

# Global regulation

## Not the time to lose interest



### EXECUTIVE SUMMARY

There is a feeling among investors that the battle against counterproductive and ill-informed regulation in the US and Europe has already been lost. In fact, much legislation, from the Volcker Rule in the US to the AIFM Directive in Europe, is entering its most critical phase, with bills being shaped by legislators and turned into rules by new regulators – just as the economic recovery appears to be stuttering. For investors, fund managers and the financial community in general, this is not the time to lose interest.

### GLOBALLY

- Greater regulation is inevitable, partly to appease voters angry about government cuts
- Everywhere, regulation is too focused on avoiding a replay of the 2008 crisis
- New rules are too locally focused and do not take account of the fact that finance is global

### IN THE US

- The Dodd-Frank Wall Street Reform and Consumer Protection Act becomes law in July
- It incorporates the Volcker Rule – separating investment and retail banks – in softened form
- Under the Act, investment in hedge funds and private equity is limited to 3% of tier-1 capital

### IN EUROPE

- The EU's Alternative Investment Fund Managers (AIFM) Directive is coming soon
- It will set up a European super-regulator
- It could exclude non-EU funds from operating in Europe

Despite the bad news, the recent US bill shows that financial institutions and investors can make their voices heard throughout the legislative process – even in its very final stages. What's more, they can continue to exert influence as regulators frame their new rules.

### THE GLOBAL TREND TO REGULATE

Finance is global, and so – often – are political trends. In the wake of the recent financial crisis, leaders around the world are increasingly serious about making cuts. These politicians are keen to tell angry voters that they are punishing those responsible for the crisis that made these cuts necessary, and to show that the culprits will never be allowed to cause such damage again.

In the public imagination, both hedge funds and private equity are often lumped together, the perception being that they are both dominated by short-term opportunists of the kind that brought economies to their knees. As a result, governments around the world are using regulation to go after these soft targets. But while this political trend is global, much of the regulation being proposed ignores the fact that finance is also global.

### CONCEDE THE POINT, NOT THE GAME

While we must accept the fact that more regulation will come, there is still time to influence its final shape. We need to convince both legislators and the public that any new rules must take account of the interconnectedness of the world's financial markets and institutions. Above all, the measures adopted must not hurt those they seek to protect: the ordinary people, such as pension-holders, whose assets we work to maximise and protect.

## OUT OF AMERICA

In the US, President Obama introduced a proposal<sup>1</sup> in June 2009 for a “sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression”.

Of the two chambers of Congress, the House of Representatives passed a bill (the Wall Street Reform and Consumer Protection Act) in December 2009 incorporating most of Obama’s proposal. The Senate’s bill has taken longer, but was finally passed on 20 May 2010 as the Restoring American Financial Stability Act.

On June 25, after a 20-hour session of the conference committee, lawmakers from both chambers finally succeeded in reconciling the two versions. The result is to be called the Dodd-Frank Wall Street Reform and Consumer Protection Act, and is expected to be signed into law by the president in July.

There were many similarities between the Senate and House versions throughout<sup>2</sup>. Both agreed, for example, that there should be a new Financial Stability Oversight Council bringing together all the various regulators and acting to maintain the stability of the whole financial system, identify bubbles, and force “systemically significant” firms to create “living wills” describing how they would be broken up in the event of trouble. Both also contained a new Consumer Financial Protection Bureau to prevent “abusive mis-selling” and to recommend “plain vanilla” versions of popular financial products such as mortgages. There was agreement too on the need to outlaw over-the-counter derivatives deals and force them through clearing houses to increase transparency and mitigate counter-party risk.

### THE VOLCKER RULE: SPLITTING INVESTMENT AND RETAIL BANKING

However, despite the many areas of agreement, a number of important elements were not settled until the final session of the conference committee. One of the most important aspects of the new bill is the Volcker Rule, named after Paul Volcker, the 82-year-old chairman of the president’s Economic Recovery Advisory Board. Banks feared that this would effectively reinstate the Glass-Steagal Act of 1933, separating the activities of investment and retail banks.

The Senate’s and Congress’s versions of this rule were very different, and have been softened in conference to the extent that most major banks’ share prices increased when the bill was published<sup>3</sup>. The large commercial banks will retain the bulk of their derivatives units, although around 30% of their assets – those judged most risky, including those based on equities, commodities and non-investment-grade CDSs – will have to be hived off into separately capitalised subsidiaries.

The securities houses, including Goldman Sachs and Morgan Stanley, will be hit harder by elements such as the ban on proprietary trading and the requirement that they cut back their investment in hedge funds and private equity (to 3%) and avoid conflicts of interest with their clients.

Even so, what happens next depends to a large extent on regulators, who will turn the two thousand pages of new laws into detailed rules – and apply them.

### Obama’s Proposal

The three main points:

1. Greater powers for regulators to monitor financial products, transactions and organisations of all kinds.
2. An increase in the amount of capital that financial firms are obliged to hold in reserve.
3. Powers enabling the government to take over a collapsing financial firm and wind it down slowly, so as to avoid the sort of panic that attended the collapse of Lehman Brothers in 2008.

<sup>1</sup> [http://www.whitehouse.gov/the\\_press\\_office/Remarks-of-the-President-on-Regulatory-Reform/](http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/)

<sup>2</sup> Tom Braithwaite, “Senate approves Wall Street reform bill”, *Financial Times*, May 20 2010

<sup>3</sup> Francesco Guerrera, Suzanne Kapner, Justin Baer, Tom Braithwaite, “Bank stocks stage relief rally as cloud lifts”, *Financial Times*, June 25 2010

## TRENDS IN FINANCIAL REGULATION

There is little in the forthcoming US regulations that will directly affect Pantheon's activities or our ability to serve our investors. But there are several features of the regulations – and the way they are being framed – that global investors should be aware of.

In military circles it is well known that generals have a tendency to fight the last war rather than the current one. The present US legislative agenda gives the impression that politicians are prone to a similar disorder. They seem concerned above all with designing detailed and watertight regulations to ensure that the financial crisis of 2008 could never happen again. But the fact that the 2008 crisis has happened in itself prevents an exact repetition: people learn from experience. The new rules designed to make this repetition impossible introduce new distortions, with extra scope for unintended consequences, new imbalances and new loopholes.

History will judge whether the crisis developed because of a lack of regulations or a failure of regulators. It certainly seems, with hindsight, that for every problem there was a regulator in place to deal with it. The problems included an asset bubble created by cheap money, securities wrongly rated as investment grade, and mortgages sold to those who couldn't afford them by salesmen who had no stake in ensuring that repayments were met. The regulators overseeing those areas were the chairman of the Federal Reserve and the Treasury Secretary (supposed to keep a weather eye out for asset bubbles), the Securities and Exchange Commission (which registers "statistical ratings organisations"), and the Office of Thrift Supervision (which closed down the Indy Mac Federal Bank in 2008). As with the 2009 Madoff fraud, which also damaged faith in financial institutions, the problem was not that new regulations were needed, but that existing ones were not enforced.

The new regulations will increase the cost of compliance for financial companies. While this will be good news for the accountants and lawyers who will be needed to implement the changes and clarify the laws, at least some of the extra cost will inevitably be passed on to investors, leading to lower returns. In trying to protect institutional investors – who are, after all, sophisticated investment professionals – the regulation will in fact end up making their jobs harder.

The political motivation behind the regulations is apparent in the way they cast financial institutions of all kinds as the enemy – a beast to be tamed, rather than a creator of wealth. After the Senate vote, President Obama said, "Over the last year, the financial industry has repeatedly tried to end this reform with hordes of lobbyists and millions of dollars in ads, and when they couldn't kill it they tried to water it down. ... Today, I think it's fair to say these efforts have failed."<sup>4</sup>

It is also noticeable that the US action has concentrated on replacing national regulators and increasing the number of domestic regulations with which financial institutions have to comply, rather than focusing outwards on agreeing a set of workable international standards and a common global approach.

We see these same features in regulatory responses elsewhere in the world: close tailoring to the specifics of the 2008 crisis, creating new regulators and regulations rather than enforcing existing ones, increasing the burden of compliance, hostility to financial institutions, and a parochial rather than international focus. The final feature common to all is their capacity to change form, in important ways, right up till the last minute.

“ No one will know until this is actually in place how it works. But we believe we've done something that has been needed for a long time. It took a crisis to bring us to the point where we could actually get this job done. ”

*Chris Dodd,  
Chairman of the Senate banking committee<sup>5</sup>*

<sup>4</sup> <http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform-0>

<sup>5</sup> Tom Braithwaite, Francesco Guerrera, Justin Baer, "Way clear for Wall Street overhaul", *Financial Times*, June 25 2010

## EUROPE'S RESPONSE: THE AIFM DIRECTIVE

Europe's Alternative Investment Fund Managers (AIFM) Directive closely fits the patterns we've identified in the US legislation.

The directive has almost reached a parallel point to the US legislation in its journey towards becoming law. As in the US, draft proposals have been passed by the two main legislative bodies – in this case the European Parliament, composed of members elected by constituencies across the EU, and the Council of the European Union (not to be confused with the European Council or the Council of Europe), composed of one minister from each member state – the minister attending depends on the subject under discussion. The former is composed of explicitly European politicians, while the latter is composed of those who have worked their way up in national politics.

Keeping the terminology straight tends to be tricky when discussing EU affairs. The European Parliament's Committee on Economic and Monetary Affairs (ECON) has produced one of the two draft proposals. The other has been produced by the Presidency of the Council of the European Union and adopted by the Council at a meeting of its Economic and Financial Affairs Council (ECOFIN), composed of each member state's finance minister. For clarity, we will talk about "Parliament" and "the Council". Both voted on their drafts within hours of each other: Parliament on 17 May, the Council on 18 May.

The aim of both drafts is to produce a piece of legislation with a much narrower scope than the US bills we have been looking at. The target is "alternative investment funds", a term which embraces both private equity and hedge funds. This broad-brush approach is a source of problems, as measures in both drafts frequently fail to discriminate between the two very different types of investment.

There are considerable differences between the two drafts, and these will be negotiated in the "trilogue" period, during which Parliament, the Council and the European Commission (its administration, with a president, foreign minister and permanent officials implementing policy) will produce a final version. The official timetable stated that this process was to be completed in June, but most observers did expect it to take longer. The plenary vote on the Directive in the European Parliament, which was scheduled to take place in July, has been postponed until September, as the Parliament, the Council and the European Commission have failed to reach a compromise in a number of areas.

“  
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 institutional investors are big boys  
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 investment decisions.**  
 ”

*Andrew Bradshaw,  
 Partner at Sacker & Partners<sup>6</sup>*

Many of the differences between the two drafts reflect the type of politicians in the two bodies, with Parliament tending to have a Europe-wide view while the Council tends to think in terms of individual member states.

### THE COUNCIL VS PARLIAMENT ON NON-EU FUNDS

The most contentious area of the proposed regulation concerns the position of funds established outside the EU – so-called "third-country" funds. Here, the Council's draft<sup>7</sup> leaves to the discretion of each member country whether to allow funds from outside the EU – with the stipulation that this provision should be reviewed when the directive has been in force for two years.

Parliament's draft<sup>8</sup> is more alarming in this area. While EU-based funds would qualify for a "passport" allowing them to market themselves to investors throughout the Union, non-EU funds would have to voluntarily subject themselves to the directive's requirements, with their national regulator being responsible for enforcement. These funds would have to be based in countries that are open to EU funds

<sup>6</sup> William Hutchings, Paul Hodkinson, "AIFM decision 'bans' EU investors from non-EU funds", *Financial News*, 18 May 2010

<sup>7</sup> [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/114524.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114524.pdf)

<sup>8</sup> <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2010-0171&format=XML&language=EN>

and that meet certain standards regarding money-laundering, terrorist financing, and the exchange of tax information. This is likely to restrict the range of investments European institutional investors can access<sup>9</sup>.

Parliament’s proposed exporting of European regulations to other jurisdictions is unlikely to be welcomed by any country, and it is not clear how the EU could compel foreign regulators to enforce its rules. As things stand, the requirements of the non-EU fund’s host country would disbar US-based funds from operating in Europe. Tim Geithner, the US Treasury Secretary, has already made two well-publicised appeals to Michel Barnier, the EU’s internal market commissioner, not to “discriminate” against non-EU funds, with an implied threat of retaliation should it do so<sup>10</sup>.

The Commission, which will arbitrate to some extent between the Council and Parliament, is believed to favour allowing third-country funds to market themselves within the EU.

**DISCLOSURE OF PORTFOLIO COMPANIES’ DETAILS**

The other major area of contention is the disclosure of details relating to the companies that make up a fund’s portfolio. The Council’s draft says that disclosure is not necessary for “SMEs” or for companies in which the fund has less than a 50% holding. Confidential information would be protected, and the company’s development plan would not need to be disclosed – but changes in the company’s number of employees would need to be made public.

Again, Parliament’s draft is more contentious. Disclosure could be necessary for companies in which the fund holds as little as 10% of the voting rights, and the only exemptions would be for companies with fewer than 50 employees. What’s more, the disclosure requirements would be more onerous and more damaging to the interests of the company. They mandate releasing research and development efforts – a huge advantage for a company’s more established competitors. And public companies taken private would continue to be subject to these disclosure requirements for a year afterwards.

**LOST OPPORTUNITIES**

Under AIFM’s third-country rules, EU investors could lose access<sup>8</sup> to:

**35%** of **private equity** funds

**19%** of **venture capital** funds

Here, the Commission’s opinion<sup>11</sup> seems to be midway between Parliament’s and the Council’s, with SMEs exempted, the “controlling stake” deemed to be 30%, and the company’s development plan to be disclosed (among other information).

The point of these disclosure requirements seems to be public oversight, in order to prevent asset stripping. But the nature of them reveals how little aware many legislators are of the scale and long-term nature of private equity investment.

**OTHER AREAS OF DIFFERENCE BETWEEN PARLIAMENT AND THE COUNCIL**

There are differences between the two drafts in many areas, including exemptions, leverage, capital requirements, periodic valuations, remuneration, and the need for a “depository” (an independent institution holding some client assets).

Some of the requirements are a result of the fact that the directive is based on the model of retail banking. For example, additional third-party valuations are a pointless exercise in an asset class for which the only valuations that really count are those at realisation. Capital requirements, forcing a proportion of clients’ money to be kept uncommitted (and therefore wasted) are also irrelevant to the needs of investors in this field. In these areas, Parliament’s draft exempts private equity funds, with the Council making no allowances and the Commission generally following the Council.

Because Europe’s citizens are more inclined to identify with their national politicians and institutions than with those of the EU, the Council tends to have the upper hand in the trilogue process. This, combined with pressure from abroad – not least the US – may be enough to avoid shutting out private equity from beyond the EU. Nonetheless, intensive lobbying will be required to make the case for more sensitive regulation. In

<sup>9</sup> Philip Inman, “Fears over EU clampdown on hedge funds and private equity firms”, *The Guardian*, 15 October 2009

<sup>10</sup> <http://www.ft.com/cms/b102c1be-2d31-11df-9c5b-00144feabdc0.pdf>

<sup>11</sup> “Comparison of Key Issues – European Parliament, Council and European Commission”, EVCA, 21 May 2010

this, the voice that will carry most weight is that of the institutional investors who are the intended beneficiaries of the regulation.

Andrew Bradshaw, a leading pensions lawyer, explained in *Financial News* that pension funds would inevitably suffer from increased compliance costs: "Large, sophisticated institutional investors are big boys and don't really need Brussels holding their hands when it comes to making investment decisions. Pension funds take specialist advice on which alternative funds to invest in, and subsequently understand the inherent risks. Many feel their investment allocation does not need to be governed by the EU."<sup>12</sup>

## THE INTERPLAY OF REGULATION

It is essential for legislators to bear in mind that each new piece of regulation does not operate in a vacuum, but interacts with existing practices, new regulations in other industry sectors, and rules introduced by other tiers of government and other countries.

The new Solvency II rules are an example of how this interplay is affecting private equity. This directive, which determines insurance companies' capital requirements, will come into force by November 2012. As a result of its treatment of private equity risk, many insurers are expected to reduce their assets allocated to non-listed stocks. These are substantial: in France insurance companies currently contribute 21% of the capital in private equity funds<sup>13</sup>.

In addition to the measures in the AIFM directive, there is a danger that European companies will be starved of venture capital, and that its institutional investors – including the pension funds on whom so many people's future security depends – will find it much more difficult to produce an adequate return on their investments.

## WHAT IS PANTHEON DOING?

Pantheon identified early on that a hastily enacted AIFM directive could do lasting damage to the private equity industry. To help prevent this, we have taken part in the industry's efforts to lobby legislators, largely through our participation in EVCA's technical committee and UK Treasury Select Committee meetings. In addition, we have separately engaged legal lobbyists in Brussels to ensure that the issues affecting the secondary market and listed private equity are addressed. And to support this, we initiated a coalition of fund-of-funds managers to table certain amendments, some of which have been adopted in the current drafts.

In order to add to the voices of concern in Brussels, we have also engaged with our LPs and GPs. A number of LPs on our advisory board co-signed a letter to EU legislators pointing out the negative consequences that aspects of the proposed regulation would have for institutional investors. We also encouraged GPs to contact their client portfolio companies and ask their CEOs to object to the potential damage to the supply of capital available to European entrepreneurs.

Pantheon will continue to work with EVCA and BVCA in Europe, to ensure that investors' voices continue to be heard by legislators and the public – and to help move the focus of the debate away from purely European issues and towards the global context.

## CONCLUSION

In our view there is an excellent case for appropriate global regulatory reform. But that reform needs to meet very simple requirements: it must not be detrimental to the interests of those it seeks to protect, it must be proportionate and non-discriminatory, and it must acknowledge that the financial system is global.

There are still opportunities around the world to move regulation in that direction, and Pantheon intends to continue working to advance these basic principles.

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<sup>12</sup> William Hutchings, Paul Hodgkinson, "AIFM decision 'bans' EU investors from non-EU funds", *Financial News*, 18 May 2010

<sup>13</sup> <http://www.edhec-risk.com/features/RISKArticle.2010-05-21.5102>

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