KIRKLAND & ELLIS

Kirkland Alert

EU and UK Regulatory Update for Fund Sponsors

24 October 2023

In this *Alert*, we summarise key regulatory developments of importance to sponsors in a number of areas, each of which will affect how private fund advisers and managers (referred to as "sponsors" in this *Alert*) operate or raise capital in key European private markets.

Routes to marketing in Europe vary among sponsors. For example, some sponsors may register funds under the applicable national private placement regime with a regulator in a European Union (the "EU") Member State so they can be marketed in that country, while others may elect to appoint a third-party fund manager that is already authorised. Others still may apply for the authorisation of their own proprietary fund manager in a European jurisdiction.

European legislation will apply differently depending on the route to marketing used by the sponsor. The key legislation in this area apply to fund managers and investment advisers and so is very relevant to sponsors who have licensed operations in Europe. However, some legislation will have a broader application — for example, a third-party manager may look to contractually pass on obligations to sponsors with no licensed operations in Europe.

Key Takeaways

- Fundraising in Europe
  - Focus continues on cross-border arrangements in the aftermath of the United Kingdom's ("UK") withdrawal from the European Union ("EU"). It is likely that regulators will continue to review models for cross-border marketing in the EU by non-EU sponsors (for example, United States ("U.S.") or UK managers).

  - The EU's Alternative Investment Fund Managers Directive II ("AIFMD II") which will be implemented across the EU is, on current estimates, expected to become effective in 2026. AIFMD II will particularly affect sponsors of credit funds and increase the volume of reporting by managers, especially in relation to delegation arrangements. AIFMD II may also have a significant impact on certain non-EU sponsors planning to market offshore funds in the EU — currently for example those with a Cayman structure.
- Sustainability
  - The detailed requirements of the EU Sustainable Finance Disclosure Regulation ("SFDR") which applies across the EU are now effective, including in relation to the standard templates required by the rules. The UK plans to issue its own disclosure and labelling regime, which will be distinct from that of the EU.
  - The EU has issued a wide-ranging consultation and review of the SFDR which may lead to a major overhaul of the existing rules.
  - More broadly, regulators in the EU and the UK are seeking to drive behavioural change by prohibiting 'greenwashing' of investment funds.

- Retailisation
  - The regulatory focus on retailisation of private funds continues.
  - In the EU, new legislation will look to reform an existing retail fund vehicle 'wrapper' called the European Long-Term Investment Fund ("ELTIF") to make it more usable in practice.
  - In the UK, the Financial Conduct Authority ("FCA", which is a key UK financial services regulator) has sought to impose more stringent consumer protection measures via a new regime (the "Consumer Duty"). The EU has published its retail investment strategy to revise EU legislation in relation to retail investors.
  - To complicate the picture, the EU and UK have diverged in their treatment of certain disclosures which must be included in a 'Key Investor Document' ("KID") when the fund is available to retail investors.

- Supervision and enforcement
  - Regulators have increasingly focused on non-financial misconduct such as bullying and sexual harassment. For example, the FCA is consulting on new rules that will embed non-financial misconduct in its supervision and enforcement regime.
  - Following a series of enforcement cases in the U.S., the UK has seen enforcement action in relation to a UK bank for the misuse of messaging services, including WhatsApp for business communications.

    - There has recently been enforcement action under the UK's Senior Managers and Certification Regime ("SMCR").
- Other regulatory developments

  There are a number of other key developments on the horizon that are summarised in this update:
    - It has been reported that the FCA is planning a review of private market valuations in the UK.
    - The UK and EU have signed an agreement on regulatory co-operation in financial services, which may indicate a partial thawing of relations post-Brexit.
    - The UK continues to pursue its national post-Brexit reform agenda, including discussions on revisions to the UK legislative framework for asset and fund management.
    - The UK is also reviewing the implementation of its prudential rules for investment firms and has overhauled the rules applicable to appointed representatives (i.e. entities which rely on an 'umbrella license' from a UK authorised firm) in the UK.
    - The EU and UK are separately developing policies in relation to the use of artificial intelligence in financial services.

Fundraising in Europe

A. Focus on cross-border marketing and reverse solicitation

There continues to be a focus on cross-border marketing by U.S., UK and other non-EU sponsors following the UK's withdrawal from the EU.

Who is in scope?

Any non-EU sponsor (including UK, U.S. or Asian sponsors / IR teams) marketing to investors in the EU.

What is changing?

In December 2022, the European Securities and Markets Authority ("ESMA", an EU financial services supervisor) published a report on the relocation of financial services firms to EU Member States following the UK's withdrawal from the EU. The report stated that EU Member State regulators:

- had authorised firms with insufficient numbers of senior managers and inadequate human and technical resources;
- had failed to meet expectations in relation to delegation arrangements by fund managers (e.g., where a fund manager delegates portfolio management to a sponsor in a non-EU country) and should be more systematic in reviewing such arrangements; and
- should introduce a more thorough review of the adequacy of licensed firms' human and technical resources.

Reverse solicitation remains an area of potential focus for regulators.

- The Cross-Border Distribution of Funds Directive ("CBDF Directive") amended the Alternative Investment Fund Managers Directive ("AIFMD") to require that any subscription to a fund will be treated as marketing (i.e., a sponsor will be unable to rely on reverse solicitation) if it occurs within 18 months from the start of pre-marketing of that fund. This requirement applies to funds managed by EU managers and has also been applied to non-EU sponsors in some jurisdictions.
- A long-awaited report at the EU level on the use of reverse solicitation remains pending; last year, ESMA (an EU financial services supervisor) reported that little information on the use of reverse solicitation was available, so it is possible that EU authorities may contact sponsors and/or investors to gather more data.
- Enforcement action relating to reverse solicitation remains limited in practice. However, the French financial services regulator took action against a distributor last year in relation to investments by retail clients in a fund not authorised for marketing in France. The French regulator rejected the distributor's claim that the investments had been made on a reverse solicitation basis, imposing financial penalties and a five-year ban on advisory activity by the firm.

ESMA implemented guidelines on marketing communications for investment funds in February 2022. For these purposes, 'marketing communications' are widely defined to include press releases and adverts but also, for example, pitch documentation and investor slide decks.

The Guidelines, in general, apply to funds managed by EU managers.

Among other points, the Guidelines require that any marketing communications:

- are identified as marketing;
- ensure that the risks and rewards of investments are equally prominent;

- are fair, clear and not misleading; and
- are consistent with the legal documentation of the fund.

The Luxembourg regulator has recently carried out reviews against the Guidelines of marketing communications provided by EU managers to professional investors and noted certain deficiencies.

What is next?

Further action by EU authorities remains possible, with a continued focus on firms' cross-border arrangements and the quality and sufficiency of substance within the EU.

B. Key fundraising developments at the national level

Under AIFMD, non-EU sponsors are required to register or obtain approval from local regulators to market a particular fund to EU investors under national private placement regimes ("NPPRs"). The complexity of the NPPR process varies between EU Member States, so it is important to monitor developments at national level.

It may be possible to carry out 'pre-marketing' in the EU prior to registration or approval under an NPPR — for example, by providing generic sponsor materials or a pitch book / teaser with high-level information. However, whether 'pre-marketing' is possible and/or whether the regulator must be notified of pre-marketing having commenced must be considered on a jurisdiction-by-jurisdiction basis.

Who is in scope?

Non-EU sponsors marketing a non-EU (e.g., U.S.) fund pursuant to a relevant jurisdiction's NPPR — for example, this would include a U.S. sponsor marketing a Delaware fund to investors in the EU.

What is changing?

The table below highlights some key developments in the EU.

Jurisdiction	*Development*
Denmark	**Pre-marketing**

	The Danish regulator has confirmed that pre-marketing is not available to non-EU sponsors. This effectively prohibits pre-marketing by non-EU sponsors to investors in Denmark — i.e., a fund must either be approved for marketing under the NPPR or the investor must have approached the sponsor at its own initiative regarding the investment.
Netherlands	**Reporting** Once a fund is registered for marketing in an EU Member State, its manager will be subject to ongoing compliance requirements, including an obligation to submit periodic reports to local regulators (known as "Annex IV reports"). Previously, non-EU sponsors were not required to submit Annex IV reports to the Dutch regulator in relation to funds registered for marketing in the Netherlands. However, with effect from Q1 2023, the Dutch regulator has required Annex IV reports from non-EU sponsors, with the first reports falling due on 30 April 2023. In practice, this is not likely to be a major additional burden, as sponsors are likely to be filing similar periodic reports in other jurisdictions.
Norway	**Pre-marketing** Norway intends to adopt new rules implementing the CBDF Directive that will prohibit pre-marketing by non-EU sponsors to investors in Norway.

However, Norway has not yet confirmed when these rules will become effective.

What is next?

Sponsors should continue to monitor their obligations under relevant NPPRs where a fund remains registered for marketing and therefore subject to ongoing obligations under the AIFMD. With an ever-changing regulatory landscape in the EU, it is also important that sponsors are up to date on the latest filing requirements and permitted (pre-)marketing activities.

C. AIFMD II

Over a decade after the AIFMD entered into force, the EU is shortly due to publish the final text of AIFMD II, which will revise and update the provisions of the AIFMD. AIFMD II is intended to further harmonise the EU's funds regime, encourage transparency in terms of reporting and disclosure, and deal with systemic risks. AIFMD II is expected to become effective in 2026.

Who is in scope?

- Any non-EU sponsor that markets a fund to EU investors.
- Any EU manager.

What is changing?

The key features of AIFMD II include:

- **Increased reporting on delegation.** Delegation plays a key role in fund management activities — for example, where an EU manager appoints a firm in the UK or U.S. to manage the portfolio of a fund. AIFMD II will require EU managers to report additional information on delegation arrangements, which will likely mean EU managers will require more information from delegates. ESMA will issue a report on market practices in relation to delegation within 24 months, so it is possible that further legislation will follow in due course.
- **Increased transparency.** AIFMD II will generally require more reporting and disclosures from managers and sponsors. For example, additional information will be

required for a firm applying for authorisation as a manager in the EU. Meanwhile, managers and sponsors (both those in the EU and non-EU sponsors who market funds in the EU) will be required to submit more detailed information as part of their regular reporting to local regulators (also known as 'Annex IV reporting').

- **Marketing ban for high-risk non-EU countries.** At present, non-EU sponsors and non-EU funds are banned from marketing in the EU if they are established in a country listed as a non-cooperative country or territory by the Financial Action Task Force ("FATF") — i.e., they are on the 'FATF blacklist'. AIFMD II will replace the FATF blacklist with the EU's list of high-risk third countries and will widen the ban to include countries on the EU's list of non-cooperative countries for tax purposes. Notably, this may affect Cayman funds, as the Cayman Islands are currently listed by the EU as a high-risk third country for the purposes of anti-money laundering, although it is possible that the Cayman Islands will be removed from the list later this year. Firms will need to consider carefully how this may affect their choice of fund jurisdiction.
- **Restrictions for loan-originating funds.** AIFMD II will create a new regulatory framework for loan-originating funds in the EU. A loan-originating fund will be subject to restrictions, including obligations to retain 5% of the notional value of loans it has originated and subsequently sold on the secondary market, not to originate loans exceeding 20% of the fund's capital to any single financial institution and prohibitions on 'originate to distribute' strategies. AIFMD II will also impose limits on leverage in respect of loan-originating funds.
- **Liquidity risk management.** A manager that manages an open-ended fund will be required to choose appropriate liquidity management tools, which include redemption gates, notice periods, redemption fees and swing pricing.
- **Cross-border access to depositary services.** At present, AIFMD requires that the depositary for an EU fund must established in the same Member State as the fund. AIFMD II will allow managers to obtain depositary services in countries beyond the home Member State of the fund, subject to strict conditions.

The majority of the new rules in AIFMD II are likely to apply only to EU managers. However, the reporting and disclosure requirements and the marketing ban in relation to high-risk countries will apply in respect of non-EU sponsors (such as U.S., Asian and UK sponsors) marketing to investors in the EU. In addition, it is possible that an individual Member State might choose to 'goldplate' other AIFMD II requirements by applying them to non-EU sponsors registering funds to be marketed in their jurisdiction.

What is next?

AIFMD II is expected to become effective in 2026. The EU institutions have provisionally agreed the content of AIFMD II but the final text has not yet been published.

Sustainability

A. SFDR

The EU's ESG disclosure regime has taken the next step in its development with the finalisation and publication of detailed requirements, including reporting templates.

Who is in scope?

- Any non-EU sponsor that markets a fund to EU investors.
- Any EU fund manager.

What is changing?

Following the entry into force of SFDR on 10 March 2021, more detailed requirements came into force on 1 January 2023. These new requirements set out the content, methodologies and presentation of pre-contractual and ongoing information in relation to the relevant fund's ESG strategy and performance. In particular, the detailed requirements include templates for sponsor- / manager-level disclosures of any negative impacts of investments (known as 'principal adverse impacts' or "PAI") and fund-level pre-contractual and periodic disclosures.

The pre-contractual disclosure template, which sets out the key ESG-related features of the fund and how they are proposed to be implemented and measured over the life of the fund, must be completed and shared with proposed investors together with the disclosures required to be made under AIFMD.

The periodic template / ongoing disclosures must be completed on an annual basis, setting out the ESG-related performance of the fund, and included with the annual report required to be made available to investors under AIFMD. The templates are relatively strict, and no amendments are permitted to the format of the template other than the size and font type of characters and colours used in the templates.

From 30 June 2023, managers and sponsors that consider PAIs have been required to publish a PAI statement on their website in accordance with a prescribed template on an annual basis. The PAI statement will include data on how certain ESG metrics are taken into account across investment decisions.

What is next?

EU national regulators will start assessing compliance with SFDR disclosure obligations and further clarity should emerge around enforcement and supervisory priorities. For example, the Luxembourg regulator recently completed a data collection exercise in relation to the ESG-related practices of managers and further exercises of this kind are expected later this year.

B. EU consultations on the SFDR

The EU has issued two wide-ranging consultations on the SFDR, in a move that has been seen in the industry as a potential first step towards 'SFDR 2.0'.

Who is in scope?

- Any non-EU sponsor that markets a fund to EU investors.
- Any EU fund manager.

What is changing?

On 14 September 2023, the European Commission (the executive arm of the EU, which draws up proposals for new EU legislation) published two consultations on the implementation of SFDR. The consultations indicate that the Commission may be preparing for a significant overhaul of the existing SFDR framework.

The first consultation is a 'targeted consultation' (i.e., it is focused on gathering responses from market participants as opposed to the general public), which comprises a questionnaire seeking views on:

- the current requirements of SFDR, including its effectiveness, market challenges and SFDR's deficiencies;
- SFDR's interaction with other legislation on sustainable finance, including the usefulness and consistency of information reported to regulators;
- potential changes to disclosure requirements, including whether to require reporting for all products regardless of their sustainability claims; and

- the potential creation of a new ‘categorisation system’ for financial products, which might involve discarding or converting the existing categorisations.

The second consultation is a ‘public consultation’, which covers only:

- the current requirements of the SFDR; and
- the SFDR’s interaction with other legislation on sustainable finance.

What is next?

The consultations will close on 15 December 2023. It is currently expected that the EU may issue its initial feedback in Q2 2024, although immediate significant policy proposals are unlikely.

C. FCA climate-related disclosure requirements

Who is in scope?

- Any UK manager with £5 billion or more of assets under management.
- Any UK private fund advisory firm advising on assets with a value of £5 billion or more.

What is changing?

In December 2021, the FCA (a key UK financial services regulator) published the Environmental, Social and Governance Sourcebook (“ESG Sourcebook”); this provides a set of rules that embed climate risk disclosure requirements for certain UK-licensed firms based on the recommendations of the Taskforce for Climate-related Financial Disclosures (“TCFD”). The reporting requirements for firms with more than £50 billion assets under management / advice (“AUM”) became effective on 1 January 2022, with the first reports falling due by 30 June 2023. Firms with more than £5 billion AUM are required to issue their first reports by 30 June 2024.

In summary, most firms will need to publish reports by 30 June 2024 (with a reference period of 2023) and each 30 June thereafter:

- Entity-level reports: A ‘TCFD entity report’, setting out climate-related financial disclosures regarding the overall assets managed / advised or administered by the firm in relation to its business.

- Product-level reports: A 'public product report', providing disclosures in respect of a particular product.

Firms will also need to provide on-demand product reports to the extent requested by investors.

What is next?

Firms that have not already engaged with the TCFD recommendations should be taking measures to do so. This should include consideration of the implications at both the entity and product level.

Firms should implement measures to collect and collate relevant data and to identify appropriate 'proxies' where data is not available.

D. FCA consultation on Sustainable Disclosure Requirements, sustainable labels and greenwashing

The FCA has closed its consultation into the UK's proposed anti-greenwashing, product labelling and disclosure regime and looks set to bring in final rules before the end of 2023.

Who is in scope?

- Any UK manager.
- Any UK advisory firm is likely to be within scope but exempt from product-level disclosure requirements, with their obligations limited to provision of certain on-demand product-level information and entity reporting.

What is changing?

A new anti-greenwashing rule will require all in-scope UK firms to ensure that references to the sustainability of financial products are consistent with the sustainability profile of the product and clear, fair and not misleading.

The FCA consultation also proposed a raft of other rules that will apply to UK firms in respect of specific products and services, albeit largely focused on retail clients:

- **Investment labels.** Three investment labels are proposed: "Sustainable Focus", "Sustainable Improvers" and "Sustainable Impact". The FCA proposes that firms marketing authorised funds (excluding feeders) to retail investors should be prohibited from using a range of ESG-related terms, including “ESG”, “sustainable”, “green”, “transition”, “impact” and “responsible”, when naming and marketing funds unless they have adopted one of the labels. UK firms that are not marketing funds to retail investors may choose to, but are not required to, adopt one of the labels.

- **Pre-contractual disclosures.** Disclosures are required to be provided to investors setting out sustainability-related features of products, including, for example, any sustainability-related objectives and associated investment policy and strategy.
- **Sustainability reports.** Firms must issue annual product-level reports, setting out the sustainability-related performance of products, and firm-level reports, setting out the sustainability-related performance of firms.

What is next?

- The rules were originally set to be finalised and published by 30 June 2023 but, following extensive feedback, the FCA has pushed back publication of the final rules to Q4 2023.

Retailisation

A. The FCA’s Consumer Duty

The FCA’s (i.e., a key UK regulator’s) Consumer Duty introduces a new outcomes-focused approach to consumer protection and requires UK firms that manage, approve or distribute retail products to embed the Consumer Duty in their services.

Who is in scope?

Any UK manager or advisory firm whose products have retail investors or where retail investors may be involved in a wider distribution chain — i.e., retail feeder funds could bring a UK manager or advisory firm into scope.

For example, this could be relevant for offerings to friends and family or if a third-party distributor is engaged to target private wealth investors.

Exemptions from the Consumer Duty requirements are available where:

- investors are appropriately opted up to professional client status (although the Consumer Duty still applies to the opt-up process itself); or

- the relevant investment has a minimum subscription amount of £50,000 (or the equivalent amount in foreign currency).

What is changing?

In general terms, the Consumer Duty requires that:

- products are designed to meet the needs, characteristics and objectives of a specified target market whilst also providing fair value;
- communications with customers must be made in a way that supports consumer understanding;
- consumer support must be provided throughout the life of the product; and
- firms should monitor that consumers are not experiencing poor outcomes and take action to rectify any such issues identified.

The intention is for the Consumer Duty to go further than existing rules by requiring UK firms to consider customer outcomes from the design process and throughout the life of the product. This has required an implementation strategy by UK firms to review current structures (including for example customer-facing documentation and communications, product development processes and target market identification), identify potential gaps or weaknesses and develop a plan to remedy any issues.

What is next?

From **31 July 2023**, the Consumer Duty came into force for new and existing products that are open to investors.

From **31 July 2024**, the Consumer Duty will come into force for closed products.

UK firms should have already considered how to embed the Consumer Duty within their products / services, including reviewing communications with consumers and the customer journey to identify where changes may be needed. Firms should also be engaging with one another (e.g., managers should be engaging with distributors) to share information on any changes that are required to comply with the Consumer Duty.

B. The EU's Retail Investment Strategy

In May 2023, the EU announced its proposed rules for the EU's Retail Investment Strategy. The proposal is intended to help retail investors access capital markets, rather than relying on low-yielding savings.

Who is in scope?

- Any non-EU sponsor that markets a fund to retail investors in the EU.
- Any EU manager managing a fund for retail investors.

Certain provisions also apply to funds marketed to professional investors. However, this approach has been challenged by industry bodies on the basis that the Retail Investment Strategy should only be applicable to retail products.

What is changing?

On 24 May 2023. the European Commission announced its proposed rules for the EU's retail investment strategy. The key changes for fund sponsors relate to:

Value for money. The EU intends to issue new rules to help ensure that investors receive 'value for money', in particular by reducing costs to investors. It is proposed that ESMA will develop benchmarks to compare the costs and performance of funds marketed to retail investors. The EU proposes that a fund that deviates from the benchmark cannot be marketed to retail investors, unless the costs are assessed to be justified and proportionate.

Definition of "professional client". The proposed rules seek to revise the definition of an elective professional clients, by:

- reducing the necessary size of the investor's financial instruments portfolio from more than EUR 500,000 to EUR 250,000; and
- allowing a client's recognised education or training evidencing that they understand the relevant transactions or services and are able to evaluate the relevant risks to be taken into account.

In addition, the proposal adds a new category that would permit legal entities to be treated as 'opted-up' professional clients if they meet certain criteria.

Against a wider backdrop of industry concern that the proposals may entail price intervention by the ESMA, on 5 October 2023, a Committee of the European Parliament published a response to the proposals. The response rejected some of the more controversial aspects of the strategy, including in particular the proposal for benchmarks for the pricing of retail AIFs and a ban on inducements. The proposal continues to be negotiated among the EU institutions.

What is next?

The proposal is at an early stage. It will need to be reviewed by, and negotiated with, the EU's institutions, which may take a year or longer. It is possible that the process could be further delayed by European parliamentary elections in May 2024.

C. UK and EU Packaged Retail Insurance-Based and Investment Products Regulation ("PRIIPs Regulation")

The PRIIPs Regulation, which applies across the EU, requires that sponsors must provide a standardised pre-contractual disclosure to retail investors setting out the key features of investment funds; this is known as the KID. The UK continued to apply the PRIIPs Regulation with minor changes after the UK's withdrawal from the EU. However, the EU and the UK have separately introduced revisions to the KID so sponsors marketing to retail investors in both the EU and UK will need to produce two separate versions of the KID.

Who is in scope?

Sponsors marketing a fund to retail investors in the EU or UK. Where a retail investor has been 'opted up' to professional investor status, that investor will be out of scope.

What is changing?

In January 2023, the UK implemented amendments to the UK's version of the KID. This included changes to the summary risk indicator and the use of a narrative on performance instead of standardised performance scenarios, as well as changes to the disclosure of transaction costs.

Separately, the EU made changes to its version of the KID, which also became effective in January 2023. Although the changes overlap with those of the UK to a degree, some of the amendments are more wide-ranging, such as additional disclosures on the key features of the investment, revised performance scenarios, further explanations on transaction costs and a link to past performance information.

What is next?

The UK plans to abolish the requirement for a KID and replace it with new rules on retail investment disclosure. In December 2022, the FCA consulted on how to approach this. This feedback period closed in March 2023. As a next step, the FCA will prepare, and consult on, its proposed rules.

The EU has proposed further changes to the EU version of the KID, including greater differentiation between different types of products, the use of past performance information and a new section on sustainable objectives.

D. UK to update marketing exemptions for high-net-worth individuals and sophisticated investors

The UK has put forward proposals to update existing exemptions for marketing to high-net-worth and sophisticated investors. This could reduce the number of investors potentially falling within these exemptions.

Who is in scope?

Sponsors marketing to retail investors in the UK, including high-net-worth individuals.

What is changing?

UK legislation requires that 'financial promotions' (including marketing communications relating to funds) can only be made, or must be approved by, a UK-authorised firm. However, there are exceptions to this rule, notably for promotions to high-net-worth individuals and sophisticated investors.

In December 2021, the UK issued a consultation on updating the existing exemptions for high-net-worth individuals and sophisticated investors. The proposals would narrow the criteria for investors to fall within the exemptions, including by:

- increasing the financial thresholds for individuals to fall within the exemptions;
- imposing greater responsibility on firms to assess whether an individual meets the relevant criteria; and
- requiring the investor to expressly confirm which criteria they meet.

What is next?

The consultation closed in March 2022. The UK has not announced when it will issue its policy statement and legislative proposal, but this is expected later in 2023.

E. ELTIF II

Who is in scope?

- Sponsors seeking to launch, or who have launched, alternative investment funds in the EU that will be categorized as ELTIFs.
- Any EU manager managing, or contemplating managing, an ELTIF.

What is changing?

An ELTIF is an EU alternative investment fund that meets specific criteria, including a minimum allocation to particular kinds of investments. Once approved by an EU regulator, an ELTIF can be marketed to investors across the EU. It can be marketed to retail as well as professional investors.

Until now, the ELTIF regime has been regarded as too rigid a framework, especially in terms of the range of investments permitted. The ELTIF II Regulation ("ELTIF II") makes a number of changes to existing legislation that are intended to make the ELTIF structure more attractive to retail and professional investors alike.

Key changes in ELTIF II include:

- a wider range of permitted investments;
- the mandatory minimum allocation of an ELTIF's capital to permitted investments will be reduced from 70% to 55%;
- easier access to ELTIFs for retail investors and less restrictive rules for ELTIFs marketed only to professional investors;
- a broader range of fund-of-fund structures will be permitted;
- potentially more flexible rules allowing for easier redemption and a secondary trading mechanism;
- higher borrowing limits; and
- co-investment by the ELTIF manager and its staff will be permitted.

What is next?

ELTIF II will become effective on 10 January 2024. It is possible to apply for authorisation under the existing ELTIF regime and switch to the new framework under ELTIF II after the implementation date, so an uptick in the number of applications is expected.

Supervision and Enforcement

A. Enforcement action in relation to non-financial misconduct

There is increasing focus on the role that non-financial misconduct (such as sexual misconduct, racism, harassment, bullying or discrimination) plays in firm culture, and the negative consumer and industry outcomes that may result.

Who is in scope?

Any UK authorised firm.

What is changing?

UK regulators have carried out a number of enforcement actions against individuals for misconduct outside their professional functions. For example, the FCA has sanctioned individuals working for FCA authorised firms who have committed violent or sexual offences, as well as acts of dishonesty.

Some developments in this area are set out below.

The insurance market Lloyd's of London fined an underwriting firm £1 million for:

- failing to notify Lloyd's of bullying and discrimination by an employee;
- failing to address that employee's misconduct; and
- allowing a 'boys' night out' in which various unprofessional and inappropriate conduct issues arose.

The FCA has announced it is investigating allegations of sexual misconduct and corporate governance issues at a hedge fund, Odey Asset Management. The FCA has commented that:

- Corporate culture that tolerates sexual harassment or other non-financial misconduct is unlikely to allow people to speak up generally. This may also raise questions about the firm's decision-making and risk management.
- The FCA may investigate non-financial misconduct to assess whether the misconduct demonstrates that (a) a firm lacks adequate systems and controls and (b) an individual is failing to meet 'fit and proper' requirements.

The FCA has noted that it receives around six reports per quarter relating to non-financial misconduct.

What is next?

In light of this recent focus, UK regulators are expected to carry out further supervisory action in relation to how firms manage and deal with allegations of non-financial misconduct.

B. FCA consultation on diversity and inclusion, including new misconduct rules

The FCA is consulting on new rules and guidance in relation to diversity and inclusion, including its approach towards non-financial misconduct.

Who is in scope?

Any UK authorised firm.

What is changing?

In September 2023, the FCA published a consultation on diversity and inclusion. The FCA proposes that firms will be subject to new rules on diversity and inclusion, including in relation to non-financial misconduct.

- The assessment of whether an individual is 'fit and proper' to work in the financial services industry will include a review of any serious non-financial misconduct committed by that individual, including in their private or personal life, such as violence, sexual misconduct or dishonesty.
- The FCA's Code of Conduct for individuals will be expanded to cover serious bullying, harassment and similar behaviour towards colleagues.
- The FCA's assessment of whether a firm meets the 'threshold conditions' (i.e., they are able to continue to hold their license) will include a review of non-financial misconduct, including criminal offences and tribunal/court findings on discrimination.

In addition, large firms with more than 250 employees (calculated on a solo entity basis, and not at group level) will be subject to requirements to:

- maintain a diversity and inclusion strategy;

- set diversity and inclusion targets;
- report diversity and inclusion data to the FCA;
- make public disclosures; and
- embed diversity and inclusion risk in their governance structures.

What is next?

The consultation will close in December 2023. The final rules are expected to be issued in 2024 and will become effective during 2025.

C. Social messaging apps

Who is in scope?

UK-authorised firms, including UK managers and advisory firms.

What is changing?

Since Q4 2021, the SEC and the Commodity Futures Trading Commission ("CFTC") have imposed fines amounting to c. $2.5 billion on financial services firms for allowing staff to use WhatsApp and other messaging apps on their phones to communicate with each other, customers, advisers and other market participants, while failing to keep proper records. In October 2022, it was reported that the UK's FCA had sent information requests to a number of global banks about the frequency and content of staff exchanges through texting and apps such as WhatsApp.

Subsequently, in April 2023, the UK's Prudential Regulation Authority ("PRA", which is another key UK financial services regulator) censured Wyelands Bank Plc for a range of regulatory failings, including poor retention of WhatsApp messages. Specifically, the bank's senior management regularly exchanged messages with external parties using WhatsApp on business and personal mobile phones. The PRA considered that the failures would have justified a fine of £8.5 million but accepted that the bank was in wind-down and so did not impose the fine.

What is next?

Regulators in the U.S. and UK are expected to continue to focus on the use of messaging apps. Firms should assess their policies and controls in relation to messaging apps, ensure that policies clearly identify whether or not messaging is permitted, which electronic communications are subject to recordkeeping requirements, and ensure that staff are properly trained.

D. SMCR enforcement

Who is in scope?

UK authorised firms, including UK managers and advisory firms.

What is changing?

In April 2023, the PRA announced that it had fined the former Chief Information Officer ("CIO") of TSB Bank Plc, £81,620 for a breach of Senior Manager Conduct Rule 2 (You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system).

The fine followed an incident in 2018, when TSB attempted to migrate its IT system to a platform created by its parent company. The disruption caused by the migration lasted for several months and led to 226,000 customer complaints and £32.7 million in customer redress. The former CIO was fined because he failed to take reasonable steps to ensure that TSB adequately managed and supervised its outsourcing arrangement in relation to its IT migration programme.

This enforcement case is a significant development. This is only the second enforcement action completed under the SMCR since the regime was created — the previous case was as long ago as 2018. Moreover, this is the first case to be based on a breach of a Senior Manager Conduct Rule, giving insight into what amounts to 'reasonable steps' to ensure that a business is in compliance.

In October 2023, the FCA announced that it had decided to fine the former CEO of Barclays £1.8 million and ban him from holding a senior management or significant influence function in the financial services industry. According to the FCA, the former CEO recklessly approved a letter sent to the FCA containing misleading statements about his relationship with Jeffrey Epstein. This comprised a breach of Individual Conduct Rule 1 (You must act with integrity), Individual Conduct Rule 3 (You must be open and co-operative with FCA, PRA and other regulators), and Senior Manager Conduct Rule 4 (You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice).

The FCA's decision has been appealed, so its findings are provisional. The decision focuses on the need for senior managers to act with integrity, be open and co-operative with regulators, and exercise good judgment, noting that this is particularly important with respect to the CEO of a major financial institution.

What is next?

These enforcement cases have taken place against the backdrop of the UK Government's ongoing review of the SMCR. In March 2023, the FCA and the PRA published a discussion paper asking firms for their views on, among other matters, the effect of the SMCR on enforcement, and whether more SMCR enforcement action is needed. It is possible that the review of the SMCR may lead UK regulators to make greater use of their enforcement powers under the regime.

Other Key Regulatory Developments

Certain further key developments on financial services regulatory matters are set out below.

FCA review of private market valuations

Recent media reports have indicated that the FCA may be planning to launch a review of private market valuations by the end of 2023. According to the reports, the FCA intends to carry out the review following concerns over the impact of higher borrowing costs in the sector.

The review is expected to look at 'disciplines and governance' in relation to valuations, including how responsibility for valuations is allocated and how management information regarding valuations is distributed. The reports note that the review has not yet been fully scoped out, and the number and type of asset management firms involved has not yet been finalised.

Growing international regulatory focus on private finance

In September 2023, IOSCO, an association comprising the world's securities regulators (including the FCA, SEC and EU regulators), published a report on emerging risks in private finance. IOSCO is analysing emerging risks and vulnerabilities in private finance, and how these could harm investors, undermine market integrity or potentially give rise to systemic risk. In that context, the report explores whether the private funds sector could have a negative spillover in relation to public markets, especially in the context of higher inflation and rising interest rates.

Although IOSCO does not make law, it can be influential in setting the future direction of regulation among the World's securities regulators. It is possible that IOSCO's focus on private markets may encourage national regulators, including the FCA, to increasingly consider perceived risks posed by private markets in the future.

Review of UK asset management regime

In February 2023, the FCA published a Discussion Paper on updating and improving the UK regime for asset management. As part of the post-Brexit reform of UK financial services legislation, the FCA intends to revise the UK regulatory framework for asset management.

In the Discussion Paper, the FCA acknowledged that professional investors often consider the application of requirements for UK asset managers as excessive, and asked whether some managers should be subject to less onerous requirements, and whether professional investors consider that any other changes are required to the UK AIFMD regime.

The FCA emphasised that any changes will be properly handled via its consultation process, and that it envisages a lengthy timetable for implementation. The Discussion Paper closed for comments on 22 May 2023.

UK-EU regulatory co-operation

In a sign of potentially thawing relations after the UK's withdrawal from the EU, the UK and EU signed a memorandum of understanding ("MoU") on UK-EU regulatory co-operation in financial services in June 2023.

The MoU is intended to encourage robust and ambitious regulatory co-operation, including by establishing a Joint UK-EU Financial Regulatory Forum. The UK and the EU will share information, work together towards addressing challenges and co-ordinate positions where appropriate.

Review of the UK's Investment Firms Prudential Regime ("IFPR")

In February 2023, the FCA published an interim review on how firms are implementing requirements in the IFPR in relation to the internal capital adequacy and risk assessment ("ICARA") process.

The ICARA process requires firms to assess the level of internal capital and liquid assets that they must hold to meet the risks to which they are exposed. The FCA highlighted areas for improvement, noting that most firms that had completed a 'group' ICARA process did not sufficiently consider firm-specific risks and harms. The FCA is continuing the review and intends to publish a final report after completing its work.

Reform of the UK appointed representatives regime

The FCA has implemented new rules and increased its supervisory focus in relation to principal firms with networks of appointed representatives — i.e., entities that rely on an 'umbrella license' from UK authorised firm.

The new rules became effective in December 2022, placing greater responsibility on principal firms and requiring additional reporting to the FCA. It is possible that the FCA may choose to impose further rules in relation to networks of appointed representatives and updated prudential requirements for principal firms, although this has not yet been confirmed by the FCA.

In June 2023, media reports indicated that the FCA has imposed restrictions on 10 principal firms for failing to provide proper oversight of their appointed representatives. The FCA did not confirm the nature of the restrictions, but the restrictions appear to have included restrictions on licensable activities and the onboarding of new appointed representatives, as well as requirements to terminate relationships with existing appointed representatives.

EU Artificial Intelligence Act

The EU has proposed the world's first regulatory framework for artificial intelligence ("AI") in the form of the Artificial Intelligence Act. The proposed legislation categorises

AI applications based on the level of risk posed to users and would affect financial services firms using AI in the EU.

The rules would ban applications that pose an unacceptable risk, regulate high-risk applications and impose transparency requirements on applications carrying a limited risk. The relevant legislation is currently being developed and expected to be implemented in 2025 at the earliest.

FCA focus on artificial intelligence in financial services

In April 2023, the FCA's Chief Data, Information and Intelligence Officer gave a speech regarding the future of regulation in relation to AI. The speech recognised the fact that the release of tools such as ChatGPT will have a transformational impact on financial services.

The FCA is increasingly focusing on the regulatory implications of AI and other technology solutions. The FCA and other UK regulators are currently considering the appropriate framework for AI in financial services. This includes with regard to the risks associated with firms' use of specific technologies by reference to certain areas of focus such as data privacy, data governance, market integrity, soundness of the financial system, governance, senior manager accountability and consumer protection.

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Related Services

Practices

- Transactional
- Investment Funds

Suggested Reading

- 30 November 2023 Sponsored Event Women's Private Capital Summit 2023
- 16 November 2023 - 17 November 2023 Sponsored Event 16th Biennial Parker C. Fielder Oil, Gas and Energy Tax Conference
- 16 November 2023 Sponsored Event Financing Wind Offshore Conference 2023