The regulation of hedge funds at an EU level: The US Sub-prime crisis in context

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TABLE OF CONTENTS

ABSTRACT

Never far from the eye of a financial storm is the hedge fund industry. Whilst there may be increasing consensus that something needs to be done there is no single unified EU regulatory framework specifically targeting hedge funds. One would expect the sub-prime crisis to create further pressure for action on hedge fund regulation but in the face of the crisis the Commission has continued to rule out any specific European Union (EU) legislation. The relationship between hedge-funds and financial crisis is complex and less causal than is often portrayed and from an EU perspective, there are strict limits on its ability to act, not least as a result of the international nature of the regulatory environment and the conflict between key actors but also because of the nature of the regulatory regime which has traditionally demanded a 'light touch' approach. However, hedge fund regulation cannot be considered in isolation but rather should be viewed in the context of a wider programme to integrate European financial services markets. Viewed from this perspective, EU regulation is in fact changing the landscape of the hedge fund industry through a process of negative integration. This process has significant implications for the nature of the investors exposed to hedge-fund activities - shifting from 'sophisticated investors' to ordinary investors exposed through their basic pensions and investments.

Keywords; hedge funds, regulation, supervision, European Commission, integration by stealth, Majone, negative integration, positive integration, European Union, Downs Issue Attention Cycle, sub-prime, financial crisis, financial services, UCITS Directive

INTRODUCTION

Financial markets are currently in the grip of a global credit crunch. A downturn in the US housing market created the US sub-prime debacle which in turn has reverberated across highly integrated global markets to become what some commentators argue is the worst financial crisis in seventy years (Lomax, 2008; 5). Never far from the eye of a financial storm is the hedge fund industry. There is increasing consensus that something needs to be done; that this 'unregulated' industry deserves more attention from regulators and policy makers and yet, there is no single unified EU regulatory framework specifically targeting hedge funds (ECMI, 6). One would expect the sub-prime crisis to create further pressure for action on hedge fund regulation but in the face of the crisis the Commission has continued to rule out any specific European Union (EU) legislation governing hedge funds.

The current policy debate is reminiscent of Downs issue attention cycle. The continued presence of hedge funds across a series of financial crisis has created public alarm. The 'alarmed discovery' has been followed by 'euphoric enthusiasm' that regulation is the solution (Hogwood, 1992; 1). In this paper, I seek to develop the debate on the regulation of hedge funds and the role of the EU by placing it in an historical, institutional and theoretical context. I consider the regulatory context in which hedge funds currently operate and demonstrate that there are limitations on the capacity of EU institutions to regulate in this area. However I argue that hedge fund regulation cannot be considered in isolation but rather should be viewed in the context of a wider programme to integrate European financial services markets. Viewed from this perspective, EU regulation is in fact changing the landscape of the hedge fund industry through a process of negative integration. Drawing on Majone's (2006) theory of *integration by stealth*. (Majone, 2006; 613), I argue that the consequences of continued negative integration in the EU securities regime, rather than financial crises, may drive future pressure for regulatory action on hedge funds.

FINANCIAL CRISIS: 'ALARMED DISCOVERY'

There is considerable popular consensus that hedge funds constitute a threat to financial stability and therefore need to be regulated in some way. There is no shortage of evidence to support concern; the deputy governor of the Bank of England said in a speech in May 2007: "If we face a financial crisis in the next few years we are almost bound to find some hedge funds at or near the centre of it…"(Grieve, 2008; 6).

The current policy debate on hedge funds is recalls Down's Issue Attention Cycle in particular stage two; 'alarmed discovery and euphoric enthusiasm' (Downs, 1972; 39-40). An issue reaches stage two of the cycle when as a result of some dramatic series of events the public suddenly becomes aware off and alarmed by the 'evils' of a particular problem. Downs argues that this alarmed discovery is invariably accompanied by 'euphoric enthusiasm' about society's ability to solve the problem or do something effective within a relatively short time period (Downs, 1972; 39-40). The continued presence of hedge funds across a series of financial scandals and crisis have resulted in public alarm about hedge funds and an increasing consensus that regulation is needed to solve the policy problem.

The first and most infamous financial scandal involving hedge funds was the ejection of sterling from the European Exchange Rate Mechanism (ERM). Hedge fund manager, George Soros, was reported to have profited $1 billion by short selling sterling (Kaletsky, 1992). The 'long-short' strategy is the most common hedge fund strategy and provides the origin of the word 'hedge'. The hedge is a 'bet' against the security going up (long selling) and down (short selling). Soros 'bet' against the UK government being able to keep sterling within the ERM (Kaletsky, 1992). Hedge funds were again linked to a national currency crisis in 1997 when fund mangers were accused of deliberately causing a sell-off of Malaysian currency. The then Prime Minister, Mahathir Mohamad, called hedge funds “unscrupulous profiteers” involved in an “unnecessary, unproductive and immoral” trade (Vines, 1997). Less than a year after the Asia financial crisis a high profile US hedge fund, Long-term Capital Management (LTCM) collapsed. The collapse of the hedge fund shocked the financial world because it revealed the extent to which mainstream financial institutions were exposed to hedge funds (1998; 8). As the hedge fund industry developed through the mid-nineties investment banks became increasing involved in this sector as service providers, supplying credit lines know as leverage. When LTCM collapsed it was borrowing $200 billion on an original capital base of $ 5 billion (Rees-Mogg, 1998). LTCM highlighted the risk that the collapse of a highly leveraged hedge fund could bring down with a major financial institution and spreading into a crisis in the global banking system (1998; 8).

Sub-prime provides the latest ‘drama’ and further fuels public alarm that hedge-funds as intrinsically threatening because it is another example of a financial crisis where hedge funds have played a role. Hedge funds, always at the forefront of financial innovation, sliced and diced, recombined and traded sub-prime loans as securities on the structured credit market and as a result became embroiled in the crisis. The crisis began to unfold in 2006 with a downturn in the US housing market and was further compounded by rising interest rates. Rising defaults forced lenders to make provisions for bad debts and by the summer of 2007, fearing the scale and location of losses arising from sub-prime mortgages, there was effectively an investor strike from global securitisation markets (Gieve, 2008; 3). With little transparency between the original underlying loan and the end investors, when the system began to unwind panic spread quickly because of the complexity and opaque nature of the loans. Two hedge funds run by the investment bank Bear Sterns collapsed as a direct result of the sub-prime crisis, creating pressure for action on hedge fund regulation (Tett, 2007; 13). At the beginning of the crisis in the summer of 2007 French President Sarkozy wrote to the German Chancellor Merkel urging the German government to use its G8 presidency to improve the transparency of hedge funds (Atkins and Hollinger, 2007; 4). The Chairman of BarCap, meanwhile, urged politician's to act on "a completely unregulated sector standing apart from banks, which does not have the necessary transparency" (Kramb and Larsen, 2007; 22) .

Although much of the current debate centres on the role of hedge funds in financial crisis, the activities of some private equity firms have also raised concern. Hedge funds involved in private equity, trade in equity investments in companies not listed on a public stock exchange. Private equity funds have long been the target of trade union groups who have accused them of having no vested interest in the long term development of their acquisitions. In the UK, the GMB (General Workers Union) has lead a campaign against the private equity fund that owns the Automobile Association (AA), accusing it of eroding workers pay and conditions and asset stripping to increase profits (Mawson, 2006). In 2005 a senior member of the German Social Democratic party accused hedge funds of "routing the economy – browbeating management, stripping assets and axeing jobs" after a group of hedge funds and a private equity fund blocked German company, Deutsche Borse, from buying the London Stock Exchange (Jenkins, 2005; 8). The present coalition German government has continued to the be the most outspoken member state on hedge funds and used its presidency of the European Council and the G8 in 2007 to put forward proposals for an international register, greater transparency and code of conduct (Benoit, 2006).

As has become evident, there is considerable apparent ground for concern in relation to the threat posed by hedge-fund activities to financial stability. In practice, however, the role of hedge-funds is not so straightforward. Hedge funds are at or near the centre of financial crisis because by their nature they are designed to exploit opportunities created by market failures and inefficiencies therefore their presence and even role in a financial crisis is predictable. The sub-prime crisis and its consequences on global markets can be seen as a loss of trust in the whole style of modern finance with its complex dispersion of risk but not in hedge funds specifically. Although Soros profited from the UK's ejection from the ERM he did not cause it and in the case of the Asia financial crisis, hedge funds were later exonerated by the International Monetary Fund who concluded that whilst some funds may have determined the timing of the crisis they were not themselves the cause and only played only a "relatively limited" role (Atkinson, 1997; 16).

HEDGE-FUNDS: THE REGULATORY ENVIRONMENT

Hedge funds operate in a highly integrated global financial market; they trade in transnational capital which crosses national and regional boundaries. In fact, most hedge funds are actually domiciled out with the authority of EU institutions in offshore markets like the Bahamas and the Cayman Islands in the Caribbean and the Isle of Man and Channel Islands in Europe (PSE, 2007; 10). The offshore markets have developed their own regulatory rules governing hedge funds but it is generally light-touch in style offering the funds certain types of additional flexibility, secrecy and openness to 'legitimate' options not quite allowed in the major financial centres, not to mention tax minimization and tax exemption strategies (Morgan and Knights, 1997; 34). The existence of these offshore markets considerably complicates the creation of any new regulatory system as they have emerged and developed precisely to avoid regulation (Morgan and Knights, 1997; 34). Although hedge funds are domiciled in one jurisdiction they are normally managed from another (CEC, 2006b; 14). The USA dominates the fund management industry with 53% of the all hedge funds having a fund manager located in the United States but the EU industry has grown consistently throughout the 1990's and now manages 27% of global assets (Gottlieb, 2007; 2). Hedge fund managers are subject to a patchwork of national regulatory regimes which oversee registration and limit access to retail markets but they operate in a light-touch regulatory environment compared to traditional financial markers such as the stock exchange and investment vehicles like pension funds where rules on transparency, valuation and disclosure are strictly laid down (CEC, 2006b; 16).

The light-touch nature of hedge funds and hedge fund manager regulation can be attributed to two factors. Firstly, hedge funds have expanded and grown without attracting much attention from regulators because they target 'sophisticated investors'. There is no commonly held definition of a sophisticated investor but it is generally held to mean institutional or high net-worth individuals (HNWI) who are sufficiently resourced and experienced to assess their own risk. Ordinary investors are generally excluded by high minimum investment levels and restrictions on the funds ability to market into what is known as the 'retail' market. For this reason hedge fund investors do not require the same level of investor protection afforded to traditional investment vehicles such as pension funds where ordinary members of the public make up the bulk of the investor base. Secondly, the light-touch regulatory context is underpinned by a belief that regulatory light zones are necessary to ensure the continued competitiveness of the EU financial services sector (Gottlieb, 2007; ; Wymeersch, 2005). Wymeersch (2005) argues that most financial innovation takes place outside of strictly regulated areas and cites hedge funds as an example. Many have argued that a light touch regulatory zone ensures that entrepreneurial hedge fund managers are not stifled by excessive regulation and bureaucracy (Wymeersch, 2005; 993).

The regulatory context within which hedge funds operate leaves limited scope for EU institutions to regulate in this area. First, the majority of hedge funds are not subject to EU authority, secondly hedge fund managers although operating within the EU are already subject to national regulation and supervision, thirdly there is no consumer or public protection imperative because hedge funds are targeted at sophisticated investors and finally there is a recognition that a hands-off regulatory approach is required to ensure the continued competitiveness and financial innovation in EU financial services market. Although there may be a growing consensus concerning a need for action, the regulatory context provides limited scope for EU institutions to solve this policy problem. Indeed, the EU response would seem to confirm this.

The question of EU regulation that specifically targets hedge funds was raised in the Green Paper on the Enhancement of the EU Framework for Investment Funds (2005) in which the Commission asked, "Are there particular risks (from an investor protection or market stability perspective) associated with the activities of either private equity or hedge funds which might warrant particular attention?" (CEC, 2005; 9). Even before the publication of the consultation findings the Commission made its position clear. DG Internal Markets Commissioner Charlie McCreevy announced to a conference of financiers in London that the Commission would not regulate hedge funds (EurActiv, 2007b). The Commission recognised that given the nature of global capital mobility any EU legislation would be meaningless without global agreement (EurActiv, 2007b).

The Green Paper question clearly reflects a policy response to the public alarm about hedge fund and the consensus that regulation is the solution. The White Paper, Enhancing the Single Market Framework for Investment Funds, concluded that there was "currently no regulatory gaps which call for EU-level intervention to regulate hedge funds…" (CEC, 2006a). The Commission has defended hedge funds in the face of the sub-prime crisis and continued to rule out regulation (Buck, 2007; 8). The Commission has also expressed support for the belief that the current regulatory context of hedge funds promotes financial innovation which is good for the European economy (EurActiv, 2007a).

The regulatory context within which hedge funds operate and the limitations this places on the ability of the EU to act in this policy area appears to render EU policy making as marginal to the debate about hedge fund regulation. Indeed, after the Commission's refusal to legislate the policy debate has moved on to an international setting. The German government has used its 2007 presidency of the G7 to put hedge fund regulation on the agenda, although as yet they have failed to secure any international agreement (Benoit, 2006). However, the policy response of the Commission on hedge fund regulation should not be viewed in isolation; instead it needs to be analysed within the wider and longer term programme to integrate European financial services markets. The financial services sector is functionally divided into three segments; banking, insurance and securities; hedge funds fall within the later. In this context EU institutions are far from irrelevant but are in fact changing the regulatory landscape for hedge funds. In order to understand the legislative response to the hedge fund debate it is necessary to shift the research lens. Current research is too narrowly focused on the responses to the current crisis and on regulation or 'positive' integration . The research lens should be drawn back to view hedge fund regulation in the context of a wider policy regime in financial services.

THE COMMISSION AND THE EU FINANCIAL SERVICES REGIME: BETWEEN POSITIVE & NEGATIVE INTEGRATION

The Commission is the key EU institution for analysis in the context of the hedge fund regulation. There is no clear legal, or Treaty basis, for hedge fund regulation except within the wider scope of financial services, which falls within the central pillars of the EU project, namely freedom of establishment; freedom to provide services and freedom of capital movement (Story and Walter, 1997; 7). Therefore EU action in this area requires the Commission to use its agenda setting role and monopoly of legislative and policy initiative to act as a policy entrepreneur. Majone (1996) argues that the Commission has played a considerable role in European integration by creating demand for EU regulation through policy entrepreneurship (Majone, 1996; 74). Public choice theory suggests that bureaucracies will always seek to maximise the size of their agency. This holds true for the Commission but rather than budgetary expansion, it seeks to expand the quantitative scope of its competencies (Majone, 1996; 64). Majone (2006) describes this as *integration by stealth.* The control of the policy agenda and absence of clear accountability standards allow the Commission to pursue objectives of political integration and self-aggrandisement whilst appearing to solve policy problems (Majone, 2006; 613).

The Commission through its agenda setting role has acted as a powerful policy entrepreneur with the result that a coherent policy regime has emerged in financial services policy (Quaglia and Rl, 2007; 8). Initially, the Commission attempted to harmonise the diverse national systems into a single unitary framework but in the early phase of financial services integration struggled to make any significant advances (Story and Walter, 1997; 26). The landmark ruling by the European Court of Justice on the Cassis de Dijon case in 1979 established the principle of mutual recognition and offered the Commission a new policy approach; rather than attempting to harmonise diverse systems into a unitary framework, harmonisation now came to mean the establishment of common standards (Story and Walter, 1997; 16). The Single European Act (1987) boosted the new approach with a treaty basis and committed member states to work progressively towards a single market in financial services. However, divergent national rules on licensing, market access and prudential measures persisted into the early nineties and remained effective barriers to a fully integrated market (Hager, 2007; 14). Monetary union and the introduction of the Euro provided a new stimulus (Grahl et al., 2005; 1005) and in 1999 the Commission put forward the Financial Services Action Plan (FSAP) which contained 43 measures to be implemented by 2005. Recognising the historical difficulties experienced integrating securities, the European Council appointed the Council of Wise Men to explore how best to adapt securities regulation and cooperation between national regulators (Visscher et al., 2007; 5). The committee, chaired by Alexandre Lamfalussy, former President of the European Monetary Institute resulted in the Lamfalussy process which created a four level system to improve the legislative process (Visscher et al., 2007; 5).

Over the last fifty years financial services policy has evolved into a coherent policy regime. European financial regulation has become increasingly centralized with rulemaking and policy formulation the result either of EU legislation, or of secondary rules drawn up by the committees within the Lamfalussy agreement (Wymeersch, 2005; 1009). The policy regime that has emerged is characterised by minimum standards, mutual recognition, removal of barriers to free trade and rule making through the Lamfalussy process. The effectiveness of the regime is illustrated by its ability to deliver the competition of the FSAP largely within the deadline. In spite of formidable technical difficulties and significant conflicts of interest among financial sectors of member states, a very ambitious legislative programme was completed (Grahl et al., 2005; 1018). The key element of the regime for hedge fund regulation is the framework to facilitate negative integration; in other words the impetus to remove barriers to the development on an integrated market. However, the sector also suffers from asymmetry; between 'supervision' which deals with monitoring of financial actors and remains very much a national effort and the application of rules which is increasingly concentrated at the EU level. This is consistent with the nature of regulation in the EU. Wymeersch (2005) argues that it is necessary to think about EU regulation in terms of these two distinct concepts; supervision and regulation, or rule making. Whereas in the US regulators tend to carry out both functions, in the EU they are clearly distinguished. Whilst 'regulation' or rule making is increasingly centralised at the EU level, 'supervision' is decentralised (Wymeersch, 2005; 988). National regulators are the primary agents in the implementation of the rules and the supervision of the market. Majone

(2006) argues that this asymmetric treatment of positive and negative has been a long-standing feature of European integration and is evidenced in the disproportionate use of negative integration over positive in the completion of the Common Market (Majone, 2006; 622).

It is in the context of the asymmetrical regulatory framework in financial services that the Commission's policy response on hedge funds needs to be understood. The Commissions capacity to act given the regulatory context of hedge funds is limited and in the context of the wider financial services policy regime positive integration, which involves the creation of supranational regulation and perhaps supranational supervisory institutions, is at odds with the policy approach that has emerged. On the other hand, the logic of negative integration which seeks to remove barriers to the development of an integrated EU market is, in practice, changing the landscape of the hedge fund industry.

Alongside the question of regulatory action to address investor protection and market stability issues the Green Paper on the Enhancement of the EU Framework for Investment Funds (2005) also asks;

> To what extent do problems of regulatory fragmentation give rise to market access problems which might call for a common EU approach to… b). hedge funds…? (CEC, 2005; 9)

The Green Paper sought to explore whether a single market framework should be created for non-harmonised investment products (CEC, 2006c; 12). Although there is no EU legislation which specifically covers hedge funds, amendments to the original Undertakings for Collective Investments in Transferable Securities Directive [UCITS] (1985) have reduced the line of difference between traditional investment funds (such as pension funds) and hedge funds (Pallesi, 2007; 104). UCITS funds are generally aimed at the retail market (or general public) and as such they carry a greater degree of regulation. Products which are considered eligible under UCITS are called harmonised products and are afforded an EU passport, which means they can be marketed across borders. All other investment vehicles such as hedge funds and private equity funds are non-harmonised products and cannot be cross-border marketed. Continued innovation and technological development in financial services means there is a gap between the directive and market reality, (CEC, 2006c; 4) with the result that products that cannot comply with UCITS are being marketed as retail products at a national level (CEC, 2006c; 2). Revisions to the UCITS[1] have dealt with this issue by reducing the line of difference between eligible investment funds and non-harmonised products such as hedge funds (Pallesi, 2007; 104). The White Paper [2] (2007) recognises that non-harmonised funds are aimed at 'sophisticated investors' and therefore concludes that there is a case for removing cross border barriers to sales and marketing for these products as well as barriers to the private placement of these funds (CEC, 2006c; 13). In effect this would mean certain Hedge Funds would become eligible funds under UCITS and form part of an UCIT fund's diversified portfolio and as such enjoy the ability to be marketed across the EU.

The CEC's legislative action in the hedge fund space is entirely consistent with the 'regulation' policy regime in financial services; the primary concern is to remove barriers that impede the development of a fully integrated European financial services market. The proposal to look at removing barriers to the marketing of non-harmonised products for professional investors is wholly consistent with a programme of negative integration which can be traced all the way through financial services legislation. The consequences of the Commission actions could have a profound effect not just on the industry but EU citizens. If certain hedge funds become eligible to form part of an UCIT fund's diversified portfolio and enjoy the ability to be marketed across the EU this is likely to accelerate a trend toward 'retailisation' already in evidence. As the hedge

[1] UCITS II and III
[2] Enhancing the Single Market Framework for Investment Funds

fund market has developed it has become more 'institutionalised', it is now no longer just the reserve of HNWI but increasingly captures a larger share of institutional investment from banks and pension funds. In the last ten years the EU pension fund industry has increased its exposure to hedge funds and is now heavily invested in the sector (Gottlieb, 2007; 2) . Negative EU integration in the hedge fund sector could have the consequence that more and more ordinary investors will be exposed to hedge funds through their pensions and investments, but supervision will be subject to a patchwork of regulatory regimes and it has been shown that the EU's ability to drive positive integration in this field is limited.

CONCLUSION

This paper has sought to place the current debate on the regulation of hedge-funds and the role of the EU in a historical, institutional and theoretical context. There is considerable popular belief that hedge funds constitute a threat to financial stability and that they need to be regulated in some way. The current policy debate recalls Down's issue attention cycle; there has been an alarmed discovery created by the role of hedge funds in a series of financial crisis with sub-prime being the latest and a 'euphoric enthusiasm' that regulation is the solution. Extensive theoretical work, particularly by Majone, demonstrates that the Commission will always seek to expand it competencies by acting as a policy entrepreneur. On the face of it hedge fund regulation presents an ideal opportunity to the Commission to act and yet even in the face of the latest sub-prime crisis the Commission has defended its decision not to seek to regulate hedge funds.

This paper demonstrates that in this policy area things are not as straightforward as they first appear. The relationship between hedge-funds and financial crisis is complex and less causal than is often portrayed; there is consensus that something needs to be done but not always consensus on what. From an EU perspective, there are strict limits on its ability to act, not least as a result of the international nature of the regulatory environment and the conflict between key actors but also because of the nature of the regulatory regime which has traditionally demanded a 'light touch' approach. However, while there is little evidence of EU action in terms of regulation or so-called positive integration, a wider view which places hedge fund regulation in the longer term programme of financial services integration reveals that the Commission is far from inactive in relation to the environment in which hedge-funds operate. The logic of negative integration which seeks to remove barriers to the development of an integrated EU market is, in practice, changing the landscape of the hedge fund industry. It is short-sighted to consider regulation to be simply supervision; it is both rule making and supervision. European financial regulation has become increasingly centralized with rulemaking and policy formulation the result of EU legislation.

This process has significant implications for the nature of the investors exposed to hedge-fund activities - shifting from 'sophisticated investors' to ordinary investors exposed through their basic pensions and investments. In this way, the rationale for the 'light touch' regime comes into question. The ability of the Commission to drive positive integration in this field may be limited but the Commission may yet find itself at the centre of a regulatory nexus in relation to hedge-funds. The Commission may need to respond to a regulatory vacuum resulting from the process of negative integration or to a 'policy window' of its own making.

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