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Germany's Co-Governing Party Proposes Sweeping Regulations for Hedge Funds

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On October 27, Germany's Social Democratic Party (SPD), junior partner in Chancellor Angela Merkel's government, proposed 14 regulatory measures aimed at generating a "culture of accountability for the financial markets" and establishing "a new balance between the market and the state." The regulatory measures, contained in a 32-page document, call for "tightly regulating hedge funds" by requiring them to be registered in a European Union country, publicly disclosing their ownership and capital structures, as well as pending transactions, restricting naked short selling and demanding that financial firms back any loans to hedge funds with 40% of their own capital, instead of the current 8%.

The proposed measures not only reflect the prevailing legislative mood in a Europe embroiled, like the rest of the world, in financial crisis, but also SPD's political position and expectations ahead of Germany's October 2009 general election. According to market players, it is too early to know if some or any of these proposals have a chance of becoming policy, but the document provides a clear blueprint for a party that hopes to win back power from the conservative Christian Democrat Party (CDU) next year.

"Since the document is only a final report of a project team of a political party, the proposed regulations are in an early stage of a political process," says Achim Döser, a Frankfurt-based financial lawyer with KPMG Rechtsanwaltsgesellschaft, a firm that is part of the KPMG International network. "Therefore it cannot be foreseen whether the proposed measures will be adopted."

"Yes, market players generally see [the document] as problematic," said an important German market player. "[But] I currently don't see any danger for the [hedge fund] industry, because there are no major legislative proposals on the table before the elections," said this person. "I have heard some of these proposals before, but they never had a chance [of becoming policy]. But that has changed since the financial crisis, and now the general view on the need of regulating certain areas depends on the outcome of the elections."

Stefan Olbermann, a spokesman for the German Finance Ministry, which is headed by the social democrat Peer Steinbrück, declined to comment. "We don't have anything to say about a party paper," he said. According to press reports in Germany, however, the blueprint comes with the blessing of Steinbrück.

A Crack Down on Hedge Funds?

German Social Democrats put forward nine "necessary measures in order to create a balanced regulatory environment for hedge funds," according to the document. Those nine proposals are:

- Mandatory disclosure of ownership structure, capital structure and ongoing transactions. If ever adopted, local market players warn that these measures could deal a serious blow to the way hedge funds traditionally conduct their business.
- Strengthened disclosure obligations to hedge fund investors. Although this is presented as a separate point, it is related to the previous proposal.
- Obligatory registration of hedge funds in an EU country. SPD's goal is to "onshore" hedge fund activities. According to a report prepared by the Munich office of law firm Weil, Gotshal & Manges, "the idea is to control and supervise activities of hedge funds by regulatory authorities similar to the existing passporting concept for banks and investment funds in the EU."
- Restricting pension funds and insurance firms' investments in hedge funds. Germany already limits the ability of these companies to invest in hedge funds, but without providing material details, Social Democrats call for increased limitations.
- Banning hedge funds from accessing public markets. It is not clear if this only applies to equity markets or also debt markets, but it almost invariably limit hedge funds investments strategies.
- Introduction of a mandatory code of ethics. SPD's idea is that all hedge funds operating in Germany should be bound to a yet-to-be-designed "code of conduct." This proposal has been a central part of Finance Minister Peer Steinbrück's "Transparence Initiative."
- "Fair taxation" of hedge fund profits. The party paper does not provide a clear outline of what "fair taxation" means.
- Prohibition of "naked" short selling. "Naked short sales on falling shares have worsened the financial crisis," says the SPD document. "Naked short selling has to be banned on an international level." KPMG's Döser says "the proposal does not intend to prohibit short selling. The SPD is concerned about naked short selling [and] therefore any short selling shall be reported to the competent authority."
- Increased regulatory equity requirements for debt financing to hedge funds. SPD's proposal calls for requiring banks to keep "at least" 40% of the initial risk on their books. If adopted, this would make loans to hedge funds considerably more expensive, according to market observers. Currently, the requirement is 8%. "I don't think this is realistic," says a market player. "On a European level we have had discussions in the 5% to 10% range."

Other Proposals

In a press statement accompanying the release of the 14 measures the SPD declared: "The principle of 'privatizing profits and socializing losses' is unacceptable for us." This is why the party document recommends that financial managers become personally responsible for losses and advocates that employees of hedge or private equity fund target companies be legally entitled to participate in any capital gains of the funds or their managers. The proposal calls for a 5% participation in capital gains, which "technically could be achieved by introducing a 'bonus' in respective legislation or by introducing respective provisions in collective bargaining agreements between unions and employer associations," according to the Weil, Gotshal report.

Other proposals include a prohibition on private equity firms investing more than 10% of their capital into the same target, and higher, although undefined, trade and capital gains taxes.

"I nearly fell off my stool when I read this digest," Hans Ostmeier, chairman of Germany's private equity federation and senior managing director for Blackstone Group in Germany said to Bloomberg. "Clearly, one year before the elections, some politicians want to revive the damning, untruthful specter that we are a bunch of locusts."

The SPD document also calls for strengthening "participation rights" of employees in companies. "Co-governing in companies is an important instrument in the long-term survival of an enterprise and has to be strengthened," the document says. Unlike in the U.S. or the U.K., Germany has a long tradition of having worker representation on a company's board.

Finally, the SPD is asking the EU for a greater regulatory oversight and the creation of a European ratings agency as a "counter-weight to the agencies that until now only exist in the U.S."

The Political Future of These Measures

Although it was Gerhard Schröder's SPD-led government that in 2004 liberalized rules allowing hedge funds to play a bigger role in Germany's financial markets, it was also SPD party boss Franz Müntefering who in 2005 compared hedge funds and private equity firms to "locusts," prompting a spirited debate about "predator capitalism" in that country.

Merkel's conservative party, regarded generally as more pro-business, has acknowledged SPD's document, saying Social Democrats have come closer to the conservative position on the financial crisis. "In SPD's 14-point proposal there are measures we have formulated a long time ago," said CDU's parliamentary leader Volker Kauder. "I'm sure we will find a common ground."

Nevertheless, Kauder was more cautious regarding the proposals related to regulating hedge funds. "It is evidently difficult" establishing when naked short sales are really damaging, he said. Furthermore, disclosure of hedge funds capital structure and ownership structure "requires closer examination."

"For two reasons, there is no good chance that the CDU will actually support these measures," suggested a German market player. "First, they don't share SPD's analysis about the consequences of this financial crisis. Second, we are in an election cycle and it is unlikely that the CDU will follow up on what was suggested. But, in Germany, you never know, you never know," he adds.

So far, market players have been relatively quiet. The Alternative Investment Management Association, a London-based not-for-profit trade association with over 1,280 hedge fund members worldwide, declined an interview for this article, saying it would not comment on internal German politics.

"The proposed regulations are in an early stage of a political process," says Döser. "We expect a [stronger] reaction of market participants when a draft bills come out."