UK Regulation of Private Funds: Key Themes for Managers in 2020

We hope that all clients, friends and their colleagues and families are keeping well in these unprecedented times. Many of the legislative developments that we discussed in our 2019 Summer Bulletin have now either come into effect (e.g., the Senior Managers and Certification Regime ("SMCR")) or have been finalised and will come into effect in due course (e.g., the revised prudential rules for investment firms). This *Alert* provides a high-level overview of the key regulatory developments that private fund managers ought to be thinking about and preparing for in 2020. More details on the developments discussed below are available in our Summer Bulletin. We have set out below some key points for firms to consider regarding the impact of the Covid-19 pandemic and the UK regulator's expectations in these circumstances.

Impact of Covid-19

The Financial Conduct Authority's ("FCA") priorities to date have been consumer protection matters and firms providing services to retail investors. On 1 April 2020, the FCA published a letter addressed to the CEOs of such firms setting out its approach to a number of issues that have seen impacts in light of the pandemic, including offering supervisory flexibility over certain matters until the end of June 2020. In accordance with the recommendations for EU regulators issued by the European Securities and Markets Authority ("ESMA"), the FCA has indicated that it has no intention of taking action against firms subject to best execution reporting requirements under the Second Markets in Financial Instruments Directive ("MiFID"), and which are required to publish their reports by 30 April 2020, provided these reports are published no later than 30 June 2020.

On 9 April 2020, ESMA further recommended that EU regulators do not prioritise supervisory action against fund managers for any delays in publishing their annual and half-yearly reports. ESMA also suggested extending the deadlines for such reports by two months and one month respectively. The FCA indicated on 6 April 2020 that it is extending the deadline for UK managers of UCITS and non-UCITS retail schemes).

The FCA has also published a statement on its expectations for all firms with respect to the impact of Covid-19. Notwithstanding the limited flexibility in certain areas referred to above, the FCA expects all firms to have contingency plans in place to deal with major events and to take all reasonable steps to continue to meet their regulatory obligations. In such circumstances, it is even more important than usual that firms are able to demonstrate that compliance policies and procedures are working and that compliance oversight is being effectively exercised, notwithstanding staff that are working remotely, in line with their business continuity programmes. Some key areas for firms to monitor at this time include:

- **Telephone recording obligations** — the FCA has stated that it accepts that some scenarios may emerge where it is not possible to record calls. However, firms should make the FCA aware if they are unable to meet their recording obligations and consider what mitigating steps they are putting in place, such as enhanced monitoring or retrospective review;
- **Prevention of market abuse** — the FCA has indicated that it will continue to monitor for market abuse and, if necessary, take action. Firms should ensure that their procedures for preventing market abuse remain effective; and
- **Reporting obligations** — where firms experience difficulties in submitting regulatory data (including transaction reporting), the FCA nonetheless expects firms not to unnecessarily delay their submissions. If there are likely to be problems with completing submissions on time, firms should consider contacting the FCA to make them aware; and
- **Short-selling notifications** — in accordance with the decision taken by ESMA, the FCA has, with effect from 6 April 2020, temporarily amended the threshold for notifying short positions from 0.2% of issued share capital to 0.1%. The FCA has clarified that firms are not required to amend and resubmit notifications submitted to the FCA prior to the change.

More generally, it is important that firms ensure that their compliance function remains visible and accessible, and that matters which require escalation continue to be dealt with appropriately. Effective internal communications and record-keeping will be key to being able to demonstrate this. Firms may, for instance, wish to consider organising remote training for staff to ensure that procedures are being followed.

The FCA has modified its rule allowing senior management functions to be performed on a temporary basis, where the absence is not reasonably foreseen, by extending the permitted period for a person to perform such functions without being approved by the FCA from 12 to 36 weeks. The FCA will not require firms to submit updated Statements of Responsibilities during this time, however it nevertheless expects firms to clearly document responsibilities internally. Although the FCA has said that it does not expect firms to assign responsibility for the firm's Covid-19 response to a single senior manager, it has reminded firms that senior managers are responsible for risks in their areas of responsibility. Firms and their senior managers should be considering emerging and existing risks as well as controls used to manage those risks.

WHAT?	WHEN?	WHO IS AFFECTED?	HOW CAN FIRMS PREPARE IN 2020?
UK Senior Managers & Certification Regime ("SMCR")	As of **9 December 2019**, SMCR has been extended to nearly all firms authorised under the UK Financial Services and Markets Act 2000, as well as to UK branches of European Economic Area ("EEA") firms and non-EEA firms regulated by the FCA, together "SMCR Firms". There is currently a transitional period for some aspects of SMCR until 9 December 2020.	SMCR Firms.	By **9 December 2020**, FCA-authorised firms are required to: • complete the fitness and propriety assessments of certified staff and issue certificates evidencing these assessments (and continue to do so annually); and • submit data to the FCA for its directory of individuals (the FCA's intention is that this information will be publically available via the FCA register at some point on or after 9 December 2020).

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Prudential & Remuneration Requirements	The EU Investment Firms Directive and Regulation (“IFD” and “IFR”, respectively) were finalised during 2019 and came into force on **25 December 2019**. Most of the new requirements (including on remuneration) will apply to firms authorised under the MiFID from **26 June 2021**, with transitional relief provided for the more onerous initial capital and own funds requirements until 2026 (for certain firms).	There will be fundamental changes to the prudential framework for MiFID firms. The rules will apply differently for MiFID firms depending on their classification: • **Class 1 firms.** Systemically important firms and large market-maker firms will continue to be subject to prudential requirements under the revised Capital Requirements Regulation and Directive (“CRR2” and “CRDV”, respectively); • **Class 2 firms.** The rules will apply in full to most other MiFID firms, which is likely to include all EU-authorised PE sponsors that are not alternative investment fund managers (“AIFMs”); and • **Class 3 firms.** There is a limited carve-out from some of the rules for small firms that are not part of larger businesses. The biggest impact is likely to be felt by MiFID firms that only have permission to give investment advice and/or arrange deals without exercising investment discretion (so-called “exempt CAD” or “adviser-arranger” firms). To date, such firms have not been subject to onerous prudential or remuneration rules. Some MiFID firms will face significant increases in regulatory capital requirements. However, there will be transitional arrangements in place for a period of five years, which are designed to reduce the immediate impact on some firms, depending on the scope of their permissions. In particular, “exempt CAD” firms should consider whether they will be able to take advantage of such transitional arrangements. Class 2 firms will need to calculate their regulatory capital requirements by reference to the risks posed to the firm, its customers and the market (so-called “K-Factors”), as set out in IFR. In addition, all MiFID firms will need to have processes in place to manage liquidity and hold at least one third of their fixed overheads requirements in liquid assets and to carry out assessments of their internal capital requirements (i.e., an internal capital adequacy process or “ICAAP”). Currently, only MiFID firms that have investment discretion need to prepare an ICAAP. IFD and IFR also extend to Class 2 firms certain remuneration requirements. Amongst other matters, these firms are required to implement a documented remuneration policy complying with a number of specified principles, and additionally, comply with certain substantive remuneration requirements, including: maintaining an “appropriate ratio” between fixed and variable remuneration; paying out at least 50% of variable remuneration in certain instruments; deferring at least 40% of variable remuneration over a 3–5 year period, and implementing malus and clawback provisions. Class 2 firms will be subject to quarterly regulatory reporting on capital and liquidity requirements. In addition, all MiFID firms will need to disclose publicly, on an annual basis, information regarding their capital requirements, risk management, internal governance arrangements and remuneration policies and practices. EU AIFMs will also need to take account of the fixed overhead requirement calculation under IFR (rather than under the Capital Adequacy Directive, as is currently the case) in determining their own funds. The UK government has indicated that it intends to implement IFR and IFD despite Brexit. The FCA has stated that it intends to publish a consultation paper on this new regime, but has not yet done so.	During 2020–2021, MiFID firms will need to: • assess how they will be classified under the new regime; • consider the impact of enhanced reporting and disclosure obligations; and • review remuneration policies and arrangements in preparation for compliance with the new remuneration rules in 2021.
Brexit	**31 December 2020 and beyond**	The UK has formally left the EU and is currently in a transition period, which is scheduled to end on 31 December 2020 (subject to any mutual agreement between the parties to extend). During this period, most existing EU rules will apply to the UK as if it were an EU member state. UK firms may continue to exercise passporting rights in other EU member states, and EU firms may continue to exercise passporting rights in the UK during this period.	The position after 31 December 2020 continues to be uncertain. While the UK government and the EU will seek to negotiate a trade deal, it is unclear whether such a deal will be agreed by December 2020 and what such a trade deal (if agreed) would look like. As such, firms should continue their contingency planning measures as if the UK will be treated as a non-EEA country from January 2021 and EU passporting rights will cease.

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Revised rules on marketing of funds in Europe	The revised rules came into force in **August 2019** and apply from **August 2021**.	A new Directive and related Regulation on cross-border distribution of funds ("CBDD" and "CBDR", respectively) create a standardised definition of "soft marketing" or "pre-marketing" by EU AIFMs. In addition, there are changes to how reverse solicitation may be relied upon, which intermediaries may be used for marketing, and de-notification of passporting arrangements. Whilst not directly applicable to non-EU AIFMs, it is anticipated that EU member states may apply at least some of the new marketing rules and interpretations of reverse solicitation to non-EU AIFMs as well. For further details on the proposals, please see our earlier *Alert*.	In due course, EU AIFMs, to whom the CBDD and CBDR expressly apply, should give consideration to: • their marketing strategies in the EU and whether, once the new rules apply, to provide notification of their intention to soft market in certain jurisdictions to test investor appetite; • for those AIFMs that use intermediaries — in particular their own UK-based investment firms authorised under the MiFID with investor relations teams based in the UK — consider whether these intermediaries' operations will be affected post-Brexit; and • consider whether it is worthwhile to make a passporting de-notification, particularly as they will be prohibited from marketing another fund with a similar investment strategy for 36 months. Non-EU AIFMs should keep a close eye on how the EU member states implement the new marketing rules and the application of those rules to non-EU AIFMs.
Operational Resilience & Cybersecurity	**Ongoing.** Responses to the consultation are due before **1 October 2020**, with a policy statement expected in the following months.	The FCA has, in the last few years, put operational resilience and cybersecurity in the financial sector firmly on its agenda. As part of its work on developing a policy framework for operational resilience in 2019–2020, the FCA, in conjunction with the Bank of England (through the Prudential Regulation Authority, or the "PRA"), published consultation papers at the end of 2019 on building operational resilience, and in particular on handling cyberattacks and data breaches. The consultation only applies to PRA-regulated firms, recognised investment exchanges, enhanced scope SMCR firms and entities authorised or registered under the Payment Services Regulations or Electronic Money Regulations 2011. It will therefore not apply to most asset managers and investment advisers. The FCA has indicated that firms not subject to the consultation should continue to meet their existing operational resilience obligations, but may want to consider the FCA's proposals. The FCA has indicated that after it publishes its final rules, it will consider whether the proposals should be applied to other firms. If the FCA does decide to extend the proposals to other firms, a further consultation will be carried out.	The deadline for the consultation has been extended from April to October on account of the impact of the coronavirus pandemic. This will have a knock-on delay on the introduction of new rules, which had been expected later this year. In preparation for such changes as will eventually be introduced, firms within the scope of consultation will need to: • identify business services that are important to them and that — if disrupted — could cause harm to consumers or market integrity through loss of business continuity, and set impact tolerances for each important business service; • identify and document the people, processes, technology, facilities and information that support the important business service; • prepare a cybersecurity policy and strategy and confirm whether the strategy has been approved by firm's senior managers (with annual reviews); and • assess engagement with critical vendors/third parties to understand risk and whether proactive relationships exist, or whether there has been engagement (or limited or no active engagement) in relation to business continuity and cybersecurity. Given the focus this area is receiving, firms not caught by the proposals may wish to consider, in any event, their existing operational resilience arrangements, especially in light of the recent implementation of SMCR. In the context of SMCR, this consideration may include how responsibility in respect of operational resilience matters (including business continuity, cybersecurity, information technology, internal operations, outsourcing, procurement and vendor management of services shared with other group members) has been allocated to Senior Managers.

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Sustainable Finance/ ESG	Most requirements under the Disclosure Regulation will apply from **10 March 2021**. The provisions of the Taxonomy Regulation (when adopted) are expected to apply from **31 December 2021**, but considering these provisions while preparing for Disclosure Regulation compliance is recommended.	The Disclosure Regulation imposes obligations on how environmental, social and governance ("ESG") matters are dealt with and disclosed by firms selling investment products or providing financial services in the EU. The Disclosure Regulation applies directly to firms that are authorised in the EU (including EU AIFMs and certain MiFID firms). These firms will be required to draft policies on how sustainability risks are integrated into their investment decision-making or advisory processes. This information will then need to be disclosed: • publicly on the firm's website (including, in instances where the firm has concluded that there are no sustainability risks, the reasons for this); • to investors, in pre-contractual information (e.g., for a fund, in the private placement memorandum); and • from 1 January 2022, in the firm's periodic reports (i.e., for an AIFM, in the annual report required under Article 22 AIFMD, and for a MiFID firm, in the periodic reports required under Article 25(6) MiFID). In addition, certain requirements may apply indirectly to non-EU AIFMs that have registered a fund for marketing under national private placement regimes (e.g., the requirement to disclose sustainability risks in pre-contractual information and in the annual report). A Taxonomy Regulation has also been proposed to ensure common use of terms in the disclosures made in compliance with the Disclosure Regulation. The precise application of the definitions of the various ESG objectives identified under the Taxonomy Regulation will be subject to the adoption of delegated acts specifying the technical criteria for each. A Technical Report has recently been published setting out recommendations from the Technical Expert Group on such criteria; it is expected that these will be adopted throughout 2020 and 2021.	There are several existing EU- and UK-specific voluntary market codes and ESG reforms that are primarily focussed on governance and are relevant to certain sectors of the asset management community. The recent ESG reforms aim to broaden that focus for all asset managers. In preparation for the operational and organisational elements of integrating ESG into investment processes and decisions, under the Disclosure Regulation, EU and UK firms should, before 10 March 2021, draft and implement an ESG policy setting out clear procedures for considering sustainability in preparation for disclosure of this on their website. Firms marketing products or services in the EU should, before 10 March 2021, review existing disclosures in private placement memoranda and other pre-contractual information to disclose how the firm has integrated ESG into its operations (and those of the fund) and the impact of sustainability risks. Before 1 January 2022, such firms should also consider enhancements to the periodic reports to be provided to investors to include information on the sustainability impacts of the fund.
Culture & Non-Financial Misconduct	**Ongoing**. 2019 saw an increase in enforcement cases focused on culture and governance, demonstrating the FCA's continued focus in this area. The FCA continues to prioritise addressing the risks to consumers posed by poor workplace cultures. The attention on non-financial misconduct in the financial services sector is set to grow, as evidenced by the FCA's recent Dear CEO Letter for firms in the wholesale general insurance sector and the FCA's recent Discussion Paper on transforming culture in financial services firms.	All UK regulated firms.	Firms should review their current arrangements and consider whether they are being proactive in tackling non-financial misconduct (e.g., discrimination, harassment, victimization and bullying), and whether their measures are being embedded in their governance and compliance frameworks. Firms should also consider wrapping these issues into ongoing training on SMCR, and the Conduct Rules, in particular.

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