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Lobbying under Pressure: The Effect of Salience on European Union Hedge Fund Regulation*

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Abstract

The virulent European Union hedge fund debate led many observers to suspect a paradigmatic battle between liberal market economies and countries in favour of tighter regulation. By contrast, this article points to the economic interests that drove government agendas. However, national preferences were not defined by the aggregate of a country's economic interests, but by very specific stakeholders only, despite the existence of opponents with considerable resources. This article argues that the unequal success of financial lobbyists depended on how their demands fitted into the government's overarching negotiation strategy. The primacy of government objectives, in turn, resulted from the high saliency of financial regulation and hedge funds in particular.

Introduction

Few issues in the aftermath of the financial crisis have garnered as much public attention as the regulation of hedge funds – the highly leveraged investment funds targeted in particular to institutional investors, which have become notorious as symbols of short-term investment strategies in recent years.[1] Indeed, the recent legislative proposal in the European Union (EU) turned into a highly politicized debate. Despite the controversy that pitted most notably France against the United Kingdom, the Alternative Investment Fund Managers (AIFM) directive was adopted in November 2010 and constituted one of the first EU legislative responses to the recent financial crisis. How can we explain this directive, which was proposed only shortly after Internal Market Commissioner Charlie McCreevy declared that he had no intentions to regulate hedge funds?

Recent studies of the AIFM directive divide into two camps. A first underlines the cataclysmic effect of the financial crisis, which allowed for a paradigm change in EU financial regulation (Quaglia, 2011). According to this view, the crisis brought financial regulation under public scrutiny and challenged beliefs about the benefits of unregulated

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[1] 'Hedge funds' are investment vehicles that are difficult to define. Besides their high leverage and the fact that they are only accessible to wealthy or institutional investors, they also pay a performance fee to the fund's manager. Using a variety of investment methods, they tend to hold both long and short positions, where investment in supposedly overvalued securities is counterbalanced by investment in undervalued securities. They are similar to, but distinct from, private equity investment, which focuses on controlling a business rather than simply profiting from market developments. Moreover, hedge funds are most notably distinguished from mutual funds, which offer professionally managed collective investment services to the general public.

markets and light-touch regulation (Moschella, 2010). The second camp cautions against an overly optimistic assessment of the scope of the AIFM directive. Although they do acknowledge increasing activism of the European Commission and countries in favour of financial regulation, they characterize the commitments as mainly symbolic politics and 'gesturing' (Buckley and Howarth, 2010; Lutton, 2008). To them, the AIFM directive has been substantially watered down by the lobbying of the financial industry in the United Kingdom (Buckley and Howarth, 2011; Lutton, 2011). Despite the financial crisis, the lobbying of the financial industry in favour of light-touch regulation is more decisive than attempts to regulate financial markets (see also Mügge, 2011). The underlying assumption in these accounts, one common in studies of financial regulation in Europe, is that narrow financial industry interests push for no or little regulation. They are opposed by an alliance between enlightened regulators and countries favouring a more restrictive approach to finance, constituted mainly of countries that simply have very small financial industries. Quaglia (2010) refers to these two camps as 'market-making' and 'market-shaping' coalitions and argues that paradigmatic change could occur after the financial crisis because the market-making coalition lost some of its political legitimacy.

In this article, I argue that it is misleading to assume that the coalition defending light-touch regulation is driven by the financial industry, while the opponents pursue either enlightened regulatory ideas or other economic interests, which arise from production regimes with little emphasis on finance. The City of London is not the only financial industry and less regulation is not the only economic interest financial firms can defend. To be sure, for the study of financial regulation in Europe, interests and ideas about financial regulation are largely confounded in the United Kingdom and in Germany. It is therefore difficult to say whether the United Kingdom pushes for little regulation in order to defend market liberalism or the City of London or whether Germany defends regulation in order to defend principle-based regulation or its long-term finance-based company model. However, France is a crucial case because it has considerably liberalized financial markets and thus a diverse set of financial stakeholders.[2] As we will see in the hedge fund battle, France's position did not result from a simple paradigmatic embrace of more regulation and no consideration for financial firms. Rather, its economic interests were ambiguous: the government could have sided either in favour of the investment industry or in favour of more regulation. It decided to do the latter in order to forge an alliance with Germany, and present itself as a defendant of more strict financial regulation in the aftermath of the crisis, which constituted a central electoral strategy for French President Nicolas Sarkozy.

Put more theoretically, the high salience of hedge fund regulation brought government strategies to the fore (Culpepper, 2011). But this does not mean that industry lobbying mattered less, it merely determined which lobbying interests were taken into account. By unpacking the strategic interests for both the government and industry in France as a pivotal case, we can see how financial lobbying had to adapt in order to be successful, which analysts focusing on financial lobbying do not acknowledge. We therefore have to understand the logic of business–government co-operation. As the present case study shows, this can only be done by understanding the effect an increase in salience can have on financial regulation.

[2] For a discussion of the evolution of French financial interests and examples of regulation support from the financial industry, see Mügge (2010, pp. 133–9).

The empirical account draws on a dozen qualitative interviews with industry representatives and policy-makers in Brussels and the Member States between December 2009 and April 2011, as well as primary documents such as legislative and policy documents and industry briefs.[3] The article begins by presenting theoretical perspectives on EU financial regulation and discussing the importance of political salience. Then I show how the issue of hedge fund regulation has moved from an issue of low to high salience. After that, I lay out industry interests and their lobbying strategies, and concentrate on the objectives of governments. I then conclude by discussing the lessons of the case study in light of the initial hypotheses.

I. Theoretical Approaches

Analyses of conflict over economic issues tend to emphasize either economic interests or ideas about regulation. I will briefly review the most common hypotheses from these two perspectives before turning to the issue of salience. Focusing on the change in salience helps to understand the particular interplay of government objectives and business lobbying in EU politics in general and of EU hedge fund regulation in particular.

Political Economy Perspectives

Materialist accounts of financial regulation tend to consider the distribution of economic interests, the institutions aggregating such societal demands and the relative market size of a given country in order to understand what position the government will defend and to what extent it can impose its views in international negotiations (Frieden, 1991, 1999). This can be studied by analyzing the composition of economic activity within a country, but also by examining the institutional advantages of the socio-economic order more generally. The 'varieties of capitalism' literature draws attention to the institutions supporting the development of national production systems. It argues that governments will defend those policy regimes that protect the areas in which the country has gained a comparative institutional advantage (Crouch and Streeck, 1997; Hall and Soskice, 2001). Although it was originally developed for manufacturing, this perspective is increasingly applied to financial services (Busch, 2004; Fioretos, 2010) as it helps to understand national difference, which can turn out to be decisive for EU regulation. In particular, countries ally more easily with those that have established similar financial and economic institutions, which can lead to a 'battle of systems' at the European level (Story and Walter, 1997). Such reasoning underlies most analyses of inter-state bargaining in the EU and forms the backbone of Andrew Moravcsik's liberal inter-governmentalism (Moravcsik, 1998).

At the most basic level, countries that already have a flourishing hedge fund industry would be expected to oppose tighter regulation in order to keep investment firms from choosing more attractive (i.e., unregulated) locations. With a varieties of capitalism perspective, we would distinguish liberal market economies such as the United Kingdom or Ireland, which seek to protect their light regulatory approach, and countries with

[3] Interviews included officials from the European Commission, MEPs, representatives from the Member State governments and regulatory authorities, industry associations and lobbyists representing the affected sectors, as well as a public official from the United States Securities and Exchange Commission.

co-ordinated market economies, such as Germany, that are more concerned about the role of finance in the transformation of their industrial structure. From such a systemic perspective, Germany should be very supportive of hedge fund regulation in order to shelter its companies from short-termist sources of finance. Other European countries fall somewhere between the United Kingdom and Germany, which represent the two extreme points of the spectrum. Moreover, this fault line should remain somewhat stable over time, as past decisions create institutional advantages for each model and will therefore be supported and defended by both private and public actors.

For our case study, a simple lobbying perspective and a varieties of capitalism perspective lead to rather similar predictions: we should see the United Kingdom pitted against countries such as Germany. The varieties of capitalism perspective gives us clues about why public decision-makers will feel that this is necessary for protecting the countries' comparative advantage and thus in the public interest, whereas lobbying perspectives suspect very partial and private interests to be at work. Both perspectives, however, are rather static and it is not clear what we should expect to happen in a country like France. The political economy perspective is thus somewhat ill-equipped to explain sudden change.

Paradigm Changes

Scholars have sought to explain change in financial regulation with respect to new ideas. In studies of transnational networks, several authors have pointed out that technical co-operation fosters cognitive convergence and shared understanding about the necessities of regulatory intervention (for example, Porter, 2005). In the European context, the analysis of regulatory paradigms requires paying particular attention to the European Commission and other supranational institutions such as the European Parliament (EP). Driven by an institutional self-interest to expand its mandate to sectors that were previously beyond its remit, the European Commission has turned out to be a key player in financial market integration (Posner, 2009).

A considerable number of Member States are also in favour of more intervention in financial market regulation, which Quaglia (2010) has termed the 'market-shaping' coalition. In the past, these actors faced a 'market-making' coalition defending liberal market principles, which dominated the EU approach to financial regulation (Posner and Véron, 2010). However, the recent financial crisis put into question these principles and gave new credence to the market-shaping coalition. In her analysis of EU hedge fund regulation, Quaglia (2011) points to this shift in ideas as the trigger for the AIFM directive in 2010. The effect of the crisis was to implicitly validate the market-shaping regulatory paradigm and to silence supporters of light-touch regulation. The focus on the role of ideas and paradigms has been central to the recently striving constructivist political economy in the field of international relations and helps to theorize how change can be produced by the crisis (Abdelal *et al*., 2010).

A purely ideas-based reading tends to overlook the economic motivations behind the pro-regulatory stances and provides an overly optimistic reading of the regulatory content of the directive. If the market-making coalition was proven right by the financial crisis, why was the directive substantially watered down from its original proposal (Lutton, 2011; Buckley and Howarth, 2011)?

Salience in EU Politics

The financial crisis was important for EU hedge fund regulation, but not as an external shock that reshuffled the political equilibrium or silenced any group of stakeholders. Rather, it led to an increase in political salience, which affects both government action and industry lobbying. Understanding the role of salience therefore helps us to see how we can observe both the continuity of economic interests and an adaptation of business and government strategies.

'Salience' is defined as the importance citizens attach to a political issue. It thus refers to the degree of public attention and has important implications for voting behaviour and policy evolution (for example, Jones and Baumgartner, 2005). To begin with, governments are held accountable for policy decisions and will try to behave in a way considered favourably by their electorate. This often includes not siding with special interest groups. In EU politics, we would furthermore expect governments to insist on intergovernmental decision-making rather than leaving an issue to supranational institutions, as tends to happen on technical issues.

Interest group politics are also affected as salience increases. Schattschneider (1975) has pointed out that increasing public attention moves conflict between different stakeholders from the private to the public sphere. During this 'socialization of conflict', the original stakeholders tend to lose control over the terms of their dispute, which is why they have an interest in keeping conflict private. For a long time, financial regulation was handled as a matter of technical expertise dominated by elite groups, which has been criticized as 'esoteric politics' (Moran, 1986). Culpepper's (2011) contribution underlines that such business influence is strongest when salience is low, which he labelled 'quiet politics'. As salience increases, formerly influential business lobbyists are forced to seek alliances with other groups and persuade public opinion that their demands are also in the public interest. This requires adapting their position and language if they do not want to lose out against other stakeholders who appear to defend more legitimate positions that can help the government maintain its electoral support.

In contrast to a paradigm change, an increase in salience will only lead to marginal changes (Mügge and Stellinga, 2010). Governments assign greater importance to the legitimacy of the policy stances they defend and actively build coalitions to succeed in intergovernmental bargaining. The quest for legitimate policy stances implies that governments favour those business lobbyists that are compatible with their overall strategy. These considerations help us to see why countries that face a greater variety of industry interests can shift their positions as result of electoral and geopolitical considerations, as will be demonstrated for the case of France. However, countries, where the defence of a national model appeals even to the broader electorate, such as the United Kingdom and Germany, continue to behave as we would expect from a varieties of capitalism perspective.

II. From Quiet Politics to High Political Salience

How did hedge funds move into the centre of public attention? Hedge funds especially developed in countries where securities markets already played a central role, such as,

most importantly, the United States and Britain.[4] In both of these countries, the regulation of hedge funds happened through *indirect* regulation. Rather than imposing registration or disclosure requirements on the hedge funds themselves, regulation applied to the counterparties. In the United States, hedge fund managers were explicitly exempt from oversight by the Securities and Exchange Commission (SEC) until recently, while British managers had to be accredited by the Financial Service Authority (FSA). In continental Europe, hedge funds were most often directly regulated through registration, disclosure and reporting requirements. In Germany, hedge funds, or more specifically the investment techniques they employed, were even prohibited until 2004. In comparison to the United States and the United Kingdom, the French and German hedge fund sector remains negligible to date (see Fioretos, 2010; IOSCO, 2009). Hedge funds went through a series of crises, but only the recent financial crises touched a sufficient number of countries in favour of regulating them more tightly and therefore increased the salience of hedge fund regulation at the European level.

Quiet Politics

The public first became aware of the power of hedge funds in 1992, when a fund run by George Soros speculated against the pound sterling and eventually forced Great Britain to devalue the pound and leave the European exchange rate mechanism. During the Asian financial crisis of 1997–98, hedge funds arguably contributed to spreading the contagion. In 1998, the collapse of Long Term Capital Management (LTCM) threatened to bring down Wall Street, which was averted after the United States Federal Reserve Bank co-ordinated a US$3.6 billion bail-out.

At that time, regulators began to scrutinize the industry, which had displayed a spectacular growth from 140 funds in 1968 to approximately 3,000 funds in 1998, managing between US$200–300 billion in capital, and approximately US$800 billion to US$1 trillion in total assets (President's Working Group on Financial Markets, 1999, pp. 1–2). In particular the International Organization of Securities Commissions (IOSCO) and the Financial Stability Forum (FSF, later renamed Financial Stability Board, FSB) issued a series of principles, guidelines and recommendations (cf. IOSCO, 2009, p. 39). However, the reports rejected the call by some more critical countries to impose transnational regulation and reaffirmed an indirect model of hedge fund regulation that focused on the prime brokers providing the hedge funds with funding (see Fioretos, 2010, pp. 708–9). Both the United States and the United Kingdom remained committed to indirect regulation and engaged in only hesitant international co-ordination through the working groups of the FSF and IOSCO.

France and Germany, by contrast, favoured a direct regulation approach. In both countries, the 1990s and early 2000s were a period of significant financial market reform towards deregulation and the liberalization of financial services, but these moves were accompanied by calls for increasing oversight. In France, discussions most notably focused on the issue of a Tobin tax, which was to be levied on financial transactions. In Germany, the role of a British hedge fund in a battle to take over Deutsch Börse and the London Stock Exchange prompted the leader of the Social Democratic Party (SPD), Franz

[4] The fund itself is a legal entity separate from its manager and can be domiciled in another country. Most often, hedge funds are registered in offshore financial centres, which attract funds through tax exemptions or low regulatory requirements.

Müntefering, to refer to hedge funds and private equity as 'locusts'. The intense debate that followed with regard to the long-term responsibilities of investors and the negative consequences of short-term finances deeply resonated with the German public. With French backing, newly elected Chancellor Angela Merkel vowed to push for a tighter regulatory regime for hedge funds and made this a central issue of the G8 summit Germany chaired in 2007 in Heiligendamm.

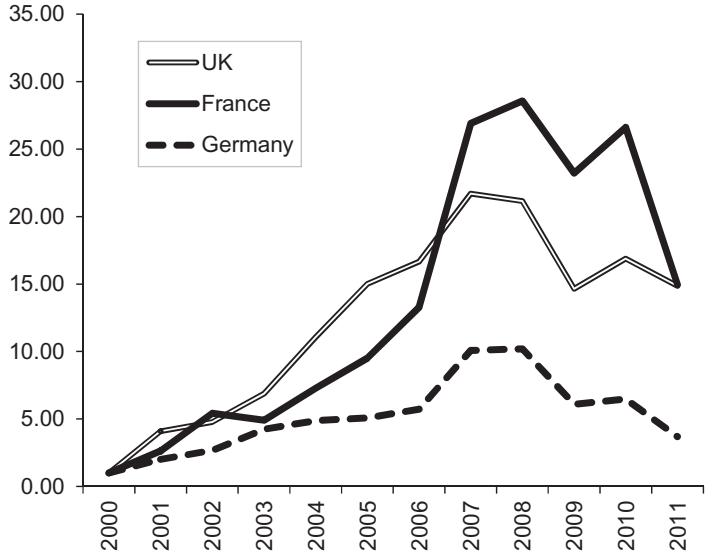
Simultaneously, the European Central Bank became involved in the issue of systemic risks posed by hedge funds and the EU began working on two directives in the early 2000s that directly touched upon the operation of the funds. First, it continued revising a directive for collective investments schemes such as mutual funds, the directive for Undertakings for Collective Investment in Transferable Securities (UCITS). UCITS are investment funds available to retail customers – that is, the general public, rather than large institutional investors. These mutual funds obtained a European passport through the UCITS directive, originally adopted in 1985, which continued to be revised throughout the 2000s in order to remove barriers to cross-border trade and specify the conditions of their operation. Second, the EU drew up a new directive on investor protection in 2004, the Markets for Financial Instruments Directive (MiFID), which also touched upon certain requirements for alternative investment. Moreover, members of the EP pressed for tighter regulation of hedge funds and private equity – most notably through the Rasmussen and the Lehne reports in 2008. However, Charlie McCreevy, the Irish Internal Market Commissioner, was concerned about the consequences of regulation for the investment industries and repeatedly declared that hedge funds would not be regulated by the EU. With the resistance of the United States and the United Kingdom, the momentum was insufficient for more than a series of principles, guidelines and recommendations. The industry was therefore able to propose a self-governance regime in order to avoid further regulation (IOSCO, 2009, p. 40; Fioretos, 2010).

Increasing Salience

The financial crisis that unfolded in 2007 led to 'alarmed discovery' of the issue and created a new sense of urgency (Lutton, 2008, p. 168). Members of the G20 publicly acknowledged the limits of the self-governance regime in international finance at the London summit in April 2009. Furthermore, they decided to grant the responsibility of monitoring systemic risks associated with hedge funds to the successor of the FSF (G20, 2009).

Almost in parallel with the London summit of the G20, the European Commission published a proposal to regulate hedge funds and private equity firms through registration and disclosure requirements on all funds previously left outside of the UCITS directive of 1985. Despite the preceding consultation the Commission had launched and despite the staunch opposition of a substantial part of the industry to these regulatory ambitions, the proposal followed up on the Rasmussen and Lehne reports of 2008 and insisted upon the need for a harmonized direct regulatory regime to be applied across Europe (Commission, 2009a, b). Specifically, the Commission proposed that all alternative investment fund managers operating in the European market be subject to authorization and oversight according to commonly defined principles. In exchange, managers authorized to operate in one of the Member States would obtain a European passport enabling them to operate

Figure 1: Newspaper Coverage



Source: Lexis Nexis.
Notes: Articles containing the search term 'hedge funds' in British newspapers, French language press and German language press, which refer to the relevant groupings of major publications proposed by Lexis Nexis. Occurrences scaled against 2000 as base year.

anywhere in the European market without having to apply for additional authorization in the respective countries. Significantly, this passport would also be available for managers of funds domiciled in countries outside the EU.

The proposal, which was produced in record time according to most observers, was met with outcry from all sides. The investment industry and representatives from liberal market economies such as the United Kingdom and Ireland complained about the costly regulatory requirements and sometimes even entirely rejected the proposal. Observers from several continental countries were concerned about the limited scope of the directive and its implications for bringing in funds from offshore financial centres into the European market. In the intensive negotiations that followed, substantial revisions were introduced and the discussion came close to entirely breaking down in several instances. Hedge fund regulation had officially moved out of the realm of 'esoteric politics' and became a matter of intense public debate. Among other things, this increase in salience is visible by simply tracing the use of the word 'hedge fund' in newspapers (Figure 1). The increase in media attention is particularly visible in France, but also notable in Germany starting in 2007.

III. Economic Interests in European Alternative Investment

What economic interests were at stake? Since financial industries had developed in several countries that were not previously liberal market economies, it is important to understand where the affected industries were located and to analyze their lobbying strategies.

Stakeholders within and beyond the Hedge Fund Industry

The hedge fund industry comprises several stakeholders: investors; the fund itself; the managers/advisers of the fund; and the prime broker/dealers, who provide lending to support leverage and facilitate short-selling, but also provide clearing and settlement of trades, and custodial services. In some cases, prime brokers can outsource services to separate custodians. Similarly, hedge fund managers can outsource administrative functions such as accounting or risk analysis to fund administrators. All in all, this implies that a considerable number of financial service activities are linked to the hedge fund industry (see Hardie and MacKenzie, 2007).

Within Europe, 76 per cent of hedge fund assets were managed out of London.[5] Other important locations include: Sweden (5 per cent), Switzerland (4 per cent), France (2 per cent) and the Netherlands (2 per cent). The funds themselves are predominately domiciled in offshore financial centres – most notably the Cayman Islands, followed by Delaware, the British Virgin Islands and Bermuda. Another 5 per cent of global hedge funds are registered in the EU, primarily in Ireland and Luxembourg (all figures from International Financial Services London, 2010).

The attraction of the United Kingdom for hedge fund management is linked to its concentration of related services. With approximately half of the European investment banking activity conducted through London, it is a central location for prime brokerage, but also administration, custody and auditing. However, among the largest hedge fund prime brokers, one can also find Deutsche Bank, and among hedge fund administrators, the French CACEIS Investor Services and the Fortis Prime Fund Solution, which is currently owned by the French bank BNP Paribas. Ireland is another important location for hedge fund administration.

Finally, many hedge funds in Europe have recently launched UCITS III-compliant fund vehicles, which they are allowed to distribute throughout Europe to retail clients. In other words, hedge funds not only offer institutional investors products, but have adapted to the regulated retail investor market in order to provide funds which qualify for the European UCITS passport. UCITS services under hedge fund management grew by an impressive 50 per cent in 2009, particularly in the United Kingdom, but also in France and Luxembourg (International Financial Services London, 2010). This development is significant because it implies that hedge funds are beginning to enter into competition with the traditional mutual fund industry, which is regulated since 1985 under the UCITS directive that prohibits both leveraging and short-selling. Second only to the United States at the global level, France is a prime location of UCITS funds both in terms of management and domicile. Some 23 per cent of European UCITS funds are managed in France, followed by Germany (20 per cent) and the United Kingdom (nearly 16 per cent). In terms of domicile, France comes in second with around 20 per cent of funds, after Luxembourg (*c*.26 per cent) (Association française de la gestion financière, 2010).

However, the AIFM directive is not just an issue for the hedge fund industry and its competitors. Indeed, one of the most central and most controversial decisions of the initial proposal was to address hedge funds through a directive covering *all* investment funds that were previously left outside the realm of EU legislation. The definition of the scope of the

[5] The United States accounts for 68 per cent of the total industry in late 2009, followed by Europe with 23 per cent and Asia with 6 per cent.

AIFM directive is therefore a negative definition, seeking to cover 'the management and administration of any non-UCITS in the European Union' (Commission, 2009b, p. 6). While pension funds and non-pooled investment such as sovereign wealth funds were excluded, private equity and venture capital funds, real estate funds, commodity funds, infrastructure funds and other types of institutional funds would have to comply with the AIFM provisions. The private equity industry was especially concerned about the directive. Private equity firms, which provide funding for companies that are not publicly traded on stock exchanges, are mainly managed in the United Kingdom (12.4 per cent), but also in France (4.7 per cent), Germany (3.3 per cent) and Sweden (1.7 per cent) (TheCityUK Research Centre, 2010). In Germany, real estate funds also play an important role.

It is thus misleading to state that only the United Kingdom had considerable economic interests at stake because it is home to almost 80 per cent of the hedge fund industry. To be sure, the City of London had a stake in almost all aspects of the hedge fund industry, as well as all other affected investment funds, but France and Sweden also have important hedge fund activities, and all the more so if related services such as prime brokerage are included. As preferred locations for the registration of funds within Europe, Ireland and Luxembourg had an interest in keeping the hedge fund industry flourishing. If one includes private equity and other investment vehicles, the spread of economic stakeholders becomes even broader. The industries and firms that we would expect to lobby in support of light-touch regulation can thus been found in the United Kingdom, France and Germany. Further support would be likely from Sweden, Luxembourg and Ireland, if one considers industry stakes only.

However, what is mostly overlooked is that a specific branch of the investment industry was quite concerned about the growth in the unregulated investment sector: collective investment funds falling under UCITS. These funds had begun to enter into the hedge funds market, where they encountered competition from hedge funds offering UCITS-compliant products. This implied that UCITS funds had a strong interest in assuring that this competition happened within the UCITS regulatory framework, wherein all market players would bear the same costs. UCITS funds are predominately located in France. In the following, I will argue that it is the political influence of the UCITS industry that was crucial for the French government's position – particularly its refusal to accept a European passport for third country funds.

Lobbying Strategies

Many members of the investment industry only realized how imminent EU regulation was when they read the first proposal of the European Commission in April 2009. Investment funds had become used to being unregulated and only paid partial attention to the consultation procedure the Commission had launched between December 2008 and January 2009. For the private equity industry in particular, the draft was a cold shower they did not expect because they had done their utmost to insist on being exempted from investment regulation (Interview with a business representative, Brussels, 4 March 2011).

In the period following the publication of the proposal, the chief executive officers of investment funds relied on their well-established ties with national politicians and insisted

on their most basic desire: to be exempt from the pending regulation. This initial lobbying period was somewhat awkward and unsuccessful at the European level. According to one representative:

> [Within the EU] if you fail to convince at the technical and technocratic level, it does not help you to be friends with the finance minister of your country or to be able to stand on your head. [. . .] Knowledge of the procedure is very important. [The investment managers], taken individually, may be falcons, but taken together, they behaved like a bunch of frightened sparrows trying to stop a steam-roller. (Interview, Brussels, 4 March 2011)

It took a while for investment firms to get organized and begin to contribute constructively to the negotiations in order to limit the negative impact on their sector of activity. The private equity industry's lobbying strategy is quite illustrative of this development: its European association, the European Private Equity and Venture Capital Association (EVCA), withdrew an initial policy statement in which it had spoken out entirely against the proposal and began to support the idea of European harmonization in order to be able to shape the details of the directive (Interview, European Commission, Brussels, 10 March 2011).

Simultaneously, the national associations lobbied their ministries, regulators and national MEPs to gain support for the common position. British industry representatives from all concerned domains furthermore co-ordinated their lobbying in both London and Brussels and deployed a tremendous effort to shift the details of the draft as well as the general attitude in the EP, but also the Commission, towards an approach favouring light-touch regulation.

Still, the British industry was initially not very adept at taking collective action because they had never been the objects of substantial regulatory efforts. Firms could chose to be represented by the Alternative Investment Management Association (AIMA), the Association of Investment Companies (AIC) or the Investment Management Association (IMA), but membership is not obligatory, contrary to France, for example. A 2009 parliamentary report highlighted that the Hedge Fund Standards Board, which collectively defines industry standards through AIMA's voluntary code of conduct, only had 34 members out of 400 to 450 firms (House of Commons, 2009, p. 128). To ward off what was perceived to be a European attack on the British regulatory model, Her Majesty's Treasury, the FSA and industry mobilized in several working groups. As one public official explained:

> Treasury held town hall meetings with hedge fund managers. You had guys worth hundreds of millions sitting on the floor because there was not enough space. They thought it would all be fine, that there was no way [the regulation] could happen. They would just shout or yell when we told them otherwise. (cited in Prabhakar, 2011, p. 23)

In contrast to these big investment funds, which only grasped the importance and functioning of the European policy-making process over the course of the negotiations in 2009 and 2010, the UCITS industry had already been playing the game since 1985. Having been active during several revisions of the UCITS directive, they monitored developments in Brussels much more closely and already had well-established ties at the national level with public officials working on EU regulation. This difference in EU public affairs experience would turn out to matter immensely since the UCITS industry was able to

make a very forceful case against some of the provisions of the AIFM directive early on (Interview with a business representative, Frankfurt am Main, 21 February 2011). According to one observer, the relationship between these funds and the French finance ministry explains the rigid position France defended throughout the negotiations. He argued:

> [French Finance Minister] Lagarde and [other French representatives] took issue with third country passports, even though it was not the position of the banking and private equity industry, or of French investors. But a small portion of the UCITS industry ended up being in competition with hedge funds and was afraid that these would be exempted from the regulatory costs weighing on the UCITS industry. They therefore said 'If they get a passport, we are dead' and the government ran with it all the way. (Interview with a business representative, Brussels, 4 March 2011)

Indeed, a French public official declared himself to be puzzled by his government's position, since it '[did] not reflect the interests of the French investment industry, which looks much more similar to the British industry than one would be led to believe' (Interview, Paris, 25 November 2009). While the French government argued that its position was congruent with its battle against tax havens, which often host alternative investment funds, several observers doubt the validity of this argument. According to proponents of the proposal, including French MEPs like Jean-Paul Gauzès, it is more efficient to impose constraints on tax havens with a passport system than without one (Interview, Paris, 19 May 2011).

Why was a small portion of the French industry so efficient in its lobbying that it outweighed all other business interests in France on these issues and almost brought the AIFM negotiations to a standstill? In the following section, I will argue that we need to consider the governments' strategies and alliances on financial regulation more generally in order to understand which demands translated into the ones the Member States defended at the EU level.

IV. Government Objectives

The French choice to defend the UCITS industry rather than other French banking or investment interests can be explained by President Sarkozy's concern about the upcoming 2012 election, which translated into a government strategy in international financial negotiations more generally. First, the UCITS concern about third country passports fit well with the government discourse against unleashed financial markets and tax havens and thus appealed potentially to the electorate. Second, France needed to build an alliance for international negotiations within the G20 and at the European level and made the strategic choice to side with Germany, which strongly advocated tight regulation. The Franco–German alliance on regulatory reform in international finance turned out to be crucial to the evolution in AIFM negotiations.

Germany had remained suspicious of hedge funds since it allowed their operation in 2004 and wished to tightly regulate them. The experience of the Deutsche Börse takeover and a general public mistrust towards alternative investment funds such as private equity, turned hedge funds into fertile ground for political activism in Germany. Nicolas Sarkozy, in turn, sought to capitalize on the financial crisis to become the founding father of a new financial architecture he intended to push under the French Presidency of the EU

in the second half of 2008, and later under the French Presidency of the G20 from 2010 to 2011, just months before the upcoming national election. Facing countries with a more light-touch tradition on financial regulation, the two governments made a pact to support each other in order to defend a pro-regulatory agenda against the Anglo-Saxon laissez-faire tradition. This general agreement fundamentally shaped alternative investment negotiations. According to a French government representative:

> Ten years ago, we were like the Germans, but we have liberalized a lot recently [. . .]. But on [alternative investment] we do not argue against the German position for political reasons, which come from the highest level. President Sarkozy has asked us to support Germany all the way. (Interview, Paris, 25 November 2009)

The first person to succumb to the pressure of the Franco–German alliance was Internal Market Commissioner Charlie McCreevy. Initially, he had publicly declared that hedge funds would not be regulated under his leadership, and allegedly signalled to his staff that anybody working on such a proposal would be fired (Interview, cited in Prabhakar, 2011, p. 110). Yet as Commission President José Manuel Barroso faced re-election in 2009, the French and German governments indicated that progress on a hedge fund directive was important to obtaining their support. With similar signals from the EP, Barroso insisted that a proposal be ready as soon as April 2009. As a result of these political imperatives, a proposal was produced in record time and without much exchange with national officials after the official consultation in January 2009. The inspiration for much of the original text came from existing European directives – in particular UCITS and MiFID – in the interest of saving time. This explains why even supporters of the regulation were disgruntled when they read the first draft (Interview, Paris, 10 December 2009). Arguing that British mistrust was partly unjustified, a French official underscored that: '[The British were] convinced that France [was] behind this directive, but I can assure you that it came from DG Market, maybe with some help from the Germans' (Interview, Paris, 25 November 2009).

Most importantly, German government representatives were concerned about the effects of alternative investment on the company structure and corporate governance regime of German firms. They therefore wanted the most comprehensive regulation possible to ensure that any type of investment would not threaten co-decision procedures and worker rights. France might have not been behind hedge fund regulation in general, but it did have strong opinions when it came to the details. A European solution was advantageous because the UCITS blueprint that was copied into the AIFM proposal reflected many of the particularities of the French market. However, the French were very concerned about the third country passport, the negative effects of which had been highlighted by their UCITS industry. Throughout the 18 months of negotiations and the 18 trialogues between the Commission, the Council and the EP, this issue turned into the most important bone of contention. The French showed no intention of opening the European market to offshore funds – a position that effectively made the proposal unacceptable to British industry.

After repeated stalemates in July, September and October 2010, it became clear that France was isolated in its opposition to the third country passport in the Council. And yet, in the run-up to an Ecofin Council, the under-secretary who was supposed to represent Germany got a call from Finance Minister Wolfgang Schäuble, who insisted: 'I promised Christine Lagarde that you will not isolate her' (Interview, Brussels, 4 March 2011). In

spite of their doubts about the substance of the French position, the Germans thus afforded France some extra time to propose a last compromise, which suggested that the new European Securities Market Authority (ESMA) should be charged with the licensing of third country fund access to the EU market (EurActiv, 2010a). The British refused to grant such powers to a European authority and even American Secretary of the Treasury Timothy Geithner intervened by writing to French Finance Minister Christine Lagarde to warn about the consequences of French protectionism.

With strong opposition from the United Kingdom and German support waning, the French finally decided to accept a compromise that allowed third country access and left it up to national regulators to grant third country funds access. In exchange, the United Kingdom accepted delaying access for third country funds until 2015. Moreover, ESMA was charged with drawing up the requirements these funds would have to fulfil, and it is expected to settle disputes between national regulators if they disagree on the eligibility of a given fund (EurActiv, 2010c).

This final agreement was reached on 26 October 2010, leading to adoption by the EP on 11 November, just in time to present the new EU regulatory framework at the G20 meeting in Seoul on 12 November, before it was approved by the Council of Ministers on 17 November. The EP had proposed substantial changes to the initial proposal, tabling a total of 1,690 amendments! This unusually high number was necessary, according to MEP and directive rapporteur Jean-Paul Gauzès, in order to build support from both camps: those who insisted on the need for more control and those who pointed to the attendant costs for affected industries (Interview, Paris, 19 May 2011). To bring the hastily written draft in line with the realities of different alternative investment funds, he held 198 meetings with industry representatives (Serrouya, 2010). The European Commission official following the directive admits he stopped counting after the number of meetings reached 150 (Interview, Brussels, March 2011).

The directive came into force in January 2011. From that date, each Member State has two years to transpose the directive into national law, with the assistance of the ESMA, which will provide advice on the most appropriate implementation measures for the 210 pages of the directive. This means that the directive is effective only in January 2013. The passport for third country funds and managers will become available after an additional two-year transition period, in January 2015.

The final hedge fund compromise reflected the intense bargaining among the EU member countries, dominated by the stances of Germany, France and the United Kingdom. The final text is significantly less ambitious than the original Commission proposal. Under the Swedish Council Presidency in late 2009, some of the most controversial elements were removed, including a leverage cap on funds, or became less stringent (for detailed discussion, see Buckley and Howarth, 2011). Although the existence of the AIFM directive testifies to the desire to reach previously unregulated parts of the financial industry, it is thus difficult to argue that the directive can be explained by a paradigm shift towards more regulation. Rather, it represents a minute compromise between Member States and their industries.

As with most political compromises, none of the negotiators obtained what they initially sought, but the directive succeeded in creating a single market for alternative investment funds. While the United Kingdom had to accept that alternative investment would be regulated at the supranational level, France did not succeed in excluding

offshore funds from the European market. However, the fund industry in London now has the advantage of providing a one-stop regulatory shop for all operations in the European market. France in turn obtained a regulatory framework for institutional investment that looks quite similar to the one it initially helped to shape for the retail mutual funds market. Despite the insistence of the French government, the origin of funds is not an issue as long as they comply with the regulatory requirements imposed on hedge fund managers. For the German government, any encompassing regulation is satisfactory as they have the least amount of their industry's economic interests at stake. Concerned with the preservation of the German corporate model, German MEPs most notably affected issues such as asset stripping (the selling off of capital immediately after buying equity), which was a central issue for private equity firms. Regulating asset stripping reduces the attractiveness for private equity firms to buy a company in order to sell off its assets and make a quick profit (EurActiv, 2010b).

Conclusions

The AIFM directive is neither the result of simple interest-based politics, nor of a paradigm change towards tighter regulation. To be sure, different parts of the financial industry were decisive for the evolution of the negotiations and the final compromise. This was the case in the United Kingdom, which sought to defend the comparative advantage of the City of London. Similarly, Ireland or Luxembourg defended the interests of their investment industries in order to protect their economic activities. The behaviour of countries with important investment activities and a tradition of liberal market economies is thus in line with political-economic predictions. Likewise, the policy stances defended by the German government are quite comprehensible from a varieties of capitalism perspective, which underlines the importance of company finance for the German industrial model.

The puzzle is the position of France. Despite considerable investment activities and large commercial banks active in alternative investment, the French government defended a very conservative stance that almost brought negotiations to a standstill. By studying the lobbying behaviour of French industry, it becomes possible to see that the French position was not just a rhetorical commitment to tighter financial regulation, it also sought to protect the interest of the domestic UCITS industry which feared competition from hedge funds in their sector.

What explains the choice of the French government to side with the UCITS industry is the effect of high political salience on policy-making, which brings government strategies to the forefront. In the strategic interactions that followed, the French position resulted from the fact that it was compatible with both public and private objectives as well as international alliance considerations. First, the UCITS position allowed France to keep up a pro-regulation rhetoric that was important for the electoral ambitions of French President Nicolas Sarkozy. Second, it was compatible with the French desire to forge an alliance with Germany in order to counter the US–UK alliance in international and EU negotiations. However, the opposition to third country passports is in itself not a necessary element of tighter regulation. This becomes evident when one studies the German lack of interest for the issue. It is thus important not to confuse the adaptation of political strategies under high salience with paradigmatic change.

To summarize, the financial industry is crucial in European financial regulation, and not just in order to understand the position of those pressing for more permissive governance. However, we cannot understand which interests will eventually be represented if we do not take into account the government's strategy, which shifts markedly once an issue moves from low to high salience. The case study thus illustrates how initially static political economy set-ups evolve over time. As Fioretos (2010) has underlined, the distribution of economic interests does not predetermine government stances. Instead, the timing and sequence of negotiations create feedback loops, which can favour some domestic interests over others. As a consequence, 'variation in states' preferences over existing institutional bargains will depend on which interest groups have succeeded in becoming embedded in the relevant regulatory decision-making structure' (Farell and Newman, 2011, p 620). Studying business–government relations – in particular in highly politicized issue areas – shows that politicians have some discretion over the economic interests they will take into account and the ones they will choose to ignore for electoral or geopolitical reasons.

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