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The Alternative Investment Fund Managers Directive

and its Impact on Norwegian Private Equity

A Master Thesis in the Major of Financial Economics
Master of Science in Economics and Business Administration

Supervised by NHH Associate Professor
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This thesis was written as a part of the master program at NHH. Neither the institution, the supervisor, nor the censors are - through the approval of this thesis - responsible for neither the theories and methods used, nor results and conclusions drawn in this work.

Foreword

My adventure at the Norwegian School of Economics began in August 2006. In three years I would obtain my BSc in Economics and Business Administration, which includes one exchange semester at Bocconi University in Milan, Italy.

In August 2009 I began pursuing my MSc together with the CEMS Master's in International Management. The exchange semester required by CEMS I spent once again at Bocconi, where I followed, among other courses, Prof. Stefano Caselli's course in Private Equity and Venture Capital.

I was fascinated by the complexity of the world of Private Equity, but in particular I was fascinated by the fantastic idea behind the management model, aiming at truly lifting companies having high growth potential and helping new companies emerge and succeed. The course however also taught me how private equity activity is often conducted in a way which may put many stakeholders at risk – investors, target companies, and managers. There is also a real contribution to systemic risk.

It came to me as no surprise that when the time came for me to choose a topic for my master thesis, it would fall within the subject area of private equity. The legal aspects of private equity were a new topic to me, and writing about the newly introduced AIFM Directive would turn out to be a challenging task, but nevertheless a precious learning experience.

I wish to thank NHH Associate Professor, Carsten Bienz, for supervising this work and providing me with useful advice in times of need. Thank you to Bocconi Professor Stefano Caselli for introducing me to the subject of Private Equity – and for continuing to be an inspiration to me and CEMS students across the world. Thank you to Britt Hjellegjerde and Anders Hoff at the Financial Supervisory Authority of Norway (Finanstilsynet) for their kindness and impeccable availability. I hope this paper can be a contribution to the initial debate on the transposition of the Directive in Norway.

With this I conclude a five-year educational adventure, which I have shared between the Norwegian School of Economics in Bergen, Norway, Università Commerciale Luigi Bocconi in Milan, Italy, and CEMS, the Global Alliance in Management Education. It has been, truly, unforgettable.

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Abstract

The financial crisis, together with more or less related events such as the fall of Lehman Brothers and the Bernard Madoff fraud got the ball rolling at the European Commission about introducing a European Directive which would aim at harmonizing the regulatory framework for alternative investment funds across the EEA. This resulted in the Alternative Investment Fund Managers' Directive (AIFMD), an all-encompassing controversial set of regulations which is to be transposed to national law by mid-2013.

This paper discusses possible implications of the Directive for the Norwegian private equity market. Private equity is only one of the target activities of the AIFMD. In Norway the Directive implies extensive additional regulation, as private equity is hardly regulated to this day. This translates into higher compliance costs. The major changes will imply the need for private equity fund managers to request authorization; the requirement to appoint depositaries for each managed fund; marketing requirements posing a possible obstacle to accessing foreign capital; and transparency requirements radically changing the way in which activities are communicated externally from PE fund managers. The Directive will probably take a heavier toll on venture capital funds, which represent a large part of capital under management in Norway and are usually smaller, compared to buyout funds, thus feeling the additional costs weighing more heavily with respect to the size of the fund. Regulators should attempt mitigating the costs of the transition, especially for venture capital funds, through e.g. favorable tax schemes or other incentive mechanisms.

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1. Introduction

1.1. What led to this Directive

What does the average man or woman associate with the expression “private equity”? Large buyouts, leverage, asset stripping, over-the-top risk?

If so, they’re right. Although this view is incomplete, it is not incorrect. The world of private equity and venture capital, as we shall soon see, is a well of opportunity for start-up ventures, maturing firms and declining companies. But like with many tools which can be used to do good, if used imprudently the result could be all but good.

In September 2008 the global investment bank Lehman Brothers collapsed as a victim of the triggers of what would soon turn into a global financial downturn. There were many of these triggers, and the cause of the crisis can certainly be, and has been, analyzed from several different perspectives. As I write this in 2011, many countries have begun to recover; some struggle still. In Europe concern that Greece may not be able to meet its public debt obligations rises by the minute, and this concern spreads to include also Italy and Spain. The financial crisis had the riskiness of debt skyrocket, which pressured interest rates upward, and in turn put certain countries, among which the mentioned Mediterranean trio, in a difficult situation with regards to public debt.

The channels through which distress in the financial sector disseminates to bring about such huge meltdowns are numerous. Among these are investment funds. Many of these funds, among which the abovementioned private equity funds, employ large amounts of leverage and alternative investment strategies in order to carry out large deals which result in value creation for all stakeholders and thus high returns and profits for investors and fund managers. The capital structure of the investments, however, and the alternative and sometimes experimental strategies don’t come without a larger side-dish of risk. This is why the business of fund management, as any other business for that matter, is regulated by law to a larger or lesser extent.

The European Union mostly regulates its member countries through directives. A directive is a legal imposition which is structured so that each country must take implementing measures to put it into force on a national level. The EU’s answer to the financial crisis with respect to the management of funds which employ alternative investment strategies is one such directive, namely the Directive on Alternative Investment Fund Managers (AIFMD). The aim of this directive is to harmonize the regulation of some types of funds throughout Europe. The European Private Equity and Venture Capital Association (EVCA) regards this Directive as the most comprehensive and revolutionizing piece of regulation the private equity and venture capital industry has ever faced. The introduction of

the Directive, which entered into force on 8 June 2011, has spread high concern among private equity fund managers, and not only in Europe, but also for instance in the United States, a country whose private equity funds both find investors and invest, among others, in Europe. This means that the Directive has an impact not only for Europe, but for all stakeholders of European alternative collective investment undertakings.

Norway is not a European Union member, but as a member country of the European Economic Area it will have to transpose the Directive into national law within the two-year deadline imposed by the Directive. Per August 2011, the work to implement the Directive has not yet begun in Norway, and so the exact impact this directive will have on the Norwegian market for private equity and venture capital is impossible to foresee. Moreover, the impact on the Norwegian industry will not only depend on how Norwegian regulators will do the transposition; in fact, the Norwegian fund managers registered abroad in other European countries will be subject to the Directive the way it is transposed in the country in question.

1.2. Research question, methodology and limitations

This paper seeks to outline possible ways in which Norwegian private equity will be affected by the AIFM Directive, ending in a short discussion on pros and cons and whether regulating fund management in Europe as a whole in the end does more good than harm. The perspective of this paper reflects the different players in this game of directive implementation: Funds and their managers; regulators; investors. In other words, the stance aims at being neutral by presenting the Directive and the analysis from a societal point of view. Thus the research question sounds:***"How might the Alternative Investment Fund Managers' Directive impact the Norwegian private equity market?"***

This question is highly normative. As we shall see, it is very difficult per today to say what the exact effects of the Directive will be, in Norway as in any other targeted country. In order to work out a properly backed analysis, the methodology for this paper consists in the study of the Directive in question and related relevant pieces of legislation, and critique and comments from field experts and professional service providers specialized in the field of private equity. What is not based on external sources is merely based on personal reflections and analysis. The portion of the paper and its conclusions based on my own reflections makes this thesis highly normative: What it concludes cannot be verified before transposition of the Directive actually does happen and is given time to have an effect on the economy. My goal is for this paper to provide a good overview of the Directive and a good basis for discussion.

2. Overview of the subject of private equity

For a beginner in the subject, private equity is best understood in contrast to public equity, i.e. equity which is traded on a stock exchange. But many companies are never listed on a stock exchange, and for those that are listed, there was probably a longer period of time in which the company's equity was privately held.

Trading public equity has, among others, the advantages of liquidity, availability, relatively low capital requirements and efficient pricing due to the large and continuously active investor base. Private equity, on the other hand, bears the opposite characteristics. Non-listed companies have fewer investors than listed ones. There are many reasons for this, one of which is that the reach of stock exchanges is very wide due to advanced trading systems and the presence in both a first-hand market (i.e. company-to-investor, financing of the company) and a second-hand market (investor-to-investor, no company financing), while private companies sell equity only in the first-hand market; Thus a private equity investment always comprises a financing decision. The low investor base doesn't allow for frequent valuation and effective market pricing as happens in a regulated market. Moreover, the often missing company track record (in the case of start-ups) makes it hard to forecast performances to carry out proper valuations. Investments are, moreover, illiquid as private equity capital is usually committed over a long period of time. These factors, among others, pose a number of challenges to all parties involved in a private equity deal and management process.But before proceeding about challenges faced by private equity investors, let me outline what I mean by "private equity" for the purpose of this thesis.

2.1. What is Private Equity?

As already explained, Private Equity is non-public equity. A very common, colloquial perception of private equity is the activity of buyouts, and especially leveraged buyouts (LBOs). While this is private equity indeed, it is not the only the only activity that can be characterized as such. Private equity activities can be linked to the six stages of the business life cycle as shown in figure 1 on the next page.

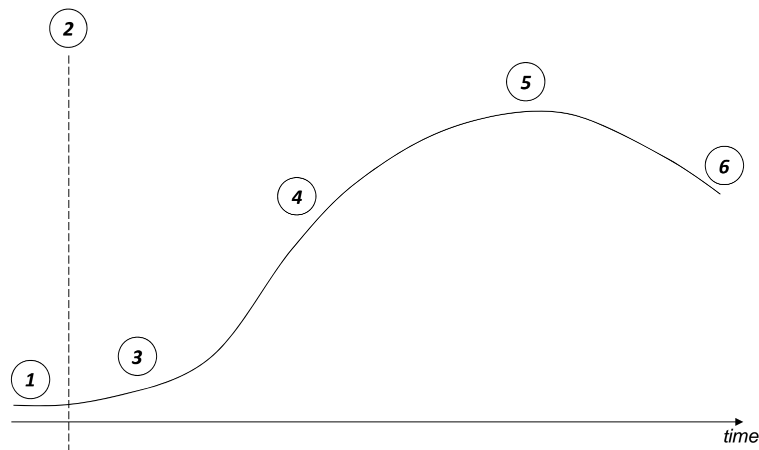

Figure 1: Business Life Cycle. *1. Development; 2. Start-up; 3. Early growth; 4. Rapid growth; 5. Mature age; 6. Distress/decline.* Adapted from Caselli (2009)

In the development phase (1) the business idea is born and possibilities are researched. The start-up phase (2) is the short phase of physically setting up the company. In early growth (3) the new venture begins operating and makes its first sales. The activity grows, but not necessarily the profit, as we are still in an entrepreneurial phase in which costs tend to exceed revenues. Rapid growth (4) is characterized by the fact that the venture is taking shape, sales are picking up and the firm is making a profit and conquering market share. In its mature age (5) the firm has stable sales and is able to manage its business with fairly little turbulence. At this stage, sales growth is hardly achieved – the only way to effectively grow is through a merger or acquisition, or expansion to new geographies and markets. Financing through private equity becomes an alternative to debt and initial public offering, because the equity can more easily be priced because of a well-established track record and ease of forecasting performance. Although the firm's activity is fairly stable, exogenous conditions, like the entrance into the market of a competitor, or a systemic financial crisis, could send the firm into difficulties and it may enter the last stage of its life cycle, distress or decline (6). Here the company might struggle to meet financial obligations, retain market shares, or other.

To each stage of the business life cycle we can link a financing activity. Private equity operators take part in all these activities to some extent. Table 1 on the next page summarizes these activities:

Stage of life cycle	Financing activity	Description
1. Development	Seed financing	Financing of the research work that goes into developing an idea that has the potential to be transfused into a marketable product
2. Start Up	Start-up financing	Financing of the initiation of the venture; preparation of business plan, set-up of physical firm
3. Early Growth	Early growth financing	Financing of the first phase of production and sales, including working capital, fixed assets etc.
4. Rapid Growth	Expansion financing	Continued financing of the activity of the firm, with increasing focus on advertising and promotion, and mostly investments in working capital (as fixed assets will mostly be in place by now)
5. Mature Age	Replacement financing	1. Acquisition financing: Financing of the acquisition of a company to target growth 2. Turnaround financing: Supporting organizational/strategic change
6. Crisis or Decline	Vulture financing	1. Restructuring financing: Attempt to bring a declining/distressed firm back to business 2. Distress financing: Financing of practical and legal procedures of the bankruptcy, sale of assets, negotiation with stakeholders

Table 1: Clusters of private equity. *Each stage of a company's life cycle is tied to different financing activities, and each has its characteristics.* Source: Caselli (2009)

For the purpose of this paper, the term *private equity* will be used as an umbrella for all the activities listed in the table above. In contrast, the term sometimes refers only to the latter stages (4-6) of the life cycle, whereas financing of the early stages (1-3) is referred to as "venture capital". This is often the case in the U.S. In this paper private equity will have a more "European" definition, with venture capital being a subset of private equity. Moreover, this definition *includes* buyout activity, but is not limited to it, underlining that in theory private equity does not have a one-to-one relationship with high leverage and purchasing 100% of the shares of a company. In practice, however, this is the most common form of private equity.

2.2. *Who invests in the company?*

Investing in private equity is not like investing in listed stock. The latter has a broad investor base. The reach of stock exchanges is wide and trading systems allow for a large number of transactions, especially in the second-hand market. There is high liquidity, and efficient pricing of the equity is ensured due to several factors. Among these are the frequency and number of transactions, the transparency of the company's historic performance making performance forecasting and valuation easier and the fact that the final value is a consensus value coming from the valuations of all

individual investors. Moreover, the capital requirement for investment in listed stock is relatively low, again opening investment opportunities to both small and large investors, both retail and professional.

Private equity investments not only have different characteristics than the ones listed for public equity; they are *opposite*. As mentioned before, there is no significant second-hand market for private equity. Any investment decision in private equity is therefore a decision to finance the activity of the target company. The amount of funding required to finance the projects of a company is significant, and such amounts aren't available to the usual retail investor. The following quote might help illustrate the size of private equity buyout deals:

"The average size of private equity-backed buyouts [in the UK] *in 2010 has more than doubled since 2009 from £39.5m to £91.2m. This is the highest average buyout size ever recorded with the exception of 2007 which was £133.7m."* (*Barclays Private Equity, 2010*)

In 2009, the global average size of private equity acquisition deals amounted to about US $100 million (*Ernst & Young 2010*). It is clear that the average man cannot possibly gather the funds to make such a deal on his own. So who is it to come up with all the money?

The answer is a closed-end fund. Such funds are the only vehicles to invest in private equity within the EEA. A closed-end fund (CEF) is a fund with a fixed size and maturity; it has a pre-established investment horizon, and investors cannot redeem their investment once they have subscribed to the fund. Maturities range up to 30 years; however the *average* maturity in Europe is about 10-12 years (*Caselli, 2009*).

The CEF is managed by an asset management company (AMC), but is a separate legal entity, meaning that the CEF is not *owned* by the AMC; it is merely *managed* by it. One AMC can possibly manage more than one fund. Investors invest directly in the fund, without going through the AMC. To cover the management costs, the AMC is paid a *management fee* (by the fund) of usually about 2% of the size of the fund at inception. This management fee covers personnel costs in the AMC in addition to legal and business advisory costs and other administrative costs. In addition, as an incentive to the fund managers themselves there is a *carried interest* which is paid to the managers once disinvestment is completed. The carried interest typically corresponds to a fixed percentage, typically ranging between 15%-40%[1] of the IRR less a so-called *hurdle rate* of about 7.5%. The carried interest incentivizes the fund managers to act in the best interest of the investors in the fund, as the amount paid to the AMC upon disinvestment is significant.

[1] Caselli (2009)

2.3. Authorization and fundraising

Before the AMC can begin its activity, it has to be authorized. An AMC is a financial institution, and in accordance with European law it must be approved and supervised by a supervisory authority, in the Directives referred to as the "competent authority" of the country. The company is always supervised by the authorities of the country in which it operates (so-called *home country control)*. In order to be approved, the company needs to present a business plan containing details on activities, investment plans, organizational structure and financial forecasts.

After its approval, the AMC will launch its activity and open a fund. There are specific timing rules which apply to closed-end funds. Funds also need approval from the supervisor. From the time of received approval, the AMC has 18 months to raise the pre-established fixed amount of funds for the CEF. Two percent of the size of the fund should be provided by the AMC. The aim of this is to align the interests of the AMC with those of the investors. In practice the negative signal effect to investors of not being able to raise funds quickly leads to incomplete CEFs being closed after a few months. A well-reputed, solid fund will have no problem selling its business plan to investors and raise the necessary funds to operate.

Fundraising is not a straightforward procedure. The success to raise funds strongly depends on the AMC's track record and reputation, in addition to the credibility and success potential of the fund's business plan. An investor ties his money for a very long time into a relatively high-risk investment – and he or she wants to be sure to receive a solid return before doing that. Why should he invest in a fund? Who is the fund manager – is he skilled? How do you know? Has anyone else subscribed to the fund? If yes, are these reputable investors? And if nobody has subscribed yet: why not? Why should I be the first to invest?

Answering these questions is a challenge every fund manager needs to address, and asymmetric information may lead fund managers to be inadequately transparent in selling the fund. This is why private equity to a large extent is a game of reputation and trust.

Raising funds does not mean receiving money into a bank account. A one-billion-euro fund wouldn't need the whole amount for the single first investment, but would spread this over more than one investment over the duration of the fund. The fundraising phase therefore consists of networking with investors, building a close relationship, and getting them to agree (in a legally binding way) to provide the funds. The payment of the funds happens over a given period of time established by the AMC, for which the investor commits to providing a percentage of the total at the beginning, and pays the rest according to a scheme, called a calling plan. This helps maximize the return to investors.

Once fundraising is completed, the fund could in theory begin investing. The flow of money is depicted in figure 2 below.

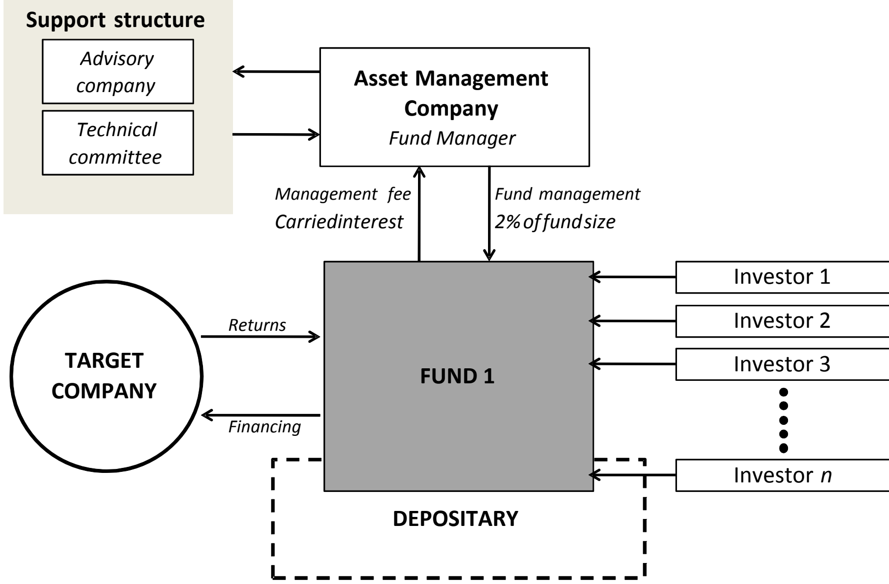

Figure 2: Flow of money in a private equity investment circuit. Source: Caselli (2009)

At this point the question might be: "But where is all the gearing?" After all, private equity operators have been heavily criticized regarding the high extent of gearing used in their investments. The answer is that CEFs *do not* typically leverage at fund level. After all, according to basic financial theory, whether the fund leverages at fund level, or leverages the companies of its portfolio, is irrelevant. Thus the capital of a fund is entirely composed of the capital provided by the investors. In order to carry out a leveraged investment the AMC needs to create a so-called Special-Purpose Vehicle (SPV, sometimes called Special-Purpose Entity SPE), often referred to as "Newco". The SPV is a company created for the sole purpose of investing in the target company as shown in figure 3.

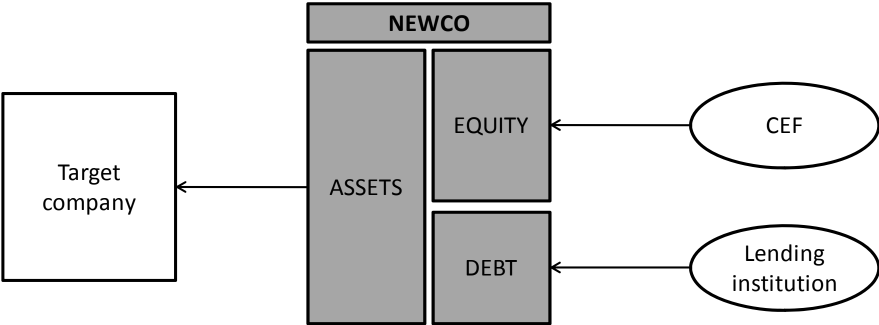

Figure 3: How a CEF leverages its investment through a Special-Purpose Vehicle. Source: Caselli (2009)

As is clear from the above summary of what is only a part of the world of private equity and venture capital, the nature of private equity investments is quite different from that of public equity. The activity is best suited to professional investors and because of the fund structure adopted and the deriving fact that it in Europe is regarded a financial service, the activity is regulated by the European Union.

2.4. Regulation of Private Equity in Europe: Before AIFMD

While there is no one directive to regulate private equity activity throughout Europe, the activities of asset management companies and collective investment funds are regulated through the Markets in Financial Instruments Directive (MiFID, directive 2004/39/EC and amendments thereof) and Undertakings for Collective Investments in Transferable Securities (UCITS, last updated version 2009/65/EC[2]). While the UCITS directive only regulates collective investments in transferable securities (i.e. liquid, tradable securities among which shares in private equity are not considered), the MiFID directive regulates all other sorts of investment firms and financial institutions which provide activities in financial instruments markets, among which asset management companies managing funds which are considered as alternative investment funds by the Directive analyzed in this paper (venture capital funds, hedge funds etc.). Moreover, the Capital Adequacy Directive (2006/49/EC) regulates the capital of financial institutions, including AIFM.

[2] The UCITS-directive was first introduced in 1988 as Directive 85/611/EEC, and has since then been amended several times. Amendments have been officially incorporated into Directive 2009/65/EC which is the last updated UCITS text.

3. Private equity in Norway

3.1. Market overview

The Norwegian market is quite small compared to those of the big European economies. Although Norway's economy is dominated by small and medium-sized enterprises, which in theory is the ideal landscape for private equity investments according to what has been outlined so far, private equity activity in Norway is still quite limited. It is, however, growing. There has been a tradition for public equity as a form of ownership, rather than private equity. There are many reasons why the PE market historically has been limited; being a small country, there are few local private equity operators. The Norwegian economy has limited diversification, with the volatile energy sector being by far the most important one; this might have been a deterrent to foreign operators to establish in Norway.

In 2009 NOK 5.7 billion were invested in private equity in Norwegian companies by Norwegian and foreign funds. In 2010, the number was NOK 15.4 billion.

The capital under management by Norwegian private equity and venture capital funds amounted in 2009 to about NOK 57.2 billion (*NVCA, 2010*), of which most was held in start-up and buyout activities. Figure 4 shows the growth over the period 2004-2009 in capital under management, divided per stage. It is clear from the figure that there has been substantial growth in the activity of Norwegian funds in the past years in all stages of the lifecycle, with seed capital experiencing low growth and buyouts seeing the largest leap. Another interesting observation is that about 45% of capital il 2009 is managed in the venture capital stages (seed and start-up).

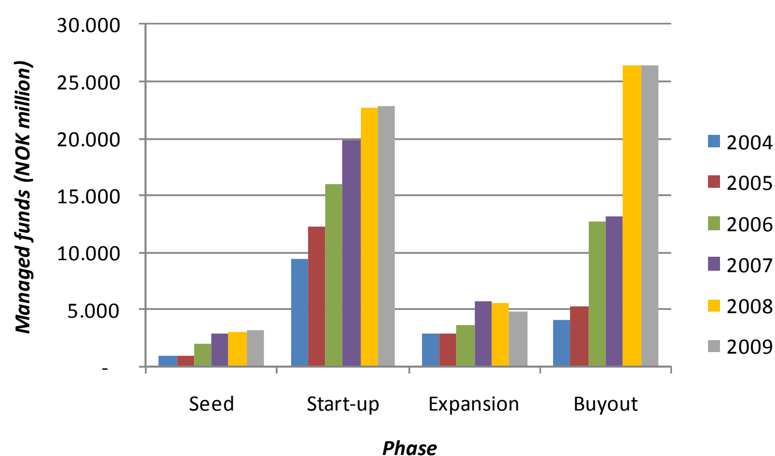

Figure 4: Capital under management by Norwegian PE/VC funds, NOK million. *Converted from EUR million with a rate of 8.0 NOK/EUR.* Source: NVCA, 2010

The largest investors in Norwegian private equity funds are funds of funds (FoF). Together with the public sector they accounted for almost two thirds of all funds raised to new funds in 2008 and 2009 (NVCA, 2010). Other large investors are corporations and family businesses, and public pension funds. It is however clear that the largest piece of the cake is covered by large investors who are well equipped with the tools and knowledge to evaluate the risks of their investments (professional investors). The breakdown of types of investors is shown in figure 5. As for geography, NVCA (2010) state in their 2010-yearbook that about half of the funds raised by Norwegian private equity operators are raised abroad.

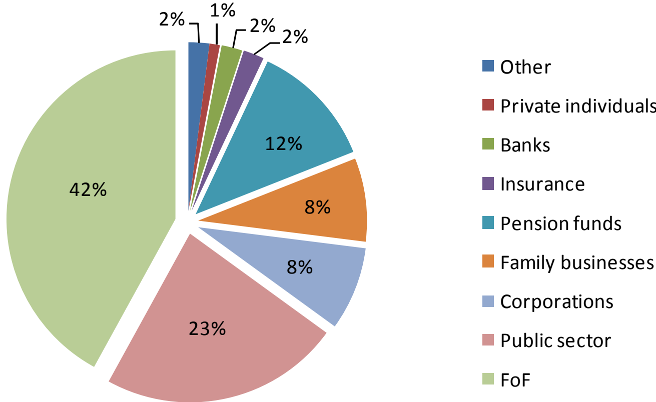

Figure 5: Breakdown of type of investor in Norwegian private equity funds. Source: NVCA (2010)

Norway is not a member of the European Union. It is, however, a member of the European Economic Area, thereby subject to the directives imposed by the European Commission. The AIFMD will therefore have to be adopted as national regulation by the Norwegian authorities.

3.2. The legal framework for private equity in Norway

In the previous section we looked at how private equity investments are traditionally carried out in Europe. It is relevant to roughly understand the structuring of these investments in order to understand the reasoning behind the Alternative Investment Fund Managers' Directive, which is, as the name so clearly states, a directive which regulates the *managers* of funds. To sum it all up, private equity in Europe is a financial service in which an asset management company markets, in a way similar to providing investment advice, a closed-end fund to a selected clientele of investors – an activity for which the AMC, under European law, needs authorization. In turn, the closed-end fund

acts as an investor, either directly or indirectly through a special-purpose vehicle, in a target company.

This is roughly the common framework which is adopted in the EU, with certain country-specific peculiarities which are not studied for the purpose of this paper, aside from what is the typical Norwegian model which, as we shall see, deviates to a certain extent from the model which was just summarized. Funds are also to a wide extent used by US limited partnerships, under the name of Venture Capital Funds (VCF). The US model is similar to the EU model, except that it is a partnership where the general partner collects funds from the limited partners and manages the VCF. The difference is that the general partner is not an investment advisory service provider (as is an AMC), but simply an investment partner, which implies that the VCF is merely an agreement between investors and not the result of a financial service. The UK limited partnership is very similar, with the use of Venture Capital Trusts and other models which will not be described here. The fact that the Anglo-Saxon private equity model does not entail any financial service in the legal sense of the word, leads to the activity being subject to very little regulation, if no regulation at all (Caselli, 2009). Moreover, because the limited partnership is not a fund legally speaking, it is able to leverage inside, without having to make use of special-purpose entities as explained in the previous section on the European model.

This short mentioning non-European private equity models in contrast to the European model bridges us smoothly over to the Norwegian model, which as we shall see, is subject to very little regulation to the extent that the authorities do not require that the investment activity be subject to any authorization requirements at all[3].

3.2.1. Legal form of Norwegian private equity funds

Colloquially, Norwegians refer to the vehicles used for investing in private equity as private equity funds, sometimes *active ownership funds* ("aktive eierfond"), referring to the fact that private equity investors actively manage the companies they acquire shares in. Often, the name will refer to the stage in the company lifecycle these vehicles invest in, namely seed capital funds ("såkornfond"), acquisition/buyout funds ("oppkjøpsfond"/"buyout-fond") *et cetera*. One could argue that, *in practice*, these vehicles are funds indeed; after all, aren't all joint-stock companies funds? Don't they pool capital from many investors in order to invest in some sort of assets? This reasoning explains how Norwegian private equity vehicles, in common speech, are referred to as funds.

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[3] I express gratitude towards Ms. Britt Hjellegjerde and Mr. Anders Hoff from the Financial Supervisory Authority of Norway for providing this information and related sources.

Legally speaking, however, Norwegian private equity vehicles aren't at all funds. They are *companies* which are structured according to different legal models treated by Norwegian law[4], namely:

- Aksjeselskap (AS) – Joint-stock company with a closed and limited number of shareholders carrying limited liability towards creditors
- Indre selskap (IS) – A company which doesn't appear to be a company to third parties, as the constituting investors are kept anonymous sometimes even to one another.
- Kommandittselskap (KS) – A company of which at least one shareholder carries unlimited liability, and at least one shareholder carries limited liability towards creditors.

Tønne and Bugge (2010) also show that there is an increasing volume of private equity transactions being operated through limited partnerships abroad.

While technically, as argued above, these vehicles are indeed funds, their legal form implies that they are not regulated by any Norwegian law concerning the management of investment funds. The Norwegian *Verdipapirfondloven* (the act of 1981 regulating securities funds and their managers, abbreviated VPFL) is intended to regulate fund management companies which provide investment services through actual funds. However, the Act contains specific requirements concerning the liquidity of the assets acquired by said funds, making the fund structure in the *legal* sense of the word an inappropriate vehicle for Norwegian private equity operators.

The AS structure is regulated by the law concerning joint-stock companies *Aksjeselskapsloven*, while the structures of KS and IS are regulated by an act designed specifically for these structures, called *Selskapsloven*. These structures are, however, not *necessarily* intended for private equity investments or financial activities in general, and the respective acts only regulate structural aspects of these companies (e.g. board of directors, taxation, capital requirements or lack thereof, etc.), and not their activity *per se*; thus we can say private equity in Norway is subject to virtually no regulation.

Through these structures, and especially the *Kommandittselskap* structure in which one investor carries unlimited liability while the other investors have only limited liability, we can observe a similarity between the structure of Norwegian private equity operations and the *limited partnership* model described on page 19. The fund managers[5] contribute with their (small) share of the funds and their management skills, and the partnering investors fund the equity for the investment. The

[4] Tønne, David T. and Magnus Bugge (2010): Valg av selskapsform for aktive eierfond i Norge. Master Thesis, Norwegian School of Economics (NHH), Bergen, Norway. Accessible through http://bora.nhh.no/bitstream/2330/2482/1/Tonne%20og%20Bugge%202010.pdf. Retrieved on September 15, 2011.

[5] The term "fund manager" will, for ease of reading, be used interchangeably for both managers of funds legally speaking, and the "funds" of limited partnerships which take a different legal form.

investing “fund” is then able to leverage before investing in the target company. The following figure 6 is adapted from Caselli (2009) and illustrates the general model of the limited partnership and similar structures, such as the Norwegian ones.

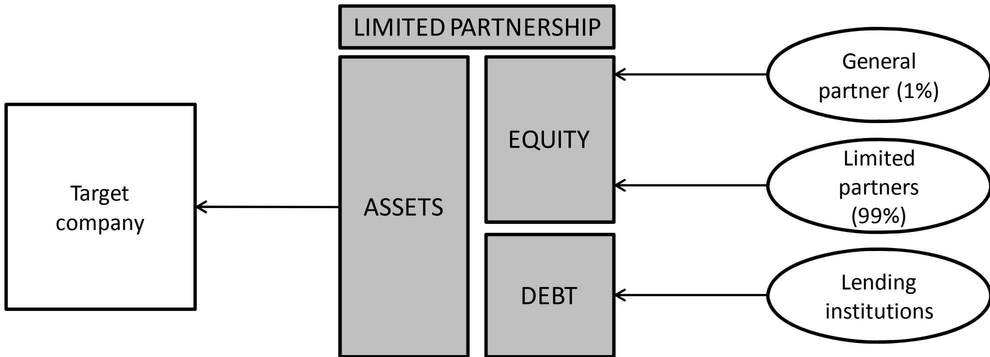

Figure 6: Structure of the limited partnership

3.2.2. Exemption from authorization

As Norwegian private equity operations are partnership, they do not fall under any legislation which considers this activity a financial service. The establishment of a fund having in the legal form of AS, KS, or IS does not require authorization and there aren’t any restrictive capital requirements as such[6]. The private equity investment management activities run by the company do not require authorization either, due to the reason outlined above that the fund management is not a financial service, but it is based on a partnership.

The Financial Supervisory Authority’s (FSA) circular letter number 23 of 2007, concerning certain authorization requirements for financial services, states that investment advisory services, defined by the same letter as “personal advice to a client concerning one or more transactions linked to given financial instruments” (FSA, 23/2007, section 2.2), requires authorization.

An interesting part of the letter is section 2.5, concerning specifically advisory companies used by private equity companies. As shown in fig. 2 on page 13, asset management companies make use of advisory companies to obtain strategic recommendations for their operations, e.g. acquisition advice, company valuations and the likes. The circular stresses that authorization is not required for the advisory companies that provide strategic advice to the private equity companies, provided that the intention of the private equity company is, in fact, the acquisition of shares in a target company and subsequent active management of the latter. Advice received by the private equity company with the mere purpose of obtaining excess returns on an investment which is held passively, is on the other hand considered as such investment advice requiring authorization.

[6] According to Aksjeloven §3-1, min. equity capital in an AS company should be NOK 100,000 (ca. EUR 12,500)

3.2.3. Why the missing authorization requirement?

There are several arguments for not having private equity operators and their advisory companies be authorized in order to conduct their activity. A comprehensive set of arguments was presented to the Norwegian Ministry of Finance by the Norwegian Venture Capital Association during the implementation of the MiFID directive through the securities trade act (Verdipapirhandelloven) and stock exchange act (Børsloven). The comments by NVCA can be found in the Ministry's legal proposition Ot.prp.[7] number 34 (2006-2007), and can be summarized as follows.

An argument for the Norwegian private equity industry not being subject to authorization requirements is the distorting effect the increased costs as a consequence to the authorization procedure will have on competition. In other words, NVCA feared that the costs tied to authorization would make countries in which this would be needed less attractive for establishing advisory activity for investment firms, and in turn investment funds, to which the higher costs will disseminate.

Moreover, NVCA argues that once taken into account that private equity is an activity in which participants are exclusively professional investors with adequate capabilities to assess the aspects of their investment and with sufficient wealth to be able to sustain the implied risk, authorization isn't really needed. Due to the fact that the advisory companies' clients (i.e. AIFMs/AIFs) are few and the investors in the fund are few and professional, the agreements between all parties will be stipulated in sufficient detail to regulate the activity of the individual fund. The long-term perspective of private equity investments and the structure of the investment and its participants ensure proper alignment of interest between all parties. Finally, as explained by circular 23/2007 (op. cit.), the advisory services provided by private equity firms' advisory companies is not an investment advisory service in the sense which requires authorization, but rather strategic advice on M&A activity.

NVCA further argues that the risk of not being authorized represents an entry barrier to the private equity sector, and stress that this will have a particularly negative impact on entrepreneurs who seek to start new ventures and are in need of more support from their investors and related advisors than do for instance mature companies. In terms of costs, the higher costs borne because of the authorization requirements will be particularly harmful to seed/venture capital funds, which are typically smaller than, say, buy-out funds and the increased cost will comprise a higher proportion of the fund size.

Without prejudice to whether these arguments are in practice valid or not, they're all more or less relevant reasons not to impose authorization on private equity funds and their advisory companies.

[7] Ot.prp. stands for *Odelstingproposisjon* and refers to propositions to the *Odelsting*, a former Chamber of Parliament which was involved in the elaboration of laws and was abolished in 2009.

For one or more of these reasons, Norwegian law does not require neither private equity firms nor their advisory companies to be authorized, the latter insofar they provide strategic advice to the private equity firm on a one-to-one agreement.

3.2.4. Implications for the analysis of the impact of AIFMD

The Alternative Investment Fund Manager's Directive will regulate the managers of alternative investment *funds*. The directive text, as shall be seen in the following section on the Directive, defines an alternative investment fund as any non-UCITS[8] collective investment undertaking in which funds are raised from investors with the purpose of investing these in accordance with a pre-set investment strategy.

The Norwegian model for private equity raises some interesting questions when contrasted against the AIFM directive. Status quo isn't really that Norwegian private equity funds aren't regulated, but rather that legally there *are no* private equity *funds* in Norway. A relevant question is whether, upon implementation of the Directive in Norwegian regulatory frameworks, private equity companies in Norway will be considered funds in legal terms or not.

Moreover, Norwegian private equity activity is not limited to investment company structures registered in Norway. Some funds/partnerships are in fact established abroad. How these will be affected by the Directive, is a highly relevant question which will only be shortly discussed later in this paper. In the following section is an outline of the Alternative Investment Fund Managers' Directive, with a focus on those aspects presumably most relevant for private equity activity.

[8] See page 14

4. The AIFM Directive 2011/61/EU

Before the transposition and implementation of the Alternative Investment Fund Managers' Directive (AIFMD), foreseen to happen in the year 2013, private equity activity in the European Economic Area is only regulated on a *national* basis. The European directives are left to each member country to be translated into national law. This leads to there being various sets of laws across Europe regulating private equity activity, and no one harmonized pan-European law.

Although a fund will be registered in only one country (called "home country"), European cross-border activity is in practice inevitable. To realize this, one can easily compare any European country to the United States of America. In an economy as large as the USA, a private equity fund *could* invest abroad – but it certainly has more than enough opportunities at home.

While the same principle might in theory apply to Europe's largest economies, the cross-border dimension remains an important aspect of private equity funds' investment activity, as most Europe-based funds would, in contrast to the US, find that there are many investment opportunities abroad in addition to in their home country.

This international dimension concerns private equity in European countries in three ways:

1. Activity within the EU
2. EU activity in third countries (i.e. non-EU countries)
3. Third-country activity in the EU

The Directive addresses all three scenarios listed above.

As stated, the AIFM Directive's (Directive 2011/61/EU) objective is to establish a set of regulations aimed at creating a harmonized regulatory framework for all member states of the European Economic Area. The EEA is comprised of 30 countries (Norway, Liechtenstein and Iceland in addition to the 27 member states of the European Union).

The AIFMD covers a number of areas of activity which Private Equity fund managers need to carry out. The text of the Directive is divided into 10 main chapters. Appendix A provides an overview of the contents of the Directive. Not all chapters are equally relevant for the purpose of this paper, thus I will limit the outlining of the Directive to the following categories:

1. General provisions: Scope and definitions
2. Authorization of the AIFM and capital requirements
3. Depositary
4. Remuneration
5. Valuation
6. Transparency requirements
7. Marketing

In the following I will present the motivation behind the main sections of the Directive. This will give an introduction to its provisions, which will then be explained more in detail in section 4.2. Finally, I will provide some criticism towards different aspects of the Directive. Both the motivation for the Directive and the criticism of it help providing pros and cons which will turn out useful for the impact analysis.

4.1. Motivation behind the requirements of AIFMD

While we can accept without further analysis that the Directive aims at harmonizing regulation for AIFM across Europe, digging deeper into the reasoning behind the individual chapters of the Directive makes it easier to understand the motivation behind the AIFMD in its entirety. In this section I will report from appropriate sources in order to provide a clearer picture of why the AIFMD is as it is, in particular with respect to authorization, depositary requirements, remuneration policies, transparency and valuation requirements and marketing.

4.1.1. Authorization

The requirement to be authorized as a MiFID or UCITS investment firm is already in place before AIFMD. The following quotes illustrate the need for authorization according to MiFID 2004/39/EC[9]:

"Due to the increasing dependence of investors on personal recommendations, it is appropriate to include the provision of investment advice as an investment service requiring authorisation." (preamble, paragraph 3)

"Persons who provide the investment services and/or perform investment activities covered by this Directive should be subject to authorization by their home Member States in order to protect investors and the stability of the financial system." (Preamble, paragraph 17)

[9] Due to the fact that the AIFMD does *not* extend to fund managers requiring authorization under the UCITS regime, MiFID provides more appropriate examples for the purpose of this paper. Much of the reasoning behind authorization, however, naturally extends to the UCITS Directive.

Two main factors are highlighted here. Firstly, authorization should be required in order to protect investors and ensure that the quality of the service provided to them at least meets the standards required by the directive in question. Secondly, concern is raised for the "stability of the financial system", in which investment service providers, be it investment firms, banks, fund management firms et cetera, play a fundamental role. The documentation to be submitted as part of the application for authorization reflects the kind of information the European Commission deems necessary for an authority to assess whether investor protection and financial stability would be secured.

Furthermore, in light of the fact that the application for authorization to the competent authority should among others contain a programme of activity including structural characteristics of the AIFM, the preamble to AIFMD 2011/61/EU, paragraph 22, requires that *"AIFMs should be managed and organized so as to minimize conflicts of interest."* While the ultimate objective is protecting investors, this requirement extends to investors, advisory companies, depositaries and other stakeholders of the AIFM.

Moreover, capital requirements are justified in paragraph 22 of the AIFMD's preamble, by two main points. Firstly, minimum capital is required to *"ensure the continuity and the regularity of the management of AIFs provided by an AIFM"*, i.e. once established, an AIFM will possess sufficient capital to be able to guarantee that its promised services be provided. This could be illustrated with a closed-ended fund example: Imagine that a CEF has a ten-year maturity, but the AIFM is managed so that after less than ten years the AIFM's capital is too low to sustain operations. While it would be possible for another AIFM to take over the managed funds, investors would incur significant costs tied to the failed operations of the former management company. This simple case illustrates the meaning of the first justification for capital requirements.

Secondly, minimum initial capital and own funds are required to *"cover potential exposure of AIFMs to professional liability in respect of all their activities, including the management of AIFs under a delegated mandate."* This clearly refers to sound risk management practices, and the same paragraphs specify that "appropriate professional indemnity insurance" is an alternative to part of the own funds.

4.1.2. Depositary requirements

An interesting discussion has arisen after the introduction of depositary requirements in the AIFMD on whether these, being stricter and more detailed than depositary requirements specified in any other related directive, should be somehow incorporated into the UCITS directive. In respect of this

discussion, a consultation paper elaborated by the Directorate-General for Internal Market and Services (DG MARKT) discusses the roles and duties of depositaries for UCITS funds. The introduction presents reasons for regulating the relationship between fund managers and depositaries, referring directly to the AIFMD. About the AIFMD provisions, the paper states:

“These constraints have been introduced in order to provide a better and more transparent regulation of the entity holding the assets and to enable an appropriate level of investor protection in general.” (DG MARKT, 2009)

Such increased transparency with respect to depositaries is a wish born as a direct consequence of 2008’s default of Lehman Brothers, and the fraud conducted by Bernard Madoff, for which he was arrested the same year:

“More recently the Madoff fraud and the Lehman default have revealed the existence of new forms of risk associated with the depositary function. These cases have shown that to some degree Member States differ in their understanding of the Directive’s [UCITS] principles as regards the exact nature of the duties of depositaries and the scope of their liability. Most importantly, the Madoff fraud and the Lehman default have underlined the lack of a level playing field in the protection offered to UCITS investors across Europe.” (DG MARKT, 2009)

Regulation of depositaries is comprehensive and revolutionizing in the sense that liability for losses of assets held in custody is to a large extent transferred to the depositary. For this reason, it is important that the quality of depositaries be guaranteed by proper authorization[10] and that its relation to the AIFM be subject to adequate regulation and transparency requirements. The combination of these provisions contributes to safer conduct by all parties, including the depositary, thus minimizing the probability of losses.

4.1.3. Remuneration policies

Private equity and venture capital funds are, as sustained by EVCA (2010), well positioned to meet the requirements of the AIFMD concerning remuneration of employees of the AIFM which are responsible for activities directly affecting the risk profile of the AIFM. As explained, the fund pays two types of remuneration to the management company: A management fee, and carried interest. The management fee, typically corresponding to 2% of committed capital, covers the “fixed” expenses, among which remuneration in terms of *salaries*. The variable remuneration, i.e. the *bonus*,

[10] Under Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions

comes with the carried interest. This portion of the remuneration to fund managers is the main incentive to manage the fund in the first place.

So why regulate the remuneration policies? Chapter 4.2.4 points out how the relation between variable and fixed remuneration was allegedly one of the incentives for the behavioral patterns observed in the financial sector prior to its recent global meltdown. OECD (2008) provides in one of its articles an example from the bank UBS:

"Staff compensation incentives did not differentiate between the creation of genuine 'alpha' versus the creation of returns based on low cost funding, nor the quality […] of staff earnings for the company. The relatively high yield from subprime made this an attractive candidate for long position carry trades (even with thin margins) via leverage […]. This encouraged concentration in the higher carry mezzanine tranches of CDO's [Collateralized Debt Obligations]. It also encouraged minimal hedging of super senior positions (in order to be more profitable)."[11]

This quote illustrates how the incentives to staff in the financial services sector were not aligned with sound value creation and encouraged too high risk exposure. The obvious reason for regulating remuneration policy is aligning the variable portion with the risk/return profile of the AIF, and thus protecting investors from overly risk exposure and conflicts of interest. Regardless of how well this matches private equity management companies' remuneration practices, here it is important to remember that the AIFMD doesn't regulate private equity only, but also other AIFM who don't necessarily follow the same remuneration practices as do private equity managers.

4.1.4. Transparency requirements and valuation

The requirement that AIFMs provide audited annual reports for each managed fund naturally aims at increasing the authorities' overview of the funds' performance and improving information available to investors and other stakeholders. Particularly information on leverage employed by the AIFM/AIF, both actual employed levels and limits to these levels, should be disclosed *"to ensure a proper assessment of the risks induced by the use of leverage by an AIFM with respect to the AIFs it manages…*" (AIFMD, preamble, paragraph 50). The AIFMD's preamble specifically addresses the contribution of employment of leverage by AIFM to "systemic risk", "disorderly markets" and the "stability and integrity of the financial system."

Furthermore, disclosure requirements upon acquisition of control in non-listed companies are deemed "necessary for those companies to assess how that control will impact their situation."

[11] Wignall-Blundell, Adrian et.al. (2008): *The Current Financial Crisis: Causes and Policy Issues*, OECD Financial Market Trends, 2008

(AIFMD). This applies for disclosure to competent authorities, boards of acquired companies and the companies' employees[12].

Another sub-component of transparency and proper external (and internal) communication is valuation. The proper valuation of the fund ensures that investors and authorities are provided with more exact information in order to assess risks, and it contributes to better fund management. While it is up to the AIFM to decide whether valuation should be carried out by an external valuer or by the AIFM itself, the valuation methodology and proof that this be carried out impartially should be approved by the competent authority upon granting authorization. This is to ensure that the methods employed by the AIFM are in accordance with sound standards in respect of the type of AIF which is being valued. The AIFMD's preamble's paragraph 29 concerns valuation and states:

"Reliable and objective asset valuation is crucial for the protection of investor interests. AIFMs employ different methodologies and systems for valuing assets, depending on the assets and markets in which they predominantly invest. […] The [valuation] process […] should be functionally independent from the portfolio management and the remuneration policy of the AIFM and other measures should ensure that conflicts of interest [and the undue influence of on the employees] are prevented."

In conclusion, transparent and correct information is important in order for all parties to have proper grounds on which to assess the risks involved in the activities in question, in this case private equity. Whether this is consistent with the nature of private equity is subject to discussion, and will be covered in chapter 5.3.

4.1.5. Marketing

Last, but not least, marketing is an important aspect of the Directive, and the reason for providing a chapter on marketing lies in the very purpose of the AIFMD, i.e. harmonize regulation of AIFs in the European Economic Area. One way of interpreting the Directive is, in fact, not in terms of restrictions, but in terms of opportunities provided, especially with respect to EU AIFM marketing EU AIF within the Union. Aside from the extent one sees the notification requirement as a restriction, the Directive imposes on competent authorities that any EU AIFM may manage any EU AIF within the Union upon notification. This means that competent authorities are not empowered to deny said marketing (unless the marketing strategy defies the requirements of the Directive). This is to avoid marketing restrictions within the Union.

[12] The Directive takes into account the fact that it cannot impose on the AIFM disclosure of information to the acquired company's employees. It does, however, require that the AIFM encourage the target's directors to disclose information to the company's employees (preamble, paragraph 54)

On the other hand, restrictions arise when third countries are involved. Third-country AIFMs/AIFs can only operate in Europe through the use of a marketing passport granted upon authorization and establishment of cooperation between the competent authorities involved. There is a need for the non-EU AIFM/AIF to comply with most provisions of the Directive. This could make Europe an unattractive marketing target for AIFMs established in countries in which little related regulation is in place. The reason for these restrictions (i.e. authorization and agreements between competent authorities) is to ensure that investors in the Union aren't exposed to funds and fund management companies whose practices are at odds with the standards defined by the Directive. Moreover, it is required that competent authorities are aware of and accept the practice of third-country marketing (either one way or the other) on an individual fund basis to ensure that information is properly exchanged to safeguard investors, target companies and the stability of the financial system. These restrictions *will* pose a barrier to third-country marketing, and the consequences will be discussed in the following chapter.

4.2. Outline of the Directive

In this section the Directive will be outline as far as is relevant for the industry of private equity. The structure follows the sections of the Directive, and reference to the relevant chapters is provided in the section titles.

4.2.1. Scope of the Directive: AIF and AIFM (Chapter I)

What is an Alternative Investment Fund (AIF)?

Private Equity (i.e. closed-end) funds are only one type of investment fund affected by the Directive. The AIFMD defines an AIF as follows:

"Alternative investment fund or AIF means any collective investment undertaking, including investment compartments thereof whose object is the collective investment in assets and which does not require authorization pursuant to Article 5 of Directive 2009/65/EC." (EC, 2009)

In other words, and AIF is a fund which pools capital from many investors and invests this capital according to a pre-established investment policy. Moreover, they are funds which are *not* covered by the UCITS Directive (as presented on page 14).

Who is regulated by the AIFMD?

The Directive regulates, as given by its name, the AIF *managers*[13]. The impact assessment attached to the proposal of the Directive submitted by the European Commission elaborates on the decision taken to target the managers rather than the funds themselves. Arguments include the fact that the operations of the fund are much closely tied to the fund manager, rather than to the structure of the fund itself. It is, after all, the manager who makes decisions on marketing, investments, internal management and disclosure of information to investors. It should be noted, although it seems obvious, that it in practice is not necessarily a single individual manager who is to be covered; in practically all cases relevant to this paper the AIFM would be an *asset management company*. The regulation of AIFMs is not only limited to those established within the EU[14]. Subjects to the Directive are all EU AIFM, whether they market EU funds or funds established outside the EU, regardless of where these funds are marketed. Moreover, AIFM established outside the EU will fall under the Directive to the extent that they manage funds established in the EU or market non-EU funds within the EU.

Fund managers managing funds totaling less than EUR 100 million, or managing funds totaling less than EUR 500 million provided the funds are not leveraged and without redemption rights for a period of five years are not covered by the AIFMD. Those managers falling below these thresholds will however be able to opt in (EVCA); the idea is for compliance with the Directive to be considered a quality guarantee to the stakeholders of AIFM.

This exemption is not irrelevant to the topic of this thesis. Private equity funds seldom leverage inside the fund, but use special purpose vehicles as explained earlier. It is uncertain whether leverage in this case is intended at fund or at portfolio level, although my own logic leads me to conclude it is fund level leverage which is intended (otherwise a fund would only be able to invest in unleveraged companies to be exempted). This means that private equity fund managers (whose funds seldom have redemption rights within five years of inception) will be exempted from the Directive if they don't leverage inside the fund.

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[13] EVCA (2010) suggest that in limited partnership arrangements the general partner is likely to delegate all asset management functions to an external AMC. In this case, the external AMC would be regarded the AIFM – thereby fully adhering to the Directive. In the case in which only some of the managerial functions are delegated to external parties, the *general manager* will function as the AIFM and be subject to the Directive.
[14] It should be noted that with the aim of consistency with the AIFMD official text,"EU" here and throughout this paper in fact refers to the entire EEA.

4.2.2. Authorization (Chapter II)

Authorization of AIFM

As of today, an AIFM needs to be authorized and supervised by the competent authority of its home country in order to be able to operate. This won't change with the AIFMD, however the requirements set by the Directive might make it easier for investors to make subscription decisions. This because once an AIFM is approved, an investor will know that certain standards have been met – and this is valid also at the international level, as opposed to status quo in which the approval requirements are set at a national level.

In order to be authorized, an AIFM will have to provide the following to the competent authority: The identity of the fund managers within the AMC and shareholders of the Company; a *programme of activity*; information on the funds to be managed, both structural characteristics and policies/rules; information on delegation of the AIFM's duties to third parties; information on the depositary. The latter implies that the depositary agreement needs to be in place prior to authorization, meaning depositaries must accept to service currently unauthorized AIFMs. Moreover, authorization requires the head office of the asset management company to be located in the same country as the registered office.

If the competent authority deems that the AIFM is able to comply with the requirements set by the Directive, it should grant authorization within two months of receiving the application, and the AIFM will be able to market activity in all EEA member states. Naturally the AIFM should be informed of the reasons why authorization is restricted or withheld in these respective cases. Authorization may be withdrawn by the authority if the AIFM does not make use of it or infringes the conditions upon which the authorization was based.

Authorization of individual AIF

Similarly to how the AMC needs approval to start operating, a fund needs approval to start marketing and fundraising. The AIFM must notify the competent authority of its home country whenever it means to start a fund. Information on the fund's intended activities and all information which is to be disclosed to investors prior to subscription to the fund should be provided to the competent authority, which will have twenty days to approve or decline the fund. It is the AIFM's home country authority which approves the fund; however, should the AIFM intend to market the fund in other member states, the home state authority will notify the authorities in the member states concerned, so as to enable the AIFM to market the fund in question also abroad.

The authorization of an AIFM happens after the competent authority has received the required information on both the AIFM itself and the AIF it intends to manage. When authorization is granted, it is based on the information submitted in the initial application. From personal considerations it seems logical that whenever an AIFM intends to open a new fund which wasn't prospected in the initial application, this is viewed as a change in the conditions for authorization. It follows that the competent authority should be notified of this change, and approval should be granted. From this mechanism it can be drawn that the managed funds need to be approved for an AIFM to be approved, and so the AIFM must ask for approval of each new fund it intends to market.

During the marketing and fundraising phase, the fund manager is obliged to disclose details on the structure of the fund. With "structure" we understand naturally the size and time horizon of the fund, but also the identities of the fund managers and of all service providers, such as the advisory company and the depositary, and all delegated functions. It is easy to imagine how an AIFM would not only have to, but *want to* disclose certain pieces of information regardless of whether said disclosure is imposed by law: An AIF which is managed by a well-reputed management company and manager, is supported by a renowned advisory company (such as a global investment bank or management consulting firm) and whose assets are kept safe by a solid depositary, will have very high credibility among investors, which is why the AIFM will want to share this information in the marketing phase.

Capital requirements

It is required by Chapter II, Article 9 of the Directive that each AIFM have minimum initial capital of EUR 125,000 if it manages external funds. For internally managed funds, initial capital of the AIFM must be at least of EUR 300,000.

Moreover, each AIFM managing portfolios exceeding EUR 250 million must provide additional own funds equal to 0.02% of the amount by which the threshold is exceeded. A member state may, however, not require of an AIFM that initial capital plus additional own funds are higher than EUR 10 million.

Regardless of this own funds requirement, the Directive states that the amount of own funds should never fall below the amount required by the Capital Adequacy Directive (2006/49/EC), i.e. 25% of the previous financial year's fixed overhead costs.

The capital set aside as required by this article must be "*invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions*" (AIFMD).

4.2.3. Depositary (Chapter III, Section 4)

Each AIF managed by the AIFM needs to have a single formally appointed depositary for the safekeeping and daily management of the fund's assets. This implies that pooling of assets from different funds for the purpose of collective management won't be allowed, and the AIFM won't be able to manage its funds' assets alone. Naturally, the AIFM will overlook its assets as has always been the case, implying that the depositary's role will to some degree be redundant. The EVCA considers this a "*significant, and potentially costly, change for private equity management in many jurisdictions*" (*EVCA, 2010*).

By "depositary" the Directive intends an "*EU credit institution [or] a MiFID investment firm subject to the same CRD [Capital Requirements Directive] capital requirements as credit institutions; or a prudentially regulated and supervised institution of a type that […] is eligible to be a UCITS depositary under the UCITS IV Directive*" *(EVCA 2010)*. An AIFM may not act as a depositary. An AIFM's prime broker may only act as depositary for the AIFM if its depositary function is made independent of its function as prime broker. These restrictions are obviously imposed to avoid conflicts of interest.

It is required for a depositary to be established in the home country of the AIF, when the fund is registered in the EU. Where the fund is not registered in the EU, the depositary should be established in the home country of the fund, in the home country of the AIFM if the AIFM is registered in the EU or in the Member State of reference of a third-country AIFM managing the fund.

In other words, the AIFMD does not regulate the depositary *per se*, but it does require the depositary to be authorized under given EU directives, namely MiFID and the Capital Adequacy Directive (2006/49/EC). Moreover, by regulating the AIFM, the Directive requires that the fund manager choose a depositary that complies with above stated requirements, and so it indirectly regulates the depositary for the purpose of AIF asset management. Moreover, liability for loss of assets in custody is to a considerable extent transferred to the depositary, something which has triggered considerable critique against the Directive from credit institutions.

The depositary's main functions are the safekeeping of the assets of the fund for which it is appointed and the monitoring and managing of cash flows and payments to and from the fund. The Depositary should also oversee that the AIFM is acting in accordance with the AIFM Directive and national legislation.

Depositaries are allowed to delegate only the function of safekeeping of assets (as specified by Chapter III, Section 4, Article 21, Paragraph 8.) to third parties, and said delegation must happen upon agreement with the AIFM. There must be "objective reason for the delegation", and the aim of

the delegation must not be to escape the requirements of the AIFMD. Upon delegation, the ultimate responsibility to carry out its functions properly remains with the depositary appointed by the AIFM and the AIFM itself.

4.2.4. Remuneration (Chapter III, Section 1, Article 13)

Remuneration policies are required to be specified according to Annex II of the Directive *"…for those categories of staff […] receiving total remuneration that takes them into the same bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage…"* (AIFMD).

The requirements on remuneration policies address especially the relationship between fixed and variable remuneration, and in particular it sets requirements on how variable remuneration should be awarded. This clearly reflects the wish of European regulators to avoid scenarios similar to those witnessed during the recent financial crisis, of which much of the blame was given to the remuneration policies of many financial institutions. Among other things, financial institutions were accused of incentivizing through variable remuneration schemes the assumption of excessive risk by their employees. The Directive's remuneration requirements clearly show that the EU is responding to learnings acquired during the Crisis.

Remuneration schemes adopted by the AIFM should aim at avoiding risk-taking in excess of what draws from the risk profile of the funds managed, and they should avoid conflicts of interest. Performance-related variable remuneration should be based on evaluations of the performance of the AIFM, of the AIF(s) managed and of the individual fund manager in question.

Significantly large AIFMs (either in terms of the size of the management company *per se* or size of the managed funds) should establish a remuneration committee responsible for overseeing the compliance with the established remuneration policies, and the compliance of said policies with the AIFMD. The Directive gives no indication of what is considered a "significantly large" AIFM.

Relative levels of fixed and variable remuneration are not set by the Directive. However, Annex II requires that variable remuneration shall not ever be guaranteed, and so remuneration policies should reflect the acknowledgment of the possibility that variable remuneration may not be paid at all. This is mainly reflected in the fixed portion, which should be high enough to make it possible that variable remuneration in the worst case is not at all awarded.

Additional requirements on variable remuneration impose that at least 50% of the variable portion be paid out as shares in the fund or equivalent instruments which entail interest of ownership of the

fund[15]. This is obviously to keep the interests of the managers aligned with those of the subscribers to the fund. Moreover, a minimum of 40%[16] of the variable portion should be deferred over at least 3 years. This bears the advantage that very high variable remuneration does not impact dramatically on the cash flows of the AIFM. The deferral of this portion of the variable compensation should be aligned with the time horizon of the fund in question and its risk profile.

The granting and payout of variable remuneration should be restricted in cases of poor performance and in case the cash balance of the AIFM does not permit the payout of the compensation without compromising a healthy financial position.

4.2.5. Valuation (Chapter III, Section 2, Article 19)

Valuation procedures should be established at fund level, meaning that an AIFM managing more than one fund will have to outline valuation procedures for each single fund it manages. The AIFM should ensure that the valuation methods are independent and in line with the Directive and national legislation. The Directive allows for the AIFM itself to be the valuer, provided that the function remains independent from the management of the funds. Alternatively, an independent external valuer may be appointed[17], upon notification to and approval by the competent authority. An external valuer may not delegate its task to third parties.

Regardless of whether an external valuer is appointed by the AIFM or not, the responsibility to oversee that the valuation of the company is executed with due care ultimately lies with the AIFM. The competent authority may require an AIFM's own valuation to be verified by an external valuer, but whether this will be the case is a country-specific matter.

4.2.6. Transparency requirements (Chapters IV and V)

For each EU AIF managed, whether in Europe or not, and for each third-country AIF marketed in the EU, the AIFM should publish an annual report within six months of the end of the fiscal year. EVCA points out that this might be a challenge for funds of funds, as the elaboration of their financial reports will depend on the elaboration of the financial reports of the portfolio funds in which the FoF invests. If the portfolio funds themselves need six months to work out their reports, the FoF cannot possibly comply with the time limit of the Directive. The Commission will probably have to elaborate further on this requirement in the next steps (EVCA).

[15] The lower limit of 50% applies only in those cases in which at least half of the value of the portfolio managed by the AIFM consists of AIF.
[16] For particularly high variable remuneration, this minimum is set to 60%. The Directive does not, however, specify what a particularly high level corresponds to.
[17] The depositary of the fund may not be appointed as external valuer unless the two functions are organizationally separated and potential conflicts of interest eradicated.

In addition to the financial reports Chapter IV, Article 23, paragraph 1 lists a set of pieces of information which the AIFM is required to disclose to investors before they invest in units of shares of the fund, among which investment strategy, identity of fund managers, legal clauses, fees, historical performance and more. Finally, requirements are set as to information to be submitted to the competent authority on a regular basis. Article 25 of Chapter V makes it clear that this information should be used by the competent authority to evaluate the contribution of the funds' level of leverage to the market's systemic financial risk.

Chapter V contains provisions for special cases which require additional information to be submitted to the competent authority, mostly referring to an AIF's acquisition of control (i.e. more than 50% of voting rights) in an unlisted company. The proportion of voting rights held should be communicated to the competent authority at the "*time when that proportion reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%*" (AIFMD). Moreover, whenever control of a company is acquired the AIFM should notify the company, its shareholders as availability of contacts allows, and the competent authority.

Article 30 of Chapter V provides regulation on asset stripping as follows: Whenever an AIFM acquires control of a non-listed target, in the time period of the 24 months following said acquisition the AIFM can in no way encourage or push the purchase, redemption or distribution of AIFM shares by the target company.

4.2.7. Marketing (Chapter VI[18])

While Chapter VI on marketing is a relatively long read, the concept is quite simple. Regardless of whether an EU AIFM wishes to market a home-country AIF in its home country or in one or more other member countries, notification should be given, for each fund to be marketed, *to the competent authority of the home country of the AIFM*. The information to be provided to the competent authority is almost the same regardless of where the AIFM intends to market the fund[19].

The competent authority should verify that the marketing of the fund as presented by the information provided in the application does not conflict with the requirements of the AIFMD, and shortly give the green light to the AIFM that it may start marketing the fund in question. If marketing is intended to happen in a foreign EU country, the competent authority should inform the competent authority of the host country that the AIFM is authorized to market the fund in that country.

[18] In addition to Ch. VI, Chapter VII contains special provisions relating to third countires.

[19] If the fund is to be marketed in the home country, Annex III applies. If the fund is to be marketed in a foreign EU country, Annex IV applies. The two annexes are, except from a couple of minor details, identical.

If the AIFM wishes to market an AIF which is registered in a member country which is not its home country, whether it does so directly or through opening a branch in the host country, notification should be given to the AIFM's home country authority. Once the notification is received and approved, and the competent authority has notified the host country of the authorization, the AIFM may start marketing the fund. When it comes to marketing third-country AIFs, either by third-country AIFMs or EU AIFMs, certain barriers arise in the shape of a marketing passport, a permit to market funds given that these be supervised by the competent authorities in given member countries of reference and given that agreements are in place between the competent authorities of the countries in question. This complicates the marketing and management aspect when non-EU AIFs/AIFMs are involved.

It is clear from Chapter VI that AIF may only be marketed to professional investors. However, this requirement is amended by Chapter VIII which allows member states to permit AIFMs to market AIFs to retail investors. In such cases, the member state in question may impose further restrictions on the marketing activities.

This concludes the rough outline of the AIFMD for the purposes of this paper. The full text can be retrieved from EUR-Lex, the collection of EU legislation and official public documents of the European Union.

4.3. Criticism of the Directive: What the private equity industry fears

This paper takes a societal stance with respect to the implementation of the AIFM Directive, as stated in the introduction. However, in doing that, the views and concerns of the private equity industry should be taken into account. While the conceptual ideas behind the Directive are I believe perfectly understandable to those acquainted with the mechanisms of the private equity industry, the Directive has been criticized by many industry pioneers for several different reasons. These criticizing views will be shortly presented in this section of the paper, which will be followed by an outline of the Directive as far as it is relevant to the industry of private equity and venture capital.

One possible piece of critique towards the Directive which fits as an introductory comment to the more detail-oriented criticism is the broad scope of the Directive. The AIFMD encompasses all collective investment undertakings which do not require UCITS authorization. The Norwegian Venture Capital Association (NVCA, 2010) states that the Directive is an incomplete regulatory

framework, which does not take into account differences between disparate asset classes[20]. An example of this from the United Kingdom concerns investment trusts, which have long traditions in Great Britain:

"The big EU targets are hedge funds and private equity firms […] The snag, however, is that the draft AIFM directive has cast its regulatory net so wide that it captures other investment vehicles, in Germany, the UK and elsewhere […] Consider Britain's investment trusts. The first investment trust was established in 1868. Many of these trusts have existed for over a century, which makes it hard to describe them as "alternative" […] Given that there has been no suggestion that investment trusts have posed any threat to the financial system or played any part in the financial crisis, why have they been included in the AIFM directive at all?"[21] (Lord J. Rothschild, 2010)

Lord Rothschild also points out that a possible reason for the broad target of the AIFMD is to avoid creative fund structures aimed at avoiding its requirements. Moreover, his example on British trusts sheds light on another aspect of the Directive which shouldn't expect much appreciation from the industry, namely the requirements on transparency and reporting. The nature of alternative investment funds, of which examples are hedge funds, private equity funds and investment trusts, is so that disclosure of information is very limited. For instance, the whole point of the trust fund is that the trustee is given trust and liberty to manage the fund as he sees fit for the assets it is composed of, hence the name of the vehicle. In this case, disclosure would counter the entire concept of the investment trust. Private equity funds have also operated with very limited disclosure in the past, partly due to the fact that the investments have such a long time horizon that performances are usually not measured well before the disinvestment stage.

Cross-border marketing is another criticized aspect of the Directive. Understanding for the Directive's aim to increase regulation and thus security about cross-border investment, particularly with respect to investment *into* the EU from outside or outbound investment *from* the EU, does not prevent critics of the Directive from viewing this as a potentially harmful restriction:

"This directive, whilst intended to integrate private equity and hedge fund activity within the EU through an investment passport, would actually restrict investments into European funds from outside it as well as reduce access for EU investors to opportunities abroad."[22] (Simon Walker, 2010)

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[20] NVCA on AIFMD, October 28, 2010. http://www.nvca.no/bransjestoff/index.aspx?mid=1051&id=425488

[21] Financial Times (FT.com), September 14, 2010: "Europe is getting it wrong on financial reform", comment by Lord Jacob Rothschild, Chairman, RIT Capital Partners

[22] Financial Times (FT.com), September 14, 2010: "EU directive would amount to investment ban", comment by Simon Walker, Chief Executive, British Venture Capital Association (BVCA)

This highlights the restrictive nature of the AIFMD, as the phrasing of the Directive might (on a subjective note) lead one to believe that the EU passport, an arrangement which grants non-EU funds the right to be marketed within the EU provided agreements between competent authorities of the involved countries are in place, is an opportunity, rather than a restriction. On a related note, in general terms care should be taken in reading the Directive not to miss the seemingly obvious fact that in the attempt to “harmonize” the European alternative investment market, the Directive imposes in fact several and significant restrictions.

Further criticism concerns the amount of leverage funds are allowed to use. It is unclear whether this leverage is intended at fund level or at both fund and portfolio level. In fact, the Directive never specifies limits to the *level* of leverage per se. Rather, it requires of the investment funds that they specify the intended leverage ratios and provide documentation on the sources of leverage as part of the application for authorization. This, however, poses restriction on the flexibility fund managers will have with respect to investment gearing. Leverage has proven to be a useful tool to gain access to cheaper capital in order to carry out large investments and increase their yield. Needless to say, leverage also increases the risk of equity capital, leading to larger losses if things go ill. The main argument of the European Commission for providing requirements related to debt capital is the avoidance of systemic risk due to leverage. For this reason, the Directive has taken measures to ensure proposed leverage limits are reasonable and thereby approved by the competent authorities and respected by the fund managers at all times. Furthermore, leverage is a factor in the definition of fund managers that are exempted from the Directive. This will be explained later, but it is worth commenting that some fund managers might adjust employed leverage to benefit from a lighter regulatory regime.

This section only provides examples of criticism that has been raised against the AIFMD. Regardless of the reasoning underlying the Directive and the benefits it could bring about, it is possible to observe from the criticism reported in this section (and much more of what is out there) that the private equity market and all other types of alternative investment markets are worried about the negative consequences of this increased regulation.

The next chapter of this paper discusses what the possible impact of the Directive might be on the Norwegian private equity industry. While at first I will outline from an economic stance what possible consequences will be in terms of cost and opportunities, the chapter will be concluded with a discussion on whether the Directive really makes sense in Norway from a legal-sociologic point of view. While this is indeed an interesting question, however, it will not receive major attention as it addresses a discipline beyond what is the purpose of this paper.

5. Impact assessment on the Norwegian market

5.1. Will Norwegian private equity funds be affected?

Going back to page 21, it was reasoned briefly upon whether private equity companies in Norway will, in fact, be affected by the implementation of the AIFM Directive. The doubt arises upon knowledge that Norwegian private equity funds aren't in fact funds in the legal form. Even after reading the Directive's definition on an alternative investment fund, it is uncertain whether the Norwegian companies will be considered funds upon transposition of the Directive, as it is uncertain whether foreign limited partnerships will be encompassed by the AIFMD.

The definition of AIFs is "*collective investment undertakings, including investment compartments thereof, which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC;*" (AIFMD, Chapter I, Article 4, §1.a.)

By this definition, competent authorities in any target country could impose that collective investment undertakings (i.e. funds), regardless of their legal form, should adhere to the Directive. The prologue to the Directive text preceding Chapter I states, in paragraph 6, that,

"The scope of this Directive should be limited to entities managing AIFs as a regular business – regardless of whether the AIF is of an open-ended or closed-ended type, whatever the legal form of the AIF, and whether or not the AIF is listed […]" (AIFMD)

It is clear from this that the legal form of the collective investment undertaking should be irrelevant to the Directive. Moreover, the fact that the Directive contains certain separate provisions for so-called "internally managed AIFs" may hint to the fact that the existence of legal structures such as those used in Norway does not prevent the AIFMD from applying to them. This, in turn, may show that the Directive does not address funds in the legal sense of the word, but fund arrangements in the practical sense, regardless of legal structure. From Chapter 1, Article 5, §§1.a. and 1.b.:

"Member states shall ensure that each AIF managed within the scope of this Directive shall have a single AIFM […]. The AIFM shall be either: (a) an external manager, which is the legal person appointed by the AIF […]; or (b) where the legal form of the AIF permits an internal management and where the AIF's governing body chooses not to appoint an external AIFM, the AIF itself, which shall then be authorised as AIFM."

Point (b) likely refers to structures as the Norwegian ones, where the AIFM is internal to the fund. While at this point it is only possible to speculate on whether the implementation of the Directive in Norway will imply that Norwegian funds be encompassed by it, the following discussion will be based on the assumption that they will indeed. Whether they should be, is a matter of opinion, a question which will be addressed later.

The rest of this chapter will address the different aspects/chapters of the AIFM Directive and infer on how the Directive could impact the Norwegian private equity market.

5.2. How will the Directive impact Norway?

5.2.1. Authorization

The authorization requirements are considerably stricter in the Directive than are those for Norwegian private equity companies. It is not required per today that Norwegian funds be authorized in order to conduct their fund management activity. AIFMD, on the other hand, imposes comprehensive requirements among which, as explained in section 4.2.2:

- Identities of fund managers and shareholders with qualifying holdings; background and reputation
- Programme of Activity (structure of AIFM and means to comply with the Directive)
- Business plan/investment strategies
- Remuneration policies
- Depositary agreement
- Capital requirements

The preparation of the documentation required for authorization could imply a more or less significant cost. It is to be noted that larger funds will have lesser problems complying with these requirements, as the cost represents a lower percentage of the fund's size and covering these through the management fee (as a percentage of committed capital) will be less of a problem.

In terms of time, the preparation of the application might imply higher costs and even risks. In particular, the fact that the agreement with the depositary virtually needs to be in place before authorization is granted poses a challenge, as the depositary will have to make an agreement with a fund which has not yet been authorized. This is already a challenge Norwegian securities funds

(which are legally structured as funds, as opposed to the private equity funds) face today due to Norwegian regulation of these.

Capital requirements are also a substantial limitation which is set by the Directive, as Norwegian funds today aren't subject to any capital requirements at all, except the NOK 100,000 required by *Aksjeloven* as minimum share capital for an AS company. In the Directive, capital requirements differ between externally and internally managed AIF.

Whether AIF in Norway will be managed internally or externally is difficult to say and depends on how the Directive is transposed to Norwegian regulation, and whether the latter will require of funds to take specific legal forms or that certain legal forms of funds be managed either externally or internally. Personal reflections lead me to believe that the reasons for not subjecting private equity to heavy regulation in Norway suggest that Norwegian authorities might attempt to make the transition into an AIFMD regime as smooth as possible for the private equity business. If it remains up to the AIF to decide whether to be managed internally or externally, it is likely that the latter will be chosen due to the lighter initial capital requirements for AIFM acting as external managers (EUR 125,000 as opposed to EUR 300,000 for internally managed AIF).

The own funds requirement will also be introduced as a new piece of regulation, and could represent a burden to very large funds. It will however be unlikely that many Norwegian funds will suffer from the own funds requirement. The EUR 10 million cap on own funds given in AIFMD (provided the own funds required by the Capital Adequacy Directive do not exceed the AIFMD threshold) implies that an AIFM's portfolio should have committed capital of EUR 50 billion! There is hardly any plausible reason to believe any Norwegian private equity fund manager will ever manage a portfolio this large. Seen from the perspective of the CAD, the ten-million-Euro threshold implies EUR 40 million of fixed annual overheads. Again, this is not likely to be the case. The average size of European closed-ended funds is EUR 200-400 million (Caselli, 2009), and depending on how many funds are managed by each AIFM, this number doesn't imply worrying own funds requirements. Moreover, the own funds aren't meant for the fund itself, but rather for the AIFM, implying that the capital the investors commit to the fund won't be directly affected by the capital requirements of AIFMD.

Naturally, the own funds requirement becomes more restrictive in cases in which a holding company holds more than one internally managed fund. This would imply that each fund needs to hold initial capital of EUR 300,000, while if externally managed, the AIFM would only need to hold initial capital of EUR 125,000 (most likely with additional own funds).

Wrapping up, there might be reason to believe that funds that today are managed internally will, because of higher capital requirements, convert to an external AIFM model. This is especially the case when the same holding/management company manages more than one fund, as reasoned above.

5.2.2. Depositary

Stressing what has already been quoted earlier, the European Venture Capital Association (EVCA 2010) considers the requirement to appoint one depositary per AIF managed by the AIFM a potentially high and threatening additional cost element to the AIFM. The main argument posed is the rise of redundancy in the functions performed by the depositary, as most private equity fund managers already perform these functions themselves, e.g. record keeping. In Norway, securities funds (UCITS-equivalents) are already required to appoint one depositary per fund, but private equity funds are not subject to this provision.

Status quo in Norway sees the depositary for private equity funds as a provider of deposit accounts and other services which the company might request. Moreover, there is a possibility that more than one entity provide the needed depositary functions. AIFMD, on the other hand, sets very specific and comprehensive requirements as to what the role of the depositary should be (i.e. safekeeping of assets, monitoring compliance with the Directive and monitoring cash flows, together with restrictions on delegation of depositary duties.

In a series of briefing papers published by law firm Allen & Overy (2011) the following is stated: "*It may come as a surprise that a directive whose declared objective is to regulate fund managers only and not the funds themselves contains such detailed provisions on the depositary function.*" Indeed, this is regulation of the structure of the funds themselves, but the AIFM is explicitly made responsible for ensuring that one depositary is appointed for each fund managed. Moreover, the Directive imposes obligations on the depositary itself, thus regulating its activities. The provisions of the Directive concerning depositaries may therefore have an impact on several levels.

Firstly, as reasoned on page 30, authorization requires that there be an agreement between the depositary and the AIFM for each managed AIF. In Norway, this is not currently the case for private equity funds, although it is a challenge faced by the "UCITS-funds" as these are regulated by *Verdipapirfondloven*. This requirement implies, however, that the financial institution in question would have to agree to acting as depositary for the AIFM even *before* the latter has been granted authorization to operate. Possible cost-side consequences of this include, but are not limited to, increased fees to the depositary-to-be as a measure of risk management from the latter's side,

increased legal costs to elaborate more complex contractual agreements, and greater selectivity from the depositaries' side concerning which funds they're able to or willing to have as clients.

Firstly, certain management functions usually provided by the fund managers themselves will now have to be provided by a depositary, and by one depositary alone. The services to be provided by the depositary certainly represent an increased cost element for the *fund*, which could compromise some of the fund's IRR. Moreover, the AIFMD requires the depositary to be established in the same country as the AIF it serves. For Norwegian AIFs, the number of depositaries available will therefore shrink considerably, to the extent to which Norwegian funds make use of foreign depositaries per today. Depending on how depositaries will respond to this new piece of regulation, it is also possible that the price of their services will increase due to lower flexibility given to the AIFM.

The question remains, whether funds will move out of Norway and be established in countries in which depositaries are more abundant and the competitive scenario is such that the funds have higher bargaining power to mitigate costs. Naturally, depositaries aren't the only factor which will determine the location of funds, but depending on the cost impact of the depositary provisions, it could be a more or less relevant factor to consider.

A third level of impact is on the depositary itself, which will benefit in terms of sales from being able to provide more services to the fund. On the other hand, the requirements imposed on the depositary will certainly make their job more challenging, especially as far as the supervisory function is concerned. Transparency in the relationship between the AIF/AIFM and the depositary will be crucial. Allen & Overy LLP (2011) support this statement:

"*Performing […] supervisory duties will be a real challenge for depositaries of AIFs. For instance, supervising issues, cancellation and redemptions of shares/units and payment of dividends will be particularly difficult with respect to funds which have either mechanisms involving automatic redemptions/cancellation of shares/units […] or a complicated distribution waterfall.*"

Although it is yet to be seen how the Directive's depositary requirements will affect Norway, it's clear that they will pose a significant challenge for private equity funds and alternative investment funds in general, and it will be important that national legislators upon transposition of the Directive not make the transition unnecessarily costly.

5.2.3. Remuneration

Annex II of the Directive contains a number of provisions relating to remuneration of staff of the AIFM. In principle, it relates to senior management and staff whose role is such that they make decisions impacting on the risk profile of the funds they manage. The purpose is, reasonably, that

remuneration schemes adopted by the AIFM align the interests of their staff with those of investors in the managed AIFs.

An amendment common to several Norwegian laws, among which the securities funds act *Verdipapirfondloven*, sets requirements with respect to remuneration policies which match almost perfectly the provisions of Annex II of the AIFMD[23]. Again, these provisions do not apply to the Norwegian private equity companies.

As EVCA (2010) state in their AIFMD Essentials report, the private equity and venture capital industry is in a good position to comply with the requirements of the Directive, because of the incentive provided by the initial capital provided by the fund manager to the fund and, in particular, the carried interest.

There are arguments, however, that question whether the interests of the fund managers and the investors are as aligned as one would have it. In one of his articles, Phalippou (2009) argues that carried interest in certain cases might be an incentive to act against the interest of investors. Traditionally, the performance of funds is measured by the global internal rate of return rather than by the effective return, which encourages large early payments to investors and may encourage early exit. Another argument Phalippou brings forth is the incentive transaction fees give to carry out many large transactions rather than few large ones. Although Phalippou's article is inconclusive and lacks empirical support, it provides some theoretical arguments which justify the need for regulation of remuneration to AIFM staff.

The magnitude of the impact the Directive will have on remuneration policies in Norwegian private equity companies is highly uncertain. From a neutral stance, one could argue that the requirements set by the AIFMD are quite sound and aim at aligning remuneration schemes with the risk profile of the AIF managed, the time horizon of the fund, and the performance of the fund and the AIFM. As explained earlier, an important restriction concerns the ratio of fixed-to-variable remuneration and the form of variable remuneration. As far as the fixed-to-variable ratio is concerned, the Directive does not specify what a "*sufficiently high proportion of total remuneration*" for the fixed portion is. Presumably, it will be up to Norwegian legislators whether they choose to establish quantitative measures in this respect; however it is possible that the splitting of total remuneration in a fixed and variable portion will be a matter left to the single AIFM to sort out. I take the liberty to infer this as the above-mentioned amendment to *Verdipapirfondloven* and other acts does *not* contain

[23] This is not a coincidence, as the AIFMD's remuneration requirements contain in large portions the principles behind directive 2010/76/EU (Capital Requirements Directive) and related amendments.

quantitatively set restrictions to the fixed-to-variable ratio, but provides the same requirement, in the same form, as does the AIFMD.

It is not, in fact, unreasonable to believe that Norwegian funds will be able to suggest themselves how to split fixed and variable remuneration. Firstly, not all fund management companies are equal, and the heterogeneity in investment strategies found in the industry would make it implausible to suggest equal guidelines for all AIFM. This can be exemplified by presenting two different AIFM, one managing funds which invest only in seed and start-up ventures, and one investing in mature companies. It would be unreasonable to expect that the fixed-to-variable ratio be the same for both AIFM, as the risk tied to the variable portion is much higher for the seed/start-up fund than for the buyout fund.

Secondly, the remuneration policies adopted by the AIFM form part of the documentation package which is to be provided upon application for authorization. This implies that the AIFM has the liberty to design and propose a remuneration scheme which, in case it proves unsatisfactory, can be negotiated with the competent authority.

Thus the AIFMD’s remuneration policy requirements need not have a big impact in Norway beyond (1) the extent to which existing policies will have to be altered and (2) the additional effort implied by the requirement to elaborate said guidelines and possibly appoint a remuneration committee as previously discussed.

5.2.4. Valuation

The requirement to set in place appropriate valuation policies is most likely to a certain extent redundant for the private equity sector. An important part of the private equity deal assessment process is, in fact, the valuation of the target company, in which the AIFM and advisory companies carry out meticulous due diligences in order to carefully assess the potential of the target.

On the other hand, however, valuation represents a possible challenge to the extent that it becomes biased as a result of the nature of returns of private equity investments. This is the so-called J-curve effect (Grabenwarter, 2005 et al.), as shown in appendix B. Returns are negative in the first years of the investment cycle because the target company is yet to perform and fund costs exceed gains to the fund. This does not at all mean that the investment won’t pay off in the long term. In the valuation of the funds it is important that these effects are taken into account so as to give a rightful picture of the performance of the fund. Moreover, it is easy to understand the importance of proper valuation to the extent that remuneration to managers is tied to net asset value. In this respect,

valuation and remuneration may be closely linked and the regulation of the one could impact the other.

The fact that it is required that valuation methods be established for each managed *fund* could represent additional cost to the extent the elaboration of valuation procedures is costly. This depends on how much funds managed by the same AIFM differ from one another in terms of factors which will be significant to the valuation methodology.

The Directive allows for external valuers to be appointed, provided that the objective is not to avoid the provisions of the Directive or any other piece of national legislation. Beyond this, the AIFMD does not provide further detail on this matter, and the extent to which valuation requirements will affect the Norwegian private equity industry is uncertain. Naturally, the approval of the valuation procedures by the competent authorities upon granting authorization to the AIFM should represent an assuring message to potential subscribers to the fund in question.

5.2.5. Transparency requirements

Norwegian AS-type joint-stock companies are required by law to provide an audited annual report at the end of each fiscal year. KS and IS companies should provide their general assembly with an annual report, but auditing is not required. Thus the AIFMD's requirement that for each fund an audited annual report be published and made available to the AIFM's stakeholders will imply added costs to the Norwegian private equity companies.

Moreover, beyond the added cost there will be an important change (and increase) in the amount of information reported on each investment fund. As explained in the introductory chapter, a characteristic of the private equity industry is that information is shared only minimally, and details on the performance of individual investments are seldom disclosed publicly. Part of the reason for this lies in the challenge of providing accurate information, as the private equity investment's actual performance can seldom be calculated before exit, and we know that the investment horizon spans over several years. While the performance of the target companies can be accounted for, the performance of the fund depends solely on the success of the disinvestment, which isn't an annually measurable parameter. It will be up to Norwegian legislators (as well as legislators in all other target Member States, as this concept is no different there) to manage this challenge. At the same time, the European Commission is still to define measures of reporting tailored specifically to the type of fund. It is therefore possible (and probable) that this challenge will be addressed at a European level.

The requirements set by the Directive on information to be disclosed to investors prior to investment hardly represent any substantial change to current practices by private equity firms. Most of these

requirements[24] such as the identities of the AIFM and its service providers are freely shared with potential investors, especially by well-reputed funds, because it helps promote the quality and reputation of the fund which is being marketed. Moreover, some pieces of information such as the description of the investment strategy, fees and costs and risk management measures are freely supplied by the fund managers because (professional) investors would never invest in a fund without having this information at hand a priori. For this reason, the introduction of regulatory requirements on disclosure of information to investors prior to investment doesn't need to represent a problem to the private equity industry.

Transparency towards competent authorities as required by AIFMD Article 24 could represent an additional administrative burden to the private equity funds in Norway. The exact information on asset classes, leverage, risk management measures, liquidity management *et cetera* to be required by the competent authority is not specified by the Directive, nor is the timing of the reporting to the authority. These are to be better defined by Norwegian legislators upon transposition. The frequency of reporting required by the competent authority will be of significance to the cost impact these requirements will imply.

5.2.6. Marketing

With the aim of taking into account the cross-border dimension of private equity and other asset classes invested in by alternative investment funds, the Directive provides extensive guidelines regarding the marketing of funds. Limited Partnerships and similar structures such as Norwegian funds are not subject to the same regulatory restrictions as AIFM/AIF structures, and marketing of the funds is no exception. Thus, Norwegian private equity firms are per today able to obtain subscribed capital from abroad without the need for approval by the Norwegian authorities.

The timetable and cost implications of having to comply with the authorization requirements relating to fund marketing could be substantial. On a first note I'd like to stress the disbelief that marketing to retail investors will be restricted be a problem for private equity firms in Norway: Private equity is hardly an asset class for retail investors, and in partnership models the closed circle of investors won't consist of retail investors. Therefore, this provision is most likely meant for AIFs investing in other asset classes.

As previously pointed out, the principle behind authorization of marketing of funds either within the home country of the fund or abroad is what in chapter 2.3 was referred to as *home country control*. The competent authority of the home country of the *AIFM* should be notified, regardless of whether

[24] Disclosure to investors is treated by the AIFMD Article 23, and can be found in the Official Journal of the European Union

the marketed *funds* are established in the same country or not. In the case of Norway, the marketing of funds through limited partnerships abroad should be notified to the Norwegian authorities, who in turn notify the authorities of the country or countries in which the Norwegian fund is to be marketed. This should happen within twenty working days of receipt of the notification from the AIFM.

Whether the additional costs brought about by the marketing notification requirement will be substantial is hard to conclude at this point. From the analysis of the impact of the different aspects of the AIFMD on the Norwegian private equity industry carried out in this chapter so far, it could be inferred that the marketing provisions do not represent the Directive's heaviest imposition, at least not as far as intra-Union marketing is concerned. What remains to be seen, however, is the obstacle the AIFMD will pose to marketing Norwegian funds in third countries. As we have seen in section 3.1, half of the capital invested in Norway is subscribed by foreign investors. The extent to which these foreign investors are established in third countries is an important factor to take into account, as these may face considerable challenges marketing and managing the funds inside the EEA. Norwegians who have established AIFMs or AIFs in third countries might want to rethink keeping them there, considering the related marketing challenges the Directive will bring about.

5.3. Should *Norwegian private equity funds be affected?*

After laying out the assumptions under which Norwegian funds will be affected by the Directive (i.e. that they legally be considered AIF by Norwegian legislation) and analyzing possible ways in which different chapters of the Directive might affect the Norwegian private equity market, the normative question remains: From a societal point of view, *should* Norwegian funds be subjected to the Directive? In other words, is the Directive good for Norwegian private equity?

In Norway's case, the question asks for a binary answer: Either Norwegian private equity companies are considered AIF, as the Directive would suggest they do, and thus fall under the AIFMD regime, or they are not, in which case status quo would most likely be preserved. In addition to being economic, this is also a legal and political question. Furthermore, in the case of Norway, it is not only a question of introducing *stricter* regulation as it will be in other EEA Member Countries; it is a question of beginning to *regulate a currently unregulated activity.* The best way to provide arguments for and against applying the Directive in Norway is to understand the backgrounds for both the Directive, and the current lack of regulation of private equity in Norway, both covered in previous sections and briefly summarized in the following.

In one hand we hold the reasons *for* implementing the AIFMD. In their directive proposal the European Commission motivate the AIFMD by the need of a harmonized European regulatory framework aimed at increasing the quality of information provided to the parties involved in alternative investments, and protecting the interests of investors, acquired companies (in the case of private equity) and the financial system in general. The important thing to remember here, however, is that although this paper discusses the impact of the Directive on the Norwegian *private equity* market, the AIFMD is not only intended for private equity and venture capital, and thus the question of whether it is right to implement it for the sake of private equity is too narrow. Because the Directive generalizes AIFs (with a few tailoring to fund type), the reasons for regulating private equity are the same as those for regulating hedge funds. In its entirety, the world of AIFs is far larger than the world of private equity alone. When the AIFMD aims at investor protection and stability in the financial system, it assumes that a large number of investors hold stakes in AIFs, and that AIFs have a significant influence on the financial system[25].

In the other hand we hold arguments *against* regulating private equity in Norway. The Norwegian market is still small compared to other European economies. It's to a large extent venture-capital based, with a large portion of funds allocated to start-up ventures (see fig. 4 on page 15). As correctly put by NVCA, the costs tied to increased regulation will have the greater impact on venture capital funds, which are usually smaller in size. But costs can be justified – or can they? According to NVCA the Norwegian private equity business is in no need of regulation, and there is no need to formally authorize the activities of neither fund managers nor their advisory companies. The former, because their clients are professional investors fully capable of assessing the risk/return profile of the fund themselves (something the AIFMD obviously disagrees with). The latter because they are not providing the AIFM and the investors with investment advice as such, but rather with strategic acquisition advice on a one-to-one basis. Taking into account the size and vulnerability of the Norwegian private equity (and venture capital) market, it could do more harm than good to regulate it. After all, there hasn't been any need to regulate private equity so far – so why now? And is regulation going to prevent the currently small-sized market from growing, or will the business be able to grow indeed, to the point that the costs of regulation can be better sustained? These questions put the discussion into a "short term versus long term" perspective.

From my personal reflections, private equity is an activity too important to be put at risk. In Norway, about 48,000 people are employed in companies with private equity operators as active owners (NVCA, 2010). These people, together with the value created by the companies in which they work,

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[25] This does not mean only AIFs have an impact on the financial system! After all, UCITS funds and credit institutions are also regulated at European level for this reason.

need to be taken into account when Norwegian regulators transpose the Directive into Norwegian law. On the other hands, target companies (i.e. the industry) must be protected from excessive risk takers which might put them at stake. Even if we assume that Norwegian funds can be easily monitored (in order to protect investors and targets) because of the small size of the market, Norway cannot as easily monitor *foreign* funds targeting the Norwegian market. The Directive will be costly, but in my opinion it is a necessary means to ensure that companies and investors be protected at an international level. Investors will be positively affected in the sense that they'll face an improved quality guarantee on the funds in which they invest. This will come at the cost of fund managers, who will face higher costs as a consequence of the Directive as discussed, and of competent authorities who will have a greater challenge monitoring the private equity activity in Norway and will likely have to employ more resources for this purpose. It will be a role of the Government to ensure that the Directive in the short term won't affect private equity funds to the extent that their activities are handicapped. This applies especially to venture capital funds, which as we have seen constitute just a bit below half of the capital under management.

In order to ensure the continued activity of private equity funds, especially with respect to the smallest funds and venture capital funds, regulators should alleviate the costs borne by the funds/fund managers. A possible way of doing this is allowing for looser tax schemes in the form of lower tax rates, shadow costs or other monetary incentives, to mitigate the cost impact of the Directive. This might be especially important in the transitional phase.

6. Conclusion

Private equity constitutes but a part of the world of alternative investment funds, and an even smaller part of the European financial system. In Norway the private equity industry is still of limited size, and regulation of the industry is virtually inexistent beyond the laws regulating the company structures of the private equity funds.

The objective of the Alternative Investment Fund Managers Directive is to harmonize regulation of AIFs across Europe so as to better be able to ensure the stability of the European financial system. This is done in a way comparable to how there already exists pan-European regulation of "non-alternative" financial institutions. Before the implementation of the AIFMD, private equity is regulated on a country-by-country basis, national regulators only being restrained by more generic EU Directives such as the MiFID and the Capital Adequacy Directive.

The objective of this paper has been to analyze the possible impact the implementation of the AIFMD might have on the private equity and venture capital market in Norway. The work to implement the Directive has not yet started in Norway as per October 2011. For this reason, it isn't possible to say how the Directive will affect Norwegian private equity. The product of this research is therefore a set of hypotheses, educated guesses, as to what may happen and how fund managers and their stakeholders will be affected.

The AIFMD regulates all alternative investment fund managers, without extensive distinctions between different types of assets the funds invest in, thus without distinctions between funds (i.e. trusts, hedge funds, private equity funds, nor any distinction between closed-ended and open-ended funds). This way it ensures to cover a large specter of investment firms and provide extensive regulation of a set of investment firms whose activities are considered to carry high risk. At the same time, it tars all alternative investment funds over the same brush, an outcome of this generalization for which the Directive has been widely criticized.

Private equity in Norway has so far not been regulated, and the introduction of the AIFMD represents potentially significant costs and challenges for the private equity industry. There is little to suggest that the Norwegian private equity companies, although not bearing the legal label of "funds" today, won't fall under the scope of the Directive. When this happens the fund managers will need to comply with the whole set of provisions imposed by the Directive. This represents a regulatory revolution for Norwegian private equity.

Fund managers and their funds will need to be authorized once the Directive enters into force as national law. This means that the AIFMs will need to bear the additional cost of applying for

authorization and all related implications of that: Setting clear investment strategies and structuring the company and the funds in a purposeful and transparent way; establishing valuation procedures and remuneration practices; constituting agreements with depositaries for each managed fund; establishing new communication procedures aimed at meeting the transparency requirements. All these costs will be particularly influential on venture capital funds, which in terms of managed capital represent about 45% of Norwegian private equity funds based on 2009 figures (see fig. 4 on page 15).

The marketing restrictions could pose a challenge for the Norwegian funds. Whenever a Norwegian fund is authorized to market in Norway, it is also authorized to market in the rest of the EEA, given notification. It will, however, be more difficult to market the funds outside the EU. In fact, the funds coming from foreign investors represent about half of the funds invested in Norway – the implementation of the marketing requirements should therefore take into account the current and potential future breakdown of fund sources per geography. Norway is a small economy and some funds, especially larger ones, may need to draw capital from foreign professional investors – an activity which should to the lowest possible extent be impeded by regulators.

Repeating that Norway is a small economy compared to many other European ones, and with regard to the private equity business still being limited in comparison to the rest of the EEA, it can be assumed that Norwegian private equity is perhaps more vulnerable to the effects of increased regulation than are large European economies. This assumption also takes into account the fact that the Directive represents a major change with respect to the low extent of regulation in place to this day. In other European countries private equity is much more regulated, and it is possible that the effects of the Directive, under many aspects, won't be as marked as they will be in Norway.

Despite the cost effects the Directive will have in Norway (as in all other countries) the Directive is a necessary measure to ensure harmonization of regulation of private equity fund managers and other AIFM. It will bring about benefits to investors who seek to be ensured of the quality of the fund managers and their funds. It will contribute to AIFM in all European countries follow high standards of transparency and honorable conduct with the aim of protecting investors and the financial system. The question whether this is good for Norway or not is in my opinion not the most relevant one, nor is it an easy one to answer because of the many effects of the cross-border dimension. The scope of the Directive is larger than private equity, and it is larger than Norway. It aims at securing the standards of AIFM and their stakeholders across the entire EEA – thus it will align regulation in Norway to that in other countries. When the Directive is a given, the important thing for Norwegian regulators and the private equity industry is not to oppose it, but to minimize transition costs.

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Appendices

Appendix A: Table of Contents of the AIFMD

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Appendix B: The J-curve Effect

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