Regulating Private Financial Institutions: How to Kill the Goose That Laid the Golden Eggs

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Abstract
Following the 2008 financial crisis, private financial institutions such as hedge funds and private equity funds have been faced with multiple calls for their regulation, both for consumer protection and systemic reasons. Various proposals for a new regulation have been made and are currently under discussion. The hedge fund community is also open to reasonable regulations. In this article, we discuss some of the key aspects of the SEC and the European Union proposals and argue that both of them suffer from severe shortcomings. An adoption in their current form would challenge the long-term viability of private financial institutions, particularly in Europe, and seriously reduce their benefits for investors and financial markets.

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Do you remember the old world of finance? It was primarily made up of public financial institutions with well-defined economic functions. For instance, commercial banks took in deposits and granted loans; investment banks dealt with corporate finance, mergers and IPOs; brokers/dealers traded securities on behalf of their clients; insurance companies underwrote policies and bought corporate debt; mutual funds managed diversified stock and bond portfolios; etc. Each of these economic functions was strictly supervised by a designated regulator and, until recently, competition between different kinds of institutions or between different economic functions was extremely limited – if not prohibited. The situation changed only in the past 20 years, when governments eliminated barriers to cross-border capital flows and opened their domestic markets to foreign financial institutions, producing an increasingly integrated world of public financial institutions.

In parallel, private financial institutions progressively developed over the years. They were typically smaller firms set up by former investment bankers, traders, asset managers, innovators, or risk-takers who wanted to escape from the limits set by larger public financial institutions. Their primary activity was to advise private pools of capital such as hedge funds, private equity funds, or venture capital funds. Unlike their public cousins, their mandate was usually broad, so they were able to engage in a variety of activities. Most of them were legally set up as limited partnerships or as offshore companies, structures that were flexible enough to allow the exploration of experimental and innovative investment approaches. Their capital was essentially provided by wealthy private individuals and more recently by institutional investors.

Positive contributions by private financial institutions to their environment include increasing market efficiency by engaging in extensive research before taking significant positions and enhancing market liquidity by actively trading around their positions and stabilizing financial markets by acting as the buyers of last resort in a number of stressed situations. The long-term nature of their capital allows them to engage in corporate governance and restructuring activities, i.e., taking large positions in firms and then advocating organizational changes to enhance efficiency and returns for investors. Last but not least, they provide capital access to non-financial firms – an area increasingly deserted by public financial institutions struggling to deal with their regulatory capital charges.

In the good old days, private financial institutions were not really regulated. The common view was that as long as they managed the private assets of wealthy individuals the general public was kept aside and the financial system was not at risk, so there was no need for direct regulation. Policymakers and supervisors relied upon (i) indirect regulation through the interaction with regulated counterparties such as banks, exchanges, and broker/dealers, (ii) market discipline, and (iii) the promotion of standards of good conduct and best practices. Of course, the situation has been re-examined whenever there was a crisis, notably after the failure of Long Term Capital Management in 1998 and the collapse of Amaranth in 2006, but the conclusion always remained the same.

Then came 2008 and the most severe financial crisis since the Great Depression. As usual, such disasters provoke unseemly bouts of finger-pointing. Who should be blamed this time? As in Agatha Christie's "Murder on the Orient Express," the list of potential suspects is long and most of them have played a key role in the deed: from greedy bankers to foolish investors, from complacent lenders to irresponsible borrowers, from lax regulators to reckless financial engineers. How about private financial institutions? For years, many expected them to be the source of the next financial fallout. Well, this time, they were definitely not culprits but victims of the crisis. Unfortunately, politicians, pressed by angry electors that had lost a large part of their savings, needed someone to blame, in order to take rapid populist measures. Like the Rothschild and other banking families in 1930s Europe, private financial institutions became a convenient scapegoat...
for all current economic problems. Many regulators and politicians – who had failed to supervise and control the risk-taking behavior of their public financial institutions – teamed up against them and pushed for comprehensive re-regulation of private players and their activities, heavier taxes on their profits, clean up of the offshore centers, and serious limits for their compensation incentives, amongst other things.

The fight intensified due to a cultural clash between continental Europe, which has no real tradition of private financial institutions, nor a proper understanding of them, and the Anglo-Saxon world. During the G20 summit in April 2009, Luxembourg’s Prime Minister Jean-Claude Juncker recalled that the crisis had "started in the U.S." because "the Anglo-Saxon world has always refused to add the dose of regulation which financial markets needed." The French President Nicolas Sarkozy announced the death of "unregulated Anglo-Saxon finance" and the German Chancellor Angela Merkel declared that "with us, dear friends, Wall Street or the City of London won't dictate again how money should be made." Consequently, it is not surprising that the U.K., as the world's second-largest financial centre, is stepping on the brakes to defend its competitive position.

Such statements are worrying and seem to confirm the existence of short-term political agendas rather than long-term views. Whilst we ought to all agree that well thought out regulation, combined with appropriate and effective oversight, can potentially yield significant economic benefits for all, including private financial institutions, we must also be aware that impatiently thought out regulation is a sure path to wasting money and achieving nothing. In addition, the private capital behind these private financial institutions is fluid and could easily move to more favorable jurisdictions or, worse still, cease to be deployed in innovative risk-taking activities.

1. The Example of Short Selling Restrictions
An interesting illustration of recent and recurring regulator intervention is the case of short selling restrictions. Simply stated, short selling is a technique used by some private financial institutions such as hedge funds to profit from the falling price of a security. Essentially, the private financial institution borrows the security from a broker and sells it, on the understanding that it will buy it back at a later date (hopefully at a lower price) and return it to the broker.

Selling a security that one does not own outright has long elicited controversy. Proponents of the strategy claim short sellers provide a valuable service by identifying companies and industries that are overvalued by irrational investors, thus bringing their valuations down to earth. They can also enhance liquidity by increasing the number of potential sellers in the market. Opponents argue that short selling disrupts orderly markets by causing panic selling and high volatility and can even trigger market crashes. Short sellers have always been unpopular, primarily because their trades go against rising equity values. It is, therefore, not surprising that in the eye of the storm in mid-September 2008, the market authorities of several developed economies decided to adopt (for the most part on an emergency basis) a series of restrictions on short selling, ranging from complete short selling bans to additional disclosure obligations. Their goal was to curb the downturn pressure on financial stocks and prevent spillage to the entire market.

Officially, the ban was a success. Very few short sellers used the alternative mechanisms such as put options or synthetic shorts, consequently shorting activities declined substantially.

Encouraged by this success, a number of regulators have already announced plans to keep certain parts of their emergency short selling restrictions in place permanently. The key question is therefore: was the short selling ban really effective and does it make sense to turn what was an emergency regulation into a permanent one?
Recent research seems to suggest there is no evidence that the ban on short selling generated any benefits relating to the promotion of efficient, orderly, and fair markets. In fact, it significantly impaired market function to the detriment and cost of all market participants. For instance, Lioui (2009) shows the ban on short selling increased the volatility of off-limits stocks more than the credit crisis did. It also increased the frequency of extreme market movements and widened the off-limits stock price deviations from their fundamental values for the duration of the ban. Gruenewald et al. (2009) suggest that in the future, the SEC’s new short selling rules (Naked Short Selling Antifraud Rule and the elimination of the options market maker exception) are likely to have negative effects on market liquidity and thus on efficient price formation. They also criticize the enhanced disclosure regime of short positions proposed by the FSA because increased transparency could either reduce short selling activity or stimulate strategic behavior and herding. Despite this, the International Organization of Securities Commissions (IOSCO) recently released a statement calling for coordination between national supervisors to regulate short selling.

2. Private Financial Institutions: The U.S. View
Let us now discuss the political calls for broader and tougher regulation of private financial institutions. In the U.S., the Obama administration recently introduced the Private Fund Investment Advisers Registration Act of 2009. This Act essentially seeks to regulate all private funds and their advisers and provide regulators with more information on their activities. It is likely to supersede three older bills currently being examined by Congress and share the same goals.

The Private Fund Investment Advisers Registration Act’s content can be summarized as follows:

- **Compulsory registration** — All advisers to private funds with assets greater than U.S. $30 million would be required to register with the SEC under the Investment Advisers Act.¹
- **Required disclosure** — All private funds would be subject to strict record-keeping requirements, disclosure requirements with respect to investors, creditors, and counterparties, as well as regulatory reporting requirements. The SEC would be authorized to conduct regular, periodic examinations of such funds in order to monitor compliance with these requirements.
- **Stricter regulation for larger funds** — Larger funds that could potentially pose a threat to financial stability would become subject to the jurisdiction of the Federal Reserve and would have to meet specific capital, liquidity, and risk management standards.

The Obama administration has also introduced the Investor Protection Act of 2009, which essentially increases the SEC’s authority to prohibit sales practices, conflicts of interest, and compensation schemes that the it deems to be contrary to the public or investor interest.

These new regulations may be well intentioned, but there are several issues that could make them ineffective or even problematic. These include:

- **Extraterritoriality** — The U.S. view is that their rules should apply worldwide, including non-U.S. advisors, with no U.S. presence, which have U.S. clients. This contradicts the G30 recommendations of January 2009 and opens the door to dual registration requirements and conflicting obligations. Not surprisingly, some advisers have reacted by evicting all U.S. clients from their funds.
- **Lack of guidance** — The new legislation gives almost plenary authority to the SEC to regulate private funds and their advisers, but does not provide much legislative guidance. As such it sets the stage for “regulatory creep” that could result in increased costs and reduced investor returns with few real benefits.
- **One size fits all** — No distinction is made between the different types of private financial institutions. For instance, who could believe that venture capital or real estate funds might entail systemic risks?
- **Registration versus authorization/licensing** — Forcing investment advisors to register is obviously useful for maintaining records, but does it really protect investors? One should remember that Madoff was a registered investment adviser who had been monitored several times by the SEC.

¹ - Note that this had already been requested in an earlier bill proposed by Senator Grassley in 2007 and an SEC rule overturned in 2006.
• **Data protection** — Disclosing portfolio information to regulators is fine, but how can it be ensured that this data is not disseminated to a broader audience?

All these issues are now being examined and discussed by the Congress, which is tasked with reviewing and amending the proposal. Although the final conclusion is still unknown, most U.S. private financial institutions are already resigned to an onslaught of new regulations. For them, it is no longer a question of if but when and how. The next question is likely to be who, as the problem of overlapping supervisory agencies in the U.S. has not been addressed yet.

3. **Private Financial Institutions: The European View**

In Europe, the situation is quite different. Historically, the activities of European private financial institutions were either unregulated or regulated only by national laws. Consequently, a harmonized, comprehensive, and effective E.U. regulatory framework has been lacking. During April 2009, in response to the financial crisis, the European Commission proposed to establish such a framework through a new Directive on Alternative Investment Fund Managers (AIFMs).

The key provisions of this Directive are as follows:

- **Compulsory authorization** — All E.U.-domiciled AIFMs would need to be authorized by the competent authority in their home Member State. To be authorized, they must provide detailed information on their planned activities, the identities and characteristics of the funds managed, and their internal arrangements with respect to risk management, audits, valuations, and the safe-keeping of assets.

- **Service providers** — For each alternative fund it manages, an AIFM must hire an independent party to value its assets and an E.U.-based depository to custody them. The depository should be liable to the AIFM and the investors of the fund for any losses suffered resulting from its failure to carry out its obligations.

- **Capital requirements** — All AIFMs would have to hold a minimum level of capital to cover potential losses and redemptions. This capital would be proportional to the level of assets under management.

- **Reporting requirements** — All AIFMs would have to report to their relevant authority on the principal markets and instruments in which they trade, their exposures, performance data, and risk concentrations.

- **Disclosure requirements** — For each fund it manages, an AIFM would have to periodically disclose to investors the risk, return, and liquidity characteristics of the fund, the identity of its service providers, the risk management systems employed, the percentage of illiquid assets and side pockets, the level of direct or indirect fees and charges, as well as any preferential arrangements (side letters) provided to other investors.

- **Leverage rules** — If an AIFM manages a fund which employs a high level of leverage, further reporting obligations to its local regulator and investors would apply. Moreover, local regulators would also be given express powers to impose leverage limits. Currently, the Directive defines a high level of leverage as a debt to equity ratio in excess of 1:1.

- **Distribution rules** — All the AIFMs established and regulated in a Member State would be able to market their alternative funds to professional investors in other Member States, subject to a simple notification procedure. Marketing of non-E.U. alternative funds in the E.U. would be substantially restricted, unless the AIFM's home state had equivalent regulations and had signed tax information exchange agreements.

The proposed Directive obviously casts a wide net; it would apply to all funds that are currently not harmonized under the UCITS Directive. This includes not only hedge funds, private equity funds, and venture capital funds, but also real estate funds and commodity funds, whatever their legal form and their country of domicile.
Hastily prepared and published, without any real industry consultation, the Directive has generated considerable debate and concern. It contains several ill-considered provisions which are impractical and may prove unworkable, since they are in conflict with other existing financial services directives. It discriminates against alternative investment funds, introducing a form of protectionism which is unlikely to benefit E.U. investors, as it will significantly restrict the choice of funds in which they may invest. Moreover, given that 80 percent of the European alternative funds are managed in London, versus 3 percent in Paris, one may wonder whether the Directive should be seen as a blatant attack on the dominance of the U.K. financial system, inspired by resentment and rivalry from some continental countries.

Paul Myners, the U.K. Financial Services Secretary to the Treasury, asserted that it was easy for certain countries to make “political capital by demanding intrusive regulation of an industry of which they have little or no experience.” He views the Directive as potentially ambiguous and thinks it requires “major surgery” before any implementation. Surprisingly, his views are now shared by the AMF, the French financial market regulator. In contrast with the strictly pro-regulation stance of French President Nicolas Sarkozy, the AMF disagrees with several aspects of the Directive. Sweden, which currently holds the rotating E.U. presidency, has also called for changes in several areas – from the scope of the Directive and the definition of funds covered, to calculations of leverage and the way the new rules would interact with existing regulations. Clearly, the Directive still has a long way to go to meet its goals.

While European politicians are fighting to agree on what should be the future regulation, a large number of private financial institutions have already gone the extra mile and set up UCITS III versions of their funds. UCITS III funds can use leverage (up to 100 percent of net asset value) and take short positions via derivatives, which is sufficient to implement a large number of non-traditional investment strategies. More importantly, UCITS III funds are automatically afforded an E.U. passport, which means they can be marketed and distributed across borders to both retail and sophisticated investors – even though some of these investors are not allowed to buy offshore funds with the same strategy. Last, their taxation is more favorable in a number of jurisdictions. On the negative side, the costs of running these UCITS III funds are higher due to regulatory constraints, which means investors should adjust their return expectations accordingly. The benefits of UCITS III structures, therefore, seem to be more on the distributors’ and managers’ side.

4. Conclusion
The global financial crisis has put an end to the cozy environment in which private financial institutions have operated until now. Their regulation is no longer seen as a counterproductive element in otherwise perfect markets, but rather a prerequisite for a functioning global economy. The key success factor will be to strike an appropriate balance between investor protection, avoiding a systemic crisis, and maintaining free markets. It is indeed a difficult balance to strike and the danger of ending up with repressive and ultimately irrelevant legislation is high. This could result in the most conservative and safe financial markets in the history of capitalism, but these markets would be utterly devoid of any spark, innovation, or enterprise. Moreover, it would definitely kill the collaboration between private and public capital to finance the recovery of banks and other public financial institutions, as initiated with the Public-Private Partnership Investment Program (PPIP) in the U.S. 3

Surprisingly, although the U.S. and Europe seem to share similar concerns about the regulation of private financial institutions, there is not much evidence of international coordination to discuss concrete reform proposals. Hotly contested issues remain open. The European Directive, in its current form, is unacceptable – and therefore non-applicable – for the U.S. Perhaps this is a good

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2 - For instance, in the U.K., when both income and capital gains were taxed at up to 40 percent, offshore funds that did not qualify for capital gains tax (CGT) treatment were not at a significant disadvantage to their regulated counterparts such as UCITS Funds. This is no longer the case since the standard rate of CGT was reduced to 18 percent earlier this year.

3 - The basic principle of the PPIP is that the Treasury co-invests alongside private financial institutions to buy mortgage assets (both residential and commercial) off banks’ books.
time to recall a quote taken from the common declaration made by the Leaders of the Group of Twenty at the end of a recent G20 summit: “We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.”

4. References
- Lioui A, 2009, The undesirable effects of banning short sales, EDHEC Risk and Asset Management Research Centre