund sector is regulated separately from the rest of the investment services sector. In the UK all investment services firms are regulated within the same regime. In chapter 4 this research has suggested that one of the reasons for the separate sector regimes in France and Germany is a consequence of the bureaucrats recognising an opportunity to seek to maximise their own institutional
power and regulatory authority. This has public policy implications beyond the investment services sector as regulatory carve outs are not unique to this sector.

For example, separate intra-sector regulatory regimes are exhibited in the regulation of the healthcare sector, in which there is variation in the regulation of ‘traditional’ medicine and homeopathic medicine. The practice is also evident in the gaming sector wherein the regulation of the established bricks-and-mortar casinos and on-course gaming varies from the regulation of online internet and mobile telephone gaming. In all the sectors mentioned in this research, market developments are blurring the established and previously accepted boundaries between products and services such as investments, and these developments raise questions about the viability of the rationale for, and institutional structure of, the regulatory approach. In essence, they question both the regulatory regime’s orientation and its organisation and whether the regime’s resources are being allocated in the most effective way.

**Closing discussion**

This study has sought to find answers to the question of what drives financial regulatory reform and why national variation in regulatory regimes persists in the face of common pressures resulting from increasingly interconnected financial markets and economic activity therein. It has sought to identify some of the reasons for the variation in regime design primarily by looking at the causal drivers of reform. The window through which the investigation has been done is one of the most dynamic and fastest growing sectors within the world’s financial system. Having
considered some of the policy implications raised by the findings of the research, and without wishing to repeat the discussion presented in chapter 2, a recap of the explanations and the theories that have framed and guided the research will add to what the researcher hopes is a valuable contribution to the study of the politics of regulation. The study has identified four explanations of regulatory regime reform and design. Each of these, financial crisis, institutional arrangements and relationships, globalisation and Americanisation has been tested as a determinant of reform and linked in this study to one or more sets of actors; the role of these state and economic actors has been looked at with the supposition that their actions may have been guided by either the public interest or the private interest theory of regulation.

The study shows that in all three cases that both financial crisis and globalisation of the financial markets are each linked to regulatory regime reform and design, and that such policy action is driven by the state actors motivated to respond and act in the public interest. That there is evidence supporting both explanations in each of the three countries is not unexpected. One of the possible effects of globalisation is the speedy transmission of a crisis from one national financial centre to another.

It is clear from the findings of this study that Moran’s (1991) finding, that regulatory regimes can be highly valuable institutional tools of comparative economic advantage, remains extremely valid. The regulatory reforms in France and Germany, and the maintenance of the status quo in the UK, were powerfully driven by the state actors’ desire to regain or sustain a competitive edge. The pressure of market
globalisation can have the effect of diminishing a nation’s position in the world’s economic and financial systems and, in support of Cerny’s (1989) conclusion regarding the importance of national self-esteem in his analysis of the regulatory reform in France in the 1980s, this study finds that the state actors in each country were motivated to a considerable degree by national pride. It is, therefore, not surprising that the influence of these two factors, recognition of the regulatory regime as a tool of competitive economic advantage and national self-esteem in the face of the force of globalisation, resulted in the design of distinctly national hedge fund sector regimes providing support for Lütz’s (1996) thesis that it is inappropriate to assume that the autonomy of state actors will necessarily be weakened by globalisation. The reforms in France and Germany may have been determined and led by the state actors, but Laurence’s (1996) assertion that a primary catalyst for reform is the footloose action of the economic actors is strongly supported by the evidence.

The economic actors’ role in the regulatory reforms and regime design is also in evidence in two of the three cases, but through a different approach. This refers to the existence of an accommodating institutional relationship between the economic and appointed state actors who use this relationship to achieve the desired regulation, underpinned by the private interest theory. The study finds that this relationship is linked to the regime reform and design in France, and to regime design in the UK. The study finds no evidence of such a link in the German case.
Regarding the value of Americanisation as an explanation, the evidence is weak. In spite of the fact that the hedge fund sector is an American phenomenon and that the sector is dominated by American economic actors, there are no findings to suggest that either the regulatory reforms in France and Germany were caused by the Americanisation of the sector, or that the design of the two regulatory regimes was based on the US model. The findings in the UK, however, are different; there is evidence that the presence of the American economic actors is linked to the development of the sector, helping the UK to become a substantial centre for hedge fund advisers and their activities. The study found no evidence, however, that the UK sector's regulatory regime was modelled on the US regime.

This research has sought to explain regulatory policy outcomes by comparing the hedge fund sector regimes in three different countries. Its findings confirm that a financial crisis catches the attention of policy makers and provides the justification to the elected state actors to reform the regime. Its findings also confirm that the globalisation of the markets presents the state actors with a dilemma: this dilemma raises the problem of how the state actors ensure that their economies and the private actors therein, can reap the benefits of globalisation without compromising the state's ability to continue to pursue national objectives. In each case the response to the pressure of globalisation was to design a unique regulatory regime to encourage the participation and activity of the economic actors, domestic and foreign. The regulatory regime is considered a valuable tool of national economic advantage.
Perhaps the most theoretically significant aspect of this study is that it demonstrates that private interest theory, at the core of which is a symbiotic and accommodating relationship between the economic and the state actors, is alive and well. Globalised markets and their facilitation of footloose economic activity suggest reduced need, certainly on behalf of these economic actors, of close relationships with the regulators. Further the growing transnational communication between regulators, and the knowledge sharing resulting from such communication, suggests that the information asymmetry between the regulator and the regulated is reduced, thereby making it less important for the regulator to have close relationship with the firms. Economic actors have been shown to have the power to place pressure on the state actors and influence regime design using two methods: they can exit, and they can talk.

This research is being finalised at the time that the worst financial crisis since the 1930s is unfolding providing students of regulatory policy specifically, and public policy more broadly, with a number of research avenues to pursue. The dust will settle and the world’s financial system will find a new equilibrium, but what of the regulatory regimes which are being blamed for not preventing, and for enabling, the economic activity that has resulted in the financial crisis? Specific economic actors are also being singled out for blame. The activities of the hedge fund actors, explicitly the practice of short selling, are being blamed currently for the collapse of the financial firms. Some of these firms have been bailed out privately, some have been nationalised and others have been left to go bankrupt. The collapse of these firms has contributed to almost freezing the world’s credit markets, as well as to the sharp fall
in the world's stock markets, both of which are having a profound effect on the global economy. What does this mean for the regulation of the hedge fund sector? To try to answer this, two questions first need to be addressed. At the hedge fund sector level, whether or not there is a causal link between the practice of short selling and financial crisis; and more broadly, the extent, if any, to which national financial policy and regulation caused the crisis.
Thesis References


Eichel, Hans. 28 April 2005. Address to the Euromoney German Capital Markets Forum in Berlin


Ladi, Stella. 2007. “Globalization and Europeanization: Analysing Change”, paper presented in panel 162 at the 57th *Political Studies Association Annual Conference Europe and Global Politics*, 11-13 April, Bath, UK


Lipper Hindsight Database. Lipper Limited, a Reuters Company. London, New York

Lipper TASS Hedge Fund Database. Lipper Limited, a Reuters Company. London, New York


Mer, Francis. 2003, 29th April. “Projet de loi de sécurité financière”, speech presented by the Minister of the Economy, Finance and Industry at the National Assembly, Paris


Appendix

Interviewees

ADM Investor Services - Chief Executive
AFG - Senior Executive
AMF - Managing Director as well as another professional
AIMA - Chief Executive
Altigefi SA - Chief Executive as well as Investment Director
AXA Investment Management - Senior Executive
BaFin - Senior Executive
BNP Paribas - Senior Executive
BVI - Chief Executive
CESR - Chief Executive
Credit Suisse - Managing Director
Dawny Day - Chief Executive
Deutsche Bank - Head of Research as well as a Managing Director
Dexia – Two Senior Executives
European Commission - Commissioner
Exane - Investment Director
FERI - Investment Director
FIM - Chief Executive
FSA - Senior Executives
Futures & Options Association - Senior Executive
Goldman Sachs - Managing Director
Harald Quandt Holdings - Investment Director
HED Capital - Chief Executive
HedgeFundIntelligence - Editor, InvestHedge
Lehman Brothers - Managing Director
Matrix - Director
Merrill Lynch Investment Managers - Chief Executive
NM Rothschild - Investment Director
Olympia Capital - Chief Executive as well as the Compliance Officer
Rothschild Financial Services - Chief Executive
RWC - Chief Executive
Sal Oppenheim - Investment Director
Simmons & Simmons – Three separate Partners
Societe Generale - Senior Executive
WestLB Bank - Senior Executive