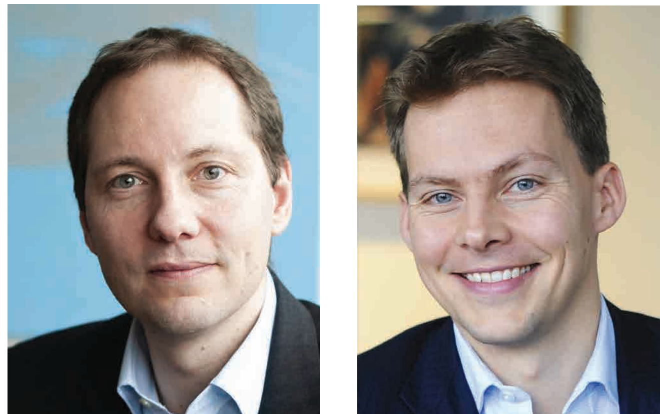
KEYNOTE INTERVIEW

The effect of regulatory change on the fundraising market



Managers will feel the impact of new proposals on both sides of the Atlantic, say Sam Kay and Will Normand, partners in the funds department at Travers Smith

Q The US Securities and Exchange Commission has recently announced some far-reaching proposals to change the rules around regulating private funds. What do those proposals involve?

Sam Kay: The rules proposed are aimed at increasing transparency and trying to prohibit certain activities that the SEC doesn't believe are in the interests of investors. The SEC seems to be moving away from its previous approach, which was focused around disclosure as a means of investor protection, towards giving direct guidance on what GPs can and cannot do.

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Elements of the proposals impact both fundraising and the way funds are operated. On fundraising, there are proposals to prohibit giving certain forms of preferential treatment to investors and to require disclosure of all other kinds of preferential treatment. For example, the SEC is saying that where a GP would like to offer a preferential fee rate to a key investor that invests across their platform, those sorts of arrangements can only be permitted if there is full disclosure. That is something we are already familiar with in Europe under existing regulations, but for US managers, it is a new approach.

Another significant change is a requirement for more detailed quarterly reporting, particularly on fees and compensation that GPs receive from

portfolio companies and investors. And those are just two of the key proposals – there are lots more that managers need to be aware of.

Q How will the changes impact European fund managers?

SK: There is an indirect impact – the US is a significant arena for GPs to raise funds and therefore the way the US rules evolve will influence market practice. Europe, along with the rest of the world, does tend to follow the changes made to US regulation because it is such a key jurisdiction for private fundraising.

A more direct impact, though, is that several of these proposed changes may apply directly to European GPs. Certain European managers, if they are raising capital in the US, already go through an SEC approval process to become what is called an 'exempt reporting adviser', and some of the rules that the SEC is proposing will apply to ERAs.

Of my two examples, the quarterly reporting changes will only apply to US-registered investment advisers, but the preferential treatment rules will also apply to ERAs. This makes sense: with regards to the reporting, the SEC is trying to gather information about how funds are being managed in the US, whereas the preferential treatment rules are about making sure US investors are protected regardless of where a GP is headquartered.

Q How are rules on sustainable finance and the taxonomy impacting the fundraising market?

SK: In order to be marketed into the European Economic Area, the EU's Sustainable Finance Disclosure Regulation requires a fund to be categorised as a particular type of sustainability product. Article 8 of the regulations covers products that either promote environmental and/or social characteristics ('light green' products) or are committed to making sustainable investments. Article 9 ('dark green') are products that invest exclusively in sustainable investments.

Any product not covered by these two articles is a 'mainstream' product covered by Article 6 of the regulations. GPs are having to consider what degree of disclosure they need to make as a result of those categorisations.

We find that GPs want to show that they are taking sustainability seriously, and that implies they are going to classify a fund as Article 8. The wider world is very much alive to the need

Q Moving away from the US and towards Europe, what are the latest updates on AIFMD II?

Will Normand: The European Commission's proposals for amendments to AIFMD have now been published, and the good news is that no fundamental change is proposed from what we are used to. The delegation model that exists still stands, with just some updates around appropriate levels of delegation and oversight, but nothing fundamental that needs to be done differently.

One thing slightly hidden away in the proposals that has caused concern relates to credit funds. There is a proposal that open-end funds should not be able to offer lending strategies – in other words, it requires credit funds to be closed-end. An increasing number of credit strategies are structured as Luxembourg open-end funds; those products have proved popular with private banks and distributors to the high-net-worth investor community, so it does look like a retrograde step.

Anything already in existence is expected to be grandfathered, so the new rules would not undermine anything already launched, but lots of industry bodies have commented. We will see what happens – these are only proposals, which will go through the parliamentary process. We are unlikely to see any new rules implemented before late-2024 at the earliest.

to be doing something on ESG, and therefore going for Article 8 is viewed as a positive thing.

The implications of all this will be felt when the EU Taxonomy Regulation comes fully into force in January 2023. This will require GPs to more accurately disclose how their underlying investments meet the criteria for environmental sustainability and "do no significant harm" to any other objective in the regulations. If you are an Article 8 or Article 9 fund, you must report and classify your activity in a very prescriptive way, and alignment with these Taxonomy rules will be complex and technical.

Certain GPs may find it quite hard to report in such a particular way. But if they have marketed a fund on the basis that they are committed to some sustainable investing and then they fall down on the reporting, it is possible they will be open to accusations of mis-selling their fund to investors. As a result, GPs and investors could end up in conflict.

Right now, it is all about disclosure and moving towards that prescriptive reporting, so managers are working out how to gather the information to comply. Some of the guidelines on the reporting are yet to be published.

WN: The interesting thing is that a number of litigation funders are already raising money with a strategy of going after what they perceive to be greenwashing in the asset management industry. This is going to be a huge focus over the coming year; there is certainly increasing pressure on managers to classify funds as Article 8, but also a growing risk associated with that.

There is also the additional burden for managers of having to comply with EU, US and UK regimes on this. The reality is, you are potentially going to have to collate three sets of data for regulators with the same underlying aims, but with approaches that don't directly marry up.

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WILL NORMAND

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SAM KAY

Q Are there any other regulatory changes or trends likely to impact the market this year?

WN: Linked to AIFMD is the review of the EU's Long-Term Investment Fund regime, which is out for consultation, and would allow for retail marketing by funds that fall within its scope. That is quite a prescriptive regime in terms of the investment limitations, but the focus is on private equity, credit and infrastructure strategies.

So far, it hasn't been widely adopted because there were failings in the original regime, but a few large managers have raised ELTIFs, and that has given rise to more interest across the alternatives community.

There is a broad focus on expanding the LP base to tap more high-net-worth investors, so the commission is looking at removing some of the impediments to managers launching those funds. That's a welcome development, and we expect those funds to become more mainstream.

SK: It is easy to be concerned by the escalating level of regulation that private funds need to deal with, but it is a sign of the importance of these funds in the market and the need for them to be monitored, regulated and supervised.

We expect the assets under management in the private funds universe to continue growing, and more oversight will attract even more investors to the asset class.

We are also seeing moves to open private funds to the defined contribution pension schemes, and there is a consultation by the UK's Department for Work and Pensions with proposals to remove some of the road blocks there.

The takeaway is that if private funds want a wider pool of capital coming into their strategies, then the cost of that is going to be a higher level of regulation. ■