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SPOTLIGHT

Credit Funds: The Year of the Regulator

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SPOTLIGHT

In this issue

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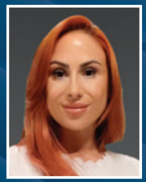

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We are delighted to bring you this edition of Spotlight Magazine, the content of which has come at just the right time, with it becoming increasingly apparent that we are in the midst of a global regulatory refresh of the private funds market.

Since the financial crisis, private markets and the use of leverage has grown significantly with private credit funds having ridden the wave of bank-induced liquidity and plummeting interest rates to significantly outperform the public markets and fixed income products. This success has caused an expansion of the investor base looking into private funds as a source of income, with retail investors increasingly set to ride the wave.

It was only a matter of time before this success caught the attention of the regulators. In recent months, a flurry of new rules and regulations have been put in place which primarily focus on ensuring that adequate risk management practices are in place, with the powers that be fearing how this previously untouched market may now feed back into other parts of the financial system and ensuring early stage protection for the retail market.

Our first article takes us through the new financial landscape for private funds adopted by the SEC, which according to the regulator seeks to enhance the regulation of private fund advisers and updates the existing compliance rules.

We will then travel across the Atlantic and cover the changes imposed by AIFMD II. While the introduction of AIFMD a decade ago imposed what were, at the time, substantial changes to the regulation of alternative funds, the AIFMD II text specifically hits credit funds requiring important changes to loan originating AIFs.

We will then turn from the macro to the micro and make a pit stop in Luxembourg to grab an update on ELTIF 2.0. ELTIFs are the only type of funds dedicated to long term investments that can be distributed across borders in the EU to both professional and retail investors. With the recent uptake of the retail market, our third article sets out how Luxembourg is paving the way for the rise of the ELTIF in 2024.

The rise of ESG over the last few years has provoked continued debate, with the SEC continuing to expand its remit and oversight with regards to ESG investing. Our fourth article summarises the SEC's new proposals on advertising, disclosure practices and greenwashing, as well as the anti-ESG pushback, which seems to be simultaneously sweeping the market.

In the year of the regulator, it would be remiss of us not to devote some time and attention to those areas of the private funds market which currently remains in the shadows of the regulator. We discuss the emergence and rapid expansion of the private secondaries credit market, questioning whether it will follow in the footsteps of its big brother and will soon be subject to increased regulatory oversight.

Finally, we look at global trends in infrastructure investment, noting that the industry is pivoting towards digitization and technology, a fast moving, and as of yet, largely unregulated asset class. We summarise the key considerations when investing in this growth market, particularly as these strategies often make for riskier offerings, than more traditional and dare we say it, regulated investments.

We hope you enjoy this edition, and please feel free to reach out to any of our contributing authors on the topics covered.

Diala Minott and the Paul Hastings Team

SEC Private Fund Rules: Battening Down The Hatches

The SEC expands into private funds

By Ryan Swan

Significant new rules affecting private fund sponsors will come online in Q3 2024; sponsors should consider business and compliance impacts, and begin preparing now.

What you need to know

- The Private Fund Rules entail a set of detailed requirements that will require significant increases in disclosure and transparency around items such as reporting, side letter negotiations, secondary transactions and expense allocation.
- The initial compliance date for portions of the Private Fund Rules begins in September 2024.
- The Private Fund Rules have the potential to be disruptive to operational practices and will require increased allocation of internal time and resources to digest and implement.

Background

In August 2023, the U.S. Securities and Exchange Commission ("**SEC**") voted to adopt new rules applicable to sponsors of private funds (the "**Private Fund Rules**"). The new rules are wide-ranging, and will affect various aspects of a sponsor's operations, including limited-partner reporting, side letter negotiations and disclosures, secondary transaction processes and expense allocation practices, among others.

Since their proposal in February 2022, the Private Fund Rules have been controversial, generating emphatic commentary from industry participants, including significant pushback from private fund sponsors. Unsurprisingly, when the Private Fund Rules were adopted in 2023, the SEC was promptly sued by several sponsor industry groups challenging the SEC's authority and process with respect to this rulemaking. Although the lawsuit will take some time to move through the U.S. court system, observers expect that there will be some action from the circuit court in Q2 2024, which could delay or otherwise affect implementation of portions of the Private Fund Rules.

Summary of the Rules

We have set out some of the most pertinent new rules below.

1. Quarterly Statement Rule,
   - requires detailed line-item accounting for fees, expenses and compensation paid by a fund or portfolio investment;
   - requires that levered and unlevered performance information is prepared using metrics prescribed by the SEC; and
   - requires the disclosure of performance calculations and the cross-referencing of governing and disclosure documents supporting fee, expense, and compensation amounts charged to be prepared.
2. Preferential Treatment Rule,
   - prohibits certain preferential liquidity (*e.g.*, redemption rights) and transparency rights (*e.g.*, information rights) that have a material negative effect on other investors; and
   - requires disclosure of all other preferential treatment, with disclosure in advance of an investor's closing for all material economic terms such as fee breaks, co-invest rights, and other similar terms.
3. Restricted Activities Rule,
   - imposes specific disclosure (and in some cases, consent) requirements in connection with activities that the SEC believes present heightened conflicts (*e.g.*, charging regulatory, compliance, and examination expenses or regulatory investigation expenses to a fund, reducing GP clawback amounts for taxes, and non-pro rata allocations of certain expenses relating to multi-client investments).
4. Adviser-Led Secondaries Rule,
   - requires an adviser that has initiated a secondary process (*e.g.*, a continuation fund) to obtain third-party pricing support in the form of a fairness or valuation opinion, together with a written disclosure describing any material business relationships during the prior two years with the opinion provider.
5. Mandatory Audit Rule,
   - requires that every private fund advised by a registered investment adviser must be subject to an annual audit, meeting the requirements of the Advisers Act's Custody Rule.

Applicability

The applicability of the rules differs on the regulatory status (*i.e.*, fully registered or exempt reporting adviser) and principal place of business (*i.e.*, U.S.-based or offshore) of an adviser. U.S.-based registered investment advisers are subject to all provisions of the Private Fund Rules. Exempt reporting advisers are only subject to the Preferential Treatment Rule and Restricted Activities Rule. For offshore advisers (whether fully registered or exempt reporting advisers) whose principal place of business is outside the U.S., the substantive provisions of the Private Fund Rules apply only to any U.S.-domiciled fund(s) (*e.g.*, a Delaware fund) of such adviser, and not to any non-U.S.-domiciled funds, regardless of whether such funds may have U.S. investors. For offshore advisers with a U.S.-registered advisory affiliate that provides sub-advisory services to its funds, it is likely that the Private Fund Rules will apply to such funds by virtue of the U.S. adviser's involvement.

Timing

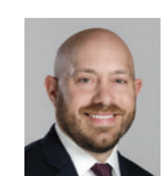
Subject to any potential delays resulting from legal challenges, large advisers (*i.e.*, those with private fund assets under management in excess of $1.5 billion) must begin complying with the Private Fund Rules (other than the Quarterly Statement Rule and Mandatory Audit Rule) in September 2024. Required compliance with the Quarterly Statement and Mandatory Audit Rules will begin in March 2025.

Implementation Steps

As advisers begin to prepare for the upcoming compliance dates, there are some practical steps to consider. First, sponsors should specifically evaluate which portions of the rules may apply to their business based on registration status and U.S. touchpoints. Next, sponsors should assess what changes they will need to make to internal reporting and other processes, in order to comply with applicable portions of the Private Fund Rules. For example, the Quarterly Statement Rule requires information that exceeds what is typical in the marketplace today, so sponsors will need to coordinate accounting, compliance and investor relations personnel to agree upon a template and process for compiling the newly required information. To ensure a smooth transition process, many sponsors are planning to run mock quarterly statement reporting exercises in advance of the implementation date. Similarly, sponsors will need to take a close look at their side letter and expense allocation practices to determine disclosure obligations. Additionally, there are significant outstanding interpretive questions that will continue to confront sponsors, as they begin to apply the detailed rules to their facts and circumstances. Absent clarifying guidance from the SEC, sponsors should maintain awareness of developing market practices and investor behaviours to inform decision-making around how to best address these ambiguities.

Conclusion

Historically, SEC oversight of private fund sponsors has largely deferred to the negotiation, disclosure and consent among sponsors and their private fund investor base. Many industry participants contend that this flexibility for private funds was intentional, and reflects deliberate policies concluding that the enhanced protection for investors in retail class products such as mutual funds was not necessary for the comparatively more sophisticated institutional and high net worth private fund investor base. In any event, the SEC has been vocal for several years about its focus on private fund sponsors in rulemaking, examinations and enforcement. The latest rules are in accord with that trend, and by upending many market-determined arrangements with investors, they represent a significant shift from the historical approach, in favour of a regime more akin to that applicable to retail asset classes. The Private Fund Rules give the SEC new fodder for examinations and enforcement, and in the SEC's policing efforts in the coming years will be focused on private fund sponsors' implementation and compliance.



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AIFMD II: Taking Aim at Private Credit

Recent changes to AIFMD see the regulators expanding their scope and remit

By Zach Milloy

10 years after the Alternative Investment Fund Managers Directive (“**AIFMD**”) entered into force, the final text of the political agreement reached between the Council of the European Union (“**EU**”) and the EU Parliament relating to the amendments to the AIFMD has been published, and most of the changes are targeted at private credit.

In March 2023, the European Council, European Commission, and European Parliament entered into negotiations to finalize the text of AIFMD II, and, on July 20, 2023, announced that political agreement had been reached in relation to the changes to the AIFMD. The final text of the legislation is likely to enter into force in early 2024, with an implementation date in early 2026.

As has been well documented by market participants and industry groups, the changes to the AIFMD represent an expanded scope for the AIFMD, reaching into product level regulations and rules through legislation primarily applicable to fund managers. The key changes relevant for private credit are summarised below.

Loan Origination Activities

AIFMD II will introduce a new regime for ‘loan origination funds’ and ‘loan origination activities’ which will apply in addition to the general AIFMD requirements already in place for EU alternative investment fund managers (“**AIFMs**”).

Alternative investment funds (“**AIFs**”) undertaking loan-origination activities, regardless of whether they meet the threshold to be a “loan-originating AIF” will be subject to the following additional requirements under AIFMD II:

What you need to know

- **Restrictions on Loan Origination:** New rules for loan origination activities, including concentration limits, a 5% retention requirement, restrictions on lending, and enhanced policies and procedures relating to assessing credit risk and monitoring a credit portfolio.
- **Loan Origination Funds:** AIFs qualifying as ‘loan-originating AIFs’ will be subject to leverage limits and a general requirement to be closed-ended.
- **Liquidity Risk Management Tools:** New requirements on liquidity management will apply to AIFMs managing open-ended funds.
- **Increased Transparency:** The scope of regulatory reporting has been expanded to include more asset and market-related data. Additionally, the scope of investor pre-investment disclosures under Article 23 has been expanded.
- **Marketing Ban for High-Risk Non-EU Countries:** Non-EU AIFMs and EU AIFMs managing non-EU AIFs will be prevented from marketing in the EU if the AIFM or AIF are established in a country listed on the EU’s list of high-risk third countries, or the EU’s list of non-cooperative countries for tax purposes.

1. *Concentration Limit*: AIFs originating loans will be subject to a concentration limit and must not make loans in excess of 20% of the AIFs capital to another AIF, undertaking for collective investment in transferrable securities (“**UCITS**”) or financial undertaking (*i.e.* banks, insurance firm or other financial services firm).
2. *Restrictions on Lending*: AIFMs/AIFs will not be permitted to lend to the EU AIFM, the EU AIFM’s delegate or any of their staff members or the depositary of the AIF.
3. *Prohibition on Consumer Loans*: Member states will have the ability to restrict and/or prohibit AIFs originating consumer loans. Shareholder loans will be exempt from the new requirements provided that the aggregate notional value of the loans do not exceed 150% of the fund’s capital. Equally, loans purchased by a fund are outside the scope of the rules, as long as the loans were originated by a third party and the EU AIFM was not involved in structuring the loan (such as by defining or pre-agreeing its characteristics).
4. *Risk Retention*: EU-managed funds undertaking loan-origination activities will need to hold a 5% risk retention interest in the notional value of originated loans. While the risk retention period is nominally to hold that interest for the shorter of eight years and the loan’s maturity, selling earlier is permitted where necessary to implement the fund’s strategy in investors’ best interests, or where the risk associated with the loan deteriorates and is disclosed to the purchaser (among other exemptions). In addition, EU AIFMs will be required to implement up-to-date and effective policies and procedures relating to granting credit, including assessing credit risk and administering and monitoring a credit portfolio where the AIF is originating loans or purchasing loans from third parties. These policies and procedures will need to be reviewed at least annually.
5. *Prohibition on Originate-to-Distribute Strategies*: EU AIFMs will be prohibited from managing AIFs whose investment strategy is to originate loans with the sole purpose of distributing those loans to third parties (an “originate-to-distribute” strategy).

Loan Origination Funds

The primary benefit to the industry of these changes is a proposal to enable AIFs to originate loans in all Member States, overcoming the banking monopolies imposed in some EU jurisdictions for origination of even business loans. The “price” for this is a set of new risk-management requirements to address (among other things) liquidity risk and interconnectedness in the financial system.

AIFMD II will also introduce a new regime for ‘loan-originating AIFs’, which will apply in addition to the above requirements applicable to loan-origination activities. A loan origination AIF is a fund:

1. whose investment strategy is mainly to originate loans; or
2. where the notional value of the AIF’s originated loans represents at least 50% of its net asset value.

In addition to the general loan-origination rules outlined above, loan-originating AIFs will be subject to leverage limits of 175% for open-ended AIFs and 300% for closed-ended AIFs. Leverage for these purposes is to be calculated in accordance with the commitment method, however, subscription lines/facilities can be excluded from the calculation.

Loan-origination AIFs are required to be closed-ended by default; however, EU AIFMs intending to raise open-ended loan-origination funds will need to be able to demonstrate to their home member state regulator that the fund has liquidity-management tools available that are consistent with its investment strategy, redemption policy and broader liquidity risk-management framework.

1. *Liquidity Management:* EU AIFMs managing open-ended funds will be required to adopt at least two (one, for money-market funds) liquidity-management tools such as gates, swing pricing, suspension of redemptions, etc., as specified in the new Annex V. AIFMs of these open-ended funds will also need to adopt specific policies and procedures relating to the use of liquidity-management tools, and in certain circumstances AIFMs will be required to notify their home member state regulator when certain liquidity-management tools are utilized.
2. *Marketing Restrictions:* Among other wider changes under AIFMD II, of particular note is the restriction on marketing. Both EU and non-EU AIFMs marketing into the EU under NPPRs will be prevented from marketing in the EU, if the non-EU AIFM or non-EU AIF is established in a country listed on the EU’s list of high-risk third countries, or the EU’s list of non-cooperative countries for tax or AML purposes. This will increase the risk of using vehicles based in jurisdictions that are periodically subject to greater scrutiny on these matters. Note that the Cayman Islands was only recently removed from the AML blacklist.

Conclusion

As details around the rules for loan-origination funds are considered, it will be interesting to see how the market reacts, particularly around the structuring of new or existing open-ended funds, which may fall within scope of the new requirements. While many private debt funds invest with the intention to hold loans to maturity, these new requirements may put EU loan-origination activities at a disadvantage, versus other global markets, particularly the U.S. Equally the real impact of the new rules will vary across products, depending on factors including investment strategy, maturity and borrower profiles.

Sponsors currently structuring new funds should consider the impact of the new rules on upcoming fund structures, particularly those funds undertaking loan origination/direct lending activities or those established in jurisdictions currently listed on the EU tax or AML blacklist.

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Luxembourg and ELTIF 2.0

Regulators hope to revive the use of ELTIFs with expansive changes

By Xavier Le Sourne and Kenza Bensaid

What you need to know

- ELTIF 2.0 came into force on January 10, 2024, with its primary aims being to broaden investor bases, enhance portfolio asset diversification and provide increased structural flexibility. For existing ELTIF's, a five-year transition period, extending to 2029 has been provided.
- Luxembourg, in its characteristic forward-thinking manner, has been proactive in its adoption of both ELTIF and ELTIF 2.0, solidifying its position as an innovation hub within the investment funds landscape.

With the U.K. finalising long-term asset fund access rules in July 2023, and Europe bringing the new European long-term investment fund 2.0 legislation into force as of January 10, 2024, the ability for private market managers to access retail investors in the U.K. and Europe has never been greater.

The European Long-Term Investment Fund ("**ELTIF**") regime was viewed in 2015 as the key conduit for connecting retail, or non-institutional investors, to private capital markets strategies. The regulator hoped that the new ELTIF structure would fulfil dual aims of boosting economies, as well as supporting the democratization of assets for a larger pool of investors. However, with limited take up since its initial implementation, the European Union ("**EU**") undertook a review of the regulation and are now hoping that the European investment horizon will be reshaped by ELTIF 2.0, which brings transformative changes to the original ELTIF regulation. These reforms came into force on January 10, 2024, however, a transition period extending until January 11, 2029 applies to ELTIFs authorized under the preceding regulations. A summary of the key changes and what they mean for the ELTIF structure going forward are set out below.

Extension of Marketing Passports

ELTIF 2.0 extends marketing passports, offering a retail AIF marketing passport that is not merely limited to high net-worth individuals, but which is available to all types of retail investors. This uniquely positions ELTIFs in the European investment landscape, as it allows fund managers to offer ELTIFs to a broad range of investors across the entire EU, granting them direct access to a wide and diverse investor base. Furthermore, this extended marketing passport not only simplifies the process of reaching out to potential investors across different EU countries, but also helps in building a stronger, more recognizable brand for fund managers. By enabling a uniform marketing approach throughout the EU, fund managers can efficiently communicate the benefits and opportunities presented by their ELTIFs.

Reaching a Wider Audience

ELTIF 2.0 removes the €10,000 minimum initial-investment amount, per investor, as well as the ELTIF-specific eligibility assessment, which required distributors to ensure that investors with a portfolio of less than €500,000 did not invest more than 10% of their overall assets in ELTIFs. These changes significantly open up investment opportunities for retail players. By harmonizing ELTIF's investor suitability checks with the well-established MiFID II framework, ELTIF 2.0 clarifies obligations for distributors and managers, thereby streamlining the investment process. This alignment ensures that the assessment of an investor's knowledge, financial situation, and investment objectives are consistent across the European financial markets, facilitating efficient distribution and management of ELTIFs.

Expanding the Portfolio and the Audience

Enhanced changes in investment structuring, diversification and portfolio exposure guidelines provide fund managers with superior liquidity-management tools. As part of this, the maximum investment in a single asset is being raised from 10% to 20%, and the minimum investment ratio in eligible assets is being set at 55%, allowing for up to 45% of an ELTIF's net assets to be allocated to assets compliant with the UCITS directive, commonly referred to as the "Liquid Pocket".

Green bonds, along with simple, transparent, and standardized securitizations also join the list of eligible assets. The latter, which captures a wide array of long-term exposures, can be included, up to an aggregate limit of 20% of the ELTIF's capital. Senior tranching can be included within the Liquid Pocket, adding another dimension to portfolio strategy. Moreover, ELTIFs can now invest in entities with a market capitalization of up to €1.5 billion (a significant increase from the €500 million cap in the original version).

This strategic adjustment will ultimately allow fund managers greater flexibility in their investment strategies by permitting a substantial portion of the fund's assets to be invested in more liquid assets, such as transferable securities, money-market instruments, deposits, and units/shares of investment funds. Such a move not only broadens the scope for diversification, but enhances the fund's overall appeal to investors by balancing long-term investments and liquidity appetite.

Borrowing

ELTIF 2.0 raises the borrowing limits permitted to be undertaken by ELTIFs, thereby allowing for a diversification of financial strategies. For ELTIFs marketed to retail investors, the limit is now 50% of the net asset value. If solely targeted at professional investors, this shoots up to 100%.

Structuring

ELTIF 2.0 extends its structural offerings beyond the current option of integrating ELTIF sub-funds into a pre-established structure. Innovations like fund-of-funds strategies and master-feeder structures, coupled with the allowance for minority co-investments, broaden the investment landscape.

Redemption

Unlike traditional ELTIFs, which imposed rigorous liquidity measures, the revamped ELTIFs embrace flexible redemption policies that adeptly marry long-term investment goals with tangible liquidity solutions, such as introducing the possibility of redemptions before the end of a fund's fixed-term life. The European Commission is currently reviewing the European Securities and Markets Authority report on the 'Regulatory Technical Standards' issued in December 2023, which is expected to fine-tune operational and regulatory aspects of ELTIF 2.0, emphasizing life-cycle alignment, redemption policies, and cost transparency.

Luxembourg's Proactive Stance on ELTIF

Luxembourg's eligibility criteria for the ELTIF label is notably expansive. Beyond just targeting sophisticated investor-focused entities like the specialized investment fund or reserved alternative-investment fund, Luxembourg encompasses other ELTIF-friendly structures, including the common limited partnership, the special limited partnership, as well as Part II undertakings for collective investment ("**UCI**"). Notably, Luxembourg UCIs set up under Part II of the law of 2010, can be placed with the public, permitting the ELTIF's alternative investment-fund manager to fully avail itself from the extended ELTIF 2.0 passport to retail investors.

This inclusive approach with regards to structuring, mirrors Luxembourg's reputation as a constantly evolving investment fund hub. Its prompt adaptation to the ELTIF amendments underscores its proactive nature. By refining its legal structures for investment funds, particularly for Part II UCIs, Luxembourg solidifies its position as an innovator in investment solutions.

Furthermore, Luxembourg's tax reforms, synchronous with the ELTIF evolution, accentuate Luxembourg's positive environment. A key highlight is the tax exemption from subscription tax for Part II UCIs, specialized investment funds, and reserved alternative investment funds when they are authorized as an ELTIF, emphasizing Luxembourg's commitment to creating a favourable fiscal climate for pan-European long-term investments.

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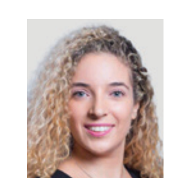

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ELTIF 2.0

AT A GLANCE

By Robin Callander and Oisin Kilgallen

Assets

- Real Assets
  - Defined as any asset which has ‘intrinsic value due to its substance and properties’. The €10millon value for an eligible real asset has been removed
- Investment in non-EU Assets
  - ELTIF investing in both EU & non-EU assets clarified
- Securitizations & Green Bonds
  - Securitizations carrying the ‘STS’ label and certain Green Bonds are now deemed eligible up to 20% of an ELTIF
- Diversification
  - Diversification limit per asset increased to 20% from 10%
- Eligible Investments
  - Eligible assets down to 55% from 70%
- Qualifying Portfolio Undertakings
  - Scope of what is deemed as Qualifying Portfolio Undertakings (*i.e.* fintechs). Investment in listed undertakings with a market capitalization value of €1.5billion, up from €500million
- Minority co-investments
  - Now eligible

Structuring

- Fund of Funds
  - ELTIF 2.0 allows an ELTIF to be setup as a Fund of Fund investing in EU funds
- Investment Advice
  - ELTIF 2.0 removes the need for the provision of ‘investment advice’ to retail investors prior to investing in an ELTIF

Key Fund Terms

- Minimum Investment Amount
  - ELTIF 2.0 has removed the minimum €10,000 investment
- Investor Cap
  - The new legislation has removed the 10% cap on ELTIF exposure for retail investors whose financial portfolio is less than €500,000
- Minimum lock-up period
  - Defined minimum lock-up period is removed and instead this determination is to be made by the ELTIF manager, demonstrating compatibility with valuation and redemption policies
- Leverage Ratios
  - Increased up to 50% of NAV where marketed to retail investors. Where solely marketed to professional investors this can be 100% of NAV
- Matching mechanism
  - Provision of a unique matching mechanism to allow investors to dispose of ELTIF positions through a form of matched secondary market before end of fund life

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Private Credit Secondaries: Coming of Age

Private credit fund AUM reaches $1.5trn

By Ted Craig

What you need to know

- The secondaries market has been dominated by private equity since its inception, however, a demand for increased liquidity, alongside the emergence of private credit as an asset class is leading to an enhanced demand for a private credit secondaries market.
- LP-led transactions currently dominate; however, we expect a rise in GP-led transaction types, as was the case for private equity.
- The private credit secondaries market can, has and will continue to borrow best practices, know-how and deal structures, technology and approaches from private equity.

Since inception, the secondaries market has been dominated by private equity since its inception. However, the combination of (a) the significant growth of the private credit asset class, (b) current investor appetite for liquidity and an increased awareness of the secondaries market as a portfolio management or liquidity 'tool', and (c) the emergence of specialist private credit secondaries buyers, means that private credit secondaries are coming of age.

The three things the market needs to grow

For the private credit secondaries market to grow, there needs to be inventory to 'trade', there needs to be supply from the sell-side, and there needs to be demand from the buy-side.

It has been fairly-widely reported that the assets under management within private credit funds have now reached approximately $1.5trn, growth having been significant over the last 10 years in particular. Indeed, private credit AUM has now surpassed that of private equity at the point at which the private equity secondaries market started to hit its stride in the years after the global financial crisis. So, there is meaningful inventory within private credit funds – *i.e.*, private credit assets – of sufficient maturity available to be the subject of a secondaries transaction. **Inventory: tick.**

Current market conditions have led to a lower level of distributions to private fund investors across asset classes and, consequently, an appetite for liquidity by other means. At the same time, some investors have been the 'victim' of the denominator effect and experienced an over-allocation to private markets during a time of increased volatility in the valuations of private markets funds. Moreover, the development of the secondaries market over the last 10 to 15 years in particular has meant that investors are far more aware of it as a portfolio management or liquidity 'tool'. Investors, therefore, have looked, and continue to look, to the secondary market to sell assets from their private market portfolios. **Supply: tick.**

On the buy-side? A number of dedicated private credit secondaries funds have recently hit the market, raised by well-established sponsors, including for example Apollo, Ares Management, Coller Capital and Pantheon. Traditional secondary buyers, along with credit investors and special situations funds, also continue to be in the market for credit assets. **Demand: tick.**

So, the timing appears to be right for the growth and development of private credit secondaries as this market comes of age and emulates the more mature private equity secondaries market.

Borrowing and learning from your older sibling

To date, private credit secondaries have been predominantly 'LP-led' transactions, with investors seeking liquidity through the sale of their LP interests in private credit funds. While it is expected that this transaction-type will remain dominant within the asset class, 'GP-led' transaction types, including continuation vehicles and tender offers, will also become more common, as they have in private equity. Not so much a 'hand-me-down' from the private equity older sibling – rather, perhaps, borrowing one of its best new toys.

We can of course not only borrow from but also learn from our elders and private credit secondaries will undoubtedly benefit from following in the footsteps of private equity, as it utilizes the best practices and know-how as well as the deal structures, technology and approaches developed over the years of evolution of the private equity secondaries market. Indeed, private credit can leverage a great deal of knowledge and experience from within the broader secondaries community. As a result, the advancements and innovation within private credit secondaries are likely to come at a faster pace than they did for private equity (which wasn't exactly slow).

We are still at the relatively early stages of the growth and development of the private credit secondaries market. Deal volume in 2022 was reportedly $17bn. While this is significant – and certainly shows considerable growth (deal volume in 2012 was approximately $0.5bn) – when compared to a credit fund AUM of $1.5trn, there is clearly potential for it to be even more so. With current market conditions, a growing, sophisticated buyer universe, and experiences and deal technologies to be borrowed from private equity secondaries, the fresh-faced, younger sibling is set to mature very quickly. Won't the parents be proud.

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ESG: 'Emergent Risk' in the United States

ESG: To be or not to be

By Tara Giunta and Daye Cho

The U.S. Securities and Exchange Commission ("SEC") is adopting measures aimed at improving the availability, accuracy, and consistency of ESG-related information published by funds and asset managers. This article provides a summary of recent regulatory changes made by the SEC as they relate to ESG investors.

What you need to know

- The SEC's final amendments to the fund "Names Rule" indicate the agency's ongoing focus on ESG-related claims and greenwashing.
- The SEC is anticipated to finalize its proposed rules on climate and ESG disclosures in 2024, which would require more information on ESG strategies in fund PPMs, annual reports, and adviser brochures.
- The anti-ESG pushback is simultaneously sweeping across the United States, sending mixed signals to investors, funds, and asset managers.

"Names Rule"

On September 20, 2023, the SEC finalized amendments to Rule 35d-1 ("**Names Rule**") under the Investment Company Act of 1940, which addresses fund names that are likely to mislead investors about a fund's investments and risks. The Names Rule initially required funds with names suggesting a focus on specific types of investments, industries, or geographic regions to invest at least 80% of their assets in the areas suggested by those names. Recent amendments to the Names Rule expand this requirement to apply to fund names that include terms like "growth" or "value," or otherwise signal a focus on one or more ESG factors. Consequently, a fund that considers ESG factors, alongside, but not more centrally than other, non-ESG factors in its investment decisions would not be permitted to use names that suggest otherwise.

In addition, funds will need to review their compliance with the 80% requirement on a quarterly basis and take any necessary corrective action within specific time frames—generally 90 days. This is a notable change from the prior Names Rule, which did not expressly require correction for "passive breaches" caused by changes in the market value of investments held by a fund. The final amendments also introduce enhanced prospectus disclosure requirements for terminology used in fund names, including consistency with terms' plain English meaning or established industry use, and additional reporting and recordkeeping requirements for funds. The amendments went into effect on December 11, 2023. Fund groups with net assets of USD 1 billion or more will have 24 months to comply, while those with net assets of less than USD 1 billion will have 30 months.

ESG Disclosures

The SEC is also expected to adopt a final rule on ESG disclosures for investment advisers and investment companies. Initially proposed on May 25, 2022, this rule seeks to require funds and advisers to provide comparable and reliable ESG-related information for their investors and the SEC.

The proposed rule would apply to registered investment companies and business development companies ("**funds**"), as well as registered investment advisers and certain unregistered advisers ("**advisers**"). The amount of required disclosure would depend on how "central" ESG factors are to a fund's strategy. The proposed rule identifies three types of ESG funds:

- **Integration Fund:** A fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions (but no more significantly so than other, non-ESG factors) would be required to describe how ESG factors are incorporated into its investment processes.
- **ESG-Focused Fund:** A fund that focuses on one or more ESG factors by using them as a significant or main consideration in selecting investments or in its engagement strategy with the companies in which it invests would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
- **Impact Fund:** A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

In addition, under the proposed rule, funds that consider environmental factors in their investment strategies would be required to disclose relevant information, such as greenhouse gas emissions associated with their portfolios.

Some industry stakeholders, however, have expressed concerns over the broad scope of the proposed rule, contributing in part to its delayed finalization. For example, several commentators have called for the Integration Fund category to be eliminated, noting that the current approach is too broad and will encompass too many funds. While it remains to be seen how the SEC will address these concerns in its final version of the rule, the agency dropped a similar approach to "integration fund" names in the final Names Rule, signalling that it may accordingly modify the corresponding points in the final ESG disclosure rule.

Climate Related Disclosures

The SEC has separately proposed a rule on climate-related disclosures. Initially proposed on March 21, 2022, this rule aims to require registrants to disclose certain climate-related information, including the registrant's climate-related risks, processes to govern such risks, and greenhouse gas emissions. This long-awaited rule is anticipated to be finalized by April 2024. In the meantime, the SEC is reportedly pressing companies with climate-related inquiries, asking more than a dozen large companies in late 2023 to explain why their annual financial reports contain less information about climate risk than their sustainability reports.

Greenwashing

In recent years, the SEC, through its Climate and ESG Task Force, has steadily brought enforcement actions against asset managers for ESG-related misconduct. These include charges of misleading statements and omissions concerning ESG considerations in making investment decisions. Taken together, the updated Names Rule and the latest enforcement actions indicate the agency's continued focus on "greenwashing," or the making of deceptive or misleading statements.

Anti-ESG Movement

As firms respond to increasing investor and regulator demands for ESG-related information, they should also pay attention to the anti-ESG movement that has gained considerable traction in the United States in recent years. Several states, including Texas, Florida, South Carolina, Kansas, and Missouri, have introduced legislation restricting the use of ESG factors by state financial institutions in making investments with public funds. Certain state treasurers have similarly withdrawn public funds from investment firms accused of promoting a "woke" political agenda above the financial interests of their customers. Industry climate initiatives like the Net Zero Asset Managers Initiative have also been under attack as allegedly violating antitrust rules, resulting in a number of members discontinuing their participation. State attorneys general have even issued Civil Investigative Demands to asset managers under their broad unfair and deceptive acts and practices authority, inquiring about firms' ESG practices. Notably, the SEC excluded any references to "ESG" in its 2024 examination priorities, instead focusing on emerging, material risks. While it would be a mistake to construe this single development as an indicator that ESG is no longer a priority for the SEC, the exclusion reflects the significant pushback that the agency has received on its jurisdiction over ESG compliance.

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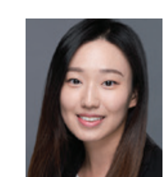

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Infrastructure: A Move Toward Unregulated Growth

Changing investment thematics are leading to increased interest in non-traditional 'growth' opportunities

By Stuart Rowson and Candice Lambeth

Global trends in infrastructure investment are pivoting towards energy transition and the "digitization and electrification of everything". To find such opportunities, asset managers (and underlying investors) are increasingly looking at investment in 'growth' companies, that is, companies which are developing and rolling out nascent technology such as next-generation battery storage and EV charging platforms.

What you need to know

- Focus on unregulated 'growth' assets driven by energy transition and digitization trends.
- The policy/legislative environment may shift to support nascent technology as seen with the U.K.'s Energy Act 2024. However, as energy transition markets expand, regulators will eventually extend regulations to protect customers (rather than investors).
- Absent any current regulation, to protect investment in 'growth' assets and new technologies, investors will look to contractual protections and using alternative structures (as explained in more detail below).

This article explains some of the key investment features and protections (some borrowed from venture capital) that investors should consider when negotiating 'growth' deals, especially where the investment is structured as a minority stake and where founding shareholders are seeking new investment.

Growth Assets

By their nature, 'growth' assets make for higher risk (and potential reward) and require more active investment strategies and ongoing growth funding. A different risk mitigation toolkit is also required compared to traditional infrastructure investment in regulated assets, which often also benefit from subsidies or licensing regimes.

The digitization of traditional/"non-digital" infrastructure, where investors modernize and upgrade existing infrastructure to avoid being stranded with unsustainable assets, may also create new and often transformative opportunities. Robotics and automation, smart monitoring systems, and AI are being introduced to enhance efficiency to existing systems and operations. Some investors (and their portfolio companies) are partnering with technology specialists to leverage synergies in the broader digital landscape – this can be through making investments into start-ups or growth businesses.

An important factor for success as nascent sectors eventually comes under the regulatory purview for investors to continue to deliver on the business model, whilst navigating regulatory changes and challenges in a competitive landscape.

Contractual Protections In Growth Deals

Enhanced / Liquidation Preferences – an investor with a liquidation preference will be able to recover their investment (plus, if agreed, a multiple of that) ahead of any other shareholder in a sale or liquidation scenario where a return is not achieved. Enhanced liquidation preferences include a "participating preference" right, which allows the investor to recover its investment and then also to 'participate' in the distribution of any remaining proceeds on a pro-rata basis (although these rights are less common).

Anti-dilution ratchets – if an early-stage investor subscribes for shares at a price higher than the subscription price set for a subsequent equity fundraising round ("**Subsequent Round**"), they would be disproportionately diluted on the Subsequent Round. To protect against this dilutive effect, the investor can negotiate an anti-dilution ratchet (outside of the usual pre-emption rights) that would, when exercised, ratchet up the number of shares to be issued to the relevant investor in the Subsequent Round to "compensate" for the shares they would have received had their earlier investment been made at the lower subscription price. The extent of the ratchet mechanic will vary depending on the negotiated position.

Convertible loan notes – convertible loan notes give the investor an option to convert loan notes to equity in the Subsequent Round at a pre-agreed discount to the subscription price. These can be issued to mitigate the 'valuation gap' where investor and company pricing expectations are not aligned at the point of investment.

Pay-to-play provisions – given the market is experiencing a difficult fundraising period, growth companies seeking investment may look to incentivize investors to continue to provide growth capital in the future, for example, by providing enhanced veto or board representation rights if they participate in Subsequent Rounds. In some cases disincentives are used and investors may lose existing rights if they choose not participate.

Preferred equity - these instruments provide lower-risk, debt-like characteristics (including return of capital ahead of ordinary shareholders and junior debt) with, in the current higher interest rate environment, attractive returns (closer to equity-like returns) especially when compared to the lower investment risk being taken. Terms of preferred equity instruments are subject to commercial negotiation (rather than market norms) and can therefore provide a flexible funding solution. Investors holding only preferred equity, however, will not participate in any upside returns, and, as such, these alternative structures are likely to remain a consideration, for so long as the risk-reward balance remains attractive.

Governance rights (including reserved matters) – these should be carefully considered by investors alongside the above deal protections and the scope of governance rights negotiated should reflect the size of the investor's stake and also take into account any other expertise or opportunities that an investor brings to the table.

Compared to traditional infrastructure investment with predictable risk profiles, an investor's approach to deal strategy and risk-assessment needs to adapt to capture and optimize 'growth' opportunities, while also anticipating challenges from emerging technologies and future regulation.

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Upcoming Industry Events

PDI Europe Summit

May 7-8, 2024

London

Debtwire and Creditflux's European Direct Lending Forum

May 28, 2024

London

Global ABS

June 4-6, 2024

Barcelona

SuperReturn International

June 4-7, 2024

Berlin

AIMA Alternative Credit Council

Global Summit

October 2, 2024

London

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