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Hedging its Bets: The UK and the Politics of European Financial Services Regulation

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Abstract

The paper considers whether we are witnessing a shift in European financial services regulation away from a 'market-making' to a 'market-shaping' paradigm after the global financial crisis. Through an in-depth examination of UK positions on new EU legislation regulating hedge funds and private equity firms, we suggest that the UK government strayed from its 'market-making' principles in supporting further regulatory harmonization and institutionalisation at the EU level. But this does not constitute a fundamental ideational shift. Instead we argue that UK leaders bet that they could shape this legislation to the benefit of the City of London and without sacrificing national regulators' autonomy, signifying more continuity than change.

Introduction

The bailouts of Greece, Ireland and Portugal have generated considerable debate about the Eurozone's framework for addressing the threat of sovereign default. Attracting relatively less attention, however, are a number of far-reaching European Union (EU) legislative actions to strengthen the regulation and supervision of the European financial services industry. One such initiative is the Alternative Investment Fund Managers Directive (AIFMD), proposed by the European Commission in April 2009 and passed by the European Parliament (EP) in November 2010. The AIMFD is the first EU legislation that regulates hedge funds and private equity firms, industries that were largely excluded from the European Commission's far-reaching 1999 Financial Action Plan. In addition, EU member states have set up a new European Securities and Markets Authority (ESMA) after a long series of parallel but related negotiations. The Paris-based authority has been granted more centralized authority than the horizontal supervisory committees it replaced. Both legislative developments point to a potential shift from a more 'light-touch' and principle-based regulatory paradigm, characterizing European regulation of this sector for the past two decades, to a more harmonized, rules-based model at the European level.

The initiation and passage of legislation overseeing the alternative investment industry is puzzling for several reasons. First, it is widely accepted that the banking sector, not the alternative investment industry, was primarily responsible for the global financial crisis. Blame has been targeted largely at financial firms who took on too much leverage to invest in risky financial products, as well as towards those who were supposed to rate and regulate them (see Sinclair 2010). Indeed, in its 2009

report setting out the causes of the crisis and recommended EU-level responses, the de Larosière Group explicitly absolves hedge funds of direct responsibility for the global financial crisis and recommends that existing national regulatory oversight of the sector is sufficient (de Larosière 2009: 24). Moreover, of the numerous reasons cited by the Party of European Socialists in their draft report to the EP calling on for tighter regulation of hedge funds and private equity firms, direct responsibility for the global financial crisis was not one of them (European Parliament 2008). Demands for stronger regulation in the wake of financial crises are unsurprising. What is more puzzling is the targeting of sectors not generally identified as being directly responsible for the crisis.

Second, while the crisis may have opened a political window of opportunity for advocates of stronger European financial regulation to create or modify rules and institutions, one can identify a number of functional reasons why hedge funds and private equity firms might have escaped this regulatory net. For one, unlike credit rating agencies, who until EU legislation was introduced in 2009 remained unregulated at the national or European level, hedge funds (or, more precisely, hedge fund managers) were already subject to national supervision prior to the crisis (Quaglia 2011: 66). Second, whereas stricter banking regulation can be justified as protecting consumers or the public, hedge funds and private equity firms service 'sophisticated investors' who are considered more able to protect themselves (Lutton 2008: 171). Finally, the alternative investment industry is more geographically concentrated than banking or other financial services. With 80 per cent of European hedge funds and 60 per cent of European private equity firms located in London, British leaders could argue that existing British supervision of this industry was sufficient and maintained the global competitiveness of the EU financial sector as a whole (ibid.: 171; House of Lords 2010: 16-17).

A third reason why EU regulation of the alternative investment industry is puzzling is that it appears to diverge from a two-decade long trend towards liberalization of financial services markets. That is, since the passage of the Single European Act in the 1980s, subsequent EU legislation has eliminated barriers to capital movements across borders, while avoiding the creation of new harmonized regulatory rules at the EU level. Some scholars attribute this outcome to repeated intergovernmental negotiations whereby the UK and like-minded 'market-making' member states manage to thwart attempts by more

'market-shaping' governments to create more centralized and binding regulatory rules (Quaglia 2010: 8). Others emphasize the role played by transnational financial capital and their Europe-wide trade associations in advancing a liberalizing agenda at the EU level (Bieling 2003; Mügge 2006; Macartney 2009). Yet in this case it appears that neither a UK-led 'market-making' coalition nor transnational capital managed to prevent the passage of this interventionist regulation. The question then arises: are we witnessing a shift towards a 'market-shaping' regulatory paradigm in European financial services regulation in the wake of the crisis?

To shed light on this question this paper focuses on the UK and its London-based alternative investment industry. A focus on the UK as a single case is justified given that it has long been considered the leader of a 'market-making' coalition. Thus, we would expect the UK to play a key role in any shift away from a light-touch, principle-based regulatory model. An interest-based explanation predicts that that the UK-based alternative investment industry would mobilize against this potentially costly legislation and, subsequently, the UK government would aggregate these preferences into a strong bargaining position against the AIFMD (see Moravcsik 1993; Underhill 1997). In this case, however, while the alternative investment industry did come out strongly against the proposed legislation, the UK government did not follow their lead. In fact, Whitehall was widely and repeatedly criticised by the industry for failing to fight on their behalf in Brussels (Masters and Tait 2009). One explanation for this discrepancy is domestic politics: ministers might have been reluctant, particularly with elections imminent, to be seen 'hugging hedgies' with public opinion so much against the City. But this explanation assumes UK leaders are held accountable for positions taken in Brussels, an assumption difficult to uphold in cases far more politically salient and less technical than this. Quaglia (2011: 677) offers an alternative, ideas-based account to explain the UK's weakened resolve to oppose regulation of the alternative investment industry: a certain degree of 'soul-searching' about light-touch regulation in the wake of the financial crisis. Her ideas-based approach suggests we may be witnessing a broader shift, both in the UK and at the European level, away from the 'market-making' approach to European

financial services regulation, so influential in the decade leading up to the financial crisis, and towards a 'market-shaping' one (see also Quaglia 2010: 161).

This paper demonstrates that the UK government's position on the AIFMD did diverge from the preferences of its powerful alternative investment fund industry. But we suggest that this does not necessarily discredit an interest-based approach to understanding UK preferences. We argue that the UK 'hedged its bets' it could take advantage of its competitive advantage, both in terms of market share and regulatory expertise, to make this modified EU regulatory regime work to the advantage of the UK. Our analysis is consistent with the insights of Moran (1991), Vogel (1996) and others that liberalization and regulation go hand-in-hand. The UK's position on hedge fund regulation, we argue, represents a continuation rather than a departure from its longstanding advocacy of a 'market-making' paradigm: in other words, that a competitive and integrated European market in financial services can be achieved by market-enhancing regulation (see Mügge 2011: 190). British leaders' acceptance that market-enhancing regulation is best organized at the European level does signify a departure, however, from the UK's position throughout the 1990s, which favoured mutual recognition over harmonization (Story and Walter 1996). We conclude from analysing the outcomes of this case, as well as some preliminary evidence from the implementation stage, that the UK government's 'bet' appears to be paying off. The watered-down Directive gives funds wider access to European markets, and UK officials are well represented in the newly created European supervisory authorities. We conclude by considering how this bet, like all bets, may have certain unintended consequences.

The paper draws on the analysis of EU documents, media accounts, and personal interviews with key actors in London to analyse the role of the UK government in the agenda-setting and decision-making stages of alternative investment legislation (with some preliminary observations concerning the implementation stage). The paper has three parts. The first section considers dominant approaches to understanding the political economy of EU financial services regulation, with a focus on the UK

preferences in particular. The second section analyses the initiation and negotiation of the AIFMD and ESMA, followed by a discussion of how this case calls for a modification of existing approaches to understanding the politics of financial services regulation. The conclusion provides some tentative suggestions concerning future theoretical and empirical lines of inquiry.

The Political Economy of European Financial Services Regulation

The creation of a single market in financial services has been a central goal of European actors since the passage of the Single European Act (SEA) in the 1980s. It has also been the site of on-going political struggles over the objectives, mechanisms and principles of financial market integration. Scholars offer different approaches to understanding these dynamics. In their in-depth account of financial integration from the passage of the SEA to its implementation in the early 1990s, Story and Walter (1997) argue that the process was shaped by a 'battle of the systems': between member states with a global capital-market orientation like the UK and those with national credit-based systems, namely Germany and France. Leading the former group of states, the UK pushed for a competitive European market for investment and banking services based on the principle of mutual recognition, whereby member states would agree to recognize each other's different national regulatory rules. Germany, meanwhile, sought to extend the EU's regulatory reach over the City of London through more harmonized legislation, while France aimed to restrict the access of London-based US and other third-country firms to European markets. While France and Germany disagreed on many legislative proposals related to financial integration, when it came to a single market in financial services they joined forces. Each feared the potential threat of a 'British Europe' where European financial markets would succumb to the kind of 'casino capitalism' defining global financial markets (Story and Walter 1997: 306). Story and Walter conclude that the UK scored important victories in negotiations to create a single market in financial services: British negotiators realized their preference for opening EU markets to investment services, while managing to thwart attempts by Germany and France to create harmonized European regulations and centralized institutions (ibid.: 318). The end result by the mid-1990s: 'a confederal regime rooted in

the inherited national financial systems but tied one to another through multiple channels and exchanges' (ibid.: *ix-x*).

In her account of European financial services legislation following the Commission's far-reaching 1999 Financial Action Plan, Quaglia (2010) offers an updated mapping of competing factions. Drawing on Sabatier's (1998) advocacy coalition framework, she maps out different objectives, instruments and underlying ideas of two main competing coalitions of public and private actors who have sought to shape EU financial regulation: what she terms 'market-making' and 'market-shaping'. The first type of coalition emphasises competition and market efficiency as primary goals of financial market integration, and favours light-touch and principle-based forms of regulation to achieve these aims. A 'market-shaping' coalition, on the other hand, emphasises financial stability and consumer protection as key objectives and supports more prescriptive, rule-based regulation harmonized at the European level (Quaglia 2010: 8; 163). With respect to underlying principles, Quaglia (2010: 143) suggests that the first type of coalition is driven by trust in markets, and the second by fundamental distrust. Table 1 provides a summary of some key characteristics of these ideal types.

Table 1: European financial services regulatory coalitions

	Market-making	Market-shaping
Financial system (Story and Walter 1997)	Capital markets-based Securities-oriented	Bank-based Credit-oriented
Main objectives	Competition Market efficiency	Financial stability Consumer protection Protection of national industry
Regulatory model	Light-touch, principle-based	Prescriptive, rule-based
Multilateral preference	Mutual recognition	Harmonization
Gov-industry relations	Industry steers	Government steers
Ideational orientation	Market trust	Market distrust
Key member states	UK	France, Italy

Adapted from Quaglia (2010); Story and Walter (1997); Mügge (2007)

Quaglia's account shares with Story and Walter (1997) a focus on member states as central actors in shaping European financial regulation. With the UK heading up the Northern market-making coalition and France the Southern market-shaping one, membership in the competing factions map quite closely with Story and Walter's 'battling systems' in the 1990s (Quaglia 2010: 162). Quaglia's account differs from Story and Walter's in two fundamental ways, however. First, member-states may play a central role in Quaglia's account, but she stresses that membership in these coalitions is 'fluid and fragmented' and comprise state and non-state actors. In this way she incorporates into her framework approaches that emphasise the importance of actors working above (and below) the level of the nation-state to shape European financial regulation. The European Commission, for one, acts as an important agenda setter in this policy arena (Bieling 2003; Quaglia 2007: 280-282; Posner and Véron 2010: 409). The Commission's allegiance to particular advocacy coalitions can be fluid, however, switching from a 'market-making' position pre-crisis to a 'market-shaping' approach (Quaglia 2011: 676; see also Moschella 2011). Other scholars focus on the important of transnational financial firms in shaping legislation. Mügge (2006) distinguishes between what he terms an 'international constellation', characterized by support for selective opening of markets and mutual recognition, and a 'transnational constellation', advocating open markets and harmonization. This distinction maps quite closely with the preferred instruments of Quaglia's two coalitions, although Mügge's account focuses on intra-industry rather than inter-state conflicts. Macartney's (2009) three transnationally-oriented factions – 'Atlantic', 'Rhenish' and 'Gallic' – shares with Mügge's an emphasis on financial firms and their associations as key actors. Yet it shares with more state-centric accounts a claim that private actors working at the European level are also embedded within particular and often advantageous national regulatory arrangements. In sum, all of these approaches conceive of European integration as a causal force above and beyond the aggregated preferences of member states.

A second key difference between Quaglia's account and those focused on the 1990s is outcomes. Whereas in the 1990s the diversity of financial systems

(Story and Walter 1997) or regulatory approaches (Underhill 1997) undermined attempts to create a single market in financial services, the 2000s witnessed a broad-based consensus about further integration leading to an extraordinary output of legislation and regulatory institutions (Posner and Véron 2010: 409). A driving force behind these initiatives, as Quaglia (2011: 678) and others have suggested, was the UK and the market-making coalition, which modelled EU legislation after Anglo-American models that granted financial firms large degrees of discretion over their activities and emphasized supranational technocratic policy-making (see Posner and Véron 2010: 410; Mügge 2011: 201). The outstanding question is what kind of outcomes the current flurry of legislative initiatives in the wake of the global financial crisis will bring. Quaglia (2010: 160-61) argues that 'the market-regulatory approach…has suffered a setback' and suggests that we are witnessing a 'shifting balance of power (at least temporarily) between the main coalitions at play in the in the regulation of financial services in the EU'.

Returning to our central research question, how well can competing advocacy coalitions account for UK preferences towards European hedge fund regulation in the wake of the financial crisis? Given that this particular legislation stood to have a clear and disproportionate impact on the UK alternative investment industry and the British regulatory model, we would expect that the UK government would defend market-making principles. If not, then the question arises: why not? Was the UK government constrained, as Quaglia's (2010; 2011) account suggests, by a shifting balance of power within the EU towards market-shaping principles in the wake of the financial crisis? Or could the UK government's apparent reluctance to fight strongly against this legislation be due to internal shifts away from a market-making paradigm? To consider these lines of argument, the following section traces the process through which AIFMD and ESMA was initiated and negotiated, with a particular focus on the UK, followed by a discussion of our main findings and theoretical implications.

Regulating alternative investment funds post-crisis: the case of AIFMD and ESMA

The decade preceding the 2008 global financial crisis witnessed an extraordinary growth of the alternative investment industry. Global assets under hedge fund management expanded from 200 billion USD in 1998 to two trillion USD by 2007 (Lutton 2008: 169). Coming to an agreement on what constitutes an 'alternative investment fund' is one of the most contentious tasks in any debate over regulation of this industry. Yet a common definition is a private investment fund limited to qualified high-net individual and institutional investors, with an expectation (not always realized) of sophisticated and long-term investment strategies providing investors with a higher and more consistent rate of return than traditional investment activities such as stocks and bonds. The alternative investment industry generated considerable political controversy well before the global financial crisis. George Soros' short selling of sterling in 1992 remains the most infamous case, leading to the ejection of sterling from the European Exchange Rate Mechanism (ERM) and one billion USD profit for Soros and his investors. Numerous other less high-profile cases across Europe, in which hedge funds and private equity firms are accused of short-selling of shares or asset stripping, has made the industry the target of protests by members of governments, trade unions and in some cases the larger public. For example, when a London-based hedge fund used its eight percent ownership stake in Deutsche Börse to block its takeover of the London Stock Exchange in 2005, the German Social Democratic Party and German trade unions criticised the foreign hedge fund for putting profits ahead of job creation (*The Economist* 2005; Lutton 2008: 170). The global financial crisis provided an opportunity for certain actors to pursue grievances against the industry that had been 'bottled up' for quite some time (personal interview, 20 May 2011).[ii]

In April 2008, amidst a deepening financial crisis, Poul Nyrup Rasmussen, President of the Party of European Socialists, presented a draft report to the European Parliament (EP) calling for tighter regulation of hedge funds and private equity firms.[iii] In September 2008, the EP's Committee for Economic and Monetary Affairs voted in favour of a resolution, based largely on Rasmussen's original proposal. The decision was almost unanimous, with just one vote against and one abstention (*EurActiv* 2008a). Soon after the EP voted in favour of the proposal, European Commissioner for the Single Market and Services, Charlie McCreevy, delivered a speech to the EP defending the role of capital market innovation and laying the blame for the crisis instead squarely with banks, mortgage lenders, credit rating agencies and supervisors. He rejected the need for further regulation of the alternative investment industry (*EurActiv* 2008b). The EP was not deterred. An amended report based on

Rasmussen's original draft was confirmed by a healthy majority when brought before the EP's plenary session for a final vote. It asked the Commission to present a legislative proposal by the end of the year to regulate the alternative investment industry based on the principles agreed by MEPs. These principles included stricter capital requirements, increased transparency, avoidance of excessive borrowing to cover leverage, and measures to avoid 'unreasonable' asset stripping (European Parliament 2008).

In December 2008 the Commission opened a stakeholder consultation on a proposal to regulate the alternative investment industry. The consultation period was very short, opening in mid-December 2008 and closing the end of January 2009. Given that the Commission typically takes at least a year to prepare a proposal and keeps consultation periods open for months, in this case it appeared to be working within a significantly tighter timeframe.[iv] According to a leading industry association official, the legislation arose within a political 'pressure cooker' (personal interview, 6 May 2011). MEPs across all party groups resented what they viewed as the Commission's delayed response to the financial crisis, and singled out McCreevy in particular. With the President of the European Commission up for re-election in June 2009, Barroso arguably 'got the message that nothing gets left unregulated' (ibid.). It became clear to those involved in these early stages that the proposed legislation was 'purely a political decision, not a technical one' (ibid.).

Meanwhile, in October 2008, the Commission established the de Larosière High Level Group to look more generally into the future shape of European supervisory architecture. Its February 2009 report urged member states to set up an 'efficient' single market with a 'harmonised set of core rules' (de Larosière 2009: 27). To achieve this objective, it proposed a two-tiered structure. A new European Systemic Risk Council (ESRC), to be chaired by the President of the ECB, would take charge of macro-prudential supervision. In particular, it would gather and analyse information with the purpose of identifying and acting on financial risks that threatened the EU economy as a whole. In the area of micro supervision, a new European System of Financial Supervisors (ESFS) would operate as a decentralised network composed of existing national supervisors, but also include three new European Supervisory Authorities (ESAs) in the area of banking, securities and pensions/insurance. While national regulators would continue to carry out day-to-day supervision, the de Larosière Report advocated conferring new competencies on the ESAs, including legally binding mediation powers in the event of disputes between

national supervisors; powers to ensure the adoption of binding supervisory standards; and the authority to implement binding technical decisions applicable to individual financial institutions (ibid.: 55-56). The Commission incorporated these recommendations into draft legislation that it published at the end of May 2009.

Press reports suggested that the UK government strongly resisted some of the de Larosière proposals, both in the Council discussions that followed and the trialogue meetings with the Parliament. Initially, the Brown Government voiced concerns about the ECB President chairing the proposed ESRC. Writing in the *Financial Times*, then Financial Secretary to the Treasury Lord Myners (2009) argued that non-Eurozone central banks and regulators, such as the Financial Services Authority (FSA), must also be represented. The Treasury also opposed new ESAs having supervisory powers that might impinge on national fiscal autonomy. For example, they cited concerns that a new European Banking Authority decision to bail out a failing British bank would ultimately have to be funded by British taxpayer's money. Ministers found this potential infringement of economic sovereignty ultimately unacceptable. Finally, the UK objected to any proposal giving ESAs binding mediation powers over national supervisors. The first issue concerning the ESRC appears to have been settled quite quickly. The other two remained a matter of dispute well into 2010 (see *EurActiv* 2009a; 2009b).

At the end of April 2009, the Commission published its first draft of legislation regulating alternative investment funds. Concerning the overall state of the draft proposal, insiders deemed it to be a 'very poor piece of legislation' (personal interview, 19 May 2011). The proposal included capital requirements, extensive disclosure rules, and leverage limits to be set by the Commission. The proposal also included a 'passport'. The proposed passport would grant managers of non-EU funds, based both within and outside the EU, permission to market their products in any EU member state under certain conditions. For one, regulatory framework and supervisory arrangements in their home country should be 'equivalent' to those set out in the proposed directive. Second, EU managers would also have to enjoy comparable access to the non-EU markets of non-EU funds that want to operate in the EU. The proposal also included a three year transposition period after which the passport would go into effect.

Negotiations within the Council and with the EP over the AIFMD proposal were contentious and prone to deadlock. Particularly controversial was the issue of the passport. France had continued to back the current system whereby non-EU funds who market their activities in the EU were required to seek permission separately from each member state. France ultimately dropped its objection to the passport, in the face of objection by the UK and others that its stance was protectionist. But it sought certain concessions in return for this change of position. Most significantly, France tied the issue of passport to the new ESMA, arguing that the new authority should be solely responsible for issuing passports and supervising non-EU funds operating in the EU. London flinched at the idea of a European body, not least a Paris-based one, acting as a gatekeeper for non-EU funds. This stand-off between the UK and France over the passport issue led to the final negotiating session with the EP being cancelled.

Finally, with the active intervention of the Belgian Council Presidency, by October 2010 a unanimous agreement was reached at ECOFIN on the AIFMD. Despite protracted resistance from Paris, British negotiators managed to get the passport proposal accepted as part of the final agreement. A passport for EU alternative investment funds will be introduced in 2013, with EU fund managers of non-EU funds and fund managers from outside the EU being able to apply after a two year transition period. Non-EU funds will now face stricter rules concerning the disclosure of their business strategies, a requirement to report this information more frequently, and guidelines stipulating they hold larger amounts of capital. The current private placement scheme (whereby individual countries will still be able to authorise funds) will continue up to 2018, when, pending a satisfactory review of the passport system, it will be abolished.

In terms of the more general reforms to the EU's regulation of financial services, a new ESRC (with the president of the ECB as chair), ESFS, plus three supervisory authorities were created along the lines of the proposals contained in the de Larosière Report. The new European Banking Authority (EBA) has been located in London, with the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) going to Paris and Frankfurt respectively. Although the ESAs do not have the power to enforce decisions with budgetary implications for member states, they do have the authority to overrule national supervisors in certain circumstances. Interestingly the role of

ESMA expanded significantly during the trialogue meetings surrounding the AIMFD in the second half of 2010. ESMA now has the authority to advise national supervisors on authorising funds. It also has new powers to request additional information from national supervisors in response to concerns that a specific fund poses a systemic risk to the EU economy. Finally, national supervisors are obliged to ask ESMA to advise on issuing passports. Although they are not mandated to follow this advice, they can be required to publish their reasons for not doing so.

Main findings and theoretical implications

We draw three sets of conclusions from this tracing of the process through which European hedge fund regulation was initiated and negotiated. The first concerns the influence of transnational capital. The UK alternative investment industry's position on the legislation was clear: support for the status quo. Few in the industry supported the need for new European regulation and pointed out that European hedge funds in particular were sufficiently regulated (Commission 2009: 9-10). Representatives of hedge funds and private equity firms argued that their professional investors did not require, and indeed did not want, protection from risk; the money they made was partly the result of the risky ventures they undertook. For the alternative investment industry, the best way to respond to the failures exposed by the global credit crunch was to strengthen the regulation of the banking sector, leaving the alternative investment industry to regulate itself. Many within the industry argued that they were being unfairly scapegoated. One hedge fund manager suggested the legislation was a 'blatant attempt by the French and Germans to sock one to London', another that that 'there is a strong perception in the City of London that Gordon Brown has forgotten us and may even be offering us up on a platter to France and Germany in exchange for supportive noises' (Masters and Tait 2009). Several prominent UK hedge funds threatening to relocate to Switzerland if the directive was not 'radically changed' (Jones 2009).

The response of UK government officials to the legislation was more ambivalent. It is true that in its submissions to the Commission's consultation process and in public statements, ministers and officials echoed many of the criticisms voiced by alternative investment funds. But they asked for more time to conduct research on the systemic impact of the legislation on global, European and UK alternative investment funds. Some government officials were sympathetic to the industry's complaints that it was not acting quickly or decisively enough on their behalf. In an article in the *Financial Times*, Andrew Turnbull, former Permanent Secretary to the

Treasury, suggested: 'the Treasury needs also to be a bigger player in EU financial services policy. It has been behind the game recently in allowing two seriously flawed directives to be promulgated' (one of those cited the AIFMD, the other the Solvency II Directive) (Turnbull 2010). Then opposition leader George Osborne attacked the Labour government for 'not standing up for the City's interests in Europe' and argued that continental European politicians were 'using the UK's perceived weakness to press home an assault on the Anglo-Saxon model of capitalism' (Jones 2009). London Mayor Boris Johnson also jumped on the bandwagon against the EU legislation after meeting with industry leaders (Masters and Tait 2009).

In terms of the specific legislative proposals, the Brown Government presented a list of concerns about the AIFMD in its evidence to a House of Lords Select Committee investigation in the second half of 2009. While it was strongly in favour of the passport idea in principle, it expressed apprehension about some of the Commission's specific proposals, especially those relating to 'equivalence' of non-EU funds regulatory framework in their 'home' country. The government was concerned that it was not entirely clear what these standards would be and who would be responsible for defining them (House of Lords 2010: 38-39). Ministers pledged to resist any criteria that were in some sense discriminatory to non-EU firms, arguing that this would lead to them withdrawing from the EU and reducing investment capital for European industry (ibid.: 40). It also argued that national supervisors should retain control over transparency rules and leverage (ibid.: 30-31; 33-35). Overall, however, the government supported – or at least did not reject – the need for further regulation of alternative investment funds.

In sum, our evidence challenges accounts that assume a close alliance between the UK government and its financial services industry in advancing a 'market-making' approach to European financial regulation. While Whitehall was opposed to a number of specific reforms that were particularly objectionable to the alternative investment industry, particularly some put forth by the EP, we observe a gap in this case between the positions of the UK government and The City. British leaders acquiesced to, if not actively supported, arguments made by members of the 'market-shaping' coalition calling for stronger regulation at the European level. Industry representatives, on the other hand, found themselves bargaining within new European constraints that it had lobbied hard to try to avoid altogether, even if it did succeed in gaining some specific concessions during negotiations. This suggests that the 'market-making' coalition, and the UK more specifically, is more internally

fractured than what both advocacy coalition and transnational capital accounts might predict.

Our second conclusion concerns a possible shift in the UK government's position away from a 'market-making' approach. In the wake of a devastating and costly global financial crisis, the UK government was, as *Financial Times* columnist Andrew Hill (2009) put it, playing a 'delicate game'. Hill goes on to suggest that the alternative investment industry would have to wake up to the fact that some degree of further regulation was inevitable:

> Some in the City have not yet realized there will be no return to the Labour love-ins of 2006 and early 2007. Higher regulatory standards are now necessary. If that means flakier components of the financial services industry defect to other jurisdictions, so be it.

Indeed, in personal interviews with industry representatives, many recognized, even if they were reluctant to concede publicly, that the UK government 'couldn't go out there and say we're against regulation' (personal interview, 6 May 2011). A domestic politics explanation would suggest that the UK government was constrained by potential electoral costs. Ministers would be reluctant to be seen to support the City in a domestic political climate so hostile to the financial industry. But our evidence lends little support to the claim that the government feared public backlash for supportive actions on behalf of the industry in Brussels. Aside from several public statements by Conservative leaders expressing criticism of the Brown Government's handling of the proposed European legislation, the issue did not generate much partisan infighting either. Indeed, once the new coalition government came to power in May 2010 it followed the same position as the outgoing one. If fear of public backlash or party politics cannot account for the UK leaders more accommodating approach to proposed European alternative investment fund legislation, this suggests that other factors were at play.

We concur with Quaglia (2011: 676) that the UK government's position stemmed in part from its own internal reflections on the financial crisis and the implications for its own regulatory architecture. The Turner Report, released in March 2009 and fully endorsed by the government, supports such a conclusion. Discussing the role of the alternative investment industry in the global financial crisis, the report suggested that EU hedge funds were already regulated and that 'it was much less clear' that they

played a role in the credit crunch (FSA 2009: 123). Yet it concluded that 'greater regulation may still be needed in the future' (ibid.: 123). The FSA in particular seemed willing to accept that Europe had a bigger role to play in the regulation of financial services. It expressed support for the de Larosière proposals to create a pan-EU regulatory body ensuring greater consistency of supervisory standards and rules in the single market. It also noted that such change would be a 'radical development', which may lead to a more centralised system of European supervision (ibid.: 17-18). In another significant departure from previous stances, the FSA pledged to replace its traditional emphasis on 'principles-based' regulation with something it called 'intensive supervision', calling this shift, too, 'a fundamental change' (ibid: 20-21; see also Larsen et. al. 2009; Davies and Masters 2009).

But can we conclude from this that UK officials were involved in more fundamental 'soul-searching' about the underlying principles of the market-making regulatory paradigm (Quaglia 2011: 677)? We suggest while the UK government did reassess its position on European regulation of the alternative investment industry post-crisis, it was not due to a fundamental paradigm shift. Instead we suggest that it was driven by an aim to make this modified European regulatory regime work to the advantage of the UK and its alternative investment industry. We suggest two interest-based reasons for this stance. For one, in the wake of the Lehman Brothers and Landbanksi episodes, where many saw the UK bearing the brunt of poor supervision on the part of US and Icelandic regulators, more harmonized and coordinated regulatory mechanisms at the EU level could be seen as a means for the Treasury and FSA to increase its influence over supervisors in other countries. Second, the Turner Report suggests that the UK authorities appear to have been contemplating changes to its light-touch, principle-based approach before the publication of the Commission's draft directive. The move towards more harmonized regulation at the European level might have been viewed by British supervisors as a means of strengthening rather than undermining their authority, albeit conditional on the newly created European authority following the FSA's evolving model at the national level. Indeed, Whitehall has not been above utilising EU institutions as a way of boosting the credibility of domestic institutions in the past, especially in the area of economic and monetary policy (Buller 2000).

Finally, returning to Quaglia's (2010: 160-61) claim that European regulatory initiatives after the crisis suggest a possible shift in the balance of power towards a 'market-shaping' coalition in the EU, our case study finds limited support for this.

Indeed, many of the initial objectives of alternative investment fund regulation put forth by the EP's Party of European Socialists were consistent with 'market-shaping' principles, namely increasing financial stability and protecting institutional investors. However, few of these objectives made it into the Commission's draft proposal and even fewer into the final draft (*EurActiv* 2009c). France did fight to maintain national control over alternative investment fund manager's access to domestic markets, consistent with a broader 'market-shaping' objective to protect national industry. Yet French leaders ultimately failed to prevent the introduction of the passport, settling in the end for a compromise in which the newly created European authority would advise, but not overrule, national supervisors on authorization. In short, the final legislation appears to fulfil 'market-making' rather than 'market-shaping' objectives: creating a more open and integrated European market in alternative investment services, with harmonized rules and institutions at the European level designed to facilitate this aim.

With respect to Mügge's (2006: 1005) argument that the liberalization and integration of European financial services has been promoted by supranational forces, namely large financial firms, we find that the alternative investment industry opposed any kind of legislation at the European level, including the passport (personal interview, 6 May 2011; Tait 2010). But we also found evidence that the industry's strategy could change in the future. According to one industry official, once alternative investment funds got over the 'denial period' that the legislation would go forward, and that the UK government was not going to oppose it, they began to organize to influence the European legislative process (personal interview, 6 May 2011). For most alternative investment fund managers this was an entirely new experience, having never been forced to lobby the EU level before. A representative for a Conservative British MEP reported that the industry learned quickly and put together an effective lobbying campaign. However, whereas the Conservative MEP would have preferred that the industry went in 'with guns blazing' against the legislation, he found them 'ready to be constructive' (personal interview, 18 April 2011), an observation corroborated by an FSA official closely involved in this process (personal interview 18 April 2011).[v] If the industry was initially unprepared to lobby in the EU, the creation of several new European alternative investment associations in Brussels suggests that they will be in the future.

Concluding remarks

The paper argues that we have witnessed a shift in the UK government's position away from a strict 'market-making' approach to European financial services regulation in the wake of the financial crisis. We argue that this shift can be explained by two sets of interrelated factors. The first is that the UK government, unlike the alternative investment industry, accepts that a competitive and integrated European market in financial services can be achieved by market-enhancing regulation at the European level. While the alternative investment industry may have supported the principles underlying an 'international constellation' (Mügge 2006), namely support for selective opening of markets and mutual recognition, the UK government appears to more committed to opening markets through harmonization of rules at the EU level. But this commitment, we have argued, contra Quaglia (2011), is due less to ideational reasons than interest-based ones. We argue that the UK supported more regulation of the alternative investment industry at the European level because it calculated that by doing so it could influence the future direction of EU regulation in this area, hoping to ensure that legislative developments are conducive to the City of London.

This leads to a final question: has the UK government's 'bet' paid off? Has it been able to make these new European regulatory policies and institutions work to the advantage of the UK now that the legislative process has entered the implementation stage? Given that the legislation went into effect in July 2011, it may be too soon to tell. But we can cite some preliminary evidence. When it come to the more general changes to financial services regulation, initial developments at the start of 2011 seem to bode well for the UK. The FSA has been able to get a number of its employees accepted into top jobs within the European supervisory agencies. Thomas Huertas has become the 'alternative chair' of the EBA, while Verona Ross has been appointed executive director of ESMA. Ross faced tough questioning from MEPs including Jean Paul Gauzes who remarked: 'I've no doubt about your competencies … and your words are sweet and soft … But I want to know that your vision of ESMA is sufficiently European' (Tait 2011b). In response, Ross admitted that regulatory authorities, including the FSA, made a lot of mistakes during the global financial crisis. She accepted that in future, the co-ordination of rules was important, and that: 'In all spheres it would be really important to have a European approach' (ibid.).

The alternative investment industry, on the other hand, remains ambivalent about the new legislation. Many oppose plans to phase out the national placement regime in

2018, and express ambiguity towards the passport policy as a whole (Tait 2010). Investors in the emerging markets have also expressed concerns that hedge funds in areas like Asia and Africa would be unable to comply with new rules relating to the passport regime (Dueck 2010). In terms of the new regulatory authority in Paris, some fear that while it is currently only a skeleton structure, employing fewer than 50 staff, it has the potential to be augmented with the gradual addition of functions and competencies, especially by the EP. According to Barney Reynolds, head of the financial regulatory group at the law firm Shearman and Sterling, 'it's an unsettling process. A single market [for the financial services] is a good thing … But people need to be close to the markets they're regulating'. Shearman was also concerned that the ESAs would follow 'a moralistic political agenda' rather than conduct a 'dispassionate technical exercise' (Tait 2011a).

This suggests that battles over the future of regulation of this sector will be waged at the European level between those who advocate stronger and more autonomous regulation of the alternative investment industry at the European level, and those who wish the new legislation remain toothless. These conflicts will play out in newly created European supervisory institutions, as well as through normal political channels. The UK has reportedly now assembled a coalition in the European Council, including The Netherlands, Sweden, Ireland as well as Czech Republic and Poland, that 'hangs together' to support decisions that are important to the UK in implementing financial services legislation (personal interview 20 May 2011). With respect to the newly created European securities authority, insiders suggest that it will be a 'battle for money and resources' (ibid.). Given that negotiation on hedge fund regulation went on so long, many outstanding issues became 'delegated acts' whereby European authorities are now tasked with finalizing rules, much of the lobbying over the future of European regulation of this sector is now being done at a technocratic supranational level. It appears that the 'old' style of 'regulatory liberalism' (Mügge 2011) that defined pre-crisis European financial services integration will continue to shape regulation of this sector.

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[ii] Another interviewee used the analogy of a fight breaking out in a pub. 'Instead of punching the guy who starts the fight [banks], you decide to punch they guy you never liked [hedge funds].' (Personal interview, 19 May 2011).

[iii] The former Danish Prime Minister is the author of a 2007 book on hedge funds, work that was inspired by the takeover by five foreign hedge funds of the Danish telecommunications firm, TDC.

[iv] Despite the short time frame, the Commission received 104 responses in total to its consultation, with over 70 percent from industry representatives (Commission 2009: 3).

[v] Sharon Bowles, chair of the EP's economic and monetary affairs committee, was less complimentary, stating in an interview with the *Financial Times* that 'the UK hedge fund mood music just puts people's backs up' (quoted in Moschella 2011: 262).