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Report

New in RegTech:

Checking in with AIFMD II; Sustainable finance; Investment monitoring changes in the UK; SEC's new private fund rules

by:

Greg Hotaling
February 10, 2024

EU: checking in with AIFMD II

As we reported in our December edition, the final compromise text for "AIFMD II" was published in November 2023, ready for the European Parliament to consider. On 7 February 2024 Parliament duly adopted the changes (that include amendments to the UCITS Directive as well), which are expected to be approved formally by the European Council within the coming weeks, and then enter into force 20 days after publication in the Official Journal. (A recently published overview of the changes can be found here.) With EU Member States given 24 months to implement AIFMD II into their national laws (or 36 months for certain provisions), fund managers are looking at 2026 as the year to watch for compliance with the reforms.

- Greg Hotaling, Regulatory Content Manager at Confluence

"To reduce duplicative reporting and related reporting burdens for AIFMs and to ensure an efficient reuse of data by authorities, data reported by AIFMs to competent authorities should be made available to other relevant competent authorities . . . as well as to the members of the European System of Central Banks (ESCB) for statistical purposes only."

- AIFMD II, Recital (25)

Sustainable finance: more in store in 2024

After a busy 2023 in sustainable finance regulation (following a busy 2022), 2024 will be… busy. Brand new frameworks are set to be finalized, such as:

- the USA's climate proposal for investment firms (see our strategy for compliance here)

- the EU's regulation of ESG ratings providers (with the Council and European Parliament having just reached a provisional agreement)

- the UK's approach for ESG ratings providers (our view of the industry and comments to HM Treasury are here)

Meanwhile frameworks such as the EU's SFDR are no longer brand new, and in 2024 require another round of technical disclosures.

Still other regimes have recently been finalized and will demand first-time disclosures in 2024. Of note is the UK's SDR, completed in late 2023. Applying to AIFMs and UCITS among others based in the UK, SDR's 2024 compliance deadlines (and our citations to the new black-letter requirements) are as follows:

31 May 2024

– Anti-greenwashing provisions. [FCA Handbook, ESG 4.3]

31 July 2024

– Product labelling. [FCA Handbook, ESG 4.1-4.2]

31 July 2024 (if using product labels)

– Consumer-facing document. [FCA Handbook, ESG 5.1-5.2]

– Naming and marketing rules. [FCA Handbook, ESG 4.3]

– Pre-contractual disclosure. [FCA Handbook, ESG 5.1, 5.3]

2 December 2024 (if not using product labels)

– Consumer-facing document. [FCA Handbook, ESG 5.1-5.2]

– Naming and marketing rules. [FCA Handbook, ESG 4.3]

– Pre-contractual disclosure. [FCA Handbook, ESG 5.1, 5.3]

Meanwhile, the UK's accompanying sustainability regime – TCFD reporting in place since 2022 – will continue to require disclosures in 2024.

Following that, new and detailed product-level and entity-level sustainability reports under SDR will be required in 2025 and 2026 (FCA Handbook, ESG 5.4-5.6).

For those just getting acquainted with SDR, here's our quick sketch of how it stacks up against its older cousin across the Channel, SFDR:

	SFDR (EU)	SDR (UK)
Territorial scope	Firms globally, marketing into EU	UK-based firms
Sustainability focus	Climate, environment, social, human rights	Mainly climate risks
Disclosures at entity and product levels	Yes	Yes
Taxonomy list of sustainable activities	Yes	No (to come)
Extensive 'harm' / 'adverse impact' assessments	Yes	No
Regulator disclosure templates	Yes	No
Sustainability labels for products	No (possibly to come) But de facto labels have arisen: 'Art. 8' and 'Art. 9' sustainability hierarchy	Yes: Sustainability Focus Sustainability Improver Sustainability Impact Sustainability Mixed Goals
Effective date	10 March 2021	28 November 2023

As 2024 unfolds, it will be interesting to hear more feedback about the extent to which reporting firms, that are covered by both SDR and SFDR, have been able to leverage common data for those disclosures. (For the FCA's view on this, see pages 122-123 of its Policy Statement.)

- Greg Hotaling, Regulatory Content Manager at Confluence

"The Financial Services and Markets Act 2023 repeals retained EU law relating to financial services. This enables the government to deliver a smarter regulatory framework for financial services."

- Sheldon Mills and Sacha Sadan, Executive Director Consumers and Competition, and Director of Environmental, Social and Governance, FCA

Investment monitoring changes hit the UK, which edges further away from EU law

It is no secret that the UK is further distancing itself from the EU (and consequently EU law), producing a large number of consultations with a view to reforming its regulatory frameworks. As of 5 February 2024, the FCA increased the initial threshold for reporting of net short positions from 0.1% to 0.2% of issuer share capital. As of that date, those with net short positions below the new threshold of 0.2% are no longer required to disclose their holdings.

This is the first of a series of actions intended to replace the retained UK Short Selling Regulation. Other reforms expected to be implemented in 2024 include certain additional powers of the FCA, a list of aggregated net short positions for each issuer, termination of the obligation to report net short positions in UK Sovereign Debt and CDSs, a positive list of in-scope shares, and the market maker exemption.

Our January edition made reference to some other anticipated reforms, in the commodity derivatives space (including position limits and their exemptions). Those amendments are also expected this year, and will affect relevant UK investors and trading venues.

- Aspasia Latsi, International Regulatory Analyst at Confluence

"The Financial Services and Markets Act 2023 repeals retained EU law relating to financial services. This enables the government to deliver a smarter regulatory framework for financial services."

- FCA, Policy Note -- The Short Selling Regulations 2024

Investment monitoring changes hit the UK, which edges further away from EU law

In a development which may impact investment advisers' compliance processes, the SEC's recently enacted Private Fund Adviser reforms are facing scrutiny from the U.S. Court of Appeals, which on February 5th heard oral arguments. Having faced questions about its authority on a number of fronts in recent years (for example under the "major questions" doctrine and climate-related disclosures), the SEC is now defending its authority under the Investment Advisers Act. Influential trade bodies such as the Managed Funds Association (as a petitioner) and the American Chamber of Commerce (which filed a third-party brief) are leading the charge against the rules. Lead counsel for the petitioners is Eugene Scalia, a former Secretary of Labor in the Trump Administration and the son of late Supreme Court Justice Antonin Scalia.

But procedurally, the most important actor is a little-known entity created recently: the National Association of Private Fund Managers (NAPFM). Formed by hedge funds shortly after the SEC proposed its reforms in 2022, and citing Fort Worth, Texas as its place of business, NAPFM is the legal entity through which the industry brought its claims to the particular Court of Appeals most likely to be hostile to government rulemaking: the Fifth Circuit, encompassing the federal courts of Texas, Mississippi and Louisiana.

While often seen (and of late, criticized) as a target for legal forum shopping, the Fifth Circuit here wouldn't be alone in viewing the SEC's new framework with some skepticism. Adopted by the SEC last August in a 3-2 decision, the Private Fund Adviser reforms have already taken flak from within the Commission itself (agree with her or not, Commissioner Peirce's dissents can make for fun reading). And the public comments submitted to the SEC during the rulemaking process showed that many private fund groups oppose the new rules, while public pensions and unions largely support them.

With respect to one key requirement set to affect adviser compliance operations — new quarterly disclosures — the issue largely boils down to this sentence in the Investment Advisers Act (Sec. 211(h)(1), added by the Dodd-Frank Act in 2010):

"(h) OTHER MATTERS. —The Commission shall— (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; . . . "

The question is whether that statement from Congress granted the SEC the authority to issue its relevant disclosure rule 211(h)(1)-2, which starting in March 2025 requires advisers to submit quarterly statements containing information on fees, expenses and performance. Competing briefs argue over the meaning of the statutory language (e.g. "investors", "terms", "relationships"), the interpretation of which by the Fifth Circuit could seal the fate of these requirements.

Other aspects of the SEC's reforms (covered in our November edition) are also targeted, relating to certain restricted activities and preferential treatment. Additional requirements, on audits and adviser-led secondary transactions, were not addressed by the petitioners in their opening brief, and hence are more likely to survive — unless the Fifth Circuit decides to vacate the entire SEC Final Rule. A useful summary of the written as well as oral arguments before the Fifth Circuit is found here.

The first compliance date for the reforms arrives in September 2024 (relating to restricted activities, preferential treatment, and registered adviser-led secondary transactions). Without a decision from the Fifth Circuit before then, it's possible that SEC's reforms could be delayed pending a court decision (of the Fifth Circuit, or perhaps ultimately of the Supreme Court).

- Greg Hotaling, Regulatory Content Manager at Confluence

"The record belies the Commission's paternalistic concern for the supposed 'disparity' in 'bargaining power' of investors (which it has no authority to redress anyway). These experienced investors, who 'often are represented' by 'the world's leading law firms', need no federal assistance pursuing their interests." [citations omitted]

- Opening Brief for Petitioners, NAPFM et al. v. SEC, United States Court of Appeals for the Fifth Circuit

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confluence.com
info@confluence.com
+1 412 802 8632
@Confluence_News
@confluence-technologies