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A WALL AROUND EUROPE?
THE EUROPEAN REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS AND THE TURN IN TRANSATLANTIC RELATIONS

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Abstract

This article explores the impact of the European regulatory response to the global financial crisis in the governance of transatlantic financial markets. The main argument is that European regulatory initiatives have sought to expand European regulatory clout over market actors domiciled in third countries but operating in European markets, thus departing from the authority-sharing arrangements that had informed the construction of an integrated transatlantic market for financial services in the period preceding the crisis. The article will explain this shift in the European approach towards the regulation of transatlantic markets by exploring the reconfiguration of EU financial regulatory politics triggered by the financial crisis. This argument will be developed by analysing the regulatory framework introduced in the EU to regulate OTC derivatives, rating agencies, and hedge funds.

Keywords: *financial regulation, transatlantic relations, derivatives, rating agencies, hedge funds*

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1. Introduction

For a number of European policymakers, the financial crisis that originated in the summer of 2007 in the US financial markets validated previously expressed concerns about the shortcomings of the Anglo-American approach to financial regulation, and presented an opportunity for Europe to leave its mark on the international regulatory response. Calling for a more active Europe vis-à-vis Washington, the French President Nicolas Sarkozy expressed his desire for "the world to see the victory of the European model, which has nothing to do with the excesses of financial capitalism" (cited in Hough 2009). What has the impact of Europe been on the extensive redesign of the rules that govern international financial markets? This paper will argue that a distinct European impact on the international regulatory response to the crisis can be found, not in the content of the rules enforced, but instead in how these rules altered the European approach towards the governance of the transatlantic financial markets.

In the years preceding the crisis, European authorities had repeatedly pushed their US counterparts to 'share' regulatory authority over transatlantic financial activities through the negotiation of mutual recognition arrangements. In a significant reversal of this approach, the European regulatory response to the financial crisis has made one of its priorities that of expanding European regulatory clout over a range of market actors domiciled in third countries but operating in European markets, instead of relying on home-country supervision by US authorities.

This analysis of the origins of this policy shift in the European approach towards the governance of financial markets will contribute to the literature on European financial regulation by highlighting the effect that the financial crisis had in altering the politics of

financial regulation in the EU. In particular, the analysis presented in this paper will highlight how the politicisation of the regulatory process has triggered a reconfiguration of the dominant coalitions within the European policymaking process and reinforced the objective of strengthening European autonomy from foreign regulatory authorities. However, the cases will reveal how this objective interacted with more traditional competitive struggles among European financial centres in informing the turn in the European approach towards the governance of transatlantic markets.

This argument will be developed through the analysis of three important regulatory frameworks introduced in Europe in response to the financial crisis to regulate over-the-counter (OTC) derivatives markets, credit rating agencies and hedge funds. Process tracing through the analysis of the primary legislation, public consultations and other official reports, as well as the financial press will be used to shed light over the causal mechanisms at the origin of this policy shift in the governance of transatlantic markets.

2. Assessing the European regulatory response to the financial crisis

Since the launch of the Financial Services Action Plan in 1999, the evolution of the European integration project in the regulation of financial markets has become an important object of scholarly inquiry. While some scholars explored the forces driving the movement towards greater centralisation of certain regulatory functions at the European level (Quaglia 2007; Mügge 2010), others analysed the repercussions of these regional developments at the international level. In particular, Posner argues that the move towards a greater centralisation of regulatory authority at the regional level has bolstered the leverage of the EU in international financial coordination vis-à-vis the US,

turning the international financial regulatory regime from the expression of a US hegemony into a “Euro-American regulatory condominium” (Posner 2009b).

However, while in other areas of the global political economy Europe was able to use its enhanced rule-making capacity and market power to promote a more “managed globalisation” (Abdelal and Meunier 2010), this was not the case in the regulation of financial markets. According to Posner and Véron (2010), instead of offering an alternative framework, European policymakers prioritised the goal of achieving, internally, full market integration in the financial services and, externally, the goal of securing more favourable terms of cross-border access to US markets for Europe-based firms. For these authors, the European power remained in this period “power without purpose”.

The financial crisis of 2007-2009 has created a more favourable terrain for the emergence of a distinct European approach in the international regulatory architecture. First, the outbreak of the crisis reinforced the dissatisfaction of many policymakers, particularly in Continental European countries, with the perceived failure of the dominant US regulatory model. Second, as Posner has argued, the crisis hit international financial markets exactly when the EU had developed the capacities to pursue an ambitious international agenda. According to Posner, EU representatives were finally willing to use their strengthened bargaining position to export this European model to the international level, rather than simply to preserve a regulatory playing level field with the US (Posner 2009a). How successful has Europe been in leaving its mark on the international regulatory response to the global financial crisis?

A first approach to empirically answer this question is to look at the agenda of international fora such as the G20. The European members of the G20 have often claimed personal success for exporting their long-standing priorities in the international agenda and the language adopted by the G20 on issues such as subjecting hedge funds and rating agencies to greater oversight and regulation closely reflect the language previously coordinated among European leaders. However, the capacity of Europe to influence the international agenda should not be overstated. In fact, proposals championed by Continental European leaders but opposed by the US authorities, such as regulating the trading of derivatives on sovereign debt or the introduction of a financial transaction tax, were not agreed upon at the international level.

Indeed, key European policymakers such as the French President Sarkozy and the German Chancellor Merkel have publicly stated that Europe would not hesitate to act unilaterally if the US and other countries did not commit to implementing stringent reforms (Willard and Murphy 2009). From this perspective, a more promising venue to identify a distinctly European impact on the international regulatory architecture is the content of the numerous regulations and directives that have been introduced in the EU to regulate a wide range of financial sectors and institutions (for a review see Moloney 2010; Buckley and Howarth 2010). However, when we compare the content of these regulatory measures with the provisions introduced during the same period in the US as part of the Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), it is often difficult to detect a qualitatively distinct European approach. On the contrary, in areas such as the regulation of derivatives, US regulators have publicly

expressed their concerns that the more lax European regulation could confer a competitive advantage on European institutions (CFTC 2011).

If not in the content of these regulatory measures, the argument presented in this paper is that a distinct impact of the European regulatory response can be found in how this challenged the dominant approach towards the governance of transatlantic financial markets. In the fifteen years before the crisis the greater integration of American and European financial markets had often been characterised by asymmetrical terms of access. While European national authorities had often recognised US regulations, their US counterparts remained reluctant to coordinate regulatory policies and continued to require European firms seeking to access the US markets to comply with US regulations on a non-discriminatory basis (Simmons 2001; Posner 2005).

During this period, European authorities increasingly sought to level the playing field in the transatlantic financial arena by pushing their US counterparts to adopt as the basis for E.U. and U.S. cooperation the same “mutual recognition” approach that had guided the dismantling of financial regulatory barriers among European countries (Schaub 2004a). The Director-General for the Internal Market Alexander Schaub described the case for this approach in these terms: “Requiring foreign market participants to comply with local rules and practices doubles compliance costs and creates legal uncertainty. At best, it adds to regulatory overheads – often with no discernible benefit in terms of regulatory protection. At worst, it creates insurmountable barriers to cross-border finance” (Schaub 2004b, p.3).

Increased European leverage, as well as the greater convergence of European regulatory policies with those of the United States combined to convince American regulators to

accommodate some of the requests coming from their EU counterparts. Despite the access to the US markets continued to remain governed primarily through the "national treatment" principle, US regulators allowed EU companies listing in a US stock exchange to use the accounting standards already adopted in Europe, explored the adoption of non-US regulation in other sectors, such as stock exchanges, brokerages, and auditing firms, and introduced different exemptions and exceptions to accommodate the EU regulations (Posner 2005; 2009b). The European attempt to level the transatlantic playing field had the overall effect of generating an "unlikely moment for intensified transatlantic sovereignty sharing" (Posner 2009b, p. 655), as EU and the US authorities increasingly allowed foreign companies to operate within their jurisdiction on the basis of the regulation and supervision provided by their home-country regulators.

From this perspective, the regulatory response to the financial crisis originating in 2007 marks a significant shift in the approach of the European Commission towards the governance of transatlantic financial markets. This shift is particularly noticeable in the regulatory policies introduced in Europe to regulate derivatives, rating agencies, and hedge funds. One of the primary challenges faced by the European Commission in regulating these markets and institutions derived from the fact that some of the main derivatives dealers operating within the European markets, hedge funds managers marketing to European investors, and the major rating agencies providing credit ratings to European corporate and sovereign debts, were all domiciled in the US. However, instead of relying on the home-country supervision provided by the US authorities, as had frequently occurred in the pre-crisis period, the regulatory measures initially introduced by the European Commission have sought to ensure that the European operations of

hedge fund managers, rating agencies, and derivative dealers domiciled in third countries would not escape European regulation. Let us briefly review this policy shift in the three issue areas analysed in this paper.

First, in the case of OTC derivatives markets, the European Commission has followed the approach coordinated at the international level by demanding banks that act as dealers in the derivatives markets to clear their standardised contracts through clearinghouses. However, rather than allowing market forces to decide the location of such clearinghouses and accepting the clearing services provided by clearinghouses located in other jurisdictions, the Commission has pushed non-European dealers to clear their European transactions through a central clearinghouses located in Europe and authorised by European regulators (European Commission 2009a).

Only after having achieved the commitment of some major third-country dealers to clear their European derivatives through a clearinghouse located in Europe (European Commission 2009b) did the European Commission open the door to third country clearinghouses. These would be authorised to access the European markets only if the legal and supervisory framework of the third-country was deemed equivalent to the one designed in Europe (European Commission 2010a, Article 23).

Second, a similar approach has also informed the European approach towards the regulation of credit rating agencies. Only two years before the crisis, the European Commission had explicitly left the supervision and regulation of the US rating agencies operating in Europe in the hands of their US home-country regulators (European Commission 2006). The crisis has led to a complete turnaround in this position, and the European Commission has made one of its main priorities ensuring that these agencies do

not escape the supervision of European authorities. More specifically, the Regulation of rating agencies proposed in 2008 stipulated that financial institutions may use for regulatory purposes only credit ratings issued by rating agencies established in the EU (European Commission 2008, Article 4). This provision was interpreted as the requirement that the bonds traded in Europe were required to be rated by analysts located within the EU and subject to the European regulation.

Only subsequently was this provision relaxed through the introduction of an "endorsement regime". This required the three major rating agencies to establish a European subsidiary under the supervision of European regulators which would "endorse" the ratings issued by the parent company and remain legally responsible, and further required that their home-country regulator had adopted "requirements which are at least as stringent as the requirements set out in" the European regulation (European Commission 2009d, Article 3b).

Third, also in the case of hedge funds, the initial proposal for an Alternative Investment Fund Managers Directive presented by the European Commission allowed managers domiciled in non-EU countries to market their services throughout Europe only after a three year transition period and under the conditions that they could demonstrate the regulatory equivalency between their home-country regulation and the stringent conditions set in the directive (European Commission 2009c, Article 35-9).

Similarly to the regulation of rating agencies described above, also the terms of access of third-country hedge funds and managers to the European markets were altered in the final version of the directive. This allowed non-EU fund to market in individual member states through the existing system of national private placement regimes until the introduction

of “third-country passport” required to market their services throughout the EU. However, the access of non-European funds to the European markets remained conditional on the presence of cooperation arrangements between European authorities and their home-country authorities, the compliance of their home-countries with international standards on anti-money laundering, terrorist financing, and tax cooperation agreement, and in the case of non-EU managers, compliance with the requirements of the Directive or equivalent rules (European Commission 2011b, recital 61-69, see also Chapter VII).

3. Theory: Explaining the European regulatory response to the crisis

How can we explain the importance placed by the European regulatory response ascribed to ensuring that third-country market actors would not access the European markets based solely on their home-country rules or supervision? The shift in the European approach towards transatlantic financial relations identified in the previous section is at odds with numerous explanations presented by the academic literature to analyse the evolution of the European financial regulatory architecture prior to the crisis.

First, some authors highlighted how in the years before the crisis Europe frequently overcame the impasse between different national models of regulation by borrowing ‘best practices’ developed within international regulatory bodies as the model for new EU directives and regulations, such in the case of the capital requirements negotiated by the Basel Committee or the accounting standards set by the International Accounting Standards Board, (Posner and Véron 2010). Indeed, the crisis has intensified the interaction between European and US regulatory authorities in devising a common

approach to the regulation of derivatives, rating agencies, and hedge funds, both through existing international regulatory bodies such as IOSCO and Financial Stability Forum, and newly created bodies such as the OTC Derivatives Regulators' Forum. However, the work of these transgovernmental institutions cannot explain the turn in the EU regulatory approach described above. In fact, international institutions as well as the G20 have frequently warned against the risk of "regulatory fragmentation" and regulatory arbitrage generated by the introduction of conflicting regulations over transnational markets.

Second, other authors have identified the main driver behind the transformation of the European regulatory architecture as residing in the interests of financial groups. While some authors have focused primarily on domestic financial groups shaping European regulatory politics through the lobbying of their national authorities (Quaglia 2008; Story and Walter 1997), Mügge has highlighted the emergence of a new group of transnational market incumbents formed by large internationally oriented European financial services firms with a common interest in removing regulatory barriers across European markets. Often within global financial industry associations or *ad-hoc* transatlantic coalitions, these firms have increasingly joined forces with those US investment banks, exchanges, and other financial firms that had acquired a significant presence in Europe in demanding the removal of the remaining regulatory barriers existing between the US and the EU which increased the costs of conducting business across their two most important markets (Mügge 2010, p.147). However, as with the international regulatory bodies, transnationally organised financial actors have followed the European response to the crisis with much concern, opposing the measures that would force them into separate geographical solutions and introduce overlapping or conflicting regulatory requirements.

A third set of explanations presented before the crisis highlighted the predominant influence of the United States over transatlantic financial relations – not only through its market power or direct diplomatic pressures, but also through the dominance of its regulatory models (Simmons 2001; Posner and Véron 2010). However, a focus on the preferences of the US is also inadequate to explain the European response to the crisis. On the contrary, the cases below reveal how American policymakers have expressed concerns for the extraterritorial dimensions of the European regulations and have defined those provisions limiting the access of US firms to European markets as "protectionist".

These observations suggest that the causes of the shift in the European approach towards the governance of transatlantic financial regulations are to be found within the multi-layered EU political process rather than outside. In particular, a fourth group of authors have instead investigated the competing political coalitions that emerged during the completion of the single market in financial services. Quaglia has identified the main cleavage as one which runs between a coalition including Anglo-Saxon and Northern member states who have promoted "a market-making, competition-friendly, principle-based approach" and a competing "market-shaping" coalition gathered around France, Italy, occasionally Germany, and including some members of the European Parliament, promoting a more interventionist approach in the regulation of financial markets (Quaglia 2010; see also Fioretos 2010). From this perspective, the focus of regulatory policies before the crisis on stimulating competition and efficiency, and in favouring market access both across European countries and between the US and Europe reflected the predominance of the former coalition in shaping the politics of financial regulation in the EU.

The analysis of the three case studies in the second section of this paper will reveal how this divide continued to inform the politics of financial regulatory reforms in Europe also after the crisis. However, the measures adopted by the Commission to extend the regulatory clout of European authorities over US market actors operating in Europe have been championed primarily by Continental European countries and the European Parliament, that is, the "market-shaping" coalition described by Quaglia as on the losing-side of EU financial regulatory politics before the crisis.

In order to explain the shift in the European approach towards transatlantic financial relations that followed the crisis it is necessary to consider the effect that the crisis had in altering the politics of financial regulation within the EU. The deepening of the crisis in the fall of 2008 has significantly politicised financial regulation across most European countries, creating a more fertile terrain for policy entrepreneurs other than the tight-knit Brussels-oriented policy community that had informed reforms prior to the crisis to influence the regulatory response (for a similar point, see Mügge 2010, p. 150). In particular, the crisis has strengthened the position in the EU policymaking process of leaders and finance ministers from Continental European countries and members of the European Parliament, who have taken advantage of the crisis to bring some of their long-standing priorities back to the European agenda. The European Commission has increasingly sought support from these more pro-regulation forces, rather than from the London-based coalition that had driven the process of European regulatory integration before the crisis toward its long-standing goal of deepening European integration in financial markets (Posner 2009a).

The depth and severity of the crisis, and the use of taxpayers' money in support of financial institutions, have increased the intellectual traction of the ideational glue that informed this "market-shaping" coalition before the crisis, in particular the scepticism toward self-regulation and the greater role envisioned for public authorities in the regulation of financial markets (Quaglia 2010). Most importantly, the origin of the crisis outside of Europe, and the limitations revealed by the crisis in the regulation and supervision of US firms in Europe by their home-country supervisors, has strengthened the case for limiting the European vulnerability to the regulatory failures of foreign authorities and for ensuring that foreign firms operating within the European territory abide by European (host-country) rules, rather than relying on their home-country regulation.

However, the uneven level of support for extending European regulatory clout to third-country market actors reveals how this ideational aspect cannot fully explain the turn in the European approach towards the regulation of transatlantic financial relations. The cases below will show how the objective of achieving greater regulatory autonomy combined with, and often provided a mask for, vested economic interests. Mügge had concluded in his analysis of the politics of EU financial reforms before the crisis that the competitive struggle had permanently shifted from the one taking place between European countries defending their respective financial firms to the one between smaller domestic-oriented and larger internationally-active financial firms occurring within the same European countries (2010). While the crisis has not triggered a complete return to the "battle of the systems" among European countries (Story and Walter 1997), the cases analysed below reveal a resurgence of more traditional competitive concerns, as

European countries maintained different stakes in the maintenance of integrated transatlantic financial markets. In particular, London's status as the main hub for American and other third-country financial firms conducting business in Europe has led the British authorities to oppose those measures that would have limited their access to European markets and to successfully achieve the introduction of "third-country passports", "equivalency provisions", or "endorsement mechanisms" that would safeguard this status.

The rest of this paper will explore how the desire to enhance the European regulatory autonomy combined with vested economic interests in informing the European approach towards transatlantic financial markets in the regulation of derivatives, rating agencies, and hedge funds.

3.1 Derivatives

While OTC derivatives markets have been a priority for regulators in the US since 2005, European authorities have largely lagged behind their US counterparts. It was only after the collapse of Lehman Brothers that the European Commission followed in the path set by the Federal Reserve Bank of New York and convened the main derivatives dealers in order to seal their commitment to clearing the majority of their credit derivatives contracts through central clearinghouses (McCreevy 2008). Unlike the US where regulators were able quickly to achieve the commitment of the main dealers eager to avoid more formal regulation, in Europe the negotiations between the European Commission and derivatives dealers stumbled because of the Commission's insistence that this central counterparty be located within the EU.

The major derivative dealers operating both in the US and Europe initially opposed this demand since the geographical segmentation of derivatives markets into an EU and US component would have forced them to split the market and liquidity. Their concerns also resonated among some US policymakers. The influential US Senator Schumer declared: "this kind of protectionist policy has no place in the modern world, and I am strongly urging our regulators at all levels to vigorously resist this power grab by the European Commission" (Schumer 2009).

In order to overcome the resistance of bank dealers, the European Commission urged the European Parliament to pass legislation to impose higher capital requirements on contracts not cleared through a clearinghouses located in Europe (McCreevy 2009). This threat was successful in twisting the arm of the major transnational dealers and in achieving their written commitment to clear derivatives through a clearinghouse located in Europe (European Commission 2009b).

How can we explain the priority placed on the geographical location of the clearinghouses? The European Commission argued that letting the market decide the location would have, in all likelihood, concentrated these trades outside the regulatory oversight of European authorities. In fact, the main US derivative dealers operating in Europe had at the beginning of the crisis taken control of a derivatives clearinghouse (IntercontinentalExchange) under the oversight of US regulators. This solution would have left European authorities with very limited powers to intervene should this US-based clearinghouse run into trouble, since central banks do not provide direct access to their liquidity facilities for financial institutions located outside their currency areas (European Commission 2009a, p. 10). As a Brussels official argued, "can we afford the

luxury of having a CCP clearing the whole world, over which we have no regulatory and supervisory powers or guaranteed access to information? And what if it goes belly up?" (cited in Grant and Tait 2009).

Similarly, European authorities also contested the desirability of storing the records of derivatives transactions into a global trade warehouse under the oversight of US authorities. This outcome was described as potentially impairing the capacity of Europe to quickly ascertain complete information regarding OTC derivatives exposures in the case of an episode of market instability. For this reason, the European Council advocated in December 2009 "the creation and operation of European-based trade repositories" (European Council 2009, p.4). The threat of the creation of a European challenger was instrumental in leading the New York-based DTCC, which had acquired an international monopolistic position, to establish a new European subsidiary subject to European regulation and supervision (DTCC 2010).

The objective of increasing autonomy from foreign authorities combined with the more traditional objective of promoting European "national champions" in the emerging derivatives clearing race. European governments recognised that letting the market decide the location of the CCP would have also probably led the clearing solution supported by the major US banks also to take control of the European market at the expense of smaller European competitors, such as Deutsche Boerse's Eurex or LCH.Clearnet. The French government and the Banque de France supported the establishment of a "Euro-zone" solution under the supervision of the European Central Bank (Jones 2009b).

This possibility triggered a prompt reaction by the British authorities. While British authorities did not oppose the requirement for a "European solution" given the privileged

position enjoyed by London over other European financial centres, they fought back against the French proposal for a "Euro-zone" clearing solution that would exclude London-based clearers from the Eurozone (HM Treasury 2009). The British government took the unprecedented step of taking legal action in the European Court of Justice against the ECB, and its "location policy" requiring clearinghouses handling a significant portion of euro-denominated contracts to be based within the single currency area (ECB 2011 p.10; Watt 2012). While the outcome of the confrontation with the European Central Bank is still pending at the moment of writing, London has been more successful in influencing the legislation proposed by the Commission. This states that "a CCP that has been authorised to clear eligible derivative contracts is required to accept clearing such contracts on a non-discriminatory basis, regardless of the venue of execution" (European Commission 2010a, p.7)

3.2 Credit Rating Agencies

Following the bankruptcy of Enron and Parmalat in the early 2000s, the European Commission had discussed but rejected the desirability of regulating the European activities of the main US rating agencies which control the market for corporate and sovereign ratings in Europe. It demanded instead that these same rating agencies should incorporate a voluntary Code of Conduct drafted by the IOSCO Code of Conduct in their internal guidelines (European Commission 2006). As a result, the supervision and regulation of the activity of rating agencies in Europe was effectively left in the hands of their US home-country regulators.

Just two years after this decision, the global financial crisis led to a reversal in the

position of the Commission. One of the priorities informing the Regulation presented by the European Commission in 2008 was to ensure that the main American rating agencies operating in the European markets did not escape the supervision of European authorities, and to “counterbalance to other important jurisdictions, notably the US”, thus ending the existing un-level playing field between the US and Europe, with the supervision of US authorities having an extra-territorial impact in the EU (European Commission 2008, p.5).

This request was not unprecedented. On the contrary, the European Parliament had in 2004 passed a report calling on the European Commission to assess the establishment of a “European Registration Scheme” for the registration of rating agencies (European Parliament 2004). Members of the European Parliament took advantage of the crisis to bring the issue back onto the European regulatory agenda, voting for two reports to achieve the same objective (Quaglia 2009). Another set of actors supporting the conduct of the European Commission was the French and the German governments, who had in the past been critical of US hegemony in this area (Engelen 2004). During the crisis, the French government had proposed mandatory registration for rating agencies whose ratings are used by European financial institutions (Hughes and Davies 2008). The then French Finance Minister, Christine Lagarde, argued that it was not possible to only have home regulation for financial institutions producing "collateral effects from financial instruments and products", as the way of selling those products was "completely extraterritorial" (cited in Jones 2008).

The imposition of a European regulation over US rating agencies was also supported by the British authorities (FSA 2009). In fact, the “endorsement clause” introduced in

European regulation requiring third-country agencies to have their ratings endorsed by a European subsidiary safeguarded the position of London as the privileged hub for the European activity of the main US rating agencies. The preferences of London and Continental European Countries have instead collided on a measure that would have further segmented the transatlantic market for ratings; that is, the creation of a European rating agency. This measure was openly supported by the German Chancellor Angela Merkel and the French President Nicolas Sarkozy as a way to challenge the hegemony of US rating agencies in Europe (Barber et al. 2008; European Parliament 2008). Following a request from the European Parliament, the Commission has launched a public consultation on the possibility of creating new European rating agencies or having the ECB and other national central banks issuing ratings (European Commission 2010b, p.19-22). However, despite the renewed support for the measure triggered by the role of rating agencies during the European sovereign debt crisis, the European Commission has adopted the same position expressed by the British authorities and opposed the creation of a public European rating agency on the grounds that this measure would lack credibility (European Commission 2011. For the British position see FSA, HM Treasury, Bank of England 2011, p. 17).

3.3 Hedge Funds

The regulation of hedge funds represents the impact that the crisis had within the EU politics of financial regulation very well. Despite the fact that hedge funds were not the main culprits in the crisis, the market turmoil has created a more fertile terrain for those policymakers who had previously supported the regulation of the sector to push their

long-standing priority into the European agenda. These include the Party of European Socialists and its president Poul Rasmussen, whose proposal to regulate the sector preceded the crisis (Rasmussen and Van de Burg 2007), as well as the French and German governments, which had promoted the regulation of the industry in the international agenda since the collapse of the US fund LTCM in 1998 (Fioretos 2010).

Most importantly, while previous Franco-German attempts to regulate the hedge fund industry in Europe had faced the decisive opposition of British authorities, the crisis has prompted a shift in this position. British authorities have endorsed a European regulation of the industry and spent their political capital in Brussels to fight those provisions more damaging for the City of London, which host the large majority of hedge funds managers operating in Europe (Helleiner and Pagliari 2009).

In particular, the same two coalitions have remerged around the conditions under which funds and managers established in third countries would be able to access the European markets. The provisions allowing funds based outside the EU to be marketed to EU investors only three years after the new rules took effect and if their home countries met "equivalent" standards became one of the most controversial aspects the Alternative Investment Fund Managers Directive proposed by the European Commission in April 2009 (European Commission 2009c, Article 35-9).

The difficulty for a third country to meet these conditions led the main international hedge fund associations to oppose the directive on the ground that it would have arbitrarily restricted access to EU markets for non-EU funds. According to the Alternative Investment Management Association, the "directive makes it so difficult and costly for non-EU funds and managers to access the EU market that it is clearly

protectionist in effect, if not in intent" (AIMA 2009). Further, US authorities raised similar concerns for the impact of the directive in discriminating against US managers and potentially excluding them from the EU markets (Geithner 2010).

Most importantly, the provisions in the directive regulating the access to the European markets were criticized within Europe by the British government. British authorities sought to remove those provisions that would threaten the status of London as the main hedge fund hub in Europe and its capacity to attract funds based in the many British Crown dependencies that act as offshore financial centres. The diplomatic offensive by the British government has thus focused on preventing what the Minister for the City Lord Myners called the "building of a wall around Europe" (cited in Jones 2009a). The Financial Services Authority called for a "global approach" that would "not impose unjustified geographical distinctions that […] would unjustifiably and significantly restrict investor choice. Europe should be neither a fortress nor a prison" (cited in Hutchings 2009).

On the contrary, a coalition led by France sought to make the terms of access to the European market of non-European funds and fund managers more restrictive than the ones initially proposed by the European Commission. Christine Lagarde described the directive presented by the Commission as a "Trojan horse", opening the door of the European markets to funds based in offshore centres subject to weak regulation (cited in Hollinger et al. 2009). The French government demanded that the rights to market across Europe would be restricted to only those funds domiciled in Europe, leaving to individual countries the decision regarding the access of funds from third countries within their national boundaries (Patrick 2009).

In the end, after lengthy negotiations, British authorities were able to safeguard the capacity of London-based managers to market non-EU funds in individual European countries through their national placement regime, and after a period of three years, to market throughout Europe through the introduction in the directive a "third country passport". The directive also sought to level the playing field between managers based in the EU or outside of it by extending the "third country passport" to those non-EU managers complying with the requirements of the Directive or equivalent rules and authorized by a European regulator. At the same time, Continental European countries were able to preserve quite restrictive conditions under which the third-country hedge funds would be granted such passport. The passport would not be accessible to funds based in off-shore centres not complying with international standards on anti-money laundering, terrorist financing and tax cooperation, or countries whose authorities had failed to sign a supervisory agreement with a European regulator. Moreover, the directive allowed individual countries to preserve barriers against non-EU funds included in their national private placement regimes for at least five years after the transposition of the directive (European Commission 2011b, recital 61-69, see also Chapter VII).

4. Conclusion

The analysis in this paper has highlighted a different European impact on the international regulatory response from the one envisioned by those commentators suggesting that the crisis would have led to the promotion of an alternative European regulatory model. Rather than in the content of regulation, this paper has located one of

the major impacts of the European regulatory response in the governance of transatlantic financial markets.

The priority placed by European policymakers around expanding the European regulatory clout over foreign market actors operating in Europe represents a change of direction from the authority-sharing arrangements that had informed the construction of an integrated transatlantic market for financial services in the period preceding the crisis. Moreover, some of the measures analyzed in this paper had an impact that extends beyond the transatlantic arena. Other jurisdictions have followed the European lead in introducing legislation to require the main US rating agencies to register with national regulators (for instance, Japan, Australia, Mexico, Canada, and Hong Kong). Japan and China have adopted location policies mandating the on-shore clearing of domestic derivatives, while Canada encourages this measure (for a review, see CFTC and SEC 2012, p. 147-48).

While the analysis in this paper has been limited to the short-term response to the crisis, an important question for scholars and policymakers will be to understand the broader significance of this policy shift. Already during the crisis, Véron has questioned the extent to which the restrictions initially proposed by the Commission on the capacity of non-European hedge fund managers, rating agencies, and derivatives dealers to operate in the European markets represented the first steps towards the creation of a “New Fortress Europe” (e.g. Véron 2010).

This paper provides some support to the notion that this may represent primarily a temporary departure from the ironing-out of geographical impediments to the emergence of an integrated transatlantic financial market that had characterized the pre-crisis period.

In particular, this paper has identified the causes of this shift in the pressure generated by the politicization of financial regulation within the EU and the changing balance between different coalitions triggered by the crisis. As a high European Commission representative has asked during the crisis, "should EU-US cooperation still be a priority when citizens and politicians on both sides of the Atlantic are asking us, regulators, for urgent repair to our 'domestic' financial systems?" (Holmquist 2009).

As the memories of the crisis fade, we may expect some of the changes in the politics of financial regulation in the EU triggered by the crisis to be reverted. The greater the distance from the crisis, the more the concerns emerged during the crisis regarding financial stability are likely to be trumped by concerns regarding the impact of regulatory policies over the attractiveness of the EU to international mobile financial activity, as well as concerns about their impact upon economic growth in Europe. Moreover, as the memories of the crisis fade, we can expect a decrease in the engagement in financial regulatory policies of those elected policymakers that have promoted measures to reassert control over those market actors creating risk for European markets. Conversely, those more internationally-oriented financial groups that have a greater stake in reducing regulatory barriers to the integration of transatlantic markets are likely to regain some of the political capital lost during the crisis. The easing of some of restrictions initially imposed on third-country access to the European markets suggests that this rebalancing within the EU financial regulatory politics may already be underway.

At the same time, other considerations suggest that the trend analyzed in this paper may have a more lasting impact on the regulation of financial markets in Europe as well as internationally. The failure of regulatory authorities in the US, as well as in other

countries such as Iceland, to properly regulate the foreign operations of their financial institutions and the socialization of the costs of these regulatory failures have reinforced the principle that firms operating within foreign jurisdictions should not escape the oversight of host country supervisors. As this paper has demonstrated, this principle has informed much of the immediate responses to the crisis in Europe. However, the support for greater 'host country' regulation of international firms active in Europe may continue to inform the politics of European financial regulation even after the coalition which initially promoted this stance loses its weight within the EU policymaking process. While the emergence of a "Fortress Europe" has not materialised, scholars will need to consider the possibility that the transatlantic divide in financial regulation may become wider rather than narrower in the future.

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