Hedge funds and private equity

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The Committee on Economic and Monetary Affairs adopted an own initiative report by Poul Nyrup **RASMUSSEN** (PES, DK) with recommendations to the Commission on Hedge funds and private equity.

Stressing that, at present, there is insufficient EU regulation of hedge funds and private equity, MEPs call on 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, in accordance with the following seven principles:

1. **Regulatory coverage**: existing Community legislation should be reviewed to identify any regulatory gaps; national variations should be reviewed and harmonisation should be promoted;
2. **Capital**: capital requirements should be mandatory for all financial institutions and should reflect risk from the type of business, exposures and risk control;
3. **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.
4. **Accounting**: a smoothing technique to counter the pro-cyclical effects of fair value accounting should be considered;
5. **Rating**: Credit Rating Agencies should adopt codes of conduct regarding visibility of assumptions, product complexity and business practices; conflict of interest should be managed and unsolicited rating should be independently categorised and not used as a means of pressure to obtain business;
6. **Derivative trading**: open and visible trading of derivatives should be promoted whether on-exchange or otherwise;
7. **Long term**: reward packages should be aligned with longer term outcomes, reflecting losses as well as profits.

MEPs ask that these proposals be implemented in accordance with the following principals:

- **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;
- **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 provide other means to align the interests of investors and originators;
- **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);
- **Valuation**: the Commission should adopt principle-based legislative measures on the valuation of illiquid financial instruments;
- **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 expose them;
- **Venture capital and SME sector**: the Commission should propose legislation to provide a harmonised EU-wide framework for venture capital, and particularly so as to ensure cross-border access to such capital for the SME sector.

Recommendation 2 on transparency measures:

- **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;
- **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**: an increasing number of pension funds and insurance companies have holdings in hedge funds and private equity. The Commission should therefore ensure that employees or staff representatives are informed about the way in which their pensions are invested and the associated risks.

Recommendation 3 on excessive debt measures:

- **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: (i) there is capital held according to risk; (ii) 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 (iii) 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.

Recommendation 4 on conflicts of interest measures:

- **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, they 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 should launch a general review of the effects of market concentration and of the effects of dominant players in the financial services industry.

Recommendation 5 on existing financial services legislation: the Commission should undertake an examination of all existing Community legislation relevant to financial markets and, based on the results of such examination, submit a legislative proposal or proposals amending the existing directives where necessary.