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CLIFFORD CHANCE 15TH GLOBAL FUNDS CONFERENCE

LUXEMBOURG, JANUARY 2024

SUMMARY BRIEFING

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SUMMARY BRIEFING

Foreword

The fifteenth Luxembourg edition of our global funds conference took place in late January 2024 at the Luxembourg Philharmonie.

As in previous years, the conference promoted the sharing of ideas and experiences with our clients and business partners.

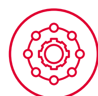
We discussed with industry leaders and experts from around the Clifford Chance network the developing democratisation of access to the alternative investment funds industry, as well as the latest regional and global legal, regulatory, tax and market developments. The discussions addressed challenges and opportunities faced by the industry, as well as evolving market practices.

If you were not able to join us on the day, or would like to refresh your memory of the topics discussed, we have prepared this summary briefing for you.

Please contact our team if you would like to discuss in detail any of the topics addressed during the conference, or for any other questions you may have surrounding the management of your funds and their assets.

Democratisation of Alternative Investment Funds

Historically, alternative investments (such as private equity, real estate, infrastructure and debt) have been reserved for institutional investors, however, in recent years we have seen significant efforts going into developing fund products that allow retail investors access to a wider range of assets and return profiles (with this trend often referred to as the democratisation of alternative investment funds). The current focus of democratised funds is on the high net worth and ultra-high net worth segments of the retail market, rather than seeking full retail exposure. Such individual investors tend to allocate very little of their portfolios to alternative investments, and this has therefore been identified as a potential growth market for alternative investment fund managers. Building on the Luxembourg market's longstanding experience with UCITS, which are distributed globally, Luxembourg is well positioned to support the development of democratised funds.



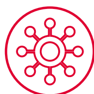
Structuring Considerations

Many managers within the European market have either already launched, or are in the process of launching, democratised alternative investment funds and, when doing so, are often keen to create platforms which do not only market to EU retail investors, but to investors in a range of jurisdictions around the world.

When considering the design of a democratised alternative investment fund, there are various layers of analysis to be done, starting with the requirements in the target investor markets. Due to the complex patchwork of rules that apply on a jurisdiction-by-jurisdiction basis, depending on the target investor markets, there is currently no one-size-fits-all fund structure or regime that works for all alternative investment fund strategies and their target investor markets; therefore all possible tools that may be available, both within and outside Europe, are on the table for consideration. However, two options that are emerging as favourites for master vehicles, are the Luxembourg Part II UCI and the ELTIF 2.0. Depending on the relevant target markets, it is likely that there will also be a need for one or more jurisdiction-specific vehicles, in addition to the master fund vehicle. For example, a foreign fund cannot generally access the French retail market (other than an ELTIF, which would nevertheless require the appointment of a local distributor). Where a democratised fund is targeting French retail investors, it is therefore common for the fund structure to include a French domiciled parallel vehicle, managed by a French alternative investment fund manager.

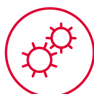
Digging down another layer, further analysis may also be required depending on the particular category of target investor within a jurisdiction and whether the product will be distributed directly to the end investor, or indirectly via a "wrapper" (such as an insurance product).

Even where a target jurisdiction does not require the establishment of a domestic fund vehicle, other requirements may apply, such as regulatory notifications or the appointment of local representatives. It is therefore crucial to determine the key target investor markets early in the structuring process, to ensure that the local requirements are appropriately catered for.



Distribution networks

From a practical perspective, managers' relationships with distributors in the key target markets are essential for managers to connect with retail investors. It is therefore important that managers take the time and devote sufficient resources to finding and developing the right distribution network and to working with their chosen distributors to ensure that the key features of their funds are well understood.



Liquidity management tools

Democratised alternative investment funds traditionally hold illiquid assets, but individual investors will usually be working to shorter time horizons than institutional investors and have a greater need for flexibility, and will therefore often expect some form of liquidity when making a commitment to a fund. As a result, careful consideration should be given to the appropriate liquidity management tools that are incorporated into the fund's terms, which should be tailored to the asset type, asset allocation and the expected cash flow dynamics. There are a range of liquidity management tools available, including redemption fees, NAV adjustments, redemption gates, in-kind redemptions, side pockets and suspensions. Although it is important to ensure the manager has the right tools available to be able to manage liquidity in different market conditions, many of these tools will not be appropriate for day-to-day liquidity management and some would only be used in extremis (for example, a suspension of redemptions). From a practical perspective, cash flow dynamics will therefore remain a key tool for managing liquidity on a day-to-day basis during normal market conditions.

The continued education of regulators, distributors and investors on the nature of democratised alternative investment funds, the reasons for the incorporation of liquidity management tools and when and why they may be used, will be key for the ongoing development of the democratised alternative investment fund market.

The World Tour: Asia, Europe, UK and US legal, regulatory, tax and market developments

US private fund advisor rules

In August 2023, the US Exchange Commission (the "**SEC**") introduced new rules that, if they are retained, will be a game changer for the US private funds industry.

The rules were introduced to protect institutional investors in their negotiations with alternative investment funds and consist of five key components; two of which apply to all private fund advisors and three of which apply only to registered US advisers. Non-US advisers advising non-US funds are out of scope of the new rules.

In particular, the new rules introduce:

1. a prohibition on the granting of preferential redemption or information rights to certain investors, if those rights would have a negative effect on other investors in that fund or in a similar pool of assets (e.g., investors in a parallel vehicle), unless such terms are offered to all investors. The prohibition on such preferential rights will come into force in two stages depending on the size of the adviser: (a) September 2024, in respect of large advisers (with US$ 1.5 billion or more in private fund assets under management), and (b) March 2025, in respect of all other advisers; and
2. a list of restricted activities which trigger disclosure and, in some cases, investor consent requirements. These restricted activities include, amongst others: (a) limits on borrowing from the fund, (b) the ability to charge costs related to investigations by any government authorities (whether within or outside the US), and (c) the ability to charge costs associated with routine regulatory examinations and ongoing compliance.

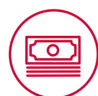
The adoption of the new rules is currently being challenged in the Texas courts. However, due to the timing of the rules coming into force, in-scope advisors should nevertheless take steps to prepare for compliance with the rules, in case the request to vacate is unsuccessful.

For further details on the SEC's new private fund adviser rules, please refer to our client briefing on the topic.

German Market updates

1. The German Federal Financial Supervisory Authority ("BaFin") recently sent questionnaires to 150 German insurance companies and pension funds regarding their investment holdings (both direct and indirect) in private equity, private debt and private infrastructure investments. Two of the key take-aways from this exercise are:
   - BaFin applies a look-through approach and so requires German professional investors to be well informed about the underlying investments in their investment portfolio and to be able to exercise some influence over the managers of the funds in which they invest. As a result, German professional investors are now tending to request more detailed information, reporting and monitoring rights from alternative investment fund managers; and
   - BaFin has begun looking closely at valuation approaches used in alternative investment funds, particularly in the context of private debt funds, and is now preparing a statement on valuations.

2. German pension funds are still focussed on applicable investment quotas:
   - there was an historic over-allocation by German pension funds to the real estate quota, but, as liquid investments have risen in value, this is no longer the case, and German pension funds are again looking to allocate investments to the real estate quota (in particular, the higher return strategies within that sector);
   - wrapper structures for alternative assets are also currently popular (for example, notes issuances linked to credit and bond quotas, which can make up a significant portion of a German pension fund's portfolio); and
   - there is starting to be some movement on the modification of the quota restrictions for German pension funds, including in relation to the developing infrastructure quota and the (as yet unresolved) movement to disconnect the rules applicable to professional pension schemes from those applicable to occupational pension funds.
3. In January 2024, the final text of the new Solvency II was published. The key point of relevance for the funds industry is the introduction of a new concept for long-term equity investments, which applies to a sub-set of equity investments to be held on average over a five-year period (the prior rules relating to long-term equity had been so restrictive that they were rarely practicable). In respect of ELTIFs and certain other low-risk alternative investment funds, there is no need to look-through to the underlying portfolio held by the fund for the purposes of this new concept. This quota is therefore likely to become a popular option in practice, given that the stress factor is 22% (rather than the normal 49% applied to private equity).



German Tax developments

There have been two recent positive tax developments in Germany:

1. at the end of 2023, the Federal Ministry of Finance issued a letter to the German pension fund association re-confirming that occupational pension funds can invest up to 5% of their assets in commercial partnerships (such as the Luxembourg SCS and SCSp), and including clarifications on how the 5% threshold is measured. Hopefully this will enable more pension funds to be able to invest directly into these types of partnership in the future; and
2. the final circular on German controlled foreign company rules (the "**CFC Rules**") was issued in December 2023, confirming that: (i) there should be no look-through in respect of debt profit participating notes (i.e., if securitisation structures are used and the notes are structured carefully as debt from a German tax perspective, the CFC Rules should not apply); and (ii) with regards to the calculation of the control tests under the CFC Rules, there was concern as to whether partners should be aggregated with all other partners if investing through a Luxembourg SCS or SCSp. However, the verification that there is no acting together between partners (and therefore no aggregation is required and no control exists) has been simplified.

Updates from the Asian market

Macro-economic issues in China have dampened investor confidence throughout the wider Asia region. However, Asian institutional investors (particularly sovereign wealth funds and pension funds) continue to be active. Middle Eastern institutional investors, which take a longer-term view, have also emerged as alternative sources of capital for the region.

Although active, Asian investors often prioritise existing relationships with managers or leverage relationships from within their network. Where Asian investors do consider developing new relationships with managers, managers can expect investors to undertake an extensive due diligence exercise before embarking on a new relationship.

Three common areas of focus for Asian investors in negotiations are:

1. disclosure and transparency: Asian investors often expect detailed reporting on the underlying portfolio investments, as well as deal allocation, transactions with affiliates and the accrual and allocation of costs (both at the fund and operational levels);
2. access to co-investments: Asian investors have been ramping up their co-investment programmes and will often expect priority access rights to potential co-investment opportunities. However, although extensive rights may be requested, investors remain discerning as to which co-investment opportunities are ultimately committed to; and
3. excuse rights: regional sovereign wealth funds in particular have very clear investment restrictions. If such restrictions cannot be incorporated directly into the fund documents, such investors will either expect strong excuse rights and, in certain circumstances, may even request the structuring of a separate investment vehicle, in order to be fully ring-fenced from any exposure to excused investments.

European Regulatory Updates

DORA

The European Digital Operational Resilience Act ("**DORA**") entered into force in January 2023 and will apply from 17 January 2025. DORA's aim is to strengthen the IT security of financial entities (including banks, insurance companies and investments firms) to support the resilience of the European financial sectors in the event of severe operational disruption. DORA harmonises the rules relating to the European financial sector's operational resilience and applies to 20 types of financial entity and ICT third-party service providers. In today's world, where so much of our personal and professional lives are digital, it is unsurprising that regulators are increasingly focussed on the risks associated with the use of information technology and third-party outsourcing. In Luxembourg, the CSSF has done a good job of preparing the market for the new DORA rules, however, entities that are in-scope of the new rules should not underestimate the amount of preparation work that will be required. Although there is still time to take action ahead of next January's go-live date, in-scope entities should take steps to begin their preparations as soon as possible, to the extent this work has not already begun.

Anti-money laundering / Know your customer rules

Anti-money laundering has for the last several years been a particular priority for the Luxembourg and European markets, and we expect this to remain the case for the coming years. The European Council and Parliament have recently agreed on parts of a new European anti-money laundering package, aimed at protecting European citizens and the European financial system against money laundering and terrorist financing, which will come in to force at a later date, following approval of the final texts and their adoption by the European Council and Parliament. In the meantime, the Luxembourg industry associations are also working, in consultation with the CSSF, on guidelines for compliance with anti-money laundering and know-your-customer requirements.

AIFMD II
The final text of AIFMD II has been approved by the European Parliament and is expected to enter into force by June 2024. Once the final text is in force, this will then need to be transposed into national law, so there remains some time before the new text becomes applicable. The industry has been pleased to see that the current delegation rules will remain in place, and there have also been some helpful clarifications that will create more legal certainty for alternative investment fund managers. In addition, the new rules will: (a) increase focus on increased transparency and reporting, particularly around fees, which is in line with global attention on this subject, (b) introduce new rules around the selection, disclosure, activation and deactivation of liquidity mechanisms, and (c) confirm that loan origination by alternative investment funds and their subsidiaries will be permitted. However, the right to passport loan originating alternative investment funds around the EU is not explicitly covered in the final text, and the domestic implementation of these rules will therefore need to be closely watched.

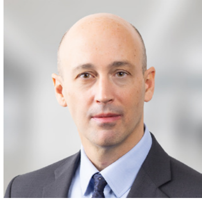
Capital Requirements Directive
Article 21(c) of the EU Capital Requirements Directive, which will come into effect in two years, prohibits lending by non-EU banks to EU borrowers. This prohibition will not only apply to retail lending, but to all forms of lending, subject to limited exemptions (e.g., in cases of reverse solicitation, intra-group and intra-bank lending, and lending that is ancillary to MiFID business). The purpose of the prohibition is to bring lending activity onshore and make lenders subject to local rules. As a result of the rules, non-EU lenders would be required to establish an EU branch or subsidiary. A transitional period will apply to the rules, but it is important to be aware of this development as it will impact not just future sources of lending, but will also require the assessment of current arrangements and whether they are characterised as loans.

UK Regulatory Update
Sustainable Disclosure Requirements
As a result of Brexit, the European Sustainable Finance Disclosure Regulation (the "**SFDR**") has not been implemented in the UK, however, the UK is in the process of implementing its own equivalent framework, the Sustainability Disclosure Requirements (the "**SDR**"). The Final SDR rules were published by the UK Financial Conduct Authority in November 2023 and the rules and guidance will apply in stages from May 2024 to December 2026. The SDR rules take a substantially different approach than has been adopted in the EU through the SFDR. The scope of the SDR is currently limited to domestic products and firms, however, a separate consultation on whether, and if so how, non-UK funds may be subject to SDR is expected later this year.

Read more: The UK's Sustainability Disclosure Requirements Regime

Cross-border marketing to UK retail investors
Another consequence of Brexit was the disruption of the ability of European retail funds to market into the UK. The UK's overseas funds regime is currently being revised, with the expectation that it will become easier to register a European fund in the UK for the purposes of marketing to UK retail investors.

CONTACTS



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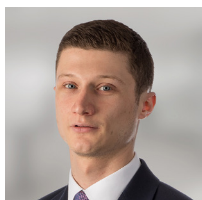

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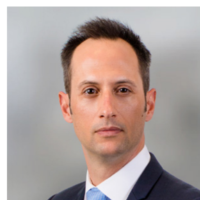

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