Key Takeaways

Skadden

Challenges for Cross-Border Distribution of Private Funds in 2022

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On January 12, 2022, Skadden partners Greg Norman and Anna Rips led the webinar "Challenges for Cross-Border Distribution of Private Funds in 2022," which considered recent changes to the rules and regimes governing the marketing of private funds in the United States and Europe. With private capital fundraising levels remaining high and fundraising increasingly becoming a cross-border endeavor, it is important for fund sponsors to be able to navigate these new and amended regulations.

Below are key points touched upon by Mr. Norman and Ms. Rips in the webinar. A recording of the event is available here.

Developments in European Marketing Rules

Much of the European Union's Cross-Border Distribution Directive (CBDD) and Cross-Border Distribution Regulation (CBDR) came into force on 2 October 2021. The legislation principally seeks to remove regulatory barriers to the cross-border distribution of funds within the EU, making it simpler and cheaper to do so.

The CBDD, for instance, introduces a clear definition of "pre-marketing," thereby harmonizing the dividing line between "marketing" activities, which trigger the full registration requirements of the Alternative Investment Fund Managers Directive (AIFMD) and "pre-marketing" activities, which do not. EU member states had adopted differing approaches to this divide, with attendant costs for Alternative Investment Fund Managers (AIFM) seeking to avoid triggering registration requirements when approaching potential investors across the EU. This benefit is further enhanced by the broad definition of pre-marketing introduced by the CBDD. Provided that the marketing information does not constitute subscription or final constitutional offering documents, AIFMs are not required to register for full marketing. Instead, AIFMs can register for pre-marketing with an informal letter to the relevant national regulators, with no direct regulatory obligations arising from that registration. This should allow AIFMs to carry out market testing before making a decision on whether to launch an AIFMD compliant fund.

However, the CBDD only applies to EU AIFMs, which means divergent approaches can still be taken by EU member states with regard to non-EU AIFMs. While some member states have applied the pre-marketing regime to EU and non-EU AIFMs alike, others have effectively prohibited non-EU AIFMs from carrying out pre-marketing activities. In such member states, non-EU AIFMS must now register their fund under the national

private placement regime before providing any information about the fund to potential investors. Consequently, implementation of the CBDD has actually made it harder for investors in some EU member states to get access to global private funds.

The CBDR, meanwhile, harmonizes rules on marketing communications within the EU. For example, AIFMs must ensure all marketing communications to EU investors are identified as such and provide equally prominent descriptions of the potential risks and rewards of investing. As with the CBDD, the CBDR does not clearly apply to non-EU AIFMs. However, given the relatively light requirements and fairly close alignment with rules in jurisdictions such as the US and UK, it is likely that most managers seeking to market private funds in the EU will look to comply with the CBDR rules. The CBDR's introduction of clear rules that broadly align with standards imposed in other significant jurisdictions for fundraising will be helpful for managers preparing communications intended for a broad range of potential investors.

Finally, it is worth noting that the CBDD and CBDR were passed before Brexit (though their implementation date came after the UK left the EU), and the rules were not automatically transposed into UK law. To date, there are no suggestions that the UK government is planning on introducing equivalent rules.

Developments in US Marketing Rules

Under the US Securities Act of 1933 (Securities Act or Act) an issuer must register sales of securities unless there is an available exemption. Section 4(a)(2) of the Act provides an exemption from such registration for "transactions by an issuer not involving any public offering". "Public offering" is not defined in the Act, so most funds rely on the Rule 506 safe harbor (also known as Regulation D), which establishes the rules and procedures to satisfy the Section 4(a)(2) exemption from registration. Among other requirements relevant to marketing under the Securities Act is the requirement under Rule 506(b) to offer securities solely to offerees with whom the issuer has a substantive pre-existing relationship. This requirement doesn't apply to offers under Rule 506(c). However, most funds continue to rely on Rule 506(b).

The US Securities and Exchange Commission (SEC) has adopted a new Rule 206(4)-1, better known as the "Marketing Rule," which went into effect in May 2021, with a transition period ending in November 2022, by which compliance with new rules will be required for investment advisers required to be registered under the US Advisers Act of 1940 (Advisers Act). The new rules codify the marketing communication approach for investment advisers in the US, clarifying four key areas.

First, the new marketing rules define and explain what constitutes an advertisement. Second, the new rules set a disclosure standard that is consistent with the Securities Act standard, prohibiting advisers from making untrue statements of a material fact or failing to disclose any material fact necessary to make a statement, in light of the circumstances under which such statement was made not misleading. Third, the rules codify certain standards in relation to the presentation of performance data, requiring advisers who include their performance results in their advertisements to present the data in a fair and balanced manner and to include net performance information whenever gross performance is presented. Finally, a number of restrictions have been codified in the marketing rules in relation to the provision of testimonials and endorsements. This regulatory development has gone a significant way in clarifying the approach US investment advisers should adopt to marketing.

ESG Considerations

In December 2019, the European Union's Sustainable Finance Disclosure Regulation (SFDR) came into force, with certain operative provisions taking effect in March 2021. The SFDR effectively amends the AIFMD to introduce new environmental, social and governance disclosure obligations on managers and funds within the scope of that legislation.

The application of the SFDR to non-EU AIFMs remains somewhat unclear. The rules under the SFDR fall broadly into two categories — product level and entity level. When the SFDR was first introduced, non-EU AIFMs approached the rules in the same way that the AIFMD is approached, where the obligations generally only apply to the product being marketed. The non-EU fund sponsor does not itself have to comply with the rules. However, when the European Commission was asked to clarify how the SFDR should apply to non-EU AIFMs, the response was still somewhat ambiguous, saying that all of the rules should apply, in particular the product-level requirements (*i.e.*, what people were applying already). As a result, market practice seems yet to have reached a landing on this question.

Product-level disclosure obligations require fund managers to make pre-investment disclosures to potential investors and provide ongoing reporting to actual investors. The form of some of these reports and disclosures is meant to be specified by regulatory technical standards. Despite the SFDR being in force, the regulatory technical standards remain in draft form and are not expected to be finalized until the middle of this year at the earliest. Fund sponsors are, therefore, left to use best efforts to comply without all the necessary details.

The SFDR represents a step towards the disclosure of ESG factors becoming increasingly regulated and assessed in marketing materials. Whilst there are no specific ESG rules in the US in relation to the marketing of investment funds, when announcing its examination priorities in early 2021, the SEC stated that it was enhancing its focus on ESG and climate risks.

In a Risk Alert issued in April 2021, the SEC presented the Division of Examination's Review of ESG Investing, which focused on three areas for staff examinations as they relate to ESG matters: the consistency of portfolio management with statements made in respect of portfolio management in the applicable disclosure and any relevant marketing materials; performance advertising and marketing, including any reports investment advisers make to sponsors of ESG frameworks and statements made in marketing materials; and compliance programs related to ESG investing practices and disclosures. That, coupled with the SEC's request for comment on public change disclosure regulation, is a strong indicator that further ESG and/or climate change regulation is to come from the SEC.