Report

New in RegTech:

Private funds regulation; the SEC's new reporting rules for shareholders; upcoming deadlines for ESG reporting by financial firms; checking in with AI.

by:

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Private funds: Regulatory change takes hold in US, planned for EU

Compliance deadlines for the SEC's new private funds reporting requirements are already upon us. On 11 December 2023, the SEC's Form PF amendments will require current reporting of certain events by large hedge fund advisors within 72 hours, as well as additional quarterly reporting by private equity fund advisors. Meanwhile the SEC's 2024 Exam Priorities reveal that, as "private funds remain a significant portion of the SEC-registered investment adviser population", the SEC will continue to focus on these advisers, including with respect to Form PF event reporting. For more details and compliance dates surrounding the SEC's new rules for private funds as well as tailored shareholder reporting, consult our November edition.

Looking further ahead and across the Atlantic, we see that the EU has taken the next step in its development of "AIFMD II", with the European Council having recently published the final compromise text. Slated to be considered by the European Parliament in February 2024, the amended AIFMD introduces new rules on loan origination by AIFMs and AIFs, and addresses other areas including liquidity risk management, regulatory reporting and depositaries. Eventual implementation by EU Member States into their national laws is expected in 2026.

"The amendments are designed to enhance the ability of the Financial Stability Oversight Council (FSOC) to assess systemic risk and to bolster the Commission's oversight of private fund advisers and its investor protection efforts."

- SEC Press Release, "SEC Adopts Amendments to Enhance Private Fund Reporting"

Post-trade disclosures: Large investors in U.S. markets face more reporting

Holders of long positions on U.S. exchanges, no matter where situated globally, should take note of the official publication of the SEC's Final Rule on beneficial ownership reporting, because that release sets the first compliance date at 5 February 2024. As we explain in Traders Magazine, investment managers need to take steps across their compliance, operations and legal departments, to adjust to the shorter deadlines and required use of machine-readable 13D/G-specific XML for filings.

When it rains it pours, and so the SEC has seen fit to impose more threshold disclosure regimes upon market participants. Institutional investment managers will need to carefully examine the SEC's recently adopted short sale position reporting Rule 13f-2, as our Aspasia Latsi details in her analysis of the new rule for Traders Magazine. The SEC has also proposed a rule for disclosure of security-based swap positions (Rule 10B-1, which was spun off from the SEC's other swaps-related rulemaking efforts). While the SEC's rules for short positions and swaps reporting will set out initial compliance dates somewhat further away than its rule for long holdings, investment firms wanting to stay in front of these changes have started planning their workflow adjustments.

"The introduction of a Short Selling rule is now a thing in the U.S. The Securities and Exchange Commission ('SEC') was urged to adopt a new short sale disclosure rule, Rule 13f-2, to increase transparency in the aftermath of the GameStop saga."

- Aspasia Latsi, International Regulatory Analyst, Confluence

ESG: Under global backdrop of COP28, EU and UK investment firms hunker down for nearby reporting deadlines

As the United Nation's Climate Change Conference marches onward in Dubai (COP28), amid controversies ranging from conflicts of interest to astro-turfing by "impossibly sultry" bots, its program reiterates the urgent call for climate action, including through private finance flows.

In the EU, where regulators seek to build reliability around such finance flows by mandating climate disclosures, investment firms are looking point-blank at the next set of new reporting requirements:

- On 1 January 2024, large financial firms subject to Taxonomy Regulation "Article 8" disclosures will need to start addressing their Taxonomy-aligned activities according to detailed regulatory technical standards.

- On 1 January 2024, the EU Taxonomy itself will introduce new industries and technical screening criteria that investment firms will want to integrate for their reporting, as detailed in an amended Climate Delegated Regulation and a new Environmental Delegated Regulation recently published by the European Commission.

- New reporting guidance issued by ESMA addresses the definition of sustainable investment, the "do no significant harm" principle, and the use of sustainability "estimates"

- Extensive changes to SFDR reporting, which on December 4th were finalized by the ESAs in the form of a Final Report with a newly revised RTS (regulatory technical standards) including new disclosure forms, now await approval by the European Commission. Once the Commission approves, the new requirements go into effect 20 days after publication in the EU Official Journal. (In a press release, the ESAs added for clarification, "These draft RTS would be applied independently of the comprehensive assessment of SFDR announced by the European Commission in September 2023".)

For a reader-friendly view of the current status and future plans for EU sustainable finance, see ESMA's just-issued statement as well as guide.

Meanwhile in the UK, 31 May 2024 represents the first compliance date for its recently finalized Sustainability Disclosures Regulation (SDR), the broad framework that imposes product and entity level sustainability reporting, anti-greenwashing rules, consumer-facing disclosures, investment fund labels and more upon asset managers and others. (In the interim, note also the FCA's newly launched consultation on anti-greenwashing guidance, closing on 26 Jan 2024.)

Lastly, an update on the American rules: the SEC has just published its Fall 2023 regulatory agenda, confirming that finalization of its proposals for ESG disclosures by issuers and by financial firms has been pushed back to April 2024.

"Private sector finance is the largest source of financial flows for climate action, particularly mitigation. Transition to a low-emission climate-resilient economy requires dedicated instruments to channel financing from mainstream institutional investors…"

- UAE Leaders' Declaration on a Global Climate Finance Framework, COP28

The state of AI regulation in the EU and US

For many, 2023 has been quite an introduction to AI. We all bore witness to the hyper-evolving technology: Microsoft Bing's AI chatbot fell in love with a reporter (February), boldface tech names like Musk and Wozniak jointly called for a pause beyond GPT4 to prevent "loss of control of our civilization" (March), and yet still the breakneck pace continued to create an environment of urgency in which ChatGPT developer OpenAI decided to fire its CEO Sam Altman, re-hire him, and restructure its board all within a 5-day period (November).

On the regulatory front, things have moved somewhat less feverishly but are picking up. In the EU, the Commission had proposed a landmark Artificial Intelligence Act in 2021. The proposal has since had to grapple with AI's overclocked progress, as well as alternative positions staked out by the Council and the Parliament. Even if approved in 2024, the bulk of the law may not take effect until 2026. (As of this writing, the three governing institutions are engaged in marathon talks, in an attempt to strike a deal on key issues before the holidays.)

In the financial sector, ESMA in February stated that "the risks related to the use of AI use in securities markets appear to be material but still limited". By August, ESMA was acknowledging the "extraordinary surge in popularity of large language models (LLMs) and other generative AI technologies", and warning that "an increasingly pervasive use of AI in the financial system comes with risks" including lack of transparency, market manipulation and a concentration of providers. We'll be keeping an eye on developments.

While the US hasn't had the appetite of the EU for a broad legislative enactment, the White House in 2022 published a Blueprint for an AI Bill of Rights, and recently issued an Executive Order on safe AI development. Perhaps by design, the Executive Order name-checks an alphabet soup of federal agencies but not the SEC, which already in July had proposed requirements to address conflict of interest risks to investors that AI could present. Even before that, in October 2022, the SEC had proposed new oversight requirements for investment advisers that outsource certain services including those incorporating AI technology.

The SEC's July proposal would impact broker-dealers and registered investment advisers who, in their interactions with investors, use a "covered technology" (a term defined to include AI but criticized by many as too broad). Firms would be required to identify and eliminate any conflicts of interest resulting from such use, and to maintain written preventative policies. Separately, the SEC's earlier proposal of October 2022 would require registered investment advisers that outsource certain functions, including those involving the use of AI, to conduct due diligence, monitor performance, and provide additional information on Form ADV about the vendors they engage. Both the Conflicts of Interest and Outsourcing proposals, according to the SEC's just-released Fall 2023 regulatory agenda, are scheduled to be finalized in April 2024.

Meanwhile, in its recently published 2024 Exam Priorities, the SEC reminds us that it has assembled teams to assess AI and other financial technology risks, who will focus on broker-dealers and advisers employing such technology.

The state of AI regulation in the EU and US

EU AI regulation will impact investment managers by requiring compliance with strict rules on AI usage, potentially altering investment strategies and operational processes."

- The state of AI regulation in the EU and US

EU AI regulation will require transparency and accountability for investment algorithms, potentially increasing costs but promoting trust and ethical practices. (25 words)"

- The state of AI regulation in the EU and US

"The EU AI Act aims to increase trust in AI by setting harmonized rules for development, placing on market and use of AI systems in the EU. Learn more: 1. www2.deloitte.com **2.** bing.com **3.** cnn.com **4.** wsgr.com**"**

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