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Hedge Fund Regulation in the European Union

Current Trends and Future Prospects

Phoebus Athanassiou



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To Virge

... è comune defetto delli uomini, non fare conto nella bonaccia della tempesta

(Niccolò Machiavelli, *Il Principe*, Capitolo XXIV)

PREFACE

This is a book published at a time of financial crisis, of uncertain depth and duration. The ongoing financial crisis and its fallout have highlighted several of the weaknesses of a host of previously unchallenged examples of 'financial innovation', calling into question the wisdom of the gradual deregulation of the financial services sector and drawing attention to the need for a review of contemporary financial markets regulation so as to fill perceived regulatory lacunae and, through that, restore confidence in financial markets. As this is a book on the regulation of financial services (however much focusing on a *sui generis* segment thereof) it is only fitting that a few lines be devoted, at its beginning, to the role of regulation in financial crisis-prevention and management as well as to some of the general conditions to be fulfilled in order for legal rules and regulatory proposals, whether those included in this book or any others, to develop their full potential.

While the ongoing crisis has shown some regulatory changes to be apposite, mainly in order to rein in the activities of hitherto unregulated but, nevertheless, not insignificant, financial market players (including hedge funds), to over-emphasize the role of regulation as a financial crisis-prevention and management tool would be to wilfully ignore two of the least palatable but, nonetheless, most fundamental lessons of the financial turmoil. One is that without robust enforcement by the competent supervisory authorities of the existing prudential supervisory rules (or those that may be put in place in the aftermath of the crisis) regulatory adjustments are unlikely to deliver their intended benefits; another is that without efficient, cross-border financial stability coordination and crisis management arrangements to pre-empt systemic events (or to, at least, mitigate their impact) even the most comprehensive and best managed regulatory regime is unlikely to fortify its constituency from the effects of an 'imported' crisis. As both of the aforementioned points are of a predominantly non-regulatory nature, overcoming the concerns that they raise postulates, over and above anything else, the political will to ring in, in time for

the next crisis, a number of fundamental institutional changes in the contemporary approach to financial supervision and cross-border cooperation as a necessary complement to some much needed improvements in substantive financial regulation.

Would the above suggest that yet another book on financial markets regulation (however topical its subject) might serve no useful purpose? Far from it. Rules are necessary to organize societal expectations of what market activities are acceptable and what business practices are tolerable and *new* rules are essential where those applicable from time to time are proven to no longer be optimally effective. What our preceding observations *do*, nevertheless, suggest is that, however necessary, rules are not, *per se*, sufficient to achieve the public good objectives underlying their adoption. Without sufficient resources to monitor compliance with the rules proposed in the pages of this (or any other) book and without a genuine network of cross-border cooperation to ensure that national supervisors have a global picture on the basis of which to determine how to go about implementing these rules or exercising whatever discretion these may allow, no rules, however perfect, can yield the results that their advocates might, however legitimately, expect them to.

Phoebus Athanassiou

29 January 2009

Frankfurt am Main

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The views expressed in this book are purely personal and are not intended to represent those of the ECB or the Eurosystem.

LIST OF ABBREVIATIONS AND ACRONYMS

AIMA	Alternative Investment Management Association
AUM	Assets Under Management
BSC	Banking Supervision Committee
CDO	Collateralised Debt Obligation
CESR	Committee of European Securities Regulators
CEBS	Committee of European Banking Supervisors
CFTC	Commodity Futures Trading Commission
CIS	Collective Investment Scheme
CRD	Capital Requirements Directive
CRMPG	Counterparty Risk Management Policy Group
CRT	Credit Risk Transfer
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	European Union Council of Finance Ministers
ECON	European Parliament's Committee on Economic and Monetary Affairs
EFAMA	European Fund and Asset Management Association
EFC	Economic and Financial Committee
EMU	Economic and Monetary Union
FoHF	Fund of Hedge Fund
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSF	Financial Stability Forum
FSR	Financial Stability Review
HFI	Hedge Fund Index
HFWG	Hedge Fund Working Group
HLI	Highly Leveraged Institutions
HNWI	High Net Worth Individual
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions

Hedge Fund Regulation in the European Union

ISD	Investment Services Directive
LOLR	Lender of Last Resort
MAD	Market Abuse Directive
MFA	Managed Funds Association
MiFID	Markets in Financial Instruments Directive
MWGED	Multidisciplinary Working Group on Enhanced Disclosure
NAV	Net Asset Value
NCB	National Central Bank
OECD	Organization for Economic Cooperation And Development
PWG	President's Working Group on Financial Markets
SAIVS	Sophisticated Alternative Investment Vehicles
SEC	Securities and Exchange Commission
SGP	Stability and Growth Pact
SMBS	Subprime Mortgage-Backed Securities
SRO	Self-Regulated Organisation
SWF	Sovereign Wealth Fund
TEC	Treaty establishing the European Communities
TEU	Treaty on European Union
UCITS	Undertakings for Collective Investments in Transferable Securities

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