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## Hedge funds and private equity

P6\_TA(2008)0425

### European Parliament resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI))

(2010/C 8 E/06)

*The European Parliament,*

- having regard to the Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent <sup>(1)</sup>,
- having regard to the Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies <sup>(2)</sup>,
- having regard to the Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts <sup>(3)</sup>,
- having regard to Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions <sup>(4)</sup>,
- having regard to Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses <sup>(5)</sup>,
- having regard to Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions <sup>(6)</sup>,
- having regard to Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses <sup>(7)</sup>,
- having regard to Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS <sup>(8)</sup>,
- having regard to Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services <sup>(9)</sup>,
- having regard to Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) <sup>(10)</sup>,
- having regard to Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision <sup>(11)</sup> (Pension Funds Directive),

<sup>(1)</sup> OJ L 26, 31.1.1977, p. 1.

<sup>(2)</sup> OJ L 222, 14.8.1978, p. 11.

<sup>(3)</sup> OJ L 193, 18.7.1983, p. 1.

<sup>(4)</sup> OJ L 372, 31.12.1986, p. 1.

<sup>(5)</sup> OJ L 82, 22.3.2001, p. 16.

<sup>(6)</sup> OJ L 283, 27.10.2001, p. 28.

<sup>(7)</sup> OJ L 41, 13.2.2002, p. 20.

<sup>(8)</sup> OJ L 41, 13.2.2002, p. 35.

<sup>(9)</sup> OJ L 271, 9.10.2002, p. 16.

<sup>(10)</sup> OJ L 96, 12.4.2003, p. 16.

<sup>(11)</sup> OJ L 235, 23.9.2003, p. 10.

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- having regard to Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings <sup>(1)</sup>,
- having regard to Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading <sup>(2)</sup>,
- having regard to Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids <sup>(3)</sup>,
- having regard to Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments <sup>(4)</sup>,
- having regard to Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive <sup>(5)</sup> (MiFID Implementing Directive),
- having regard to Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market <sup>(6)</sup>,
- having regard to Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 establishing a new organisational structure for financial services committees <sup>(7)</sup>,
- having regard to Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing <sup>(8)</sup>,
- having regard to Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) <sup>(9)</sup> (the Capital Requirements Directive),
- having regard to Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) <sup>(10)</sup> (the Capital Adequacy Directive),
- having regard to Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies <sup>(11)</sup>,
- having regard to the Commission proposal for a directive of the European Parliament and of the Council of 21 April 2008 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (COM(2008)0119) (Solvency II Proposal),
- having regard to the Commission communication of 21 December 2007 on Removing obstacles to cross-border investments by venture capital funds (COM(2007)0853),
- having regard to its resolution of 15 January 2004 on the future of hedge funds and derivatives <sup>(12)</sup>,
- having regard to its resolutions of 27 April 2006 <sup>(13)</sup> on asset management and of 13 December 2007 on Asset Management II <sup>(14)</sup>,

<sup>(1)</sup> OJ L 178, 17.7.2003, p. 16.

<sup>(2)</sup> OJ L 345, 31.12.2003, p. 64.

<sup>(3)</sup> OJ L 142, 30.4.2004, p. 12.

<sup>(4)</sup> OJ L 145, 30.4.2004, p. 1.

<sup>(5)</sup> OJ L 241, 2.9.2006, p. 26.

<sup>(6)</sup> OJ L 390, 31.12.2004, p. 38.

<sup>(7)</sup> OJ L 79, 24.3.2005, p. 9.

<sup>(8)</sup> OJ L 309, 25.11.2005, p. 15.

<sup>(9)</sup> OJ L 177, 30.6.2006, p. 1.

<sup>(10)</sup> OJ L 177, 30.6.2006, p. 201.

<sup>(11)</sup> OJ L 184, 14.7.2007, p. 17.

<sup>(12)</sup> OJ C 92 E, 16.4.2004, p. 407.

<sup>(13)</sup> OJ C 296 E, 6.12.2006, p. 257.

<sup>(14)</sup> Texts Adopted, P6\_TA(2007)0627.

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- having regard to its resolution of 11 July 2007 on financial services policy (2005-2010) — White Paper <sup>(1)</sup>), in particular paragraph 19 thereof,
  - having regard to its resolution of 20 February 2008 on the Integrated Guidelines for Growth and Jobs (Part: broad guidelines for the economic policies of the Member States and the Community): Launching the new cycle (2008–2010) <sup>(2)</sup>,
  - having regard to the International Organisation of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation of May 2003, which include principles for, inter alia, the marketing of collective investment schemes including hedge funds,
  - having regard to the study by the European Parliament Policy Department for Economic and Scientific Policy on Hedge Funds on Transparency and Conflict of Interest, of December 2007,
  - having regard to the Hedge Fund Working Group's best practice standards of 22 January 2008, and the subsequent setting up of a Hedge Fund Standards Board to act as custodian of those standards,
  - having regard to Article 192, second paragraph, of the EC Treaty,
  - having regard to Rules 39 and 45 of its Rules of Procedure,
  - having regard to the report of the Committee on Economic and Monetary Affairs and the opinions of the Committee on Legal Affairs and the Committee on Employment and Social Affairs (A6-0338/2008),
- A. whereas there is at present national and EU regulation concerning financial markets that directly or indirectly, though not exclusively, applies to hedge funds and private equity,
- B. whereas the Member States and the Commission should ensure the consistent implementation and application of that regulation; whereas all further adjustments to existing legislation should be the subject of a proper cost/benefit analysis and should be non-discriminatory,
- C. whereas the Commission has not responded positively to all aspects of Parliament's earlier requests, including those made in its abovementioned resolutions of 15 January 2004, 27 April 2006, 11 July 2007, 13 December 2007,
- D. whereas hedge funds and private equity have very different characteristics and no unambiguous definition of either exists but both are investment vehicles used by sophisticated rather than retail consumers; whereas they cannot be appropriately treated as a single category for product-specific regulation,
- E. whereas hedge funds and private equity are increasingly important alternative investment vehicles that not only have a significant and increasing share in global assets under management, but also improve the efficiency of financial markets, by creating new investment opportunities,
- F. whereas several global, EU and national institutions have, long before the current financial crisis, analysed potential concerns in relation to hedge funds and private equity as regards financial stability, risk management standards, excessive debt (leverage) and the valuation of illiquid and complex financial instruments,
- G. whereas an analysis conducted by the Financial Stability Forum in 2007 concluded that financial stability concerns were best addressed through enhanced supervision of all actors,
- H. whereas in its Global Financial Stability Report of April 2008, the International Monetary Fund (IMF) concluded that there is a 'collective failure to appreciate the extent of leverage taken on by a wide range of institutions — bank, monoline insurers, government-sponsored entities, hedge funds — and the associated risks of a disorderly unwinding',

<sup>(1)</sup> OJ C 175 E, 10.7.2008, p. 392.

<sup>(2)</sup> Texts Adopted, P6\_TA(2008)0058.

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- I. whereas realising the Lisbon Agenda requires long-term investment in growth and jobs,
- J. whereas such long-term investment requires well-functioning stable financial markets in the EU and globally, contributing to the real economy, which can be achieved only by ensuring the presence in the EU of a competitive and innovative financial industry,
- K. whereas hedge funds and private equity in many cases provide liquidity, foster market diversification and market efficiency by creating demand for innovative products, and aid price discovery,
- L. whereas financial stability also requires better supervisory cooperation, including at global level, which logically requires, continuing improvements of current EU supervisory arrangements including regular exchanges of information and enhanced transparency of institutional investors,
- M. whereas the Commission should investigate the possibilities of regulating off-shore market players globally,
- N. whereas appropriate levels of transparency towards investors and supervisory authorities are crucial to ensure such well-functioning and stable financial markets as well as for promoting competition between market actors and products,
- O. whereas the Commission should monitor and analyse the effects of the operations of hedge funds and private equity and to consider putting forward a directive on minimum transparency rules on how investments are financed in the future, risk management, methods of assessment, managers' qualifications, possible conflicts of interest as well as the disclosure of ownership structures and the registration of hedge funds,
- P. whereas in order to satisfy the need to monitor market activity for supervisory purposes, information on hedge fund exposures and lending should be made available to competent supervisory authorities without excessive burdens,
- Q. whereas the fund industry is expected to move further towards binding measures on corporate governance with a view to achieving greater transparency which must also be made public; calls for an improvement of controlling mechanisms,
- R. whereas Member States should use best practice to ensure that company pensions acquired by employees are shielded from bankruptcies;
- S. whereas the Commission should consider including in the definition of the prudent person principle, whenever that principle is incorporated in the existing Community legislation, the requirement for investors to verify that the alternative investment funds in which they invest comply with appropriate legislation and the industry's best practice standards,
- T. whereas the current diversity of private placement definitions in the Member States constitutes an obstacle to the internal market and creates an incentive for the leakage of high risk products onto the retail market,
- U. whereas a one-stop-shop website for codes of conduct should be established, including a register of those who comply, their disclosure and explanations of non-compliance; observes that reasons for non-compliance can also be a learning tool; whereas that website should be established for the EU and promoted internationally,
- V. whereas in its Global Financial Stability Report of April 2008, the IMF warned that 'corporate debt market appears vulnerable as default rates are set to rise, owing to both macroeconomic and structural factors',

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- W. whereas the recent increase in private equity transactions has significantly increased the number of employees whose jobs are ultimately controlled by equity funds, and, therefore, due regard should be paid to existing national employment laws as well as Community employment law (in particular Directive 2001/23/EC), which was formulated when this was not so; whereas national and Community employment law should apply on a non-discriminatory basis, including fair and appropriate treatment of all economic actors with similar responsibilities towards employees,
- X. whereas under many legal systems, hedge funds and private equity that own and control companies are not regarded as employers and are therefore exempt from employers' legal obligations,
- Y. whereas in the event of extreme debt loads companies present a higher risk profile,
- Z. whereas, as with other entities, there may be conflicts of interest either arising from the business model of private equity or hedge funds or from the relationships between those vehicles and other actors in financial markets; efforts to enhance existing Community legislation should not be restricted to hedge funds and private equity and should be in line with global standards such as the IOSCO principles for the management of conflicts of interest by collective investment schemes and market intermediaries;
- AA. whereas the remuneration systems for managers of hedge funds and private equity may give rise to inappropriate incentives leading to irresponsible risk taking,
- AB. whereas hedge funds were amongst the investors in the complex structured products that were subject to the credit crisis, and thus incurred losses as did other investors.,
- AC. whereas in order to minimise the risk of future financial crises and given the strong interactions across markets and between market participants as well as the objective of a level playing field across borders and between regulated and unregulated market participants, several initiatives in the EU and at global level are under way, including a review of the Capital Requirements and Capital Adequacy Directives and a proposal for a directive on Credit Rating Agencies, in order to secure more coherent and harmonised regulation across the board,
- AD. whereas principle-based regulation is an appropriate approach to regulating financial markets as it is better able to keep up with market developments,
- AE. whereas there is need for action at EU level on the basis of the following seven principles for financial institutions and markets:
- regulatory coverage: existing Community legislation should be reviewed to identify any regulatory gaps; national variations should be reviewed and harmonisation should be promoted, for example through colleges of supervisors or otherwise; international equivalence and cooperation should be pursued;
  - capital: capital requirements should be mandatory for all financial institutions and should reflect risk from the type of business, exposures and risk control; longer liquidity horizons should also be considered;
  - originate and distribute: to achieve a better alignment of the interests of investors and originators, originators should generally retain exposure to their securitised products by holding a representative stake in the product; disclosure should be made of the level of the stakes originators keep in loan products; as an alternative to retention, other measures to align interests of investors and originators should be investigated;
  - accounting: a smoothing technique to counter the pro-cyclical effects of fair value accounting should be considered;

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- rating: to increase transparency and understanding in the ratings market, Credit Rating Agencies should adopt codes of conduct regarding visibility of assumptions, product complexity and business practices; conflict of interest should be managed; unsolicited rating should be independently categorised and not used as a means of pressure to obtain business;
  - derivative trading: open and visible trading of derivatives should be promoted whether on-exchange or otherwise;
  - the long term: reward packages should be aligned with longer term outcomes, reflecting losses as well as profits,
- AF. whereas such action would provide a legal basis, universal and comprehensive, encompassing all financial institutions above a certain size, mutually taking into account international supervisory and regulatory practices,
1. Requests the Commission to submit to Parliament by the end of 2008, on the basis of Article 44, Article 47(2), or Article 95 of the EC Treaty, a legislative proposal or proposals covering all relevant actors and financial market participants, including hedge funds and private equity, responding to the seven principles outlined in Recital AE and following the detailed recommendations below;
  2. Confirms that the recommendations respect the principle of subsidiarity and the fundamental rights of citizens;
  3. Considers that the financial implications of the requested proposal or proposals should be covered by EU budgetary allocation;
  4. Instructs its President to forward this resolution and the accompanying detailed recommendations to the Commission, the Council and the governments and parliaments of the Member States.

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ANNEX TO THE RESOLUTION:  
DETAILED RECOMMENDATIONS ON THE CONTENT OF THE PROPOSAL(S) REQUESTED

***Recommendation 1 on financial stability, capital and universal regulatory coverage***

*The European Parliament considers that the legislative act to be adopted should aim to regulate:*

Capital requirements — Investment firms including partnerships and limited partnerships, insurance companies, credit institutions, conventional funds (such as UCITS and pension arrangements) should be required to comply with capital requirements. The Commission should ensure that appropriate capital requirements be risk based, not entity based, for all financial institutions. Consideration regarding adherence to codes of conduct may be taken into account by supervisors. Those capital requirements should, nevertheless, not be additional requirements to already existing rules and should in no case be regarded as a guarantee in the event of any fund failure.

Originators and Securitisation — The Commission's proposal(s) concerning capital requirements should require that originators hold portions of securitised loans on their balance sheets or impose capital requirements on the originator that are calculated on the assumption that it held those portions or provide other means to align the interests of investors and originators.

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EU oversight of Credit Rating Agencies — The Commission should establish a mechanism for EU review of Credit Rating Agencies, procedures and compliance, with duties allocated to existing bodies such as the Committee of European Securities Regulators (CESR), also in order to foster competition and enable market access in the field of credit ratings.

Valuation — The Commission should adopt principle-based legislative measures on the valuation of illiquid financial instruments in line with the work of competent international bodies in order better to protect investors and the stability of financial markets, taking into account the various initiatives on valuation currently under way in the EU and globally and examining how best to promote this valuation.

Prime brokers — The transparency requirements applicable to any institution providing prime brokerage services should be increased in line with the complexity and opacity of the structure or nature of the exposures, to which their dealings with all products and actors, including hedge funds and private equity expose them.

Venture capital and SME sector: The Commission should propose legislation to provide a harmonised EU-wide framework for venture capital and private equity, and particularly so as to ensure cross-border access to such capital for the SME sector in line with the Lisbon Agenda. For this purpose, the Commission should implement, without delay, the policy proposals set out in its communication on removing obstacles to cross-border investments by venture capital funds. The proposal should be in line with principles of good regulation and should avoid additional legal, fiscal and administrative complexities at EU level.

### **Recommendation 2 on transparency measures**

*The European Parliament considers that the legislative act to be adopted should aim to regulate:*

Private Placement Regime — The Commission should submit a legislative proposal for the establishment of a European private placement regime allowing for cross-border distribution of investment products, including alternative investment vehicles, to eligible groups of sophisticated investors. Such a proposal should establish, where appropriate, the following principles of disclosure to investors and relevant public authorities:

- general investment strategy and fee policy,
- leverage/debt exposure, risk-management system and portfolio valuation methods,
- source and amount of funds raised, including internally,
- rules providing for full transparency of high level executives and senior managers' remuneration systems, including stock options,
- registration and identification of shareholders beyond a certain proportion.

Investors — The Commission should, in cooperation with supervisory authorities, devise rules to ensure clear disclosure and communication of relevant and material information to investors.

Private equity and protection of employees — The Commission should ensure that Directive 2001/23/EC always grants the same rights to employees, including the right to be informed and consulted, whenever control of the undertaking or business concerned is transferred by any investors, including private equity and hedge funds.

Pension schemes — Since the mid-1990s, there has been an increasing number of pension funds and insurance companies with holdings in hedge funds and private equity and any failure would negatively affect the pension entitlements of the pension schemes' members. In reviewing Directive 2003/41/EC, the Commission should ensure that employees or staff representatives are informed directly or via trustees about the way in which their pensions are invested and the associated risks.

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**Recommendation 3 on excessive debt measures**

*The European Parliament considers that the legislative act to be adopted should aim to regulate:*

Leverage for private equity — The Commission should, while reviewing Directive 77/91/EEC on capital, ensure that any amendments adhere to the following fundamental principles: there is capital held according to risk, there is a reasonable expectation that the level of leverage is sustainable both for the private equity fund/firm and for the target company, and that there is no unfair discrimination against specific private investors or between different investment funds or vehicles that use similar strategy.

Capital depletion — The Commission should propose harmonised supplementary measures at EU level, where needed, on the basis of a review of existing national and Community legislative options in order to avoid unreasonable asset stripping in target companies.

**Recommendation 4 on conflicts of interest measures**

*The European Parliament considers that the legislative act to be adopted should aim to regulate:*

The Commission should introduce rules to ensure effective separation between services that investment firms provide for their clients. The European Parliament wishes to reiterate that any adjustments should be applicable to all financial institutions and thus non-discriminatory. As recommended by the IOSCO, financial institutions, which provide a range of different financial services should have policies and procedures, including proper disclosure, at the firm or group level that enable it to identify, assess and develop appropriate means of addressing conflicts or potential conflicts.

Credit Rating Agencies — Credit Rating Agencies should be required to increase information and eliminate or mitigate asymmetric information and uncertainty and disclose the conflicts of interest under which they operate without destroying the transaction oriented financial system. In particular, Credit Rating Agencies should be required to separate their rating business from any other services (such as advice on structuring transactions) that they provide in respect of any obligations or entities that they rate.

Market access and concentration — the Commission's Directorate General for Competition should launch a general review of the effects of market concentration and of the effects of dominant players in the financial services industry and in the light of the international situation including hedge funds and private equity. It should assess whether Community competition rules are applied by all market players, whether there is unlawful market concentration or any need to remove barriers to new entrants as well as the need to remove legislation favouring incumbents and current market structures where competition is limited;

**Recommendation 5 on existing financial services legislation**

*The European Parliament considers that the legislative act to be adopted should aim to regulate:*

The Commission should undertake an examination of all existing Community legislation relevant to financial markets in order to identify any lacunae as regards the regulation of hedge funds and private equity and, based on the results of such examination, to submit to the European Parliament a legislative proposal or proposals amending the existing directives where necessary, in order better to regulate hedge funds, private equity and other relevant actors. Such proposed regulation should be purposive.

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