

FUNDAÇÃO GETULIO VARGAS  
ESCOLA DE ADMINISTRAÇÃO DE EMPRESAS DE SÃO PAULO

ROMAIN PAUL MARTIGNIER

**PRIVATE EQUITY REGULATION: WHAT ARE THE CONSEQUENCES OF THE  
ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD) ON  
PRIVATE EQUITY MANAGERS?**

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of Fundação Getulio Vargas, as a  
requirement to obtain the title of Master in  
International Management (MPGI).

Knowledge Field: Gestão e  
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## **Abstract**

The recent global financial crisis brought significant regulatory changes in the worldwide financial industry. In Europe and in the alternative asset sector specifically, a new regulation by the name of Alternative Investment Fund Managers Directive saw the daylight in 2010. This far-reaching and complex Directive with the main goal of regulating and overseeing alternative investment funds has triggered many discussions and represents an industry game-changer. Thus, this research will focus on the impact and consequences of the Directive on private equity fund managers and the role of regulators. In other words, what are the effects, what does that mean in a quantitative and qualitative sense, and how is it likely to influence the outlook of this asset class? In order to provide the reader with an extensive view on the topic, the paper will first discuss relevant theory and literature, using mix-methods and legal-dogmatic approaches. Further, descriptive case studies, analysis of existing surveys, and interviews with industry experts will supplement the paper in order to understand primary implications of the Directive with the goal of providing useful insights for further private equity regulation research.

**Keywords:** Private equity, Regulation, AIFMD, Alternative Investment Funds

## **Resumo**

A recente crise financeira global trouxe mudanças regulatórias significativas no setor financeiro em todo o mundo. Na Europa e no setor de ativos alternativos especificamente, um novo regulamento com o nome de Directiva Gestores de Fundos de Investimento Alternativos viu a luz do dia em 2010. Este abrangente e complexa directiva, com o principal objetivo de regulamentar e fiscalizar os fundos de investimento alternativos provocou muitas discussões. Assim, esta pesquisa vai se concentrar sobre o impacto e as consequências da directiva relativa aos gestores de fundos de private equity e o papel dos reguladores. Em outras palavras, quais são os efeitos, o que isso significa em um sentido quantitativo e qualitativo, e como ele é susceptível de influenciar as perspectivas de esta classe de activos? A fim de fornecer ao leitor uma ampla visão sobre o tema, o papel vai primeiro discutir teoria e literatura relevante, usando mix-métodos e abordagens jurídico-dogmático. Além disso, estudos descritivos de caso, análise de inquéritos existentes e entrevistas com especialistas da indústria irá complementar o papel de forma a compreender as implicações principais da directiva com o objetivo de fornecer informações úteis para pesquisas futuras private equity regulamento.

**Palavras-chave:** Private Equity, Regulamento, AIFMD, Fundos de Investimentos Alternativos

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## List of Abbreviations and Acronyms

<b>AIF</b>	Alternative Investment Fund
<b>AIFM</b>	Alternative Investment Fund Manager
<b>AIFMD</b>	Alternative Investment Fund Manager Directive
<b>AuM</b>	Assets under Management
<b>CAGR</b>	Compound Annual Growth Rate
<b>CaIPERS</b>	California Public Employees Retirement System
<b>CSSF</b>	Comité de Surveillance du Secteur Financier
<b>EFAMA</b>	European Fund and Asset Management Association
<b>EU</b>	European Union
<b>FCP</b>	Fond Commun de Placement
<b>GP</b>	General Partner
<b>HNWI</b>	High Net Worth Individual
<b>IRR</b>	Internal Rate of Return
<b>LBO</b>	Leverage Buy-Out
<b>LP</b>	Limited Partner
<b>ManCo</b>	Management Company
<b>NPPR</b>	National Private Placement Regime
<b>PE</b>	Private Equity
<b>SBA</b>	Swiss Banking Association
<b>SFA</b>	Swiss Fund Association
<b>SFAMA</b>	Swiss Fund & Asset Management Association
<b>SICAR</b>	Société d'Investissement en Capital à Risque
<b>SICAV</b>	Société d'Investissement en Capital Variable
<b>SIF</b>	Specialised Investment Fund
<b>SME</b>	Small and Medium Enterprises

<b>SPV</b>	Special Purpose Vehicle
<b>TER</b>	Total Expense Ratio
<b>UCI</b>	Undertakings for Collective Investment
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

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# **1. INTRODUCTION**

## **1.1. Introduction, Research Gap and Analysis**

Triggered by the global financial crisis of 2008/2009, bank scandals, Madoff's Ponzi scheme, and a general negative perception of the financial sector, several new laws were issued by worried politicians and regulators in order to prevent future crises of this dimension and to convey a message of change. Thus, the Alternative Investment Fund Managers Directive (AIFMD) is one of them, and intends to tighten the regulatory framework under which alternative funds operate. This paper will focus on the Directive, which has been a hot topic for years in the investment management world, and specifically its impact on the private equity industry. It is an interesting topic insofar that there is only little academic documentation on the Directive and its quantitative and qualitative effects on private equity funds, although it represents the most comprehensive and far-reaching regulation for alternative investment funds issued as of today. Moreover, it is important to mention that this paper will try to convey the perspective of the private equity industry rather than the point of view of regulators.

## **1.2. Objectives**

The objective of this Master Thesis is to shed light on the Alternative Investment Fund Managers Directive, and to study possible qualitative and quantitative impacts on the private equity industry. The far-reaching Directive will be explained in details and relevant effects on private equity funds and their managers will be analyzed. Thus, these required managerial and financial changes will be highlighted, and potential additional costs will be quantified based on common assumptions, study results, and interviews. The ultimate goal is to discuss if AIFMD has serious consequences on future efficiency and performance of private equity funds, and if so, what would be potential solutions and alternatives. As the Directive has not yet reached its final state, the analysis will be based on the status quo on the 2<sup>nd</sup> quarter of 2015. Further analysis will have to be performed once all aspects of the Directive will be completely implemented.

### **1.3. Structure of the Paper**

The paper will be based on five main chapters. First, the fund industry, and in particular the regulation of this sector, will be discussed. In fact, different types of fund will be explained, followed by a brief overview of the fund industry today. Then, the role of governments and regulators of the financial industry will be discussed before deep-diving into the history and roots of the AIFM Directive. In the second part of the paper, the structure, characteristics and risks of private equity funds will be explained, as well as typical regulatory provisions aimed at this asset class. Next, the AIFM Directive and its main provisions will be thoroughly presented in a pragmatic, but comprehensive way in order to provide the reader with a sound knowledge of how the Directive represents a game-changer in the alternative fund industry. At the end of this chapter, a recent implementation status update will also be given. The fourth chapter will then focus on an analysis of the Directive based on primary and secondary research. Thus, results of interviews with industry experts and secondary survey results will be analyzed in order to find out what are the real impacts and challenges for the future for the private equity industry. Finally, in the fifth chapter, a conclusion will be reached based on the theory and the performed analysis, whether AIFMD is indeed a real game changer in the industry, and if yes, what is the outlook and next steps for private equity funds managers.

### **1.4. Methodology**

#### **1.4.1. Explanation of Methodology**

The paper was conducted under a qualitative exploratory approach. According to (Nije & Asmiran, 2014), this methodology is especially suited for topics on which little information exists, which is here relevant. Thus, the impacts and consequences of the newly issued Directive are still relatively unknown and could change depending on the time horizon under scrutiny. Further, as existing literature on the subject is limited, using an exploratory approach seemed to be the best way to tackle this research. To be more specific, the author followed a subset of

exploratory qualitative research, namely a mixed-methods approach (Starr, 2012). Thus, the combination of qualitative and quantitative methods characterizing this approach are considered optimal in order to find out the “why” and “how” on the one side, and the “by how much” on the other. Further, this research will follow a type of mixed-methods approach characterized by first a survey, then in-depth interviews to round out and enrich the findings (Starr, 2012). The difference in this paper, however, is that the survey will come from a secondary source as primary (quantitative) information in the private equity industry is difficult to obtain. Other sources will include existing literature on regulatory issues, academic journals and professional documents issued from third-party providers, specialized newspaper articles, and of course European law for instance.

For the chapter about the Directive itself, a legal dogmatic approach was considered the most appropriate. This method is mainly used in legal science in order to understand that the law and its application are two different components, which complement or compete with each other (Varga, 2011). Accordingly, these two components are studied as the parts of a unified and integral system. In this context, the author uses this approach in order to interpret the Directive and make comments on the norms discussed. Further, in order to better explain specific provisions of the law, descriptive case studies will be used as a tool to describe an intervention and the real-life consequences in which it occurs (Yin, 2003 as cited in Baxter & Jack, 2008).

To sum up, the methodology used by this paper consisted in a qualitative research, specifically focused on a mixed-methods approach, and using a legal dogmatic method coupled with descriptive case studies for the part concerning the analysis of the Directive itself.

#### **1.4.2. Sample and Selection Criteria**

The sample gathered for the analysis part of this paper stems from two sources – one secondary and one primary. For the secondary sample, the author relied on a vast survey performed by the bank BNY Mellon and published on January 2014. This survey was of high interest and relevance for this analysis for several reasons. First, it was precisely targeted at finding out what were the main impacts of the Directive on alternative investment fund managers and how

prepared the latter are to face increased compliance requirements. Second, it provided a quantification aspect regarding costs of the implementation. In fact, the alternative fund industry is known for being discrete and relatively opaque, meaning that finding quantitative data is difficult without significant effort or tight links to the industry. Lastly, the survey gained insights from a large pool of respondents with aggregate AuM over USD 4tn, thus representing an important sample of the industry and hence benefiting the significance of the results.

Concerning the primary source, the study involved three participants who are based in Luxembourg and Switzerland. For the purpose of this paper, it was important that all three have both, extensive experience in the private equity sector and a legal background. Thus, one of the participants works in a mega private equity fund, and the other two are working or worked in a leading Swiss bank (mainly in its Luxembourg branch) and were heavily exposed, as fund managers or investors, to alternative funds, specifically private equity, and legal and risk management matters. Further, it was ideal that the participants were active in those two jurisdictions as especially Luxembourg is the main platform for investment funds in the world after New York, making it the most important one in Europe. Conducting these interviews was helpful for the following reasons. First, it provided first-hand qualitative information from industry experts, which was not possible to take out of the aforementioned survey. Thus, it was important for the analysis to also gather subjective opinions of professionals in the industry concerning the “real” development and implementation status of the Directive, especially because the survey was published one year ago. Second, it allowed the author to ask specific questions that were of high interest for the paper and that permitted to make links to existing theory.

Overall, as Rudnick (2012) would define, comparison is a mandatory component of qualitative research as it allows addressing differences and similarities across, within and between the data obtained from the different groups studied. In fact, the author believed that having a source based on multiple choice questions and also providing quantitative data on the one side, and having another source based on interviews and subjective opinions on the other, proved to be complementary and ideal for the analysis part. This allowed for comparison between the two, but also for supporting the one or the other assumption linked to existing regulatory theory.



### **1.4.3. Research Method Design and Interpretation of Findings**

As mentioned above, the two sources for the analysis were BNY's survey results and the interviews performed between July and September 2015. Confidentiality being considered crucial in the private equity sector, it was unlikely that the author would obtain first hand documentation from a broad set of fund managers, hence the importance of the survey. Further, the interviews were based on a relatively small sample, but allowed the author to gain sufficient insights to perform an analysis and comparison with the survey and with existing theory.

The interviews were mainly conducted in a structured way, in which the conversation follows a pre-determined sequence of questions (Starr, 2012). However, a semi-structured approach was sometimes followed in order to build on interesting answers provided by the participants. This allowed going deeper on certain topics that the author felt could be interesting for the analysis, even though not initially planned. In order to preserve information in the best possible way, almost all interviews were taped and later transcribed. Thus, thanks to the structured interview approach and the transcripts, the data could easily be compared. Where possible interviews were performed in-person or by phone and lasted between 35-55min. A detailed interview sample can be found in the Annex (p.96).

## **2. THE FUND INDUSTRY**

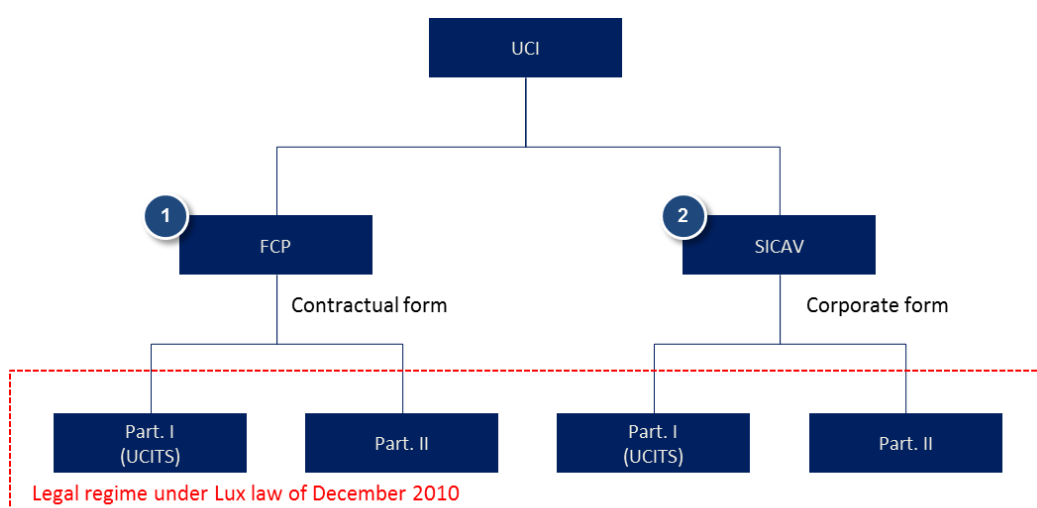
### **2.1. What is an Investment Fund?**

Investment funds are pool of assets with specified risk levels and asset allocations, into which one can buy and redeem shares. By pooling savings from various sources, they offer investors a number of advantages, particularly in terms of risk diversification and lowered costs through economies of scale (EFAMA, 2015). Further, investment funds can be open-ended or closed-ended. The main difference is that shares in an open-ended fund can be redeemed at any time, normally every day, but that in a closed-ended fund investors are locked-in for a certain period of time ranging from months to several years. Private equity is a typical example of a type of close-ended fund for instance. Based on this categorization, coupled with differences in investor protection and in the restrictiveness of investment policies, funds can also generally be divided in “Undertakings for Collective Investment in Transferable Securities” (UCITS) or alternative investment funds. As of 2014, UCITS represented 70% of the European fund market in terms of net assets, amounting to EUR 7.1tn. On the other side, alternative funds, or non-UCITS funds made up the residual 30%, or EUR 3.1tn (EFAMA, 2015). UCITS are normally open-ended and have strict requirements in terms of investor protection. In fact, as the name indicates, these funds can mainly only invest in transferable or so-called liquid assets, with of course a few exceptions, thus considerably minimizing risk. On the other hand, alternative funds can be open or closed-ended, but have special investment policies and are generally thought to be targeted at professional investors due to their higher risk and often complex investment strategies. Thus, alternative funds, such as hedge funds, real estate, and private equity funds for instance, enjoy a large liberty in terms of investment spectrum and are less regulated than UCITS.

Assets under management that are professionally managed in Europe can also be broken down into two main categories: investment fund assets (see definition above) and discretionary mandate assets. The first type is generally offered to retail investors, and the latter are mandates typically received from institutional clients such as pension funds, insurance companies and high-net-worth individuals (hereafter referred as “HNWI”) for instance. Thus this kind of mandates give the asset management company the sole authority to buy and sell assets and

execute transactions on behalf of the client (EFAMA, 2015). The investment strategy is defined with the client, including risk profile and asset allocation.

In order to better understand the different types and where alternative investment funds, such as private equity funds for instance, are situated in the legal framework, the paper will use the Luxembourgish system as example (see Figure 1). In fact, Luxembourg is the largest fund administration platform in Europe (and the second largest in the world after the U.S.), and thus one can assume that the majority of investment firms, no matter what type, will have a presence in the country.



**Figure 1 Luxembourg's Legal Framework**  
Sources: Deloitte, Banque Pictet, author's own illustration

The Luxembourgish legal framework described above is based on the “2010 Law”. In general, funds, no matter what type, be it open or closed-ended, alternative or UCITS, are found under the umbrella term “Undertakings for Collective Investment” or UCI. On the second layer, an UCI can be managed in two different forms. First, under a contractual form called “Fonds Commun de Placement” or simply FCP, or second, under a corporate form called “Société d’Investissement à Capital Variable” or short SICAV. A FCP fund is a type of fund that has no legal personality. Thus, it is an investment vehicle run by a management company on behalf of joint owners, who are liable only up to the amount contributed by them and whose rights are represented by units intended for placement with the public by means of a private offer (CSSF, 2015). In other words,

investors in this type of funds are not shareholders, but simply holders of units in the funds. In contrast, SICAVs referred in the law are legal entities (companies) which must have their registered offices in Luxembourg (Deloitte, 2012). Investors are shareholders of the company and their rights are represented by their shareholdings in the SICAV. Further, as indicated in the name, a SICAV has variable capital, meaning that its capital is always equal to its net assets. Consequently, unlike for other companies, a change in its articles is not required each time the level of capital issued changes (Deloitte, 2012). On the third layer, each legal form (situations 1 and 2 in Figure 1) can have funds registered under two categories. First, Part I of the law, namely UCITS, and second, Part II, namely all other funds such as hedge funds, private equity funds, real estate funds, commodity funds, infrastructure funds, and institutional funds just to mention the most important ones. Part I funds or UCITS are, as mentioned above, open-ended funds, which can sell their shares anywhere in the European Union through a so-called EU Passport. They typically have more restrictive investment policies and high investor protection. By contrast, Part II funds are all other funds that do not qualify under Part I due to some or all of the following (negative definition) (CSSF, 2015):

- Funds that are closed-ended
- Funds that raise capital outside the EU
- Funds for which restrictions on UCIs do not apply (e.g. hedge funds)
- Funds that have a special investment policy and do not invest in transferrable securities or assets eligible under the UCITS framework

Further, Part II funds are not eligible for distribution in more than one EU Member State. In other words, they have to apply separately in each EU country they wish to sell their fund (in contrast to UCITS' EU Passport). All this is important to understand as it represents the legal framework on which we will discuss AIFMD more in details later in this paper.

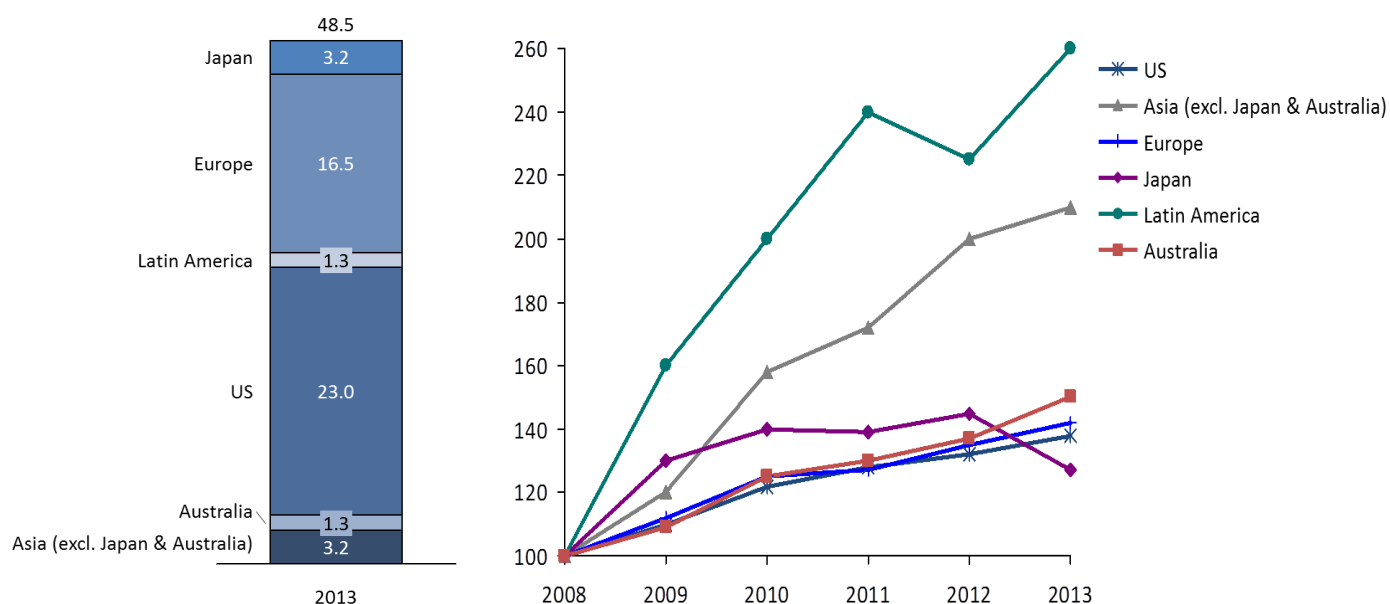
## **2.2. The Fund Industry Today**

All information mentioned in this section concerning quantitative and qualitative data of the fund industry, if not stated otherwise, are taken from EFAMA (2015) as it represents the most

comprehensive and most respected source among industry actors concerning investment fund information.

The global fund industry has never been as strong as today. According to EFAMA (2015) and industry experts, the global asset management industry managed around EUR 48.5 trillion in net assets at the end of 2013. The asset management industry represents about a quarter of total worldwide financial assets. The world's largest market is still the United States with EUR 23 trillion in assets under management (hereafter referred as "AuM") or 46% of global AuM, followed by Europe with EUR 16.5 trillion or around 33% of all assets at the end of 2013.

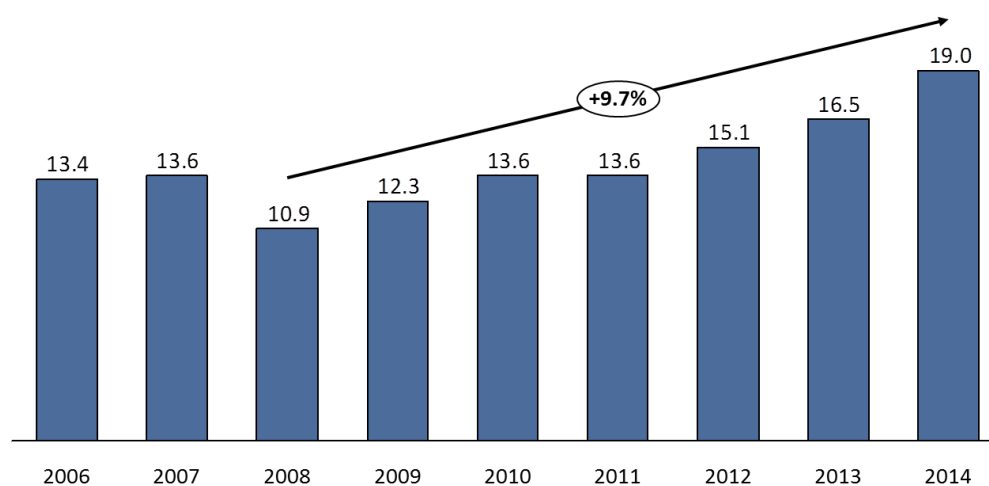
Also, it is interesting to note as observed on Figure 2 that the growth of worldwide AuM was largely fueled by Latin America and Asia (excl. Japan and Australia). Thus, the latter have seen their AuM more than double over the years. The developed economies of Europe, the US, Japan and Australia have all enjoyed strong growth in assets of between 20% and 50%. In contrast, Europe and the US have registered almost identical growth in terms of AuM over the six years period despite the significant differences in economic performances across these two regions.



**Figure 2 Global AuM (in \$tn) End 2013 and Growth Index (Base year: 2008=100)**  
**Source: EFAMA, author's own illustration**

In Europe, professionally managed assets rose by 8.6% in 2013. This growth was mainly achieved through improved confidence that the worst of the euro area financial crisis had passed,

and through relatively effective monetary policies implemented by European leaders. This paved the way towards gradual economic recovery, which got under way during the second quarter of 2013. The situation continued to improve in 2014, even if the pace of economic recovery remained very moderate. Thus, increased investor protection and low interest rates pushed investors to allocate more resources to investment funds in order reach return goals. According to EFAMA (2015), total AuM in Europe increased by approximately 15% in 2014 to reach an all-time high of EUR 19 trillion. This represents an impressive compound annual growth rate (CAGR) of 9.7% since the financial crisis of 2008/2009.



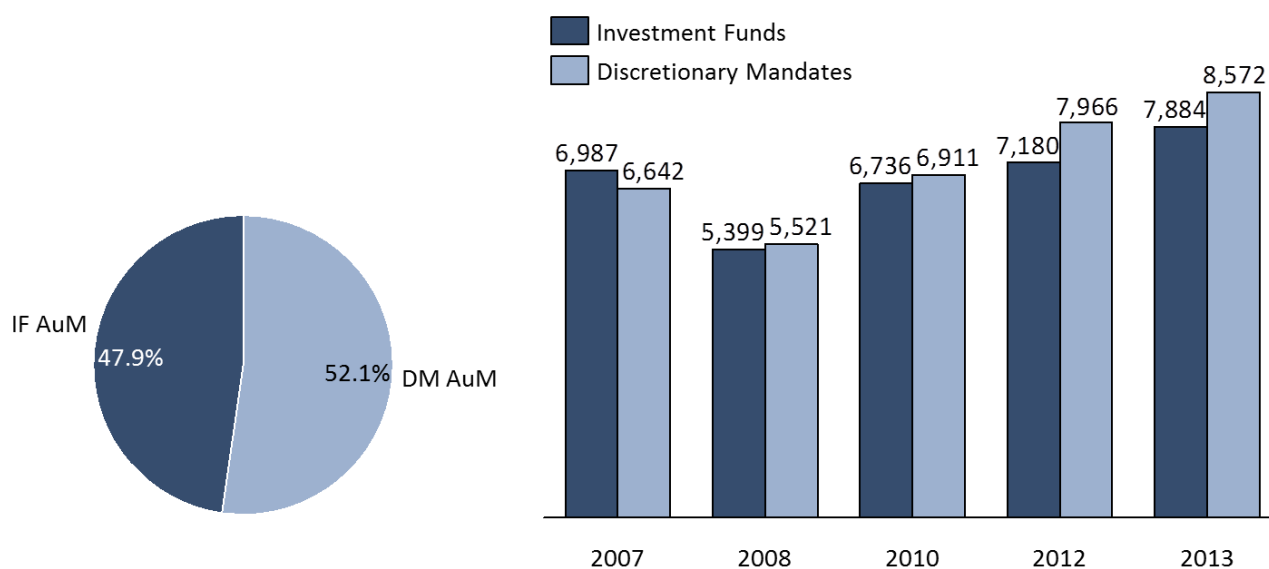
**Figure 3 European AuM (in €tn)**  
**Source: EFAMA, author's own illustration**

The main players in this industry are the UK, France, and Germany, with market shares in terms of AuM in 2013 of 37%, 20%, and 10% respectively. Further, in 2013, all countries registered growth in AuM, although the growth varied significantly across countries. The UK registered a healthy growth of 13%, and countries such as Hungary, Turkey and even Greece showed growth in the 13-20% range. This could be explained by the fact that, as already mentioned above, investors are looking for assets generating higher returns in our current low interest rates environment. As concerns the split between European discretionary mandates and retail investment funds, both have been growing in past post-crisis years and have surpassed end 2007 levels. Thus, discretionary mandates represented almost EUR 9 trillion or just over 52% of total

AuM at the end of 2013. Conversely, AuM in investment funds stood just under 48% and amounted to almost EUR 8 trillion (see Figure 4). On a country basis, major differences can be observed. Thus, for instance, the share of AuM in Netherlands, Portugal, and Italy managed discretionarily is between 85% and 70%, whereas in Germany, Turkey, and Romania, the share is only between 18% and 0%. It is further interesting to observe that assets under discretionary mandates have outgrown assets in investment funds since the 2008 crisis. This can be explained by the fact that discretionary mandates tend to be more risk averse than investment funds as they invest a higher proportion of assets into fixed-income securities than investment funds. They also depend primarily on the institutional client segment of the market, which has grown at a faster pace than the retail market over the past five years. It will be interesting to observe the evolution of this split as investment funds for retail clients are becoming increasingly investor-friendly, benefiting from increased protection and availability of information. This will indirectly be discussed later in this paper.

At this point it is interesting to mention what are believed to be the most critical success factors for asset managers and how this might change in the next years. Even though it is difficult to rank them as investors will have different preferences and requirements, the most notable selection criteria are fees, brand name, reach of the fund, and of course performance. This paper will not explain in details what the competitive factors in this industry are, but it is worth to give a brief overview of some ideas. Fees are of course a critical factor and vary greatly between types of fund and also between funds in a same segment. Differences in fees also depend, in turn, on the reputation of the fund manager, the reach of the fund, and the internal (organizational) structure of the fund. Some argue that the size of a fund also plays a role as a large one typically enjoys more economies of scale, and thus is able to transfer some of the resulting savings to investors in the form of lower management fees. Typically, in the private equity industry for instance, annual management fees, as compensation for investment management services rendered and irrespective of the distribution to be made to the shareholders, are between 1% and 2% of the committed capital (CACEIS, 2010). In recent years, one could observe a trend that fees are decreasing as some funds are getting larger and larger, and thus as mentioned above, enjoy more economies of scale. Second, brand name, as in any other industry, plays an important role as well. Particularly retail investors, with presumably less expertise in a specific segment would tend to go for a more famous brand as it is often associated with trustworthiness. For

institutional investors, however, it is of course less relevant as they have better access to information and are able to choose adequate funds irrespective of the brand name. Another key competitive factor is the reach of the fund. Thus, especially nowadays, investors are increasingly looking for high diversification potential, not only in asset classes, but also geographically. Therefore, funds with global reach or fund managers with a broader spectrum of funds covering many asset classes and geographies might have advantages. Last but not least, performance is always an important and obvious factor. Thus, even though past results are not always a good indicator for future results, actual returns on investment, internal rate of returns and the likes are important measures that investors look at when selecting funds. One important factor that was not mentioned until now, which as we will see later in this paper might change somehow the critical success factors of the asset management industry, is compliance to a broad set of new regulations that have seen the daylight in the last years.



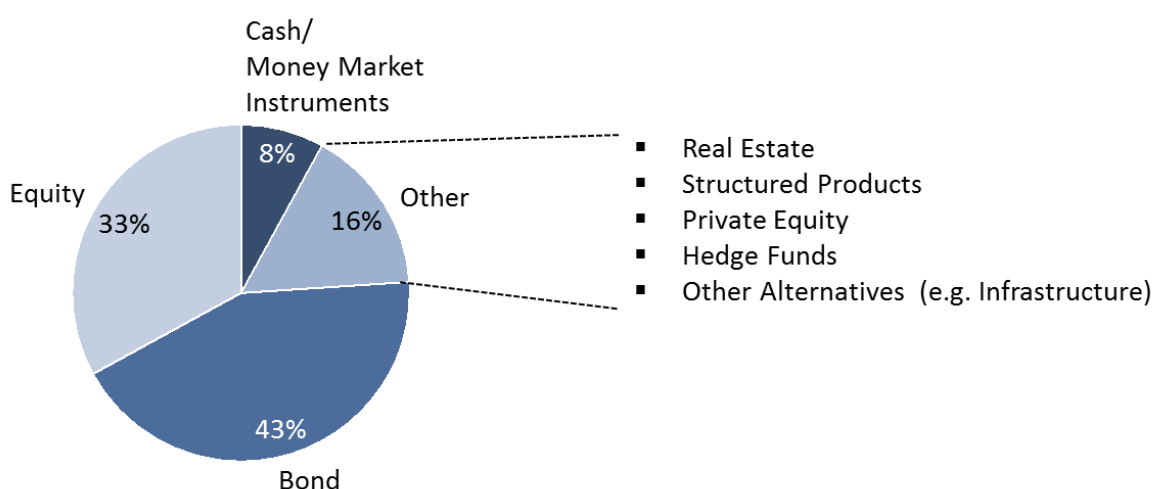
**Figure 4 Discretionary Mandates vs. Investment Funds and Evolution of the two (in €bn and as of 2013)**

Source: EFAMA, author's own illustration



## 2.2.1 Asset Allocation

Depending on the type of clients and their respective preferences in terms of risk level, time horizon and outcome target, the asset management industry can adjust the proposed asset allocation to meet the expectations of its diverse range of clients. This has as a goal an optimal diversification, which occurs through investing in different economic sectors, geographies, and asset classes. If we have a look at Figure 5, we can see that fixed-income assets or in other words bonds represent the main asset class.

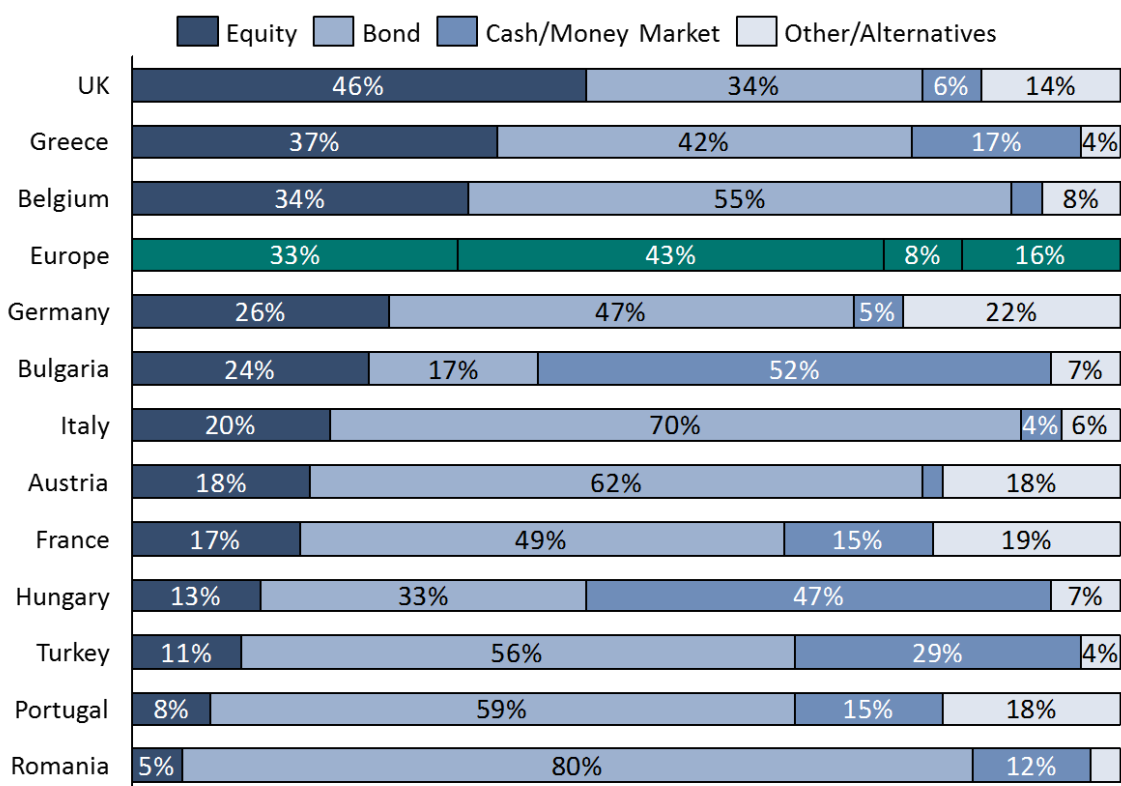


**Figure 5 Asset Allocation and Other Assets (End 2013)**  
 Source: EFAMA, author's own illustration

Concerning the evolution of the different asset classes, allocation to bonds increased during and after the crisis, benefitting from extreme levels of risk aversion on financial markets. Thus, it grew from 40% to 46% in the period 2007-2013Q2, but declined to 43% by the end of 2013 after the Federal Reserve in May 2013 announced that it might reduce the size of its bond-buying programme known as quantitative easing, and thus led to substantial turmoil in the markets and slowed down considerably the demand for bond funds. In parallel, the improvement in economic conditions, combined with rising stock markets (most main market indexes standing currently at record highs), increased the attractiveness of equity funds, triggering a rebalancing of asset managers' asset allocation towards equity. However, one can observe that this phenomenon applies more to "retail" investment funds than to discretionary mandates, the latter having historically been rather focused on bonds. Different causes can explain the de-equitization in this

segment, including the growing maturity of pension liabilities due to population ageing and changes in regulatory and accounting rules encouraging institutional investors to avoid volatile assets. Further, the share of money market instruments has steadily declined since 2008, as the low interest rate environment made this product type less attractive. Other assets or mainly alternative assets share of total assets on the other hand, stood at 16% in 2013, a 6% increase when compared with 2010. In fact, investors increasingly search for risk-adjusted returns that are uncorrelated to the market, and, in a high-liquidity environment, tend to invest more in long-term, locked assets that ultimately deliver higher returns than traditional assets, such as private equity for instance.

After having seen the European average asset allocation, it is important to mention that substantial differences exist between EU countries. In fact, having a look at investment behaviour of different countries will allow for better understanding of the dynamics and implications of AIFMD later in the analysis part of this paper.



**Figure 6 Asset Allocation by Country (End 2013)**  
Source: EFAMA, author's own illustration

Looking at Figure 6 on the previous page provides interesting insights on allocation tactics in different European countries. According to the data, the UK allocates a considerable portion of its total assets to equities (46%), which can be attributed to a long established culture of equity investing in the Anglo-Saxon world. The equity exposure in other large markets, such as in France (17%), Germany (26%), and Italy (20%) for instance, remain significantly lower. Conversely, asset managers from Italy, Belgium, Romania, and Austria for instance seem to allocate a big chunk of their portfolio to fixed-income instruments, reflecting different cultures and needs from investors. Also, Germany, France, UK, Austria, and Portugal seem to represent important markets concerning alternative investments in terms of % of total assets. This is relatively true for absolute values as well, especially for the UK, Germany, and France. Thus, as we will see later in this paper, these three countries have influential roles in the European investment fund industry.

### **2.3. The Role of Governments and Regulators**

According to Tanzi (2011), there is no more fundamental question in economics than what role the governments should play in a country's economy. In other words, the search for the optimal economic role of the state is difficult but crucial, and it cannot be assumed that the current role is necessarily optimal. Thus, that role may have been promoted by events that required state interventions no longer considered necessary or even by mistake (Tanzi, 2011). Similarly, it cannot be assumed that the role of the state in the past would be optimal today because the economy and the society may have changed, requiring different interventions. It must be seen as an evolutionary role that adjusts to the changing ecology of the market, and, at the same time, influence that ecology (Tanzi, 2011). It is often argued that the guiding principle that should justify state intervention in the economy should be market failure (Tanzi, 2011). Thus, when markets fail or are expected to fail, the state must intervene. This clearly makes sense as the modern state is responsible to protect the weakest (economic actors) and avoid any collapse or major damage to its economy. The difficult part, though, is to find the right cost-benefit balance. In other words, what are the advantages of additional regulation versus the marginal costs on economic actors and markets in general? In fact, too many additional costs (in form of

regulations) would result in lost competitiveness of the economy on the one hand, but too few could lead to an economic collapse on the other, resulting in turn in significant costs for governments and society as a whole. If markets worked perfectly, there would be no need for an economic role for the state, beside of course its important political and social functions for which it would need some financial resources (Tanzi, 2011). As the markets are far from being efficient, regulations are of course in place, but are unfortunately not always effective. Thus, the absences of global and efficient regulations over this global financial activity and of regulatory institutions are thought to have significantly contributed to the crisis of 2008-2009. This is especially true in our increasingly interconnected world, in which spill overs across countries are becoming more important and visible at all time. According to Tanzi (2011), some economists have referred to it as casino capitalism, fueled by international speculation, herd instincts, contagion, and pressure to conform and generate competitive short-run profits. O'Brien (2012) also argues that apparent success was measured by short-term objective efficiency criteria (e.g. lower transaction costs, expansion of corporate profits, increased shareholder returns for instance), and that potential negative externalities or risks such as excessive leverage, inflating asset bubbles, or deteriorating quality of balance sheets were self-consciously ignored. In fact, the focus on short-term gains is an important point that we are going to discuss more in detail when talking about certain provisions of AIFMD. Tanzi (2011) also argues that there is clearly a large misallocation of regulations in most countries and that some participants in the financial market that had strong political power had been able to prevent the introduction of needed regulations in their activities. Thus, George Stigler (1975), a Nobel Prize winner in Economics who focused most of his work on regulations, believed that the regulators are often captured by the regulated and that the regulations rarely or never make a market more efficient. A significant problem according to them and many others is that governmental interventions to deal with all these well-identified failures, such as the global financial crisis, require an apolitical state. And as we all know, this is unfortunately non-existing. Further, Tanzi (2011) argues that as financial stability is a clear example of an important global public good, governments should concentrate their activity on prevention, much more than ex-post repair or correction. Similarly, O'Brien (2012) states that in order to reform regulation agenda by adding the normative criteria of permissibility, responsibility, and legitimacy, which will be explained more in detail in the next chapter, a more interventionist role for the state should be implied. According to him, and in line

with Tanzi's (2011) thoughts on prevention, extending responsibility and accountability to those involved in financial product design rather than clarifying the enabling conditions that govern marketing and sale would constitute a drastic shift in the structure of the financial services industry. Further, regulators should also focus on creating ongoing dialogues with professionals that should be linked to definable agreed objective and measurable outcomes (O'Brien, 2012). In other words, it is crucial for governments to emphasize and possibly change business ethics rather than adding rules, which are too easily transacted around. Of course, as we will see later, the interference of politics and lobbying makes it difficult. We will see later to what extent these ideas have been taken into account in the development of the AIFM Directive.

When talking about increased interventions from the state in the form of additional regulation, other important questions arise – what are the costs of regulation and what are the unintended consequences on target and related sectors? According to Littrell and Thompson (1997), costs of government regulation cannot satisfactorily be estimated, let alone its benefits. They argue that most countries perform regulatory cost-benefit analyses, but that they revealed themselves to be flawed and inaccurate. One of the reasons is simply the fact that costs tend to be underestimated and numbers used for costs as well as for benefits are most of time unreliable (Littrell and Thompson, 1997). In fact, regulators, market actors, and associations for instance might have different views and diverging estimates concerning additional costs and benefits of new regulation. Littrell and Thompson (1997) suggest a two-step model in order to better forecast costs. The first step is to accurately measure cost of completed projects. For instance, in the context of AIFMD, European regulators might have tried to measure cost of similar laws already implemented in the fund industry, in particular the UCITS law, in order to forecast the costs of the new Alternative Directive. Step two involves using measured costs to specify and refine regulatory should-cost models. Further, Littrell and Thompson (1997) suggest that cost measurement is an accounting problem. Quarles (1995) takes it further and argues that the utilization of a cost-accounting technique known as activity-based costing is the best way to find out how much regulations actually costs at corporate level. However, many studies confirm the weakness of existing accounting systems for purposes of measuring regulatory expense (Littrell and Thompson, 1997). According to them, existing systems tend to focus mainly on direct labor costs, but tend to forget transaction costs that arise out of the regulatory process. This can be easily illustrated in the case of AIFMD for instance – additional overhead costs required by the

directive are easily quantifiable, but what about opportunity costs? In the chapter 4 of this paper, we will discuss cost issues of AIFMD more in details.

Concerning unintended consequences of regulatory oversight and control, Militello (2014) wrote an interesting article published in Ernst & Young's Global Financial Service Institute. According to him, regulators are largely problem solvers who seek intended consequences. However, observations demonstrate that regulatory intentions and outcomes frequently do not coincide as financial managers, the targets of new regulations, face increased regulatory induced business dilemmas and are forced to rethink their strategy (Militello, 2014). In other words, unintended consequences are the results of how these dilemmas are managed from an industry, organizational, and professional perspective. Thus, in every industry, additional regulation will spur strategic thinking on how 1) to avoid it or 2) to cope with it in the best possible way. Militello (2014) mentions as one unintended consequence an increasing interconnectivity of financial organizations. Thus, regulation brings actors closer as new services, new types of businesses, new partnerships are created in order to cope with regulation. This in turn can logically lead to an increased systemic risk and self-perpetuating regulatory reach. He calls it the paradox of regulation. In chapter 4, the paper will further discuss this topic.

## **2.4. History of Regulation and Roots of AIFMD**

This section of the paper will focus on the regulatory environment of investment funds in general, how it is formed, and how oversight and control functions are performed. It will first focus on the period right before and after the crisis until today, and further describe generic theory on financial regulation with a focus on investment funds. This will be useful in order to understand the regulatory implications of the crisis, and later in this paper, what are the roots and consequences of AIFMD.

The changes in financial market regulation motivated by the financial crisis of 2007/2008 are part of a long historical process. Thus, since World War II, the globalizations of financial markets and financial crises in different parts of the world have repeatedly led to institutional change in financial market regulation (Mayntz, 2012). Thus, she argued that two parallel

developments took place starting in the late 1970s. On the one hand, she argues that regulation and supervision were strengthened and tended to become integrated, and standards claiming compliance internationally were developed. On the other hand, however, in the financial markets, both market actors and transactions were increasingly deregulated (Mayntz, 2012). As a result, liberalized financial markets continued to change without commensurate changes in the regulatory framework, creating a regulatory gap which became manifest in the 2007/2008 crisis. Concretely, banks had not been required to retain on their books part of certain securities they issued, hedge funds and private equity firms were not required to comply with capital standards of Basel II, and the market saw the rise of asset backed securities and credit default swaps to name just a few of the regulatory gaps and events that permitted the financial markets to become bloated with toxic assets (Mayntz, 2012). Further, innovation in this sector was mainly driven by the motivation of avoiding compliance with existing rules – a prominent example for this is the creation of SPVs by banks and investment firms. In other words, the crisis is seen as being an aggregate of many events that took place in past decades.

The crisis triggered dramatic changes in the overall financial market governance structure. In fact, the most obvious effect has been a shift away from private self-regulation towards public or direct regulation. The immediate reaction to the crisis was crisis management at national, European, and international levels in order to prevent the meltdown of the existing financial system and major disruption of the real economy. It also paved the way for reforms as leaders started to realize that changes in the governance of financial markets should be introduced (Mayntz, 2012). Thus, as Mayntz (2012) would argue, the process on all political levels switched from the previous “low politics” to “high politics”. Reform demands prepared, among others, by the Stiglitz commission were comprehensive and directed at the financial system as a whole. Institutions such as the G20, which was formerly a low-key body of central bank governance and finance ministers, became increasingly important and played a crucial role in the post-crisis international economic cooperation (Mayntz, 2012). Further, reform agenda moved from compensation schemes for bankers, capital reserves that banks are obliged to hold, and behaviour of rating agencies to more difficult topics, such as ways to reduce the moral hazard posed by systematically important banks that were “too big to fail” (Mayntz, 2012). In general, one could say that what formerly appeared to be technical issues to be dealt with by experts were transformed into a publicly observed process of high-level policymaking. Thus, according to

Acharya, Cooley, Richardson, and Walter (2010), financial intermediaries and the structure of the financial architecture cannot be allowed to impose politically unacceptable costs on society, either by failing individuals deemed worthy of protection in financial matters, or by permitting firm-level failure to contaminate other financial institutions and, ultimately, the system as a whole. In other words, protecting the financial system from misconduct and instability is fundamentally in the public interest, and thus explains the sudden increased involvement of politicians in the aftermath of the crisis. Of course, the latter are inevitably facing difficult policy trade-offs between financial efficiency and innovation on the one hand, and institutional and systemic safety and stability on the other (Acharya and all. 2010). Measures that assure greater financial robustness may make financial intermediation less efficient or innovative for instance. Similarly, efforts to promote financial innovation may erode transparency, safety, and soundness. Competitive pressure among financial centres may also trigger a race to the bottom in terms of systemic robustness to internal and external shocks (Acharya and all. 2010). All this to make clear that choosing the adequate policy is difficult and never short of conflicts. We know that excessive regulation involves costs, but cannot quantify them properly, and we know that underregulation or laxness can unleash disaster, which can only be retrospectively observed. So optimal regulation is the art of balancing the immeasurable against the unknowable (Acharya and all. 2010). According to what the paper just mentioned, it is not surprising that financial literature in general considers financial crisis as a recurrent phenomenon.

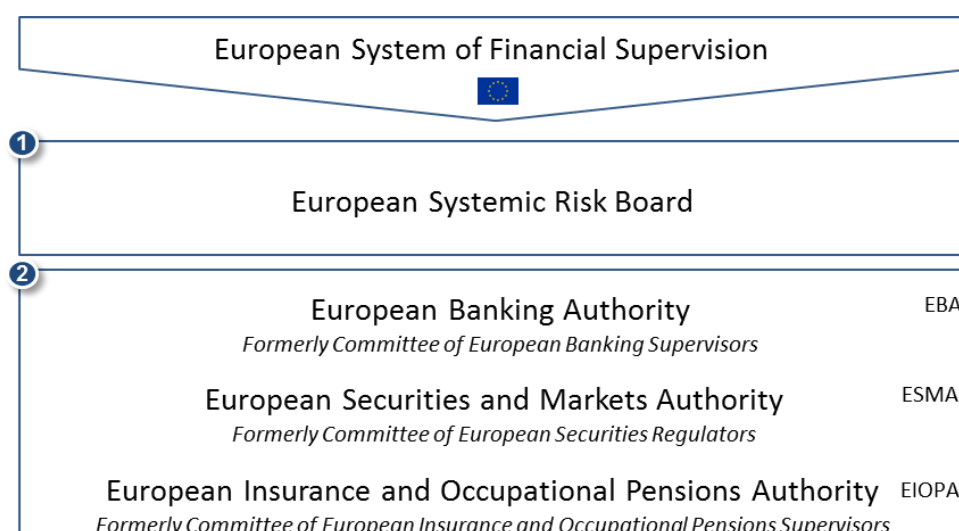
Although the worst of the financial crisis has passed, the defects of the dominant institutions remain, and continue to pose grave risks to future financial stability (Acharya and all. 2010). Thus, the same authors (2010) argue that a new regulatory architecture, based on four aspects; (1) encourage innovation and efficiency, (2) provide transparency, (3) ensure safety and soundness, and (4) promote competitiveness in global markets, has become inevitable and it is crucial to understand how it will perform. Regulatory architecture is critical to resource allocation and economic growth. In fact, economies with inefficient financial systems demonstrably waste more economic resources and grow more slowly than otherwise comparable economies with efficient capital systems. Good financial architecture has to be robust to shocks that emanate from the financial system and the real economy, both domestically and internationally (Acharya and all. 2010). According to O'Brien (2012), however, the root cause of the crisis was basically vested in a lack of ethics and moral principles. He argues (2012) that



unless accompanied by effective mechanisms to integrate ethics and accountability in regulatory design, reform is likely to fail because the belief system that facilitated the crisis remains resilient. Interestingly, and conversely to other authors cited in this paper, O'Brien (2012) considers efficiency criteria alone as insufficient bulwark for authority and legitimacy. Thus, the regulatory reform agenda should not only address solely efficiency (i.e. lower transaction costs), but should also apply three additional distinct but overlapping criteria. First, permissibility or the question whether a particular product can be sold, and if so, to whom and on what basis? Second, responsibility or who carries the risk if the investment sours and on what terms? Lastly, legitimacy or does the product serve a legitimate purpose and who should determine it? If we compare O'Brien's idea (2012) with the proposed regulatory architecture of Acharya and all. (2010) one can distinguish significant differences on what the focus should be. Although a common point would be the need for increasing transparency. In fact, O'Brien (2012) argues that deficiencies in shared commitments to rules, principles or norms were particularly apparent in the design, marketing, sale and regulation of complex financial products, which in turn demonstrated the limits of disclosure. In other words, he believes that professional and/or sophisticated investors trading as individual or institutional investors were aware of the risks, but transacted around as the search for yield trumped reason. Stein (2011) would go so far and explain this fact as resulting from a culture of mania, in which denial, omnipotence, triumphalism and over-activity prompt individuals to take on extreme risks. This rather psychoanalytical view of the reasons behind the crisis is helpful to understand the rationale behind human actions that led to the crisis, but are out of scope of this paper. So what has been initiated so far?

According to Mayntz (2012), governance structures have changed most at the national and least at the international level. Thus, at the international level there were changes in the mandate, composition, and weight of some agencies in the overall process of regulation. For instance, the former Financial Stability Forum, a group consisting of major national financial authorities such as finance ministries, central bankers, and international financial bodies, changed into the Financial Stability Board, and additional resources were given to the IMF. In other words, some institutions were renamed and/or were given additional tasks for the future, but no new agencies were created at the international level, nor were these existing bodies given the competence to make binding decisions for lower level jurisdiction and market actors. International bodies are

still restricted to monitoring, recommending, and trying to coordinate (Mayntz, 2012). More substantial change took place at the level of the European Union, where a new agency, the European Systemic Risk Board, was created and where the three previously existing committees that were supposed to coordinate national supervisors were transformed into European supervisory agencies with greater power. In fact, these agencies have some decisions-making power and the competence to intervene, under certain conditions, in areas hitherto under exclusive national jurisdiction (Quaglia, 2012) (see Figure 7). The most relevant European agency for the sake of this paper will be ESMA, which amongst others oversees the European asset management sector. Thus, as we will see later EMSA is the main regulator dealing with the AIFM Directive.



**Figure 7 European Regulatory Agencies**  
**Source: European Commission, author's own illustration**

The European Commission and these new agencies with their greater power did not wait long until making use of their new structure and responsibilities. In fact, between 2007 and today, more than 30 new regulatory reforms (AIFMD included) saw the daylight, and 5 have been proposed by the Commission and are currently being reviewed (European Commission, 2015). This represents an impressive regulatory performance, and the trend is growing. Among these implemented regulations, one can find many game-changing laws such as EMIR (derivatives), CRD III (remuneration and prudential requirements for banks), MiFID (securities markets),

MAD (market abuse), and of course AIFMD. Thus, the next paragraphs will focus on the development of alternative fund regulation and on how the AIFM Directive came to life.

Concerning alternative investment fund regulation, it is important to emphasize the role of hedge funds. In fact, these funds were the primary target of politicians in the aftermath of the crisis as, even though some argue that they are providers of liquidity (Aragon & Strahan, 2010), they were generally considered to be highly leveraged, and thus posing serious threat to systemic stability. Prior to the financial crisis, two different approaches in terms of policy discussions existed concerning the regulation of hedge funds: one in favour of regulations, sponsored by Germany and France, and one resisting regulation, championed by the US and the UK (Woll, 2012). It is during the preparation of the G20 summit in April 2009 that the split over how to regulate hedge funds and other alternative investment funds re-surfaced. Several countries, led by France and Germany with the support of Italy, pushed for a tougher regulatory regime and wanted the funds to be overseen similarly to banks (Woll, 2012). Thus, they argued that Europe should play an instrumental role in shaping global regulatory regime. By contrast, the US and the UK, known for their financial laissez-faire tradition, favoured more disclosure over more regulation. The G20 summit that year resulted in the agreement that additional regulation and oversight to systematically important hedge funds and other alternative funds would be implemented. Two months later, in June 2009, the European Commission presented its first draft Directive of AIFM. As we will see in more details later in this paper, this directive intended to include a broad range of financial entities, mainly private equity funds, hedge funds, and real estate funds. During the second semester of 2009, and under the Swedish presidency of the EU, the draft directive was partly revised, due mainly to intense lobbying from the US and the UK. Sweden, having a relatively important private equity industry as well, was seen as also having a vested interest in the revision of the Directive (Woll, 2012). At that time, European Commission President Jose Manuel Barroso also faced re-election, and France and Germany jumped on the occasion and indicated that progress on a hedge funds directive was important in order to obtain their support (Woll, 2012). Eventually, after highly politicized members states negotiation rounds that lasted for 18 months, and that pitted most notably France against the UK, an agreement between the Council of Ministers and the European Parliament was reached in late October 2010, and the directive was due to enter into force in July 2013.

This new regulation, among others, was seen by the some countries (e.g. Luxembourg, Ireland, UK, and the Nordics) as over-prescriptive and costly to implement, creating potential regulatory arbitrage vis-à-vis countries outside the EU. Also, since even the Commission's original proposal acknowledged that hedge funds were not responsible for the financial crisis, the battle seemed to represent rather an ideological commitment to supranational regulation on the one hand (cf. France), and national autonomy and a continued lack of intervention on the other (cf. UK) (Woll, 2012). In fact, numerous industry experts were wondering if AIFMD did not simply arise from mere opportunism, from politicians exploiting the momentum of the financial crisis, and the general delicate image of the financial sector, to drive a pro-regulatory agenda. This represents a very interesting point as never before in the European Union politicians were so involved in the development of financial regulation. In other words, AIFMD was one of the most-disputed post-crisis regulations, which really showed political confrontations between France and the UK. Thus, as Woll (2012) describes it - understanding the stakes and the evolution of the regulatory efforts requires a study of the interests and coalitions within the EU that led to the current regulatory framework.

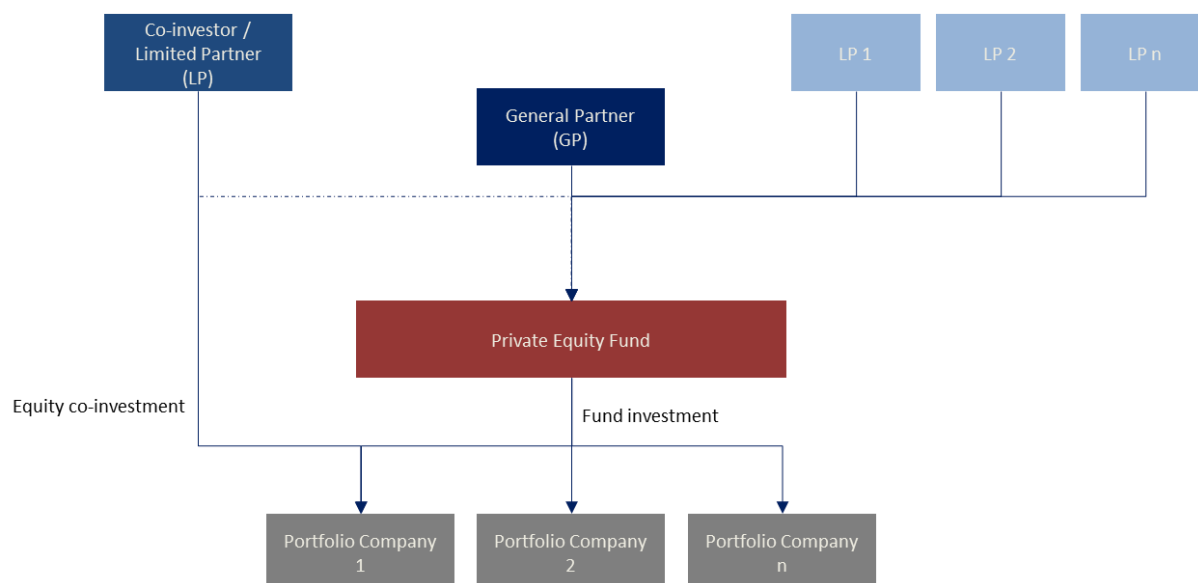
All in all, AIMFD not only represents an issue to the hedge fund industry, but also for all non-UCITS investment funds. Thus, one of the most central and most controversial decisions of the initial proposal was to address hedge funds through a directive that covers all investment funds that were previously left outside the realm of EU legislation. In other words, AIFMD is a negative definition of the Law. This will be explained further in part 3 of this paper. The key takeaway at this point is that this new regulation was a cold shower for the private equity industry as they were never considered as primary target and because they had done their utmost to insist on being exempted from investment regulation, fact that characterized their success in the past.

## **2.5. Private Equity Regulation**

In general, the private equity industry has often been subject to debate. Some people see the business as fundamental to the growth of an economy, as it generates jobs for workers and taxes for the government, and others see private equity firms and other involved parties as greedy institutions whose only goal is to benefit themselves and strip companies of their assets (Heed, 2010). One thing is sure, the private equity sector has been significantly growing since the mid-1970s when it became a separate (alternative) asset class. Further, private equity firms play an important role in merger and acquisition activity when the goal is to transform under-performing companies to capital-efficient and profit-generating companies (Heed, 2010). In other words, private equity investments are important for an efficient capital allocation on the markets. They provide intermediation between sources of funds and private companies seeking risk capital (Fleming, 2010). The rapid growth of this industry has been fueled by the strong development of financial markets around the globe, but especially in developed markets such as the U.S. or in Europe. Thus, financial innovations, development of stock markets, a large development of pension funds systems, pension funds being a major type of (institutional) investor in private equity funds, and other factors such as new rules and standards of management like shareholder value, all directly or indirectly contributed to the private equity sector's growth (Bedu & Montalban, 2013).

### **2.5.1 Private Equity Funds**

The definition and purpose of private equity having been already explained in the previous section, this part will focus on the structure of such funds. First, it is interesting to mention that there are different types of private equity funds. Thus, one can distinguish funds that invest in early-stage companies, or so-called venture capital funds, expansion stage, and later stage in management buyouts and buyins (Wright & Robbie, 1998). Figure 8 will provide a better understanding of how these funds are structured.



**Figure 8 Private Equity Fund Structure**  
Source: Author

The main actors identifiable on the graph above are the General Partner, the Limited Partners, the Co-Investor, the fund itself, and the portfolio companies. The General Partner, commonly referred to as GP is the private equity firm/manager. GPs are responsible for setting up the fund, finding capital, managing and monitoring investments, and liaising with investors, regulators, and third parties. In addition, GPs are required by Limited Partners (LPs) to invest their own money in the fund in order to show that they believe in their strategy, thus reducing conflicts of interest and risk for investors. This commitment will be in aggregate between 1% and 5% of the fund (Gilligan & Wright, 2008). Concerning the remuneration of GPs, two main sources exist – management fees and carried interest. During the investment phase, management fee will typically be 1.5%-2% of the committed fund size, and will gradually decline during the post-investment phase when it is more about monitoring the performance of the fund. Further, the bigger the fund, the larger the management fee (albeit at a lower percentage than for smaller funds) and the more funds under management the greater the fee income (Gilligan & Wright, 2008). Originally, the management fee was intended to pay for the operating costs of employing staff and other expenses associated with the fund manager’s business. It is also important that fund managers find the right balance concerning the use of fee income, between reinvesting in growing the personnel, infrastructure and assets of the business, and recruiting and retaining the best employees and partners by offering competitive remuneration. The second and most

important GP revenue stream is the carried interest. The share of capital profits is shared among the fund managers and their staff according to whatever arrangements they have agreed among themselves and with their limited partners (Gilligan & Wright, 2008). These arrangements regarding the distribution of capital profits are commonly referred to as the waterfall. In fact, the share of profits for the private equity firm is the residual profits after deduction of several payments to LPs from the net positive cash flows obtained. Thus, when portfolio investments are sold, the fund will normally return to the LPs 100% of their contributed capital. In addition, a so-called hurdle rate exists. This preferred return is the Internal Rate of Return (IRR). For example, a hurdle rate of 8% (8%-10% being considered as standard) means that the fund must achieve a minimum IRR of 8% before receiving an interest in the proceeds of the fund (CACEIS, 2010). This gives the fund manager the incentive to achieve returns higher than the hurdle, and in turn reduces the impact of poor performance on the return on investment for LPs. After the capital contribution and the hurdle rate are received by the LPs, the next and last distribution made by the fund manager is typically allocated between the GP and the LPs (CACEIS, 2010). Industry standards are talking about an 80/20 split, meaning that 80% are distributed to LPs and the residual 20% go to the GP. There are also differences between the European and the US waterfall model, but this will not be discussed in this paper.

Investors, or so-called LPs as mentioned above, are the ones providing the majority of capital to a private equity fund. Their main motivation to invest in this asset class is often to diversify their portfolio, and so spread their risk, and generate higher returns. Thus, Neerza & Tripathi (2014) argue that institutional investors invest in private equity for financial reasons because it yield higher risk adjusted returns as compared to other alternatives and there exist a greater scope for diversification. LPs are in most cases institutional investors or at least well-informed investors as alternative funds such as private equity represent complex investments with significant risk. Thus, typical investors are pension funds, banks, insurance companies, corporates, governments, HNWI, and even sometimes academic institutions (e.g. endowment funds). Their remuneration is composed of dividends, interest and capital gains as already explained in the previous paragraph. Further, once the so-called subscription agreement is signed, the investor irrevocably commits himself to invest substantial amount of money, called on in partial payments during the first few years of the fund's life cycle, into the chosen private equity fund (Gilligan & Wright, 2008). This represents capital calls made by the GP of the fund.

Alternatively, a LP can also be a co-investor of the GP. In fact, it can co-invest directly into a target company, taking a minority ownership in the latter. Of course, the co-investor might at the same time be a regular investor in the private equity fund. Similarly, on a GP level, private equity firms may invest in enterprises in a syndicate with other private equity firms. Syndicates are a form of interfirm alliance in which two or more private equity firms co-invest in an investee firm and share a joint pay-off (Lerner, 2004). This has happened relatively often in recent years as private equity houses tend to be increasingly involved in bigger deals, acquiring companies with high valuations. Other common factors are risk sharing and access to deal flow (Lockett, Meulemann & Wright, 2009).

Further, there is the private equity fund itself. The fund is the collective investment vehicle through which GPs make their investment in a portfolio of target companies. These structures can be set up under different legal forms and often benefit from attractive tax treatments. According to Gilligan & Wright (2008), private equity funds will be structured to achieve a balance between maximum tax efficiency to the investors and the managers, managing regulatory costs and benefits, controlling and managing potential liabilities to the investors and the managers, and maintain confidentiality regarding its partners and investors. Private equity funds typically have a finite lifetime of around ten years. However, exceptions exist such as so-called evergreen funds, which have investors with rolling annual commitments. For simplicity, these funds will not be discussed here. Finally, the fund itself takes majority position in the target companies it invests in.

Before ending this section it is important to mention that Figure 8 describes a simplified version of a private equity structure, which appears to be more complex in reality. Thus, additional layers of complex investment vehicles, sometimes in different jurisdiction, are very common. However, the proposed structure is enough to understand the main actors and their interaction, which in turn is sufficient for the sake of this paper.



### 2.5.2. Characteristics and Risks

A main characteristic of private equity funds is the use of leverage. Thus, since the late 1980s, the use of leverage has accelerated, mainly as a result of low interest rates and innovative financial engineering, raising concerns about financial stability. In fact, according to Kohn et al (2008), the amount of leveraged loans and high yield bonds outstanding tripled between 1999 and 2007. Even though the use of leverage in buyout transaction for instance has been drastically reduced over the last years (GPs nowadays putting significantly more equity in transactions than in the past), recent events such as the sub-prime market crash in the U.S., the global credit crisis, and Madoff's Ponzi scheme, led to an increased scrutiny of all types of alternative funds from regulators, investors, and politicians. Thus, McCahery & Vermeulen (2010) argue that until then, the alternative asset sector successfully avoided this very scrutiny of regulators and lawmakers which arguably contributed to its success in attracting investors. Beside concerns arising from overleveraged transactions as mentioned above, potential costs to investors from insider trading and price fixing arising from "club deals" by mega funds capturing the largest amount of net capital flows also nourished the trend of increasing regulation of private equity funds and their managers (McCahery & Vermuelen, 2010). According to Heed (2010), risks associated with private equity activity can be split in two categories – external and internal risks. External risks come mainly from the fact that private equity-backed companies have less of a cushion to rely on in case of a rapid economic downturn such as a deep recession for instance. Thus, these portfolio companies are often highly leveraged, and a failure could severely impact the private equity fund at the top of the pyramid. Now, the failure of large private equity companies could negatively impact other fund managers' ability to raise new funds from debt investors, although the latter were still doing well (Heed, 2010). This, in turn, would affect existing and future investors, who could be concerned and thus incentivized to reduce their risk exposure. Further, he also identifies (2010) two additional triggers for external risks, all potentially leading to increased systemic risk, namely concentration of debt and refinancing needs. On the internal side, Heed (2010) identifies excessive leverage, asset stripping and tax treatment, conflicts of interest, and transparency as the main risks. The internal risk of excessive leverage is similar to the one explained above, with the difference that Heed (2010) illustrates two schools of thoughts. One is stating that high debt levels are beneficial to companies as they can take advantage of tax shields

and flexible financing options, and the other is arguing that leverage levels are increasingly close to the limits of prudence. Asset stripping and tax treatment are two other aspects that have often been discussed. Workers unions in many countries are worried that debt-finance means that jobs have to be cut to generate short-term returns and repay loans. In fact, Walker (2008) explains that private equity firms are often accused of asset stripping when they sell valuable corporate property, land and machinery or other assets that allow them to meet performance targets and cover their fees. A famous example of bad press provided by Teather & Treanor (2007) is when Permira, a leading European private equity fund acquired Birds Eye from Unilever. Permira pledged to keep workers' employment terms for at least three years, but had within five months closed down plants and cut nearly 500 jobs. On the other hand, Heed (2010) argues that there must be a levelling between corporate efficiency, profitability, and social responsibility. He also throws in the uncomfortable question: What is better – the badly performing private equity-backed company that sees its assets stripped off and people laid off in order to redress the situation or the badly performing company without backing that will eventually go bankrupt and where all employees will lose their jobs? As we can see, there is no black or white. Another criticism is the tax treatment of private equity firms' profit extraction (Heed, 2010). In fact, they use complex fee structures that allow them to bypass or minimize taxes on carried interest. Thus, the carried interest is upon the realisation of the investment taxed on a pass-through basis as long-term capital gains and the tax rate for long-term capital gains are less than income tax (Private Equity Council, 2009). Thus, critics argue that carried interest should be treated as income and not as capital gains. As concerns conflicts of interest, the main risks are agency costs or situations in which an employee or partner of the fund manager has a seat at the board of a company owned by the fund. Finally, a major issue in the private equity sector is the fact that there are no standardised methodologies for disclosure, valuation and performance reporting (Heed, 2010). Thus, private equity firms are under no legal obligation to make further market disclosures of their operations or interests in private portfolio companies other than general public company reporting requirements. This, in turn, results in little transparency and limited availability of comparable data, and on broader level may increase systemic risk (FSA, 2006).

As a next step, this paper will discuss the rationale and actual regulation of private equity managers and their funds.

### 2.5.3. The Regulation of Private Equity

According to McCahery & Vermeulen (2010), the private equity bonanza as well as the laissez-faire in the alternative asset sector has ended since the global crisis of 2007. As we will see at the end of this paper, private equity investments have today already reached pre-crisis levels, but the point that regulators and policymakers increased their scrutiny is a good one as we have seen the development of many new regulations in the asset management sector, with especially the emergence of AIFMD. A wide range of regulatory options, from industry self-regulation to governmental intervention, are being considered in order to lower the level of risk and to redress the balance between investors and private equity firms (McCahery & Vermeulen, 2010). They also argue (2010) that despite the absence of collapses in the buyout market, regulators, were, even before the downturn, considering a number of governmental measures designed to reduce the incidence of buyouts, including caps on leverage limits or limits on the levels of interest payments that are tax deductible. In other words, there is clearly a trend of increasing regulation. However, the optimal strategy depends on many factors and has always been hard to find.

According to McCahery & Vermeulen (2010), private equity funds are dominantly regulated by contract. These funds, which are predominantly formed as limited partnerships, limited liability partnerships or limited liability companies, are able to take advantage of various exemptions and exclusions explicitly provided within the regulatory framework, such as the avoidance of taxation at fund level because of the “pass-through” principle which passes on tax liabilities to investors or contractual flexibility that allows the managers and investors to enter into covenants and schemes that align their incentives and reduce agency costs (Lerner & Schoar, 2005). This contractual basis also has some drawbacks as the private equity industry must face the dilemma of identifying well-suited techniques to increase transparency and reduce the level of risk without substantially damaging the flexibility and the benefits of the business models that have prospered thanks to limited interventions when based on a contractual basis.

Overall, as the role of private equity is increasingly important in our modern economies, debates on whether more detailed regulation and supervision of funds is required, are still ongoing. Many believe that a hands-off approach might be warranted given the contractual mechanism that prevail in the governance of private equity. Moreover, McCahery & Vermeulen (2010) explain

that private equity funds are evolving into more transparent investment vehicles, pushed by two factors. First, institutional investors are demanding better risk management, which encourages private equity funds to adopt better valuation techniques and controls, and second an increasing number of fund managers are joining respectable industry bodies such as the British Venture Capital Association, the European Private Equity and Venture Capital Association, or the Private Equity Growth Capital Council for instance, in order to improve their reputation. Thus, membership in these institutions often requires increased transparency and the acceptance of best practices in the industry. Therefore, McCahery & Vermeulen (2010) argue that the contractual nature of private equity funds in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity industry are themselves capable of disciplining opportunistic behaviour by fund managers and advisors. This is an interesting point that will further be discussed when interpreting the results of different interviews performed for the sake of this paper. The two (2010) further examined three different kinds of regulations, namely self-regulation, co-regulation, and governmental regulation.

As already briefly touched in the previous paragraph, self-regulation remained for a long time the most important regulatory function. It is based on soft law principles, guidelines, and industry standards specifically tailored to the private equity industry, mainly propagated via international private equity associations or national industry bodies. These guidelines can be broad and provide a set of optional measures that focus on different operational aspects such as provisions enunciating the duties and responsibilities of different actors, guidelines providing greater transparency with for instance the development of timely reporting or the issuance of interim financial statements for investors for instance, and many others (McCahery & Vermeulen, 2010). These guidelines often become mandatory for members of such associations after a certain trial period. This means that the more private equity fund managers are members of such associations, the better it is for the industry in general. Also, once the critical mass is reached, it even becomes a disadvantage for fund managers not willing to adopt these practices in their dealings with investors and third parties. This is also a point that will be discussed in relation to the AIFM Directive. All in all, McCahery & Vermeulen (2010) argue that besides enhancing the likelihood of the adoption of good governance practices, optional industry guidelines can function as self-regulatory mechanism in response to increased political pressures for greater disclosure and transparency of fund capital structures and management practices. The

main advantage of this approach is considered being the flexibility and adaptability of the regulations.

Co-regulation on the other side is a combination of governmental and non-governmental regulatory actions that has the advantages of the predictability and legal certainty of legislation along with the flexibility and acceptance of self-regulation (McCahery & Vermeulen, 2010). They argue (2010) that this model's success depends not only on the flexibility of the techniques employed by the different parties, but also on the alignment of the regulatory benefits and the incentives of the parties engaged in the regulatory process. In theory, financial benefits themselves provide sufficient incentives, given the removal of regulatory barriers. Regulators have suggested that economic studies show that the respective benefits and costs of private equity funds are inconclusive producing little support for new legislation in the area (McCahery & Vermeulen, 2010). This is an interesting statement that will be discussed later in this paper. Thus, AIFMD has been largely pushed by politicians and not regulators themselves, providing interesting thoughts on whether such a major regulation was really needed. However, according to McCahery & Vermeulen (2010), there is also evidence that co-regulation has worked well in the case of best practice codes of corporate governance. In fact, advantages of having government-sponsored monitoring committees is to issue industry-wide compliance levels, which in turn would result in greater consistency in disclosure across funds for instance that would not only benefit institutional investors in meeting their fiduciary duties to their clients, but will inevitable facilitate funds in their capital raising efforts with investors. Similarly, it will reduce the risks of abuses concerning conflicts of interest and other practices for instance. A major challenge here is considered to be the ability of government regulators to understand the impact of their intervention, the scale of their target and its ultimate effectiveness on firms. As aforementioned, it is always difficult for regulators to assess the effectiveness of new regulations and especially to forecast potential unintended consequences that may arise. McCahery & Vermeulen (2010) emphasizes the importance of incentives to induce individual fund-level cooperation. Thus, in case of insufficient incentives, they would expect that some level of harmonization might be needed given the dispersion of private equity funds internationally, to obtain these regulatory goals. In general, some people in the industry believe that self-regulation measures and industry co-regulation might be more effective, given the complexity and range of activities pursued by private equity funds, than direct regulatory intervention.

However, according to McCahery & Vermeulen (2010), direct governmental intervention could be a useful strategy in some situations. In fact, as the development of efficient self-regulation measures and industry guidelines in leading countries where private equity funds have a significant presence is a relatively recent phenomenon, direct regulatory intervention could ensure the widest diffusion of new industry standards. As already mentioned earlier, private equity funds typically enjoy a relatively light regulatory oversight as they are largely outside the scope of existing regulatory regime in most jurisdictions. Consequently, many risks have been identified in past years as being potentially dangerous for systemic stability, especially after having seen the consequences of the global crisis a few years ago, demonstrating the impact of interconnectivity in the financial sector. Thus, governments have strong incentives to minimize typical risks inherent to the private equity industry such as excessive leverage, unclear ownership of economic risk, conflicts of interest, and market abuse. This paper will not go more in details as risks have already been discussed, but MacNeil (2008) provides an interesting table gathering the different market participants and respective risks (see Figure 9). In the next chapter we will discuss the AIFM Directive in depth, which illustrate the perfect example of a far-reaching direct regulatory response.

Participants	Risks			
	High	Medium	Medium Low	Low
PE Firms	Market abuse & Conflicts of interest	Excessive leverage		
Lenders	Market abuse			
Investors		Market access	Market opacity	Reduction in market efficiency
PE -owned Firms		Excessive leverage		

**Figure 9 Risk Assessment and Market Participants**

Source: MacNeil, author's own illustration

Further, to deal with the problems involving participants and transactions in the private equity market as discussed previously, McCahery & Vermeulen (2010) describe four legal tools:

Enhancing disclosure and fund reporting, enhancing market access, governance and investor protection, and taxation. First, enhancing disclosure and reporting requirements will provide significant benefits to investors and can be an effective tool in limiting abusive actions by fund managers. Especially the disclosure of management fees and carried interest is thought to be useful for investors to make more informed investment decisions. This leads us to the second point, enhancing market access. According to McCahery & Renneboog (2004), empirical research on venture capital and private equity shows that the quality of the legal environment is an important determinant in raising the supply of investment funds. In fact, since exiting is crucial for private equity funds, the creation of deep and vibrant securities market is considered important for the development of a liquid market for IPOs (McCahery & Vermeulen, 2010). A crucial point here is that some markets are characterized by a small number of dominant firms that limit or restrict access, largely to the detriment of retail investors. Therefore, regulators have good reasons to address this problem by facilitating more competition. Third, the tool of governance and investor protection. Examples of insider trading and market manipulation for instance have, in the past, led the market to suffer, triggering significant losses for investors and undermining the confidence in public markets. Therefore, regulators placed bans on these practices, revealing to be an effective tool to prevent specific forms of abusive harms. Karpoff, Lee & Martin (2008) describe the benefit of this type of action as two-fold. First, given the complexity of these transactions and the number of parties involved, the expenditure of resources to investigate these transactions tends to favour centralized oversight. Second, they argue (2009) that there is evidence that regulatory strategies that favour stiff sanctions will have a strong deterrence effect that offers support for more enforcement actions by securities regulators. Finally, there is the tool of taxation. Thus, this type of intervention focuses on the taxation of capital gains, withholding taxes, deductibility of interest payments, and of carried interest earned by the GPs of a fund. However, McCahery & Vermeulen (2010) argue that a favourable taxation regime is an important determinant to the development of a favourable private equity environment. Fiscal measure that are unattractive for both investors and fund managers will inevitably place serious stress on the vitality of this industry.

When discussing the AIFM Directive in the next section, it will be interesting to see if and how it touches these four proposed legal tools for private equity regulation.

### **3. THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE**

#### **3.1. Introduction**

As extensively seen in the previous part of this paper, AIFMD resulted as the EU's response to the global financial crisis and the general concern that alternative investment funds remained largely unregulated. AIFMD finds its roots in the well-established and notorious Undertakings in Collective Investments in Transferable Securities (UCITS) law, which was build up through a series of laws between 1988 and 2014 and is now a trusted brand worldwide. The main goal of the UCITS Directive is the protection of investors, thus aimed at providing individuals with a secure environment for fund investing. Therefore, the main provisions of this law, of which some were transplanted into the AIFMD are the following:

- Liquidity – funds must be open-ended and must generally invest in transferable securities or in other liquid assets, for instance in money-market instruments, bonds, shares and any other instruments offering the right to acquire these securities through subscription or exchange. Further, investors wishing to sell their holdings in a fund, whether because they believe the value may fall or for any other reason, can do so without delay. This is a crucial characteristic of UCITS.
- Diversification rules – funds must respect some diversification rules when investing in different asset classes. The most common restriction is the so-called 5/10/40 rule. This means that a maximum of 10% of a fund's net assets may be invested in securities from a single issuer, and that investments of more than 5% with a single issuer may not make up more than 40% of the whole portfolio. Of course, some exceptions exist but are considered out of scope of this paper.
- Key Investor Information Document (KIID) – funds must issue a document containing information on the general investment strategy, target asset classes, and risk profile for instance
- Cooperation between EU Member States – an important goal of the UCITS Directive was also to enhance the integration of the European fund market, and thus fuel cooperation between EU Member States



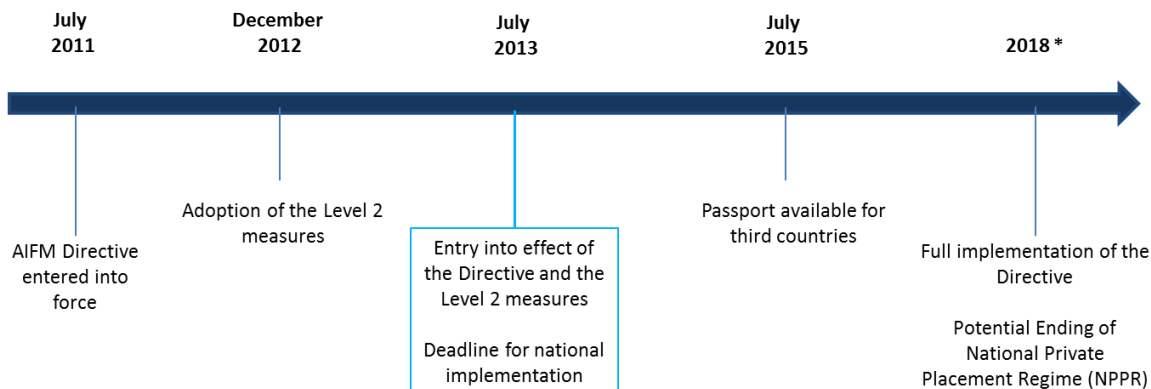
- Management Companies (ManCo) Passport – allowing management companies registered in one European Member States to distributed/market their funds in another EU country without significant effort.
- Separation of risk management and portfolio management – the two functions must be independent in order to minimize the possibility of conflicts of interest.

In fact, especially the provisions on cooperation between EU Member States, the Passport, and the separation of risk and portfolio management were transferred to AIFMD.

In this chapter, the Directive and its key components will be thoroughly explained and later put in relation with private equity activity. Before deep-diving into the Directive it is important to have a look at basic definitions. In other words, what are AIFs and AIFMs? According to article 4 (1) of the Directive, AIFs means collective investment undertakings, including investment compartments thereof, which:

- 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
- Do not qualify as a UCITS

The AIFM on the other hand, is the legal person appointed by or on behalf of the AIF to be responsible for providing portfolio management services and/or risk management services. In other words, the AIFM can be an external manager appointed by the AIF, the AIF itself or other service providers. It is also important to mention that there can only be one AIFM per AIF. As concerns the timeline of the Directive, Figure 10 is showing the main milestones of AIFMD's development. In July 2011, the Directive was first published in the EU Official Journal and thus entered into force. In December 2012, the implementing measures of the Directive, the so-called Level 2 measures, were adopted, and in July 2013 AIFMD officially entered into effect in the European Union and is from then on legally binding for EU Member States. In July 2015, third countries, which definition will be given in the marketing part of the AIFMD, will be able to apply to the AIFMD Passport. Finally, in 2018, EMSA may decide to abolish National Private Placement Regime (NPPR), which are the national laws of EU Member States governing the distribution of investment funds, and thus the Directive would be fully implemented.



**Figure 10 AIFMD Timeline**

Source: Baker & McKenzie, author's own illustration

So what were the objectives of this broad regulation? According to ESMA (2013), there are four: 1) Regulate an industry that operated under a very light regulatory framework and bring it closer to the UCITS framework. 2) Harmonize and achieve a single EU market and common rules for managers of Alternative Investment Funds. 3) Protect investors and increase transparency, and 4) increase responsibility of AIFM holdings and ensure regulators have proper tools to control systemic risks. The second important question to ask when analysing new regulations is who is impacted? In the case of AIFMD, target regulatees are managers of private equity funds, hedge funds, real estate funds, retail non-UCITS funds, and non-EU funds managed or marketed in the EU. In other words, almost every kind of funds not categorized under the UCITS brand fall under the Directive. Of course, as for any regulations, there are a few exclusions and exemptions that are important to consider (see Figure 11). Moreover, as we are talking about a European regulation, the scope of the Directive is limited to European-considered funds or fund managers. This paper will treat this more in details later when talking about the marketing Passport of AIFs, but it is important to mention three critical questions to ask in order to see if a fund or fund manager will originally fall under AIFMD:

- 1) Where are the target investors?
- 2) Where is the fund located?
- 3) Where is the investment manager based?

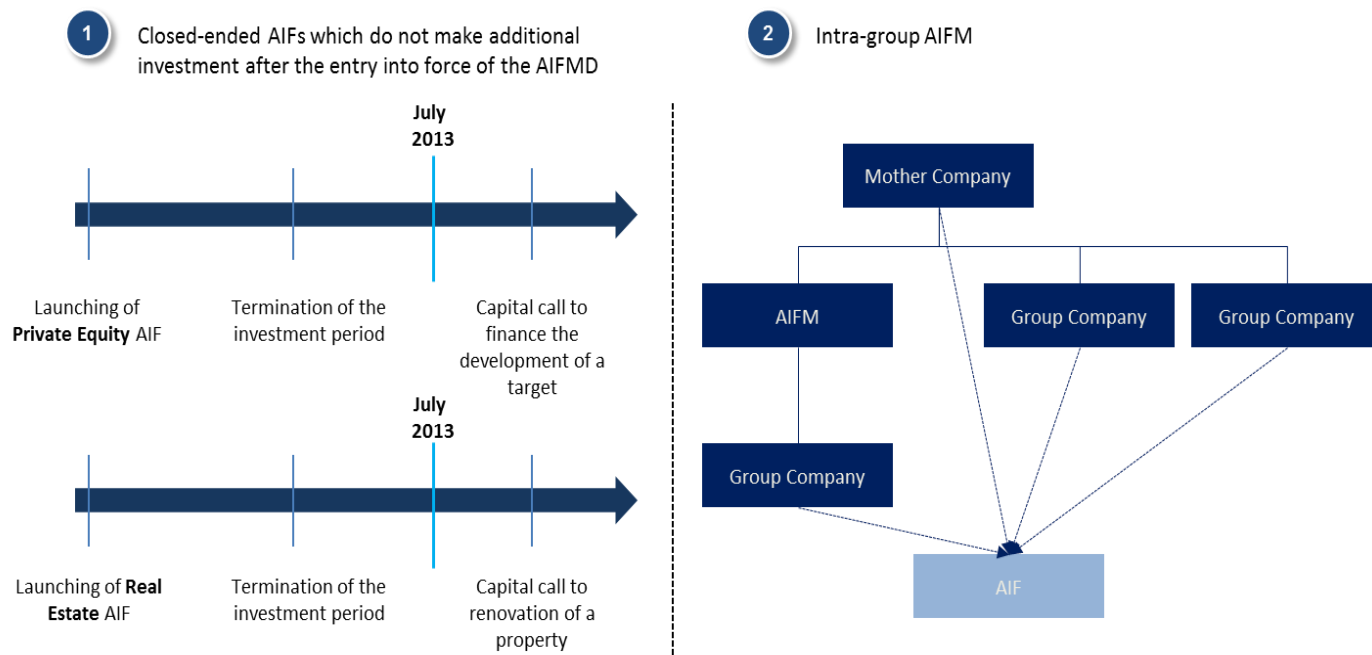
If one of the three is located in Europe then AIFMD will apply (partially or fully depending on the situation).

Exclusions	Exemptions
<ul style="list-style-type: none"> <li>▪ Institution for occupational retirement</li> <li>▪ Employee participation scheme</li> <li>▪ Supranational institution</li> <li>▪ National central bank</li> <li>▪ Government</li> <li>▪ Social security or pensions scheme</li> <li>▪ Holdings</li> </ul>	<ul style="list-style-type: none"> <li>▪ Full exemptions               <ul style="list-style-type: none"> <li>○ Intra-group AIFM</li> <li>○ Closed-ended AIF with no additional investment after entry into force of AIFMD</li> </ul> </li> <li>▪ Partial exemptions               <ul style="list-style-type: none"> <li>○ Closed-end AIF with closed subscription and that expire at latest in July 2016</li> <li>○ AuM Threshold</li> </ul> </li> </ul>

**Figure 11 Exclusion and Exemption Criteria**  
Source: ESMA, author's own illustration

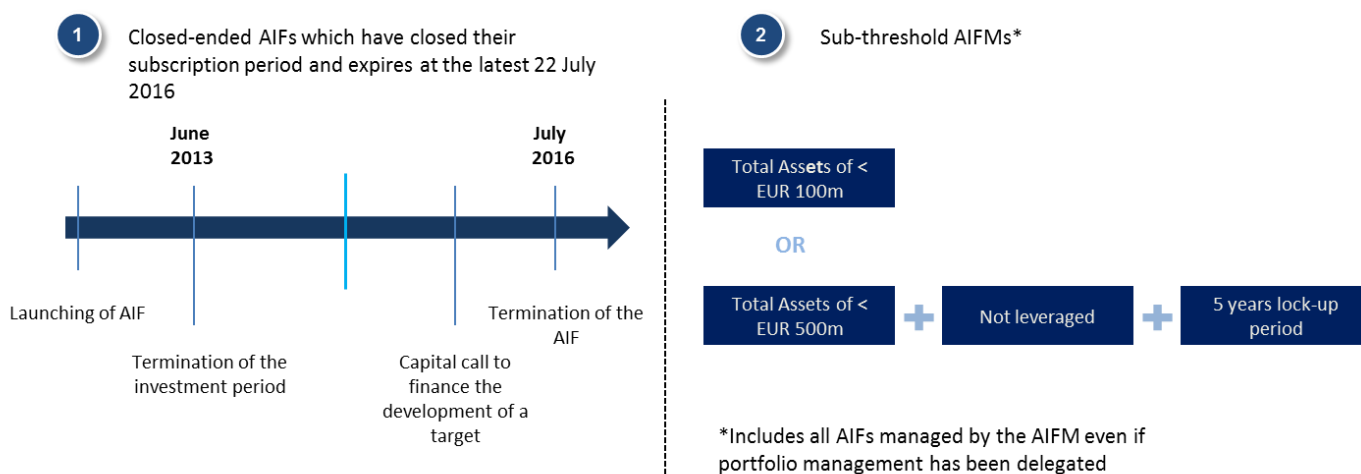
As we can see, exclusions from AIFMD are mostly governmental or social institutions, or holdings for instance. Exemptions on the other hand, are AIFs that are subject to either full or partial exemptions. Fully exempted from the Directive are either intra-group AIFM, in which the fund's investors are exclusively the mother company and/or its subsidiaries (see Figure 12), and closed-ended AIFs which do not make additional investment after the entry into force of the AIFMD. For the partial exemption, the main criterion, as illustrated in Figure 13, is the size of the AuM that an alternative fund possesses. Thus, an AIFs with total assets of less than EUR 100m or less than EUR 500m if not leveraged (meaning with no debt) and with no redemption rights in the first 5 years (which is very often the case for private equity funds), will not fall in full under the Directive. Alternatively, close-ended AIFs which have closed its subscription period and expire at the latest 22 July 2016 will also benefit from the partial exemption. In contrast to the full Directive, AIFMs under partial exemption will only be subject to registration obligation and semi-annual reporting on AuM. The registration obligation consists in stating the total value of AuM and handing over the offering documents or a general description of the investment strategy to the relevant national authorities, whereas the reporting on AuM requires the disclosure of the main instruments in which the fund is trading, a break-down of financial instruments, the markets in which the fund is active, and the principal exposures and most

important concentrations of the fund's portfolio. As we will see later in this paper, this represents a significantly lighter version of the full Directive.



**Figure 12 Full Exemption Criteria**

Source: Baker & McKenzie, author's own illustration

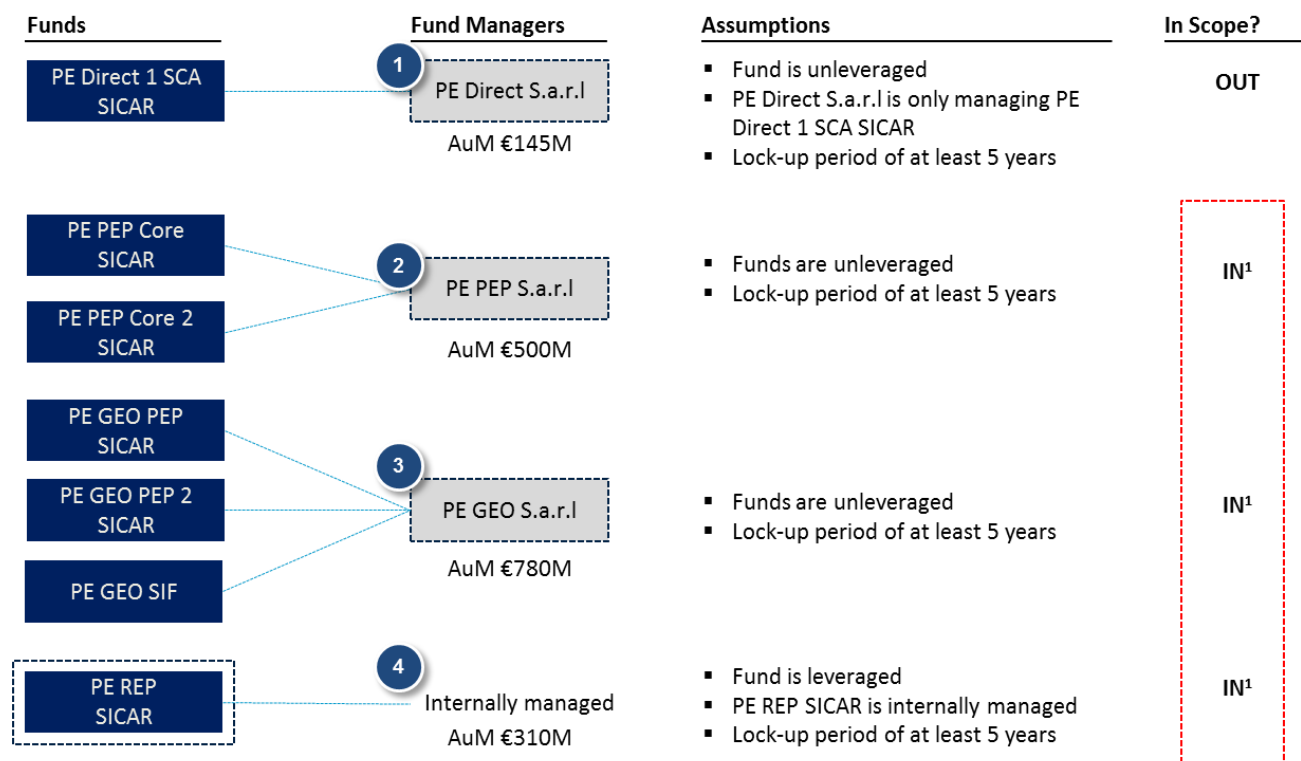


**Figure 13 Partial Exemption Criteria**

Source: Baker & McKenzie, author's own illustration

In order to better understand when an alternative investment fund falls under the AIFMD Directive, let's have a look at the short case study illustrated on Figure 14. Thus, the most

common factor looked upon when assessing if a fund falls under AIMFD is the sub-threshold regarding total assets managed by an AIFM as shown in Figure 13 point 2. On the left side of the case study we can see different private equity funds belonging to different fund managers. In some situations, in number 2 and 3 for instance, a fund manager manages several funds. In fact, a fund manager can have an unlimited number of funds, but as mentioned earlier, a fund can only have one fund manager. In situation 4, we have an internally managed fund, meaning that the management of the fund happens at the fund level and is not contracted as it is the case in the other three situations. However, it is treated the same way as the others should it fall under the Directive. Further, below the funds' names we can find some words such as "SICAR" or "SIF" for instance. These are types of Luxembourgish legal structures, typically used for private equity and other alternative funds because of their high flexibility, under which funds are operated. The first critical aspect is now to look at the AuM of the different fund managers. The only one that sticks out at first glance is situation 3, in which the fund manager has assets clearly above the EUR 500m threshold. In contrast, in the other three situations, we have to continue the assessment and look at the additional criteria of leverage and lock-up period illustrated in Figure 13 point 2. In situation 2, the fund manager is not leveraged and has the required lock-up period of at least 5 years, but has exactly EUR 500m AuM, meaning that it would still fall under the AIMFD by a very small margin. Similarly, in situation 4, it is enough to see that the fund manager is leveraged, and thus that the AuM threshold to be out of scope of AIMFD is required to be below EUR 100m. The fund manager having AuM of EUR 310m obviously exceeds this limit. Finally, the only one out of scope of the Directive is situation 1, in which the fund manager has EUR 145m AuM, but is unleveraged and respects the lock-up period requirement. Thus, this fund could raise its AuM until slightly below EUR 500m without being bothered by the Directive. In reality, however, private equity fund managers are aiming at increasing their asset base in order to legitimate higher management fees, thus increasing the risk of falling under AIFMD. In fact, this represents a dilemma for many and is going to be discussed more in detail in the analysis part of this paper.



<sup>1</sup> Full exemption: Closed ended AIFs which do not make additional investment after the entry into force of the AIFMD  
 Partial exemption: Closed ended AIFs which have closed their subscription period and expires at the latest 22 July 2016

**Figure 14 Case Study - In or Out of Scope?**  
 Sources: ESMA, author

### 3.2. Provisions of AIMD

After having seen the origin of the Directive, its timeline, the basic definition of the main actors, the targets of the regulation, and the assessment criteria, the paper will discuss the key provisions and required changes at both, fund manager and fund levels.

Also, at the end of the paper, we will focus on provisions having the most significant impacts on private equity fund managers specifically, but it is ideal to first understand general provisions and requirements of AIFMD.

Key provisions of AIFMD can be split in two parts. First, the provisions at the level of the manager, the direct impact of AIFMD, and second, the provisions aimed at the fund level, the indirect impact. The separation exists for simplicity and logic purposes and do not specifically

mean that one is more important than the other. For the sake of length, this paper will enumerate key provisions of the Directive and provide brief definitions of chosen highlights. Further, for provisions considered more important or crucial to further understand the impact on the private equity fund industry, a more detail analysis will be provided. In fact, AIFMD is a very broad and complex regulation, still subject to changes by the time of writing as still some Q&A sessions are organized by ESMA in order to clarify some interpretation gaps. In other words, only a few experts know the regulation and its real implications well, but as in any regulation some key topics are more important than others, thus the approach of this paper.

In order to facilitate the understanding, the road to AIFMD compliance will be split in three distinct areas. First, authorization requirements at both AIFM and AIF level. Second, organizational aspects, still at AIFM and AIF level, and finally, reporting procedures mainly at the fund level.

### **3.2.1. Authorization**

The route to AIFMD compliance starts at the authorization level, where several provisions are required in order to obtain the AIFM licence. First, the provisions at AIFM level:

- General information about management and qualifying stakeholders

The AIFM will have to provide information on the persons who conduct the business, and on the identity of direct or indirect shareholders with 10% or more of the capital or voting rights in the AIFM or the ability to exercise a significant influence over management of the AIFM and the amounts of their holdings. The so-called “Qualifying Investors”.

- Capital requirements

Many alternative investment structures will face increased capital requirements under the AIFMD, which establishes a minimum capital requirement of EUR 125,000. In addition, when AuM exceed EUR 250m, additional capital equal to 0.02% (or 2 bps) of the amount exceeding EUR 250m will be required. However, the additional amount is capped at EUR 10m. On the other hand, self-managed funds as we have seen in Figure 14 situation

4, will have a minimum capital requirement of EUR 300,000, but no variable additional capital requirement beside the mandatory liability insurance explained a few lines below. Thus, for private equity AIFs that are internally managed, the capital requirements of AIFMD have a limited impact as the minimum capital to be reached after 6 to 12 months for these types of vehicles, is far above EUR 300,000. On top of that, both types of structure will need to have additional own funds or hold a professional indemnity insurance in order to cover potential professional liability risks. This is based on ESMA's final advice, and the additional funds will amount to a minimum of 0.01% of AuM.

Depending on the case, this can represent significant increases in own capital and thus lead to higher cost of capital for AIFMs, mainly due to opportunity costs.

- Remuneration policies

Changes in remuneration practices brought by AIFMD have been largely criticized by the alternative fund industry when the Directive saw the daylight in 2010. In fact, major changes, with some having their roots in the UCITS V law but in a less stringent form, have been dictated by the Directive. The latter lays down principles for firms to ensure that their remuneration policies and practices “are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage” (ESMA, 2013). Thus, one can recognize in these words the wish of regulators to reduce systemic risk and uncontrolled risk-taking.

The remuneration provisions fall into three categories. First, governance or who gets involved in the decision-making. Second, risk alignment or the design and structure of remuneration, and finally, transparency or the disclosure of the amounts paid and the processes involved.

The key rules on remuneration policies remain concentrated on finding an appropriate balance between fixed and variable remuneration, and on promoting a focus on long-term performance of staff. Thus, at least 50% of variable remuneration should consist of units or shares of the AIF or equivalent. Further, at least 40% to 60% of variable remuneration should be deferred over a minimum period of 3 to 5 years, and vest no faster than on a



pro-rata basis. Overall, variable remuneration should be subject to financial performance of the fund and downward adjustment by way of malus or clawback adjustments. In order to avoid unfunded golden parachutes, the Directive also states that payment on termination of employment should reflect performance and not reward failure. Moreover, for funds of significant size (generally thought of as managing more than EUR 1.25bn with more than 50 employees), a remuneration committee including non-executive members should be set up.

Currently, ESMA is still discussing topics regarding remuneration policies as many questions and discussion have arisen in recent years.

- Delegation arrangements

Delegation arrangements is a very important provision to understand the impact of AIFMD on private equity structures and other alternative investment funds. This key provision for AIFs has as main goal to avoid the proliferation of so-called “Letter Box Entities”. These entities, often opaque offshore vehicles, are extensively used when structuring alternative investment funds in order, for instance, to avoid taxation at their domiciles. These structures are considered by many as dangerous as it is difficult to keep track of their affiliation and thus could potentially fuel systemic risk.

Delegation provisions in that context are on AIFM level. The two core functions of the AIFM are portfolio management and risk management. Until before the entry into effect of AIFMD, these two functions could be performed together. However, the Directive stipulates that portfolio management and risk management now have to be clearly separated by a so-called “Chinese Wall”. This in order to minimize conflicts of interest and reduce the propensity of taking risk. It also represents a major change for alternative investment funds, which were used to be relatively untouched by regulation until then. As we will see later in this paper, this provision also has a considerable impact on private equity funds, especially those of smaller sizes. Under the Directive, managers will be able to delegate these functions to third parties under certain conditions. When delegating portfolio management and/or risk management, the delegate will need to be an authorised and supervised asset manager. Of course, the AIFM may not delegate both functions in

whole at the same time (otherwise hurting the “Letter-Box” prohibition). The question at this point is what does it mean “in whole”? As for many provisions of AIFMD, the principle of proportionality prevails, meaning that it is often a case-by-case situation.

If no expertise remains in the fund, the AIFM has no longer power to take decisions, there is a loss of supervising power over the delegates, or if the total of delegated tasks exceeds remaining tasks of the AIFM, then the latter will lose its status. In fact, it is crucial that the AIFM retains the necessary expertise and resources to supervise the delegates tasks effectively and manages the risks associated with the delegation as well as retains the power to make decisions in key areas which fall under the responsibility of the senior management.

Finally, we will talk about the required provisions at AIF level for the first step of the compliance process, namely authorization.

- Disclosure of information to regulators and investors

Each AIF managed by an AIFM will have to provide a certain amount of information, both to regulators and investors. First, information about the AIF’s investment strategies, leverage policies, risk profiles and other characteristics of the AIF, including information about the Member State or third country in which it is established or expected to be established, will have to be shared. In addition, information on fund rules or instruments of incorporation, information on arrangements made for the appointment of the depositary for the AIF, and information required by the Directive to be disclosed to investors, will also need to be communicated. If an AIFM is already authorised as a management company under the UCITS Directive and has provided information to its home regulator in that regard, however, the Directive does not require the AIFM to provide such information mentioned above to its home regulator again, provided that such information is up to date.

### 3.2.2. Organizational Aspects

The second step in the compliance process are all the provisions related to the organization and operations of the AIFM and its AIF(s). To follow the logic of the first step, let's start first with the provision at AIFM level.

- Operating conditions

The Directive contains a broad set of general principles that the AIFM must comply with, including the requirements to act honestly and in the best interests of the relevant AIF and its investors, and the integrity of the market when conducting its business activities (Linklaters, 2014). These operating conditions, largely detailed in the Level 2 measures published by the European Commission on December 2012, regulates the way AIFMs operates their AIFs.

One of the most critical operating conditions is the conflicts of interest. The AIFM must take all reasonable steps to identify conflicts of interest between for instance, itself and the fund it manages, two funds it manages, a fund it manages and another client of the AIFM or two of the AIFM's clients. Thus, an AIFM must maintain and operate organizational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage, and monitor conflicts of interest in order to prevent conflicts from adversely affecting the interests of the AIF and the investors in it (Linklaters, 2014). Beside conflicts of interest, the Directive also covers, as already briefly mentioned in the delegation arrangements provision, provisions on risk management. In fact, it requires the risk management function of the AIFM to be functionally and hierarchically separate from the operating units and portfolio management functions. Effective risk management policies and procedures in order to identify, manage, and monitor on an ongoing basis all risks relevant to each AIF's investment strategy must be implemented (Baker & McKenzie, 2013). The Directive also requires the AIFM to periodically review and update its risk policy and systems and to further implement quantitative and qualitative risk limits, covering at least market, credit, liquidity, counterparty, and operational risks.

Operating conditions provisions require in general the AIFM to establish, implement, and maintain procedures and policies on different topics such as accounting, decision-making, internal control mechanism, confidentiality, business continuity, internal organisation, and supervisory function for instance.

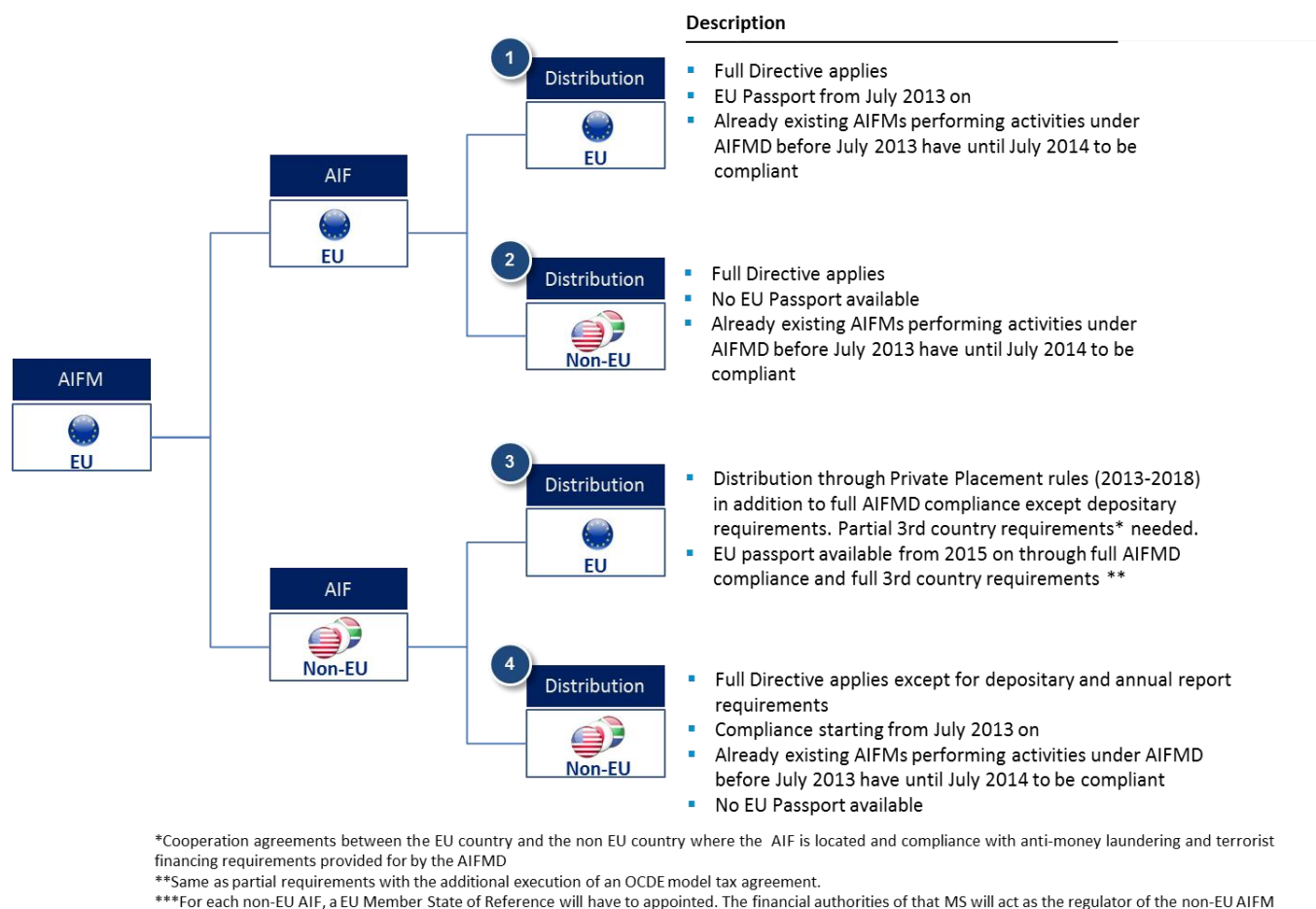
As concerns the organizational provisions at AIF level, here are the crucial ones:

- Marketing of AIFs

The marketing or distribution of AIFs and the EU passport are some of the most crucial and most discussed provisions of the AIFM Directive. Largely based on existing regulation for UCITS funds, they have been transposed to AIFMD and represent one of the few active advantages of being AIFMD compliant. For the sake of simplicity, the paper illustrates the eight different situations that can occur when funds are distributed, depending on three levels. First, if the AIFM is located in the European Union or not. Second, if the AIF is based in the European Union or not, and finally if the AIF will be distributed in the European Union or not, or in other words where the fund's investors are based.

Situation 1 in Figure 15 can be considered as the base case, in which the AIFM, the AIF, and the distribution are in the boundaries of the European Union. Thus, in this case, the full Directive applies without exception and the EU Passport becomes available with the entry into force of AIFMD, namely in July 2013. Obtaining an EU Passport basically means that once your AIF is registered in its home Member State, it can be distributed in other Member States of the European Union without having to apply for an AIF in the new country. Thus, the authorities of the fund's home country will communicate and exchange information directly with the new country's authorities. This uniformization and increased cooperation between EU countries represents significant time and money savings as it drastically reduces transactions costs. In addition, already existing AIFMs performing activities under AIFMD before the entry into force of the Directive in July 2013 have until July 2014 to be compliant (ESMA, 2013). This is the so-called "Grandfathering" rule. The situation 2 is similar apart from the fact that the AIF is marketed outside of the European Union. Thus, the only difference is that there is

logically no EU Passport available. Situation 3 and 4, however, differ in many aspects. Both illustrate the situation in which the AIFM is based in the European Union, but the AIF is not. In situation 3, the AIFM will have two choices to market his non-EU AIF in the European Union. First, it can distribute it through the National Private Placement Regime of the target country, or starting in 2015, it can apply for an EU Passport. National Private Placement Regimes (NPPR) are the already existing, national rules regulating the distribution of investment funds in EU countries. These NPPR are known to vary greatly in terms of strictness between countries. For instance, France and Germany are famous for being very protective of their investment fund industry, in contrast to others, such as Ireland and Luxembourg, who advocate open markets. However, AIFMs will still need to fully comply with the Directive (except for depositary requirements as the AIF is located in another country outside the European Union), and partial third country requirements, which can be summarized by the existence of cooperation agreements between the EU country and the non-EU country where the AIF is located, will be needed. The second option is to first use the NPPR and opt for the EU Passport when it becomes available in 2015. In this case, full AIFMD compliance (including depositary requirements) and full third country requirements will be asked. The full third country requirements differs from the partial one only in that the former requires the two countries (the EU and non-EU country where the AIF is located) to have an OCDE model tax agreement. At this point it is important to mention that NPPRs in the European Union might be phase out by 2018, meaning that only the EU Passport option would remain. Thus, if the AIFM plans to distribute its non-EU AIF in the EU on a long-term basis, it might be ideal to apply to the EU Passport starting in 2015 already or relocate its fund directly in an EU country and enjoy the benefit of the Passport starting already in 2013. As concerns situation 4, the starting position is similar to situation 2. The only difference is that the AIFM can ignore the depositary and the annual report disclosure requirements as both the AIF and the investors will be located outside the European Union.

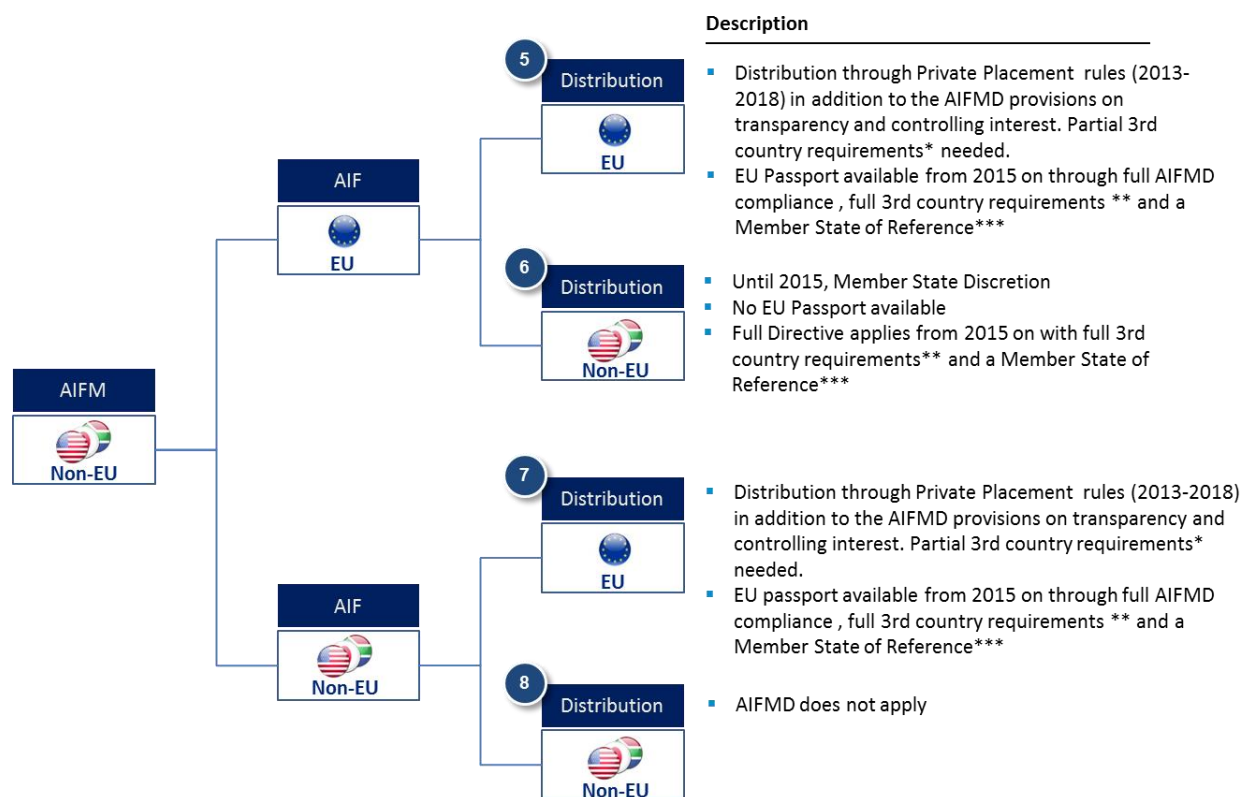


**Figure 15 Marketing of AIFs for EU AIFMs**  
Sources: ESMA, author

The AIF marketing scheme for non-EU AIFMs is, however, slightly more complicated. Situation 5 in Figure 16 is somewhat similar to situation 3 in Figure 15. Thus the non-EU AIFM will be able to distribute its EU AIF to EU investors through either NPPR or, starting 2015, through the aforementioned EU Passport. The difference for the first option is that the non-EU AIFM will not be required to comply with the full Directive as in situation 3, because it is not located in the European Union. However, it will need to comply with AIFMD provisions on transparency and controlling interests. Similarly, for the second option, the non-EU AIFM will have to appoint an EU Member State of Reference on top of the same requirements as in situation 3. For case 6, the situation is fairly different. In fact, for non-EU AIFMs distributing an EU AIF outside of the

European Union, meaning that it is just using the EU as a platform to locate its fund, the full Directive will apply from 2015 on, coupled with full third country requirements and the appointment of a Member State of Reference. Of course, no Passport is available as the fund is not marketed in the EU. Further, until 2015, EU Member States will have the liberty to choose under what conditions (national rules vs. AIFMD) they would accept such situation. Situation 7 is similar to situation 3, with the exception that for the NPPR option, non-EU AIFMs have less stringent AIFMD requirements as they only need to comply with the provisions on transparency and controlling interest. Also, for the second option, namely the EU Passport, the additional appointment of an EU Member State of Reference is needed. Finally, for the situation 8, AIFMD does not apply as neither the AIFM nor the AIF nor investors will be based in the European Union.

The marketing of AIFs is crucial to understand as it dramatically changes the way alternative investment fund will be distributed in the future, and may in turn also change the European private equity landscape. The simplified access to new European markets through the EU Passport might motivate AIFMs to comply with the Directive as soon as possible in order to benefit from it early. The question that arises at this point and that will be discussed in the last chapter of this paper, is whether this benefit outweighs the substantial additional costs of compliance? The main issue at the moment is that ESMA has significant delay in issuing final guidelines concerning the EU Passport for EU and third-countries AIFs, meaning that the main advertised benefit of the Directive is not active yet.



\*Cooperation agreements between the EU country and the non EU country where the AIF is located and compliance with anti-money laundering and terrorist financing requirements provided for by the AIFMD

\*\*Same as partial requirements with the additional execution of an OCDE model tax agreement.

\*\*\*For each non-EU AIF, a EU Member State of Reference will have to appointed. The financial authorities of that MS will act as the regulator of the non-EU AIFM

**Figure 16 Marketing of AIFs for non-EU AIFMs**  
Sources: ESMA, author

#### ▪ Controlling interest and asset stripping

This provision is specifically aimed at private equity funds. If a private equity fund makes an investment that takes control (>50%) of a company that is not a SME (e.g. >250 employees), additional disclosures to the investors, target company, target company shareholders, authorities and employee representative will have to be made. More importantly, the Directive introduced some limitations on asset stripping, which is the acquisition of a company with the purpose to sell off its assets with profits, a practice existing for a long time in the private equity sector. AIFMs managing AIFs controlling non-listed companies would not be allowed, for a period of two years following the acquisition, to facilitate, support or instruct any distribution, capital reduction, share



redemption and/or acquisition of own shares by such companies. Similarly, the AIFM will not be able to vote in favour of such events. The anti-stripping restrictions do not apply to acquisitions of small and medium entities.

Overall, such restrictions would mainly affect AIFs with LBO and distressed/turnaround strategies. If impacted, AIFMs will need to consider these restrictions when planning an acquisition as they may impact the timing of their expected returns.

- Depositary

The provision concerning depositary requirements is also important and is one of the most discussed of the Directive. In fact, in many jurisdictions in the European Union, this provision is synonym of important changes.

First, what is a depositary and who is eligible? The AIFM Directive states that the depositary must be a “credit institution” (meaning a deposit-taking bank) or an investment firm with the regulatory permission to act as a custodian (Dechert, 2013). The depositary acts not only as custodian (meaning the one physically holding the AIF’s asset) but also as a sort of monitor or auditor of the fund. A more detailed explanation can be found in the following paragraphs.

Private equity funds and other AIFs will be required to appoint a single depositary that will be liable to the fund and its investors. For EU funds, the depositary has to be EU domiciled. In comparison, for non-EU funds it can be a third country depositary subject to cooperation agreements and other conditions. In general, funds will be required to appoint a depositary which is a credit institution or similar. However, Member States will have the liberty to permit certain private equity funds, namely those that do not permit redemption within five years following the first investments and that generally do not invest in assets that must be held in custody, to appoint law firms, notaries or other authorised investment firms. Thus, for many private equity fund managers, this should reduce the costs of outsourcing this function.

So what are the duties of the depositary? Depositaries have three core functions. First, the so-called oversight duties. Oversight duties are not delegable and consist in performing control on the existence, the proper implementation, and on the adequacy of procedures

at the level of the AIFM (e.g. respect of national laws). Second, and probably the most notable function of a depositary in general, the safekeeping duties. In fact, the depositary must effectively hold and preserve the financial instruments of the AIF/AIFM in custody. It will further need to verify ownership and maintain record of the assets. One could argue that the depositary plays the role of the gatekeeper of the AIF/AIFM's assets. Thus, the latter cannot be assigned or transferred without the depositary being informed and involved in the transaction. Finally, a new function came into force with the Directive, namely the cash monitoring. The cash monitoring duty is not delegable and focuses on ensuring that AIF's cash flows are properly monitored, the payments upon subscription to the AIF are received, and that AIF cash has been booked in cash accounts opened in the AIF/AIFM's name.

Another new provision for depositaries is the revised and increased liability. Thus, the depositary is subject to near strict liability - on loss of financial instruments held by it in custody, the depositary is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM acting on its behalf) without undue delay (Linklaters, 2014). These rules of liability have been strengthened in order to, again, minimize systemic risk. Thus, as the (financial) assets held in custody by a depositary will very probably be re-used for the depositary's own cash generation (think regular bank account – the cash deposited on the account is used by the bank as capital that it will invest for its own purpose) it is important that stringent liability rules are put in place, especially in this case as we are talking about investors' money. Events such as Madoff's Ponzi scheme for instance were definitely a major contributor to this provision, as assets held in custody or in sub-custody tended to get "lost" and were insufficiently documented, resulting in severe discussions on who would be held responsible for investors' lost assets.

The challenge that arose with the Directive is that depositaries will need to review their current set up, develop and adapt their systems and procedures, as the requirements of the Directive differ significantly with existing ones (PwC, 2012). This in turn, means that depositary fees are increasing and that existing agreements will need to be re-drafted, consuming additional time and generating additional costs. The impacts on private equity

funds specifically are limited, as these types of AIFs generally do not have many financial assets to be held in custody as they invest in “real” assets.

- Valuation

The Directive stipulates that independent valuations are to be carried out for each AIF managed. For closed-end funds (such as private equity funds for instance), it specifies that the valuation of assets should be performed in case of an increase or decrease of the capital of the AIF (PwC, 2012). There is no additional guidance provided in ESMA’s Final Advice, and thus the industry would argue, that in practice, it is understood that the only issue of units/shares of closed-ended AIFs takes place at the point of acceptance by the AIFM of the commitment from the proposed investor to the fund (PwC, 2012).

Regarding the independence of the one performing the valuation of the AIF, the Directive provides two options. Either the valuation is performed by an independent external valuer or by the AIFM itself, but only if the valuation function is functionally independent from the portfolio management and conflicts of interests are mitigated. Many private equity fund managers traditionally carry out many valuation activities themselves, and thus these requirements will certainly have a significant impact on smaller PE houses which currently do not have the necessary infrastructure (Baker & McKenzie, 2013).

- Leverage

The Directive requires AIFMs to set the leverage limits for each of the AIFs it manage and demonstrate that those limits are reasonable and are being complied with at all time. For AIFs employing significant leverage, the AIFM will need to report information about the overall leverage employed to the competent authorities and to investors on a periodical basis. More details on this matter will be provided when talking about reporting and transparency requirements. Overall, this provision has a relatively low impact on private equity AIFs as there is general concern from the industry with respect to the competent authorities’ ability to impose limits, especially without proper harmonisation across European Member States.

- Transparency requirements

The Directive imposes requirements for information to be given to investors and regulators, both in the marketing process and on an ongoing basis (Linklaters, 2014). In the annual report, aside from the increased information expected in the AIF's report of activity, the only noteworthy requirement concerns the disclosure of the remuneration (PwC, 2012). Thus, total remuneration of the AIF will need to be disclosed, including a split between fix and variable components. Remuneration policies and practices for the different staff levels will have to be provided as well.

As concerns the disclosure to investors, the AIFM will have to make full disclosure of information related to investment strategy and objectives of the AIF, the types of assets in which the AIF may invest in, techniques it may employ etc. Apart from the requested information before the investment phase, a periodical disclosure is also required by the Directive. Thus, information on risk management, trading activity, use of leverage, and for private equity AIFMs, information on portfolio investments, will be covered. For private equity funds holding controlling interests in unlisted companies, an extended reporting to the regulator, both qualitative and quantitative, as well as additional disclosures in the annual report will be required (PwC, 2012).

Moreover, the AIFM will be required to regularly report to its regulators aggregated information on the main instruments in which it trades, the markets of which it is a member or actively trades, and the diversification of the AIF's portfolio including its principal exposures and most important concentrations of each of the AIFs it manages (Baker & McKenzie, 2013). The information to be provided to the home regulator by the AIFM must occur:

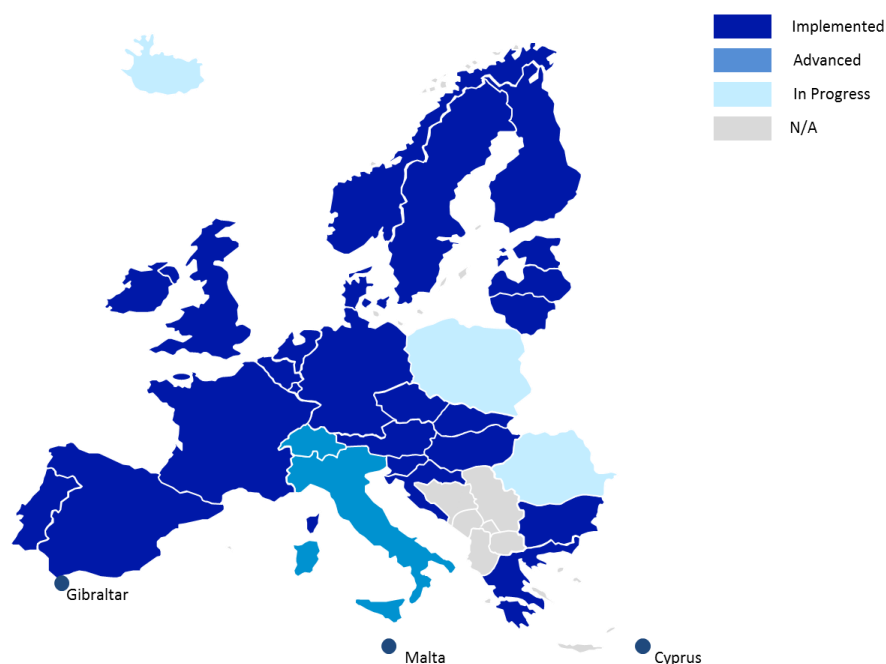
- On a half-year basis in relation to AIFs whose AuM exceed either EUR 100m or EUR 500m, but do not exceed EUR 1bn for each EU AIF
- On a quarterly basis in relation to AIFs whose AuM exceed EUR 1bn for each EU AIF
- On a quarterly basis in relation to AIFs whose AuM include any assets acquired through leverage and exceed EUR 500m for each EU AIF

- On an annual basis for unleveraged AIFs which as part of their core investment policy invest in non-listed companies and issuers to acquire control (or in other words, unleveraged private equity funds)

As we can see above, the more AuM, the more often an AIFM will have to report to competent authorities. This follows again the root goal of the Directive, to minimize systemic risk. All in all, it can be said that the AIFMD increases significantly disclosure requirements and thus, additional processes and procedures will be necessary. Reporting and disclosure requirements required by the Directive will be further discussed in this paper, as many consider them the most burdensome requirements for private equity fund managers.

### 3.3. AIFMD Transposition Status

As the Directive requires many changes, not only for AIFMs and their AIFs, but also for governments and regulators, and after all also because it is a long political process, the implementation of AIFMD is not simultaneous across the European Union. In fact, not every EU Member State has yet transposed the Directive into national law. Figure 17 will give a brief overview of where we actually stand.



**Figure 17 AIFMD Transposition Status in the EU (as of 2015)**  
Source: KPMG, author's own illustration

As illustrated on the figure above, the AIFM Directive has been implemented in almost every European country. Some exceptions persist, such as in Poland, Romania, and Iceland where the transposition of this new law has been delayed. In Italy, all amendments necessary for the implementation of AIFMD have been passed, the only missing step until the official entry into force is the publication in the country's Official Journal, which is expected to happen this year. In Switzerland, the situation is slightly different. Thus, in certain areas the rules for AIFs are stricter as the ones of AIFMD, and in others they are less strict. The Swiss Funds and Asset Management Association (2015) explains that the country has already adapted its regulation in order to be conform with AIFMD, but still has some areas of differentiation.

## **4. ANALYSIS AND DISCUSSION**

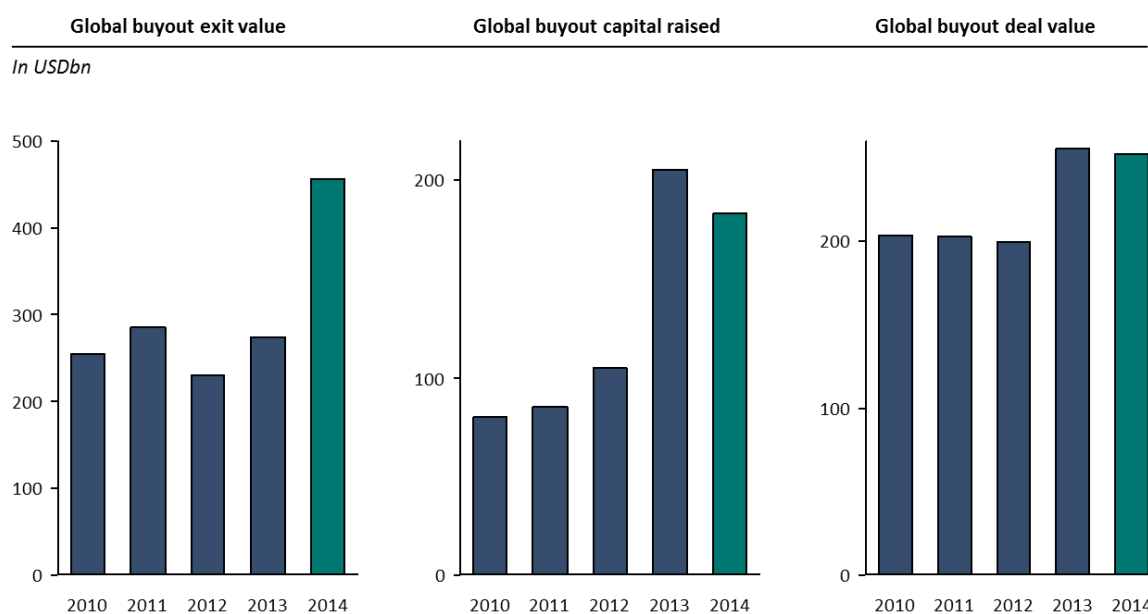
After having explained in details the most important provisions regarding private equity regulation and the AIFM Directive, the analysis part of the paper will be split in three parts. First, a part dedicated to the analysis of a major research project done by the bank BNY Mellon and FTI Consulting, which discusses additional costs and challenges generated by the AIFM Directive. Similarly, in the second part, an analysis of different expert interviews on the same topics will be performed. Finally, in the last part, a general analysis of the impacts of AIFMD will be done based on the two previous sections and other information mentioned in this paper. Alternatives and future prospects of the private equity industry will then be discussed before reaching a conclusion on (regulatory) private equity outlook.

### **4.1. Overview of the Private Equity Industry**

#### **4.1.1. The Private Equity Activity Post-Crisis**

The private equity industry, which was characterized by buoyant growth until its peak in 2007, took a severe hit during the global financial crisis of 2009. Since then, however, the situation

improved and in 2014, the sector delivered strong results (Bain & Company, 2015). In fact, the private equity markets have been taking advantage of a world flushed with capital that shows no signs of breaking anytime soon. As we can see in Figure 18, worldwide value of buyout exits climbed to an industry record last year. Further, the boom in exits triggered strong distributions of capital to LPs, boosting in turn fund-raising activities for 2014. On the other side, it is undeniable that last year has been a great time to be a seller, but conversely it has been challenging to be a buyer. Thus, the combination of a surge in global liquidity and near-zero interest rates has inflated asset valuations, significantly pushing up acquisition multiples on private equity investment targets (Bain & Company, 2015). Similarly, asset prices will remain high because of huge (and growing) reserves of cash, namely dry powder, and tough competition for deals.



**Figure 18 PE Exits, Fund-raising, and Investments (End 2014)**  
**Source: Preqin, author's own illustration**

The increase of buyout exit value in 2014 amounting to USD 456bn is due on the one hand to a surge of trade deals, in which strategic buyers acquire private equity portfolio companies, and on the other, strong public equity markets in North America and Europe, laying a solid foundation for lucrative IPOs (Preqin, 2015). In fact, cash-rich corporate acquirers, feeling pressure to meet shareholder demands for growths, were poised to open their wallets for private equity companies

that fit their strategic goals, even in the case of overvalued companies (Bain & Company, 2015). In addition, low interest rates and wide-open debt markets significantly contributed to corporations' ability to buy. In terms of the number of buyout exits, 2014 have seen 476 sales, well above previous years. There were most notably healthy double-digit growth in North America (22%) and Europe (16%). In terms of returns, a recent survey by Preqin (2015) found that only one out of every 12 LPs felt that private equity failed to meet its expectations compared with one out of 4 surveyed in July 2009 – a significant increase in satisfaction that could be explained by strengthening markets. Another interesting fact highlighted by the Global Private Equity Report 2015 of Bain & Company, is that the average holding period of portfolios has lengthened as private equity funds continued to harvest unrealized value. Thus, the median holding period had extended to a record-long 5.7 years in 2014 vs. 3.4 in 2008.

Fund raising in 2014 was strong, even if a bit lower than two years ago. The good performance in raising fund comes from the important cash distributions from an exceptional year of exits. Thus, LPs were eager to top up their allocation to PE, their best performing asset class for many of them (Bain & Company, 2015). Worldwide in 2014, 1,001 private equity funds landed USD 499bn in new capital commitment, a little less than half this number was raised for buyout funds. The strong growth was particularly fueled by growth funds, secondaries and venture funds.

As concerns buyout investments, the activity has been fairly flat since the latest expansion cycle that started back in 2010 (Dealogic, 2015). In fact, buyout firms announced 1,955 transactions in 2014, with a total deal value of close to USD 252bn. The forces behind this relative stagnation are twofold. First, private equity funds, because of the conditions already mentioned above, are facing intense competition and did battle with GPs' self-imposed restraint not to overpay (Bain & Company, 2015). Second, the aforementioned rise of the public equity markets has lifted the floor on valuation that prospective buyers face, increasing acquisition multiples to levels that price many deals out of reach. In addition, vast sums of dry powder, USD 1.2tn at the end of 2014, supplemented by abundant cheap debt in the hands of eager private equity buyers, pushed up prices in a capital-saturated market where attractive assets were in limited supply. This triggered a tough competition from familiar deal-making rivals. Interesting to mention is also the fact that big club deals that were so popular in 2006 and 2007 are almost non-existent anymore according to Dealogic (2015) information. Thus, equity check size for any deal has been limited



to what a single fund can write along with potential co-investors. Regulators are also trying to limit the amount of leverage on deals. For instance, in the U.S., regulators have issued guidance to banks not to finance takeovers where debt exceeds six times EBITDA (Bain & Company, 2015). As a result, the average size of deals decreased.

#### **4.1.2. Outlook of the Private Equity Market**

So where does that leave the private equity industry today? The following paragraph will also be based on Bain & Company's Global Private Equity Report 2015, which highlights four forces that have exerted increasing influence over private equity in recent years and will likely weigh heavily in the industry's evolution in ways that every investor in this asset class will need to be aware of in 2015 and beyond. First, there is a clear capital superabundance triggered by vast global expansion of investors' balance sheets. Total financial assets are more than 10 times global real GDP. In fact, totalling some USD 600tn in 2010, financial assets will increase by another 50% by 2020 according to Bain's Macro Trends Group. Even though this phenomenon helped private equity firms getting back up after 2009, the huge sums of capital available in the future might cause problem, as discussed previously. Second, the report considers the challenges posed by shadow capital in the hands of LPs. Thus, in recent years, institutional investors have been experimenting new ways to participate in private equity deals beyond the conventional constraints of being passive partners in private equity funds. These institutional investors are putting vast sums of money to work in new ways apart from their traditional role as LP in a fund. For instance, they are increasing their co-investing activity and sometimes even bypass private equity funds to invest on their own. This will surely change the way GPs and LPs interact in the future. Another trend is the refocus on the U.S. Even though Europe especially has historically been a major market in the private equity universe, both as prime investment destination and in terms of the number of fund managers basing their operations there, the U.S. still represents the industry's biggest and most mature market. Currently a rare oasis of improved GDP growth in an otherwise struggling global economy, the U.S. economy is benefiting from unique sources of strength in its consumer, energy, and technology sectors that could provide a solid foundation for sustained expansion (Bain & Company, 2015). Conversely, most European economies are

slumping, as sovereign debt woes, deflation pressures, currency instability and near-zero GDP growth threaten to break up the Eurozone. Further, as 2015 began, the European Central Bank launched a EUR 1.1tn quantitative easing program in an urgent bid to reignite growth, but banks' business lending remains weak amid gathering signs of a recession in the major European economies (Bain & Company, 2015). Also, some see structural and political tensions that threaten to pull the Eurozone apart in the not-too-distant future. Even if this sounds overly pessimistic, it is important for Europe-focused private equity firms to storm-proof their portfolios by taking advantage of currently favourable debt markets to lower borrowing costs, lighten covenants or pull equity out of assets that may need more time to ripen in Europe's slow-growth environment, and pressure test new investment strategies. Thus, private equity funds, armed with vast reserves of dry powder and facing a diminishing supply of crisis-resistant acquisition opportunities, will need to be on guard against the risk of investment bubbles (as it may already be the case in the real estate sector in France and Germany). A recent survey by Roland Berger on private equity professionals in Europe showed that the majority of respondents (62%) see a need to re-adapt the private equity business model (Gatti & Chiarella, 2015). Finally, the last trend is considered to be that LPs are facing challenges in identifying the most successful GPs to invest behind. Private equity fund returns have become more compressed than ever before, the steady outperformance of leading private equity firms is less consistent than in the past and longer holding periods are making it harder for LPs to rely on the performance of a GP's current fund as a guide for determining future performance, and thus whether or not to commit to the firm's next one once launched (Bain & Company, 2015).

#### **4.2. AIFMD Research by BNY Mellon**

A few months before the official entry into force of the AIM Directive, BNY Mellon conducted in December 2013 a series of surveys amongst alternative fund managers in order to assess the preparedness to implement the AIFMD. A total of 52 respondents from institutions with an accumulated total of over USD 4tn AuM participated in the survey. Further, beside the compliance progress, BNY Mellon also focused on the myriad risk management and compliance monitoring requirements relating to the Directive, such as data and monitoring requirements,

what the key challenges are, the cost of compliance, how risk management solutions are developing, and how far down the line the industry is in preparing for authorisation. Especially the quantification of costs is interesting for the paper as primary data on this topic is difficult to collect. The topics covered will be the general preparedness for risk and compliance obligations, cost of preparing for risk and compliance obligations, challenges, independence, and solutions used by AIFMs.

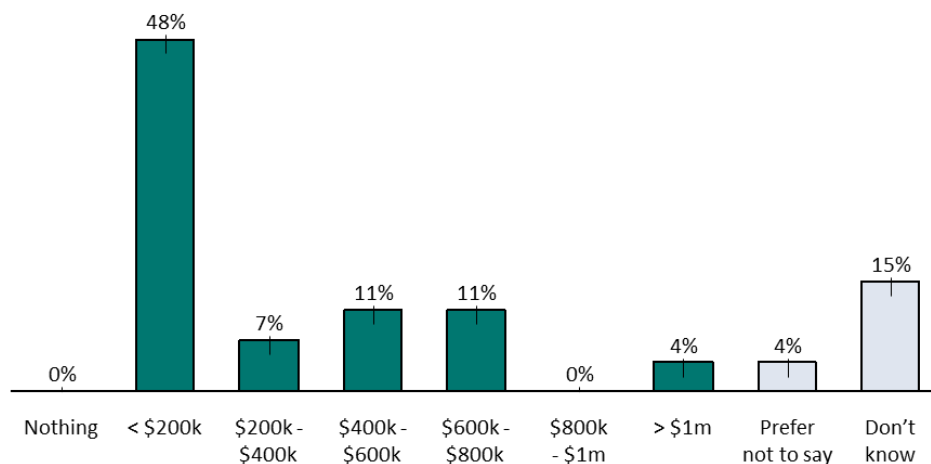
#### General preparedness for risk and compliance obligations

There is evidence that AIFMs are delaying their application as only 19% of the respondents had or expected to submit applications at the end of 2013. Thus, this means that 81% had still to submit their applications, 41% of which were planning to do in the first quarter of 2014. Taking into account the amount of time taken for in-house functions, external administrators and depositaries to fully prepare, and the time needed by regulators to review applications, BNY Mellon was expecting many to miss the deadline of July 2014. They also showed that many AIFMs had to make final decisions on how they would approach many of the critical elements needed to be compliant. Concerning the implementation of risk management requirements, only a little more than half (55%) of the survey's respondents had fully implemented (16%) or were near completion (39%) of the risk management requirements. The residual 45% being either under development, at a design or even at a conceptual state. The survey emphasizes the fact that firms with flexible risk management systems will find implementation for the purpose of AIFMD less onerous, particularly for those having already a risk management framework at work, which could be leveraged. The study then digs deeper into the implementation status of the five key risk management categories already mentioned in this paper, namely market risk, counterparty risk, credit risk, liquidity, and operational risk. Overall, the study shows that the majority of respondents are at or near completion for most risk areas, but that close to 33% still had to move beyond conceptual stages in any of the five key areas. Concerning the implementation of compliance monitoring, 29% and 39% of respondents had them fully implemented or were near completion respectively. The survey further split the compliance requirements in two parts, investment restrictions and leverage monitoring. For investment restrictions, 80% of respondents were fully implemented (37%) or near completion (43%), whether as for leverage monitoring only 67% of respondents had the same status (20%

implemented and 47% near completion). This suggests that AIFMs had more difficulties to come up with solutions concerning leverage monitoring.

### Cost of preparing for risk and compliance obligations

The second part of the survey focuses more on the cost incurred as a result of the AIFM Directive. BNY believes that the industry has had time to make a fairly precise assessment of the total costs of gaining authorization and implementing the Directive. Thus, the mean expected cost of implementation for those respondents selecting an amount during the survey is USD 300,000 vs a mean of USD 305,000 in a previous survey done by the bank a year before, in July 2013. This suggests that respondents might have assessed the additional costs properly, the difference between the two numbers being marginal. Further, according to BNY, an accumulated total of over USD 20bn AuM are covered by AIFMD. Figure 19 below shows the range of projections of expected costs to be incurred. Thus, the projection is broad, but only fewer than half the respondents (48%) believe the cost will be less than USD 200,000. In the previous survey done by the bank, this percentage was at 43%, meaning that some respondents initially overestimated costs.



**Figure 19 Total Cost Expected from AIFMD**  
Source: BNY Mellon, author's own illustration

Then the survey tried to find out how fund managers would allocate the cost of AIFMD compliance. As of December 2013, 45% of respondent were still assessing on how to cope with

the additional cost, 26% were likely to pass on cost increases at least partly onto the fund, impacting the TER and thus impacting in turn investors, and 29% responded that the cost will be entirely borne by the firm. Interestingly, no respondent considered passing on the cost of AIFMD entirely to investors. Further, BNY asked about where fund managers expected additional costs to be borne, and the results were the following: 46% of respondents believed that the main cost bracket would come from additional technology needed to comply with the Directive. 36% were concerned about external service providers, 29% about additional staff, and 29% of respondents considered other internal costs. What is striking is the high percentage of respondent (43%) still assessing where exactly cost will have to be borne.

### Challenges

Concerning risk and compliance challenges, the survey found out that 93% of respondents see the increased cost of supporting risk and compliance data and firms reporting as the most important challenge (25% see it as very challenging and 68% as slightly challenging). Further, finding experienced staff related to the risk and/or compliance functions is also considered a challenging task with 25% and 46% who see it as very challenging and slightly challenging respectively. The area showing the least concern is empowering the risk and compliance officer to be truly independent in the organization, with only 50% of respondents considering it at least slightly challenging. In other words, building Chinese Walls within firms does not seem as big of an issue. Finally, both the collection of appropriate data to feed the risk management process and the monitoring of operational risk are considered at least challenging with both 82%. Overall, the survey shows that fund managers do not consider the implementation of AIFMD as an easy task.

### Independence

First, BNY Mellon shows how the survey participant would address the additional requirements for regulatory reporting, considered by many as the most burdensome requirement of the Directive. Thus, 66% of respondent considered using in-house resources to cope with reporting requirements, which would explain why many consider additional technology cost as the main cost bracket. Further, 23% were thinking about using the services of administration service providers, and 26% using depositary service providers. Interesting to mention is that 3/4 and 9/10 of the respondent willing to use the service of administration service providers and depositaries

respectively, also considered the in-house option. This clearly indicated that most of AIFMs are still unsure or are considering mix methods. Similarly, 37% of respondents are still assessing what would be the best strategy. The survey also touches the heavily discussed topic of additional staffing. In fact, BNY found out that 39% of respondents decided that they are adequately equipped to handle the administrative requirements of AIFMD with their existing staff. In other words, that their existing resource will simply absorb the pressure of additional regulatory reporting. This suggests that these AIFMs are seeking to minimize the cost burden of compliance, while at the same time believing that the in-house department, as we have seen above, is equipped to fulfil reporting obligations with related data and systems. Otherwise, 22% of respondents believed that they would add 1 or more staff, and 26% are still assessing what would be the need. Conversely, 13% of participants believe that there is no significant additional work needed, and thus that no additional staff will be hired.

### Solutions

Finally, the survey focuses on solutions concerning reporting and compliance requirements. Thus, the importance of monitoring risk and compliance under the AIFM Directive is understood by the great majority of respondents, with 83% looking to either report daily or provide an online dashboard to summarise the risk and compliance reports, 50% and 33% respectively. 60% plan to provide monthly suite of comprehensive reports, 10% will only focus on market risk, and 7% are not planning to provide regular risk or compliance reports. One of the other key areas for compliance reporting is the regular provision of high quality, objective, and independent data. The main sources for this need, according to BNY, are in-house administration platforms or portfolio managers. As aforementioned, technology is considered by respondents to bring the highest cost. When asked about what tools and technologies they were thinking of using to deliver AIFMD risk metrics and compliance monitoring, 47% considered portfolio manager to deliver risk and compliance reports as the main tool. Closely followed from solutions developed in-house (43%). Also, 37% are considering technologies from external service providers and 27% were still assessing. Finally, another crucial question was asked related to the outsourcing of risk reporting and compliance reporting requirements. BNY found out that 61% of respondents were not planning to outsource these tasks. In contrast, 21% were considering outsourcing measures and believed that their current fund administrator has an offering that

meets their requirements, and 11% had already outsourced this function. Last, 7% of respondents were willing to outsource these reporting requirements, but were still looking for an adequate solution.

## **4.3. Interview Findings**

### **4.3.1 Participants Overview**

Three industry experts were interviewed between June and September 2015 in the hope of finding out more on the impact of AIMFD on private equity funds. The interview was structured in three parts and consisted in only open questions without intervention of the interviewer. First, an overview of where we actually stand concerning the AIFMD implementation and the role of regulators were discussed. Second, questions related to the impact of the Directive on private equity funds and third parties, and lastly questions about the future prospects of the private equity market were asked. A brief presentation of the participants is given below.

#### Sophie Charles

Sophie Charles is a lawyer and started her career as legal adviser at Deloitte Luxembourg. After a few years she joined UBP in Geneva, a large Swiss private bank, as fund lawyer. She then came back to Deloitte Luxembourg where she was a core member of the Regulatory Consulting practice, specializing in alternative investment funds, in particular private equity and real estate. After her time at Deloitte, she joined the real estate fund of LVMH where she was the Legal and Compliance Officer of their fund based in Luxembourg. Recently, she joined one of the largest private equity firms worldwide, Oaktree Capital Management, where she holds the crucial role of Conducting Officer in Luxembourg.

#### Yves Martignier

Yves Martignier is also lawyer and started his career at Banque Pictet, Switzerland's largest private bank, where he held various positions in his 20 years tenure. In his career, he was President of Pictet Gestion in Canada, the private banking arm of Pictet, Legal Executive in

Luxembourg, and for many years General Counsel of Pictet Funds, through which he developed an in-depth expertise of the fund market and relevant regulations. He also participated in several working groups at the Swiss Fund Association (SFA), the former Swiss Funds & Asset Management Association (SFAMA), and at the Swiss Banking Association (SBA).

#### David Martin

David Martin holds a Master in Law from the University of Lausanne in Switzerland, and started his career at PricewaterhouseCoopers. After his time at PwC, he joined Pictet Funds in Switzerland, where he headed the Risk Management and Compliance department. Today, David is the Head of Business Risk and Public Policy for Pictet Asset Management worldwide. He also participated in several working groups at EFAMA and is considered an industry expert.

#### **4.3.2. Participant 1: Sophie Charles**

When asked about recent updates on the implementation situation of AIFMD and how she would assess the role of regulators in Luxembourg, she smiled and said that not everything is going as smooth as initially planned. For the first session of reporting required by the Directive that happened this year, she explained that a total reorganisation was needed for many funds, and that many of them are still in delay, especially smaller funds due to their initially slimmer structure. As concerns the CSSF, SC gave a positive cooperative image by saying that they consider normal to give AIFMs enough time to be compliant, and that their duty is to help them in the first place, not to sanction them. Further, the CSSF apparently had to work many weekends in order to manage the additional workload generated by the first reporting session, the AIFM applications, and the monitoring of the Directive's implementation in general. Still today, many applications for AIFM licences are received by the CSSF.

SC was then asked to explain how she feels about the consequences of AIFMD for private equity firms, if she thinks that they are out of proportion as many people believe in the industry. She said that AIFMD is definitely expensive. She believes on the one side that requirements for minimizing conflicts of interest and enhancing the internal organization of funds is beneficial, but considers the Directive overall as being too burdensome for AIFMs. Thus, operational costs



are going up as AIFMs have to hire compliance managers and audit requirements are strengthened. She further states that reporting requirements are enormous, but that no one (cf. regulators and even some investors) has the time to really go through it, meaning that it is almost useless. On top of that, she argues that some requirements of the Directive, in particular concerning provisions on remuneration, are flawed. Thus, the use of advisors, who are easily put out of the scope of the Directive, is widespread in the private equity industry. SC wanted to demonstrate with this example that many provisions were not targeted specifically at private equity funds, but rather at all alternative investment funds in general, and as we can deduce, the *modus operandi* of real estate or hedge funds for instance are different. Another example, according to her, are the advantages featured in the Directive, such as the EU Passport for instance. In fact, the EU Passport is not of a big use for private equity funds as the marketing/distribution is done prior to a fund's launch. In other words, this advantage is almost useless, and thus demonstrates again that it was not adapted to private equity. The only real benefit SC sees is that AIFMD compliance will please investors, whose selection criteria are becoming increasingly strict.

When asked about potential alternatives for AIFMs, SC mentioned external AIFMs, even though she does not really seem to believe in its benefits. External management companies would take on the required risk management function on behalf of the fund, and delegate the investment management back to the fund managers, potentially reducing costs. Initially, the risk management function was always performed by the GPs as due diligences are done before launching a private equity fund, unlike for UCITS for instance where it is done day to day. SC also talked about the use of the multiplication technique, in which fund managers create ad-hoc empty structures in order to fall below the AIFMD threshold mentioned in the theory part of this paper. Thus, they also sometimes create fake investment managers, the real one being elsewhere, in order to multiply the structures. This last technique is considered illegal. In order to see if the multiplication technique makes economic sense, SC says that a classic cost-benefit analysis of the cost of AIFMD compliance versus the cost of additional structures should be performed. For this matter, the size of the fund will of course play an important role. However, the OCDE is apparently preparing a new fiscal regulation against opaque holdings, so funds are slowly avoiding having empty structure under their control, and thus the multiplication technique will soon become obsolete.

Concerning the increase in costs, SC believes that it should be around 2 bps of AuM, depending on the base structure, but that it is difficult to assess. According to her, one thing is sure is that investors are increasingly looking at fees. In other words, additional compliance costs will cut returns, and could even prove to be critical if the fund is already operating on a low margin as charging additional fees to investors will likely be difficult. This point has largely been attacked during the initial discussions on AIFMD, but as it was a highly political debate (as seen in the theory), the final text of law is based on compromise between different nations, rendering it not very efficient on many points. Alternatively, when discussing if the Directive has sparked the creation of new services or types of firms, she responded with a big “yes”. Reporting services coming mainly from Big4 audit firms for instance, have surged. Similarly, external risk management services helping private equity fund managers setting up adequate risk management frameworks, or insourcing risk management activities have also seen the daylight.

Overall, AIFMD has triggered many debates and lead to discontentment of many private equity firms, especially with U.S. ones. However, over time, these fund managers realized that they could not simply ignore the European market, which is important in size and easier to access than the Asian market, because of the Directive. Concerning the future of the industry, SC argues that a wave of consolidation in the private equity industry will take place sooner or later, due mainly to increased regulatory and operational costs. To support this argument, she told the example that 10 years ago people were launching small funds with around EUR 50m AuM, but that this would be unimaginable today because of economies of scale issues. In fact, she believes that smaller funds will have a particular rough time in surviving in the future. Otherwise, she believes that private equity activity will continue to grow in the future, despite AIFMD and future regulations. However, there will be operational changes and a general professionalization of private equity actors.

### 4.3.3. Participant 2: Yves Martignier

When asked about the recent updates concerning the implementation of AIFMD, YM said that things are moving forward even though ESMA is in delay on certain topics. He believes that it might have been caught short and underestimated the additional workload triggered by the transposition of AIFMD. Thus, since the initial discussion on the Directive, many consultation and Q&A sessions were needed in order to discuss the interpretation of the law, and there are still many provisions in need of clarification. However, he believes that regulators are doing a good job in providing help and support for alternative fund managers applying for AIFM licences, and that most European regulators are adding up resources. Further, he does not believe in any real (geographical) arbitrage possibilities for private equity fund managers in terms of regulatory race to the bottom as the Directive is fairly uniformed across the European Union.

Concerning the consequences of AIFMD, YM seems to agree that the Directive in general was not designed in an optimal way, as it regroups many types of alternative funds, having very different needs and operating modes, in one basket. He argues that for private equity funds and AIFs in general, reporting requirements represent a significant burden, triggering additional costs (which he was not able to quantify) and the loss of crucial management time that could be used for other endeavours. Also, some private equity managers might not be happy about deferred remuneration and the minimum share of variable remuneration. Further, YM mentioned that fund marketing costs are going up and that in parallel, private placement rules are becoming stricter (the EU regulators want to discourage fund managers to opt for NPPR and use the EU Passport instead). As a result, AIFMs are outrageously taking advantage of the reverse solicitation. Overall, Yves does not consider the AIFM Directive to be unbearable for private equity fund managers. However, he does believe that depending on the size of the fund, the implementation of the Directive represents a significant burden. He illustrates this with the following example: if a small private equity fund initially with 2-3 employees has to hire a new employee, such as a risk manager for instance, it immediately increases costs significantly. On the other hand, the fund with already 15 employees that has to hire one additional staff will not be bothered too much. Yves argues that many AIFs in Luxembourg for instance, tried to structure their funds so that they do not fall under the scope of the Directive. Concerning additional costs, he believes

that they will mainly be borne by the fund managers as investors have a strong position when it comes to selecting private equity funds. Some may opt for a shared model.

Yves also agrees that Directive has spurred additional business for third parties, especially for financial services firms such as Big4s. The latter have a deep expertise in investment management, especially in Luxembourg, and have created reporting services to cover the high demand coming from AIFMs. He also mentions the rise of external risk management companies, to which private equity funds can outsource their risk management duties. According to Yves, the risk management function is especially important in order to minimize conflicts of interest. For instance, as private equity managers earn their carried interest based on the return of their fund (IRR), they are incentivized to exit their investments early. However, in a fund with a lifetime of 10 years for instance, it is not in the interest of investors as they tend to prefer having a constant return over a few years. Thus, the risk manager exists, beside the initial risk assessment before launching the private equity fund and the recurrent monitoring, to avoid this kind of conflicts.

All in all, YM sees private equity as a very attractive asset class and do not consider AIFMD as being a threat to the industry overall. Of course, as in many parallel sectors, regulation is becoming an increasingly important topic that has to be coped with. Thus, he believes that the ability to develop new competences based on regulatory strategy will become more and more important in the future, as well as future concerns on taxation. He finally believes that bringing more transparency in the private equity market would rather be positive as it would help AIFMs to attract new investors and will lead to a better image of the alternative investment fund industry as a whole.

#### **4.3.4. Participant 3: David Martin**

When asked about recent updates on the Directive's implementation, David mentioned that in a post-Level 3 environment, everything has been said and written in terms of operational management of AIFs. The big remaining question, however, is the initially praised EU Passport. Thus, ESMA recently reached the verdict that the initial deadline of 2015 concerning the

Passport availability for third countries would be further discussed as it considers it too early to take a final decision. According to DM, AIFMD, as any law in general, should be based on a give and take basis. However, at the time being, AIFMD represents only an additional burden for AIFMs as the benefits of the EU Passport are not active yet. On the other side, he believes that AIFMD is better for private equity funds than the UCITS Directive for instance, as the former defined guidelines and requirements without defining a concrete output. Thus, UCITS orders for instance a certain percentage of liquidity depending on the AuM, which is irrelevant for private equity fund as it is a close-ended fund. Further, in terms of risk management provisions brought by the AIFM Directive, DM does not see any particular additional constraints for private equity funds.

As concerns the role of regulators and their behaviour, DM considers them to become increasingly pertinent. They have historically often been considered as “dummies” from the industry, but this is changing as they increasingly ask relevant questions and put their fingers where it hurts. Thus, the industry has difficulties abandoning this image. DM argues that the rise of regulators is also due to massive increases in resources, especially through hiring very senior people coming from the industry, and thus experts in the alternative fund sector. However, he mentions that EMSA has suffered very high political pressure from EU countries that one cannot trust self-regulation in the industry anymore, but he fears that it is actually overwhelmed. Thus, they were supposed to work on the EU Passport provision as mentioned above, but did not.

When asked about arbitrage possibilities due to differences in the transposition of AIFMD into national laws, DM believes that it is not really relevant. A few differences might exist, but the main provisions are the same everywhere. However, the main pain point, concerning private equity in particular, is the difference in fiscality, which is absolutely not uniformed across the EU. In fact, taxation on carried interest varies greatly between countries, and thus represents a major stake for the private equity industry in the future. David further believes that the consequences brought by AIFMD are not out of proportion for private equity firms. Even though he argues that the reporting requirements are heavy in terms of costs and paperwork, he believes that it is no “industry killer”. However, it is important to have the necessary experience and to be well informed about your own operations. He admits, though, that the consequences might be somewhat more costly for smaller funds, but that no one really has a choice. In fact, when

(institutional) investors will have to choose between two funds, one AIFMD-compliant and one non-compliant, they will ask themselves questions and probably opt for the compliant one. In other words, everyone will soon be obliged to comply with the Directive.

Concerning methods to avoid AIFMD compliance, DM does not consider the set-up of additional fund managers in order to split AuM between them, and so stay below the AIFMD threshold, as a very interesting idea. Of course, a cost-benefit analysis is always needed, but he argues that institutional investors seldom invest in funds smaller than EUR 100m. He adds that he does not see the point of pursuing a “chicken game” just to save some EUR 100,000. Further, he admits that for a bunch of guys that are willing to create their own private equity fund, AIFMD might come costly, but if it is to create a fund with the goal of scaling up business and looking for investors, being compliant with the Directive would definitely be a plus.

When asked about how AIFMs would handle the increase in costs, David mentioned that some will be forwarded to investors, but that the bulk will be borne by AIFMs. He personally thinks that remuneration issues were exaggerated. He illustrates this by saying that every time a new regulatory initiative comes out, people are crying wolf. In the case of the AIFM Directive, many fund managers reacted and said they would leave Europe if, for instance, a cap on bonuses as foreseen by the Directive, would be implemented. In the end, not many people left attractive cities like London or Paris to move to Chile for example, just to save some money.

DM also agrees that the rise of AIFMD has led to the creation of new services, and that outsourcing is a good strategy. Thus, he argues that Big4 accountancy firms developed new reporting services, which are working very well. However, AIFMD was initially thought to protect investors and not to create jobs. Concerning external AIFMS, he argues that they already existed during the time of UCITS, but that depending on the result of a thorough cost-benefit analysis it could be an interesting idea for some private equity funds. Overall, he believes that reporting services would have the greatest outsourcing potential, but that there are many ways to implement AIFMD depending on the structure of the fund. Further, he does not believe that any fund would really cease operations or relocate to avoid the Directive.

Finally, he is confident that the private equity industry will continue to grow in the future, but it will have to adapt to changing regulatory conditions in order to be successful.

#### 4.4. Analysis

The analysis part will be structured in three ways. First, the macro effects of AIFMD, or in other words, a discussion on the fundament of the AIFM Directive, the role of regulators, and the reasons behind the issuance of this complex regulation. Then, on a more micro level, the provisions and their impact on AIFs and private equity managers specifically will be analyzed based on the results of the survey and the interviews performed. Finally, the paper will provide some thoughts and ideas on the future of this industry based on what we have seen so far, and enumerate potential risks.

As a matter of fact, the AIFM Directive was perceived as an industry killer when industry actors first got wind of the initial discussions happening at the highest European political level. Thus, general panic spread out amongst hedge fund and private equity managers, both European and foreign. The Europeans believed it meant the end of the European private equity market competitiveness, and the others were thinking, or even threatening, to stay away from Europe in the future. One can argue that the panic was somewhat legitimate. In fact, AIFMD is definitely, if most probably not an industry killer, a game changer for the alternative fund managers. The first questions that arise are if the Directive was initially a good idea and if yes what is the ultimate purpose of this regulation? As we have seen in this paper, AIFMD could be interpreted as a political product rather than a tool to solve a concrete existing problem. Thus, it was the first time in the asset management industry that a regulation got so much attention, and the question is why? In fact, it has been proven that hedge funds, which were the primary target of pro-regulation politicians, and other alternative funds were not the cause of the global financial crisis, and did not significantly aggravate the situation. Further, a proof that the Directive was maybe an act of despair from European politicians is also the lack of clear separation between the different alternative asset classes. As we have seen, all non-UCITS funds were simply put in the same basket and regulated in mainly the same way, even though they have completely different operating modes and characteristics. Thus, as politicians and regulators were not reacting to an already existing issue, one could believe that this was a mere reaction to the financial crisis and the overall negative perception of alternative funds. In principle this is not a problem, but according to many actors in the industry, this makes the regulation not particularly efficient and, worse, expensive as we will discuss soon. This could be true considering the fact that until before

the entry into force of the Directive, the alternative fund industry was mainly self-regulated and performing rather well. Issues on transparency and market abuse were being dealt with through a growing number of respected associations propagating guidelines mandatory to adherents, and institutional investors seemed to keep investing more and more in the alternative asset class. Everything seemed fine. On the other side, the radical implementation of AIFMD for all alternative funds was maybe simply an act of prevention. Maybe politicians and regulators thought it would be good idea to design new rules proactively and not always on a post-crisis basis as it has most often been the case in financial history. One thing is sure, there has been a shift towards public regulation since the crisis. Thus, as we have seen in the interviews, regulators are becoming more involved, cooperative, and are eager to gain understanding and control over the industry, until then, rather acting in the shadow of big financial institutions. Therefore, they are significantly growing their staff and are deepening their expertise by hiring senior people from the industry. Be aware, the image of the naïve and ignorant regulator might come to an end very soon. Eventually, this could bring industry players and regulators on a same level, fostering on-going dialogue, and leading in turn to a change in business ethics rather than to additional stiff rules. However, some might argue that stiff rules and direct regulation are not always bad. Thus, stiff rules with clear defined sanctions could have a strong deterrence effect, and direct government regulation would ensure a wide diffusion of new standards for instance. Even though the overall effectiveness of AIFMD can be questioned, there is no doubt about the wide and efficient transposition of the Law in European Member States. In fact, everyone seems to agree that they are no real (geographical) arbitrage possibilities when it comes to AIFMD compliance.

On a micro private equity level, we found out in this paper that the AIFM Directive is definitely burdensome for fund managers. First, one could argue that they were victim of the bad press around hedge funds, and thus got “punished” for being categorized as an alternative asset class. In fact, private equity was not initially on the front line when the Directive was being discussed. Moreover, it was even more a bad surprise as the success of private equity historically relied on the fact that they avoided scrutiny from regulators. Now, with AIFMD, the game has changed. Survey and interview results seem to match, regarding reporting and transparency requirements as the most burdensome/costly provisions. Thus, even though many seem to be still assessing the real financial impact the Directive might have, technology and the cost of outsourcing reporting



functions to external providers seem to be the major cost brackets. Overall, almost the majority of the survey respondents forecasted compliance cost of AIFMD to be less than USD 200,000. This is significantly lower than the 2bps of AuM mentioned by an interviewee, assuming an average fund size of about USD 700m (Preqin, 2015). In fact, this would result to compliance cost amounting to USD 14m, which seems completely exaggerated. Maybe it is a sign showing that, as mentioned earlier, many private equity professionals simply do not know yet the real financial implications of the Directive. Similarly, both sources of information also tend to differ concerning the hiring of additional staff. Thus, the survey shows that a majority of fund managers do not intend to add staff, whereas interviewees feel confident that headcount will increase. This could maybe be explained by the fact that fund managers about whom they are talking do not outsource as much as the survey respondents.

Risk management represents also an important discussion topic. As we have seen from the survey, only a small share of fund managers had already separated this function in the past, and thus the majority will have to set up new risk management frameworks. Again, many private equity fund managers seem to wonder what strategy to adopt and how to best implement it, especially because risk management in private equity happens mainly before the launch of the fund. The most burdensome provisions, as aforementioned, are reporting duties and transparency requirements. In fact, everyone seems to agree that the AIFM Directive is a real pain point in that matter. Not only because of the depth of the information that has to be provided, and we know that private equity has been a discrete industry, but also because of the frequency of the reports. Interesting is also the fact that some interviewees believe that these reporting requirements are close to useless, because regulators and also investors do not have the time to go through all of it. Thus, we found out in these interviews for instance that ESMA and other national regulators are considerably in delay with the implementation of the Directive, so how could they possibly have the time to read all the additional information? Maybe it is a way to make fund managers aware of their responsibilities, and on the other side, regulators may simply need some time to adapt as well. Similarly, remuneration has been a hot topic since the inception of the Directive. Even though, the feared caps on bonuses were not implemented, significant changes, such as deferred remuneration and an increased variable component for instance, have sparked some discussions. Although many might have shown discontentment we have seen in this paper that maybe this was a good idea in order to promote long-term focus of AIFMs regarding

performance. On the other hand, some legal techniques in the private equity exist in order to bypass these requirements, so what is the point? Overall, it must be said on the side line that these regulatory practices are nothing new, as they already existed in the banking sector. Then comes the topic of asset stripping. The asset stripping provisions, which are specifically targeted at private equity funds, might sound good in terms of protection of portfolio companies and their employees, but are they really needed? In fact, we have discussed the example of the private equity firm Permira and the dilemma between shedding some assets, and thus generating negative press, and letting the target company go bankrupt. Without initiating a moral discussion around this, the first option might be better for the economy. Further, we have also seen the trend that assets of private equity funds are kept for a longer period of time, meaning that real asset stripping cases are becoming increasingly rare. This is probably due to the fact that private equity funds have better screening frameworks, and more importantly, as discussed in this paper, LPs are more interested in long-term returns than short term gains. In any case, when do we have an asset stripping situation? Is it after laying off 10% or 50% of the workforce, is it after selling off 20% or 40% of the business? The problem with the proportionality principle, as often used in the Directive, is that it is assessed on a case-by-case basis, and thus needs significant resources that eventually could be used in a better way.

An additional question mark is how private equity managers are going to deal with the increased cost of compliance? As we have seen in the survey and interviews, no fund manager intends to fully pass on the costs to the fund, and thus raising the TER. Of course, this makes sense as competition in the private equity market is growing and no one wants to lose LPs for future fundraising. Many are still assessing the situation, but private equity managers will certainly be pressured to bear the biggest part of incremental costs, thus reducing their own return. This leads us to the discussion if costs generated by AIFMD are overproportioned for smaller private equity funds. The majority of interviewees believe that indeed smaller funds, or funds already operating on a lower margin, could face difficulties to survive in the medium to long-term. Thus, for a small private equity firm, hiring additional staff or investing in new reporting technology signifies an important proportional increase in total costs. As in any industry, economies of scale will play an increasingly crucial role in the future of asset management, triggered by growing competition, more demanding LPs, and increasing regulatory pressure.

As concerns the main benefit of the Directive for AIFMs, the so-called EU Passport, the opinion of the private equity industry seems pretty clear. It is inexistent. Thus, because of the different mode of operation and fund marketing process of private equity funds, the Passport per se is relatively useless. Further, even if it were an advantage, European regulators are significantly in delay concerning the issuance of final guidelines, and keep postponing them. In parallel, national regulators are already tightening the rules for NPPR placement in order to incentivize the use of the Passport, and thus AIFMD compliance. One can ask how this is supposed to work. Thus, as we have seen, regulations should always be based on a give and take basis, unfortunately with the Directive it is not the case. Until now, and especially for private equity funds, it is perceived as representing a mere burden, and thus can explain the general disdain. As a result, the unintended consequence of abusive use of reverse solicitation is currently happening in Europe.

However, a positive consequence of AIFMD, even though it was not initially the goal, is the creation of additional business for third party providers. Thus, as discussed, many new services focused on risk management, reporting, and data analytics for instance have seen the daylight, boosting the interconnectivity of the financial sector and sparking innovation. Another benefit of the Directive is the increased investor protection. One could argue that this is not really needed as only professional or well-informed investors invest in private equity, and thus probably already had sufficient resources to perform thorough due diligences on fund managers, but still it represents an additional risk reduction measure, which is always good to have. In other words, being AIFMD compliant will probably play the role of a quality seal that will soon become inevitable in order to attract institutional investors or to avoid them starting to invest directly in company by bypassing private equity firms.

Overall, even though some consider the Directive as being too burdensome for the European private equity sector, most do not believe that it is unbearable. Of course, fund managers will have to adapt and will have to rethink their business model in order cope with additional regulatory costs, but this will probably lead to innovation and a professionalization of the industry, which in turn would be good for every stakeholder. As there is no best way to implement the Directive, new competitive advantages might arise from it, who knows? Also, the initial threats of leaving the European market are unfunded in most cases. Thus, many fund managers understood that they have no choice than to comply with AIFMD as the European

private equity market is still too important to simply leave aside. In addition, if we look at general concerns about the future of the private equity industry, additional compliance requirements are almost never cited. Thus, economic downturns and slowing growth, increased competitive pressure, national structural changes, or fiscal policy for instance, are all potential issues, but regulation does not seem to worry most industry actors. What we might see in the future, though, is a wave of consolidation in the private equity sector due to increased costs and pressure on fees coming from investors and increased taxation on carried interest. In other words, private equity funds managers will have to deal with it.

## **5. CONCLUSION**

As we have seen, the AIFM Directive is changing the rules of the game. Thus, the consequences for private equity fund managers are important, and the industry might most probably change. In theory, the Directive is well designed as it addresses some of the common issues of alternative investment funds, such as excessive leverage, asset stripping, conflicts of interest and transparency issues for instance. However, there are severe concerns that it is more of a package solution rather than a well-thought and precise regulation aimed at reducing specific risks depending on the alternative asset class. This, in turn, leads to the conclusion that the Directive maybe stems from an impulsive reaction of politicians pressured by the general public at the aftermath of the global financial crisis. The problem with this, as we have seen, is that it will never be able to efficiently regulate all kinds of alternative funds, if no further specifications are provided. Thus, private equity funds are suffering for something they are not responsible for. Of course, pro-actively enhancing market transparency and reducing market abuse is a good thing, but why then issue such a burdensome and far-reaching Directive if specific points could be individually regulated? If we put ourselves in the shoes of regulators, we could believe that they did it correctly. In fact, they were able to significantly leverage provisions from the UCITS Directive, which has been a huge success in the fund industry, and were able to standardize methodologies across the entire European alternative fund industry. However, one could argue that the standardization goal of the Directive is the main problem, thus mainly following the general trend of enhanced communication exchange and integration of European financial

markets, as it has been the goal of the European Commission for decades. The concrete qualitative and quantitative impacts of AIFMD and private equity fund managers will still need to be assessed as many aspects are still under development as we have seen, and many fund managers are still thinking about how to best cope with this new situation. However, as we have seen, one can already say that even though some divergence exists it implies high compliance costs, and that many industry players feel that they are treated unfairly.

As the AIFM Directive has been only recently transposed into national laws, it would be interesting to conduct further research in a few years in order to correctly assess if it was indeed a good idea, and what are the real financial and organizational implications of the Directive. Thus, we are in an intermediate state as we have seen that both regulators and private equity firms are in the process of figuring out how it should go forward. Regulators, on the one side, have to focus on asset class specifications and delivering the sweet side of the Directive, and on the other, private equity fund managers have to realize that they cannot avoid tightening regulation, and concentrate their efforts on finding viable implementation solutions and leverage these compliance requirements in the best possible way.

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## 7. ANNEX

### 7.1. Interview guide

- What is the current attitude from PE funds towards AIFMD? Where are we now in the implementation cycle?
- How would you assess the role of regulators? Are they responsive, cooperative and organized?
- Is the impact of AIFMD the same in every EU countries? Are there any regulatory arbitrage possibilities?
- Do you consider AIFMD as leading to consequences out of proportion for PE firms? If yes, why?
- In this context, are there any differences for funds of different sizes?
- In your opinion, what are general disadvantages/advantages of AIFMD for the PE industry?
- What are the most burdensome requirements for fund managers? Do you think they make sense?
- What would be alternatives if a fund manager chooses not to comply with the regulation?
- How will PE firms cope with increased costs? Will they be passed on to investors or borne by the AIFM?
- Has the rise of AIFMD led to the creation of new services/types of firms?
- What are typical activities that PE fund managers could outsource as a way to facilitating greater operational efficiency and potentially saving costs?
- Do you believe that some funds will cease operations or relocate in order to avoid the Directive?
- How do you see the evolution of the PE industry in the years to come (especially after the AIMFD implementation)?