

The Norwegian Ministry of Finance opens for Norwegian hedge funds

On 14 March 2008 the Norwegian Ministry of Finance put forward a proposal for legislation regarding changes in the Investment Funds Act which will allow the establishment of Norwegian hedge funds (referred to as "special funds"). The draft legislation will also to a larger extent than today open for marketing of overseas hedge funds in Norway.

SUMMARY

The draft legislation can be summarised as follows:

- "Special funds" introduced as a new subcategory for securities funds which are regulated by the Investment Funds Act.
- Special funds are given a broad right to raise loans, trade in derivatives, engage in short sales and securities lending. Special funds are further exempted from the general protection rules which otherwise apply for Norwegian investment funds (i.e. UCITS-funds) related to the issue and redemption of units, absolute investment limitations (requirements for assets etc.), relative investment rules (requirements to risk diversification etc.) and management remuneration. At the same time the requirements for strategy statements, risk limits and the fund's guidelines for measurement and risk management are tightened. The special fund will send periodical reports to the investors, the Financial Supervisory Authority of Norway and the custodian regarding the actual risk of the fund during the relevant period.
- Special funds can be sold to the public only pursuant to advice from an investment adviser with a license in accordance with the Securities Trading Act. This requirement does not apply in connection with sales to professional investors. The Financial Supervisory Authority's original proposal, that special funds can only be offered to private investors with a financial wealth exceeding NOK 5 million, has not been maintained in the proposed legislation.
- The most important supervisory measure of the Financial Supervisory Authority will be the approval of the articles of association for the special funds.
- The original proposal from the Financial Supervisory Authority entails that private equity businesses could be included under the Investment Funds Act. This was criticised during the public hearing and the proposed legislation does not provide for the establishment of an organisational structure for

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private equity businesses. In connection with this, reference is made to the fact that ordinary company law provides a sufficient framework for the organisation of such businesses.

EXPECTED ENTRY INTO FORCE

The proposed legislation presupposes that important rules are given in regulations, including rules pertaining to the reporting of risk and the role of the custodian. The statutory rules will most likely be adopted by the Storting during the spring. The Financial Supervisory Authority will be given the task of formulating draft regulations, which will be sent to a general hearing. If the proposed legislation is adopted by the Storting and the hearing of the new regulations does not reveal any particularly complicated or unclarified issues, the statutory rules with the accompanying regulations might come into effect on 1 January 2009. However, this is an uncertain estimate.

IMPORTANT CONSIDERATIONS BEHIND THE PROPOSED LEGISLATION

Norwegian investors can already purchase units in foreign special funds. It is only the marketing that the foreign funds are prevented from undertaking in the Norwegian market.

Based on this, the Ministry of Finance emphasises that the important issue is whether arrangements should be made for that Norwegian management companies for investment funds shall be able to offer special funds (hedge funds etc) pursuant to the Investment Funds Act, and not whether it should be permitted or forbidden to sell special funds to Norwegian investors. Pursuant to the assessment by the Ministry of Finance, neither *the consideration of financial stability* nor *assertions of lack of transparency* in special funds would call for a continued prohibition against the establishment of Norwegian special funds. On the contrary, reference is made to the fact that Norwegian special funds will be subject to Norwegian rules pertaining to transparency etc., something that could provide better conditions for control of the funds' activities and make it easier for Norwegian investors to fulfil their obligations pursuant to the Norwegian Tax Assessments Act. Reference is also made to the fact that the competitive situation in the Norwegian funds industry would in itself indicate that arrangements are made for the establishment of such funds in Norway.

With regard to the *consideration of investor protection* the Ministry notes that special funds entail different types of risks compared to investing in general investment funds, however this does not necessarily mean that the risks are greater. It is acknowledged that the rules pertaining to risks in the Investment Funds Act are not appropriate for funds that seek absolute yields (such as hedge funds) something that calls for significant exemptions from the Act. On the other side there is no point in permitting such funds to be established under the Investment Funds Act if none of the provisions of the Act could be applied for their activities. This dilemma is solved by exempting special funds from a number of operating rules that follow from the Investment Funds Act at the same time as the Act's "structural rules" (for organisation etc) are applied. In addition, separate limitations are introduced on the sale and distribution of such funds, cf. below.

DISTRIBUTION OF SPECIAL FUNDS – REQUIREMENT TO RECEIVE ADVICE FROM INVESTMENT ADVISORS

According to the Ministry's assessment, it is neither necessary nor appropriate to reserve investments in Norwegian-established special funds for especially wealthy individuals. The Financial Supervisory Authority's original proposals to introduce requirements for minimum financial wealth (NOK 5 million) and minimum subscription amounts (NOK 500,000) have therefore not been followed up.

Special funds can therefore be sold to non-professional investors, however, such that the interests of this group of investors is ensured through a requirement that sales of units in special funds/hedge funds can only take place after advice from an investment advisor with a license pursuant to the Securities Trading Act (implementing MiFID). However, management companies for investment funds that are subject to the rules for investment advisory services may also provide the required advice. The Ministry can

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provide regulations for this, including provisions for how specific the relevant investment advice must be in order to fulfil the requirements of the Act.

The new rules for investment advice entail, among other things, that the advisor must be of the opinion that the investment is specifically "suited" to the investor in question. The requirement for a specific assessment entails that the authorities can not classify a group of funds as being generally unsuitable for non-professional investors. The core elements in such a suitability assessment will be whether the investment is in accordance with the customer's investment objectives, whether the customer is financially capable of handling the risk and that the customer has the necessary experience and knowledge to understand the risk. The Ministry notes that it is precisely such considerations that a potential investor in a special fund should receive qualified advice on. Reference is made to the fact that poor advice can result in liability for compensation for the advisor.

This imposed "channelling" through an investment advisor does not apply to professional investors as defined in the Norwegian securities regulations (implementing the MiFID definition of a professional investor).

REGULATION OF THE PRODUCT – EXEMPTIONS FROM IMPORTANT RULES IN THE INVESTMENT FUNDS ACT

General information

Special funds differ from regular investment funds (UCITS-funds etc.) by the fact that they often aspire to positive yields regardless of the market development, and to achieve such yields there are fundamental differences between the investment strategies in hedge funds and traditional funds. It is normal for hedge funds to debt finance parts of investments, engage in short selling and enter into derivative contracts. The main risk in regular investment funds is associated with the development in the financial instruments the fund has invested in (i.e. general market risk) which is handled through detailed requirements for risk spreading and placement restrictions. Special funds that seek absolute yields are not necessarily exposed to general market risks in the same manner. Based on this, a number of exemptions are proposed from the general rules contained in the Investment Funds Act that regulate such risks. For certain issues special rules are also proposed for special funds that will take into consideration these differences in risk.

Requirement for prospectus

No changes are proposed to the general prospectus rules which apply to regular investment funds. The management company must therefore ensure that a complete and abbreviated prospectus is prepared for the relevant fund.

Requirements for articles of association

Special requirements are proposed for the articles of association of a special fund, including requirements for the articles of association to state the fund's area of investment, strategy, risk guidelines and methods for risk management. A number of special funds will have investment strategies that will be difficult to define in writing in the articles of association because flexibility in strategy is a central characteristic of such funds. The more detailed requirements for descriptions of risk will have to be specifically assessed and the exercising of judgment by Financial Supervisory Authority's will no doubt be a decisive factor. Furthermore, in the regulation the Ministry could set more detailed requirements for the special fund's risk and management of risk. Like the present situation, the articles of association shall be included in the complete prospectus.

The issue and redemption of units

The continual issue and redemption of units is a central characteristic of investment funds. However, according to the draft legislation the special funds are granted the right to restrict the issuing of new

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units ("closed access") because such funds will have an actual need to limit their size to maintain profitability. According to the draft legislation, special funds are also granted the opportunity to restrict the unit holders' rights to continual redemption of units ("closed exit"). This is due, among other things, to the fact that the investment strategies used by a number of special funds assume a certain level of predictability in the fund's liquidity. However the fund must be open for redemption at least once a year. The minimum annual opening period shall not be less than two weeks. In addition, the fund shall be open for redemption in connection with certain special occurrences, including amendments to the articles of association. In the preparatory works of the proposed legislation, special mention is made of the responsibility investment advisors will have for informing potential non-professional investors about such restrictions in the redemption right.

Eligible assets and requirements for diversification

With regard to rules on eligible assets, it is proposed that special funds (as opposed to general funds) shall be able to invest in, among other things:

- *Unlisted financial instruments:* The exemption applies both with regard to shares, money market instruments and bonds etc. In principle the exemption applies to the special fund's right to invest in unlisted derivatives. However, the right to invest in derivatives assumes amendments to the derivative regulation. The derivative regulation will also allow special funds to be able to invest in credit derivatives and currency futures and currency options.
- *Fund in funds:* The right to establish Norwegian special funds that invest in foreign special funds is conditional upon, among other things, the foreign fund and the administration of this being subject to adequate monitoring in the home country. In addition, it is a condition that satisfactory regulatory cooperation is established between the Financial Supervisory Authority and the home country of the management company. Therefore it is not a requirement that regulatory cooperation is established with the fund's home country. This is important with regard to the many funds that are established outside the EEA area.
- *Other assets:* No amendments are proposed to the current statutory rules that require the assets of investment funds to be placed in financial instruments. However, there is the possibility that special rules could be provided for this in a regulation. Units of limited partnerships are currently not defined as financial instruments under Norwegian law, and are thus exempted from the investment universe of investment funds. A regulation as mentioned above might rectify this situation, if the Ministry should choose to do so.

With regard to the requirements for diversification of the investments of special funds, the following is proposed:

- Special funds are exempt from the general obligation to ensure a composition of the portfolio which "appropriately spreads the risk of loss".
- The prohibition against securities fund placements in one individual company not constituting more than 5% of the fund's capital shall not apply for special funds.
- With regard to the placement restrictions for an individual issuer, it is, however, proposed that the prohibition against owning more than 10% of the shares in an individual issuer shall apply for special funds. To the extent to which this restriction should entail a restriction for certain investment strategies, the Financial Supervisory Authority will be able to make exemptions.

Borrowing, short trading and securities lending

An important condition for the investment strategies of many hedge funds will be the right to raise loans (gearing), loan out financial instruments and engage in short trading. For this reason, special funds are exempt from the statutory rules that restrict the Securities fund's right to engage in such activities.

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Since special funds are granted the right to raise loans and trade in derivatives, the question of whether unit holders can be liable for more than their investments can soon be raised. Therefore it is proposed to emphasise in the wording of the Act that unit holders are not liable to the creditors for the fund's obligations. This applies to investors in their roles as unit holders such that investors can take on obligations for the fund or its creditors on a contractual basis.

The role of the custodian

The custodian for special funds is assigned a special control function pursuant to the draft legislation that in many ways will be a supplement to the on-going supervision by the Financial Supervisory Authority. Among other things, the custodian is given a special responsibility to supervise the management fees. The custodian's tasks will be regulated in more detail in a regulation.

Requirements for value assessments etc.

As long as special funds are open for subscription and redemption, the net asset value of the fund must be continually calculated to ensure the equal treatment of unit holders. In addition, it is necessary to calculate the fund's value when determining the management fees, since this will often be based on the development in the value of the fund. At a minimum, such a calculation will be made every sixth month. However, during periods in which the fund is closed, the proposed legislation does not require a continual calculation of the value of the fund.

Requirements for risk management

Pursuant to the proposed legislation, special funds must institute a system for managing risk which makes it possible to monitor and measure the risk in the fund. However, special funds could have a number of different risk strategies and it is therefore proposed that more detailed rules should be introduced for such requirements for risk management in a regulation.

Management fees

In the proposed legislation it is proposed that a special fund should be relatively free to design its structure for management fees, including discounts on an individual basis. It has therefore been signalled that the current regulation pertaining to differentiation of management fees of investment funds, shall not be applicable for special funds. However it is emphasised in the preparatory works that such individual discounts may not amount to a violation of the basic principle of equal treatment of the unit holders.

MARKETING AND SALES OF FOREIGN HEDGE FUNDS IN NORWAY

The Investment Funds Act and the new statutory rules for special funds also apply for foreign "investment funds". The reference to investment funds entails, among other things, that foreign fund constructions that are included under the scope of Act must have the same fundamental features that characterise an investment fund pursuant to Norwegian law. These are assessments that must still be made after a specific assessment of each fund, and no amendments are proposed in the Act for this point. However it is stated that unit holders in "investment funds" can not be liable to the fund's creditors, cf. above.

Foreign investment funds, including hedge funds, must, in accordance with applicable laws, have permission from the Financial Supervisory Authority prior to any marketing advertise in Norway. Such permission requires, among other things, that the home country of the fund has rules that give investors "protection that is, at a minimum, at the same level as the protection they receive from investing in a Norwegian investment fund". No changes have been proposed for these rules. The national "benchmark" will however be changed considerably if the new statutory rules are approved by special funds being exempt from the important placement rules in the Act, such that it could be expected in the future that the Financial Supervisory Authority will, to a greater extent than at present, permit marketing of foreign hedge funds in Norway.

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