Alternatives Watch 2022 Outlook: Tannenbaum Helpern Syracuse & Hirschtritt LLP

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In the latest installment of our ongoing *Alternatives Watch 2022 Outlook* series, we turn our attention to what may be on the regulatory horizon and what the industry needs to be prepared for as new rules come into play.

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In our discussion, we look at what investment firms can expect in 2022 from regulators and with respect to ESG-related developments. Also, Wayne speaks to fund structures expected to be in demand this year.

What's new on the horizon regulatory wise that private markets managers should be aware of?

On Nov. 10, 2021, SEC Chairman Gary Gensler delivered a speech at the Institutional Limited Partners Association Summit, identifying several areas of focus. These include private fund fees and expenses, side letters, performance metrics, fiduciary duties and conflicts of interest, and Form PF. Chairman Gensler's stated concerns have been confirmed by the SEC's more recent announcement of proposed new rules and amendments under the Investment Advisers Act of 1940 (the Advisers Act).

All indications are that there will be a renewed emphasis on transparency with respect to fees and expenses being passed on to fund investors. In addition to management and performance fees, in the private equity space this will include monitoring and other portfolio company-related fees. The proposed rules would require SEC registered advisers to provide investors with quarterly statements detailing fees, expenses and fund performance.

Other areas to be prioritized include enforcement of advisers' fiduciary duties and mitigation of conflicts of interest between advisers, their affiliates and parties with whom they have ongoing business relationships. While adequate disclosure of potential conflicts has always been recognized as essential, here the SEC may look to prohibit certain relationships. As among investors, the SEC will be looking to curtail preferential treatment to some and not others, specifically with respect to preferential liquidity terms and disclosure regarding underlying portfolio investments. This will result in a focus on managers' use of side letters.

Managers should also be looking for enhanced audit requirements, enhanced prohibited transaction rules and Advisers Act amendments addressing managers' compliance policies, including retention of, and access to, books and records. (Sources: https://www.sec.gov/news/speech/gensler-ilpa-20211110; https://www.sec.gov/files/ia-5955-fact-sheet.pdf)

Separately, through 2021 the SEC's enforcement activity evidenced an expanded focus on insider trading, bringing actions involving "insider tips" disseminated through the dark web and against an executive under the previously untested theory of "shadow trading," alleging a target company executive's trading in the stock of an industry competitor — neither the acquirer or the target — constituted actionable misappropriation of material non-public information. Managers should be monitoring this case, particularly as it may impact the design of compliance programs with respect to internal trading restrictions.

Are there any fund structures that you are seeing more interest in within your practice? For example, are co-investments and secondaries still going to be on the upswing this year?

From what we've seen in our office coming out of 2021 into 2022, all indications are that co-investments, cross-investments, and secondary purchase transactions will continue to increase in number. Due in part to the increased number and value of secondary transactions, one of the SEC's current proposals is that SEC registered advisers be required to obtain a fairness opin ion from an independent opinion provider in connection with any adviser-led secondary transaction.

More generally, we continue to see private equity and other illiquid strategies, and therefore closed-end fund structures, predominate. While launches of credit and real estate funds continue at a steady pace, more niche strategies, such as cannabis and digital assets, also remain strong. With respect to cannabis, the fact that legalization at the Federal level has not taken place continues to constrain investment, while the variations among individual states' laws have provided an opportunity for astute managers to invest in certain industries both directly related, and ancillary to, cannabis cultivation, manufacture, distribution and sale. Significant regulatory issues, as well as investor uncertainty, continue to keep the number of digital asset-related fund launches relatively low (in my office at least). What we are seeing in the digital asset space are managed account arrangements with experienced digital asset investors leveraging their investing experiences to attract investors.

Tax considerations and regulatory requirements continue to play a large role in determinations of structure and entity domicile. With respect to the latter, while Cayman remains a very popular non-U.S. domicile for non-U.S. funds, we've seen some advisers migrate to BVI and other jurisdictions as the Cayman Islands Monetary Authority (CIMA) has added regulation and more oversight requirements.

How are your clients most effectively applying ESG?

As a practical matter, most if not all managers are aware and supportive of global ESG initiatives at both the manager and portfolio company levels. The more difficult issue we see, other than for those manager clients specifically dedicated to ESG as the main framework for their investment strategy, is how to address the interplay of ESG and other strategies.

At this point, U.S. domiciled managers that do not have a significant presence in the EU or elsewhere outside the U.S. are seeing an overwhelming amount of information with respect to global disclosure and reporting initiatives, with few, if any, having an immediate impact on manager disclosure practices. This is likely to change during 2022 as the SEC has indicated it will soon be promulgating its own ESG-related disclosure guidelines. Steps already taken by the SEC include its creation of a Climate & ESG Task Force to focus on "identifying any material gaps or misstatements in issuers' disclosure of climate risks under existing rules," (See https://www.sec.gov/news/press-release/2021-42) and the Department of Examination's issuance of a risk alert identifying existing weakness in ESG-related disclosures and providing guidance for investment managers offering products to serve the demand for ESG-focused investments.

To meet this demand, the SEC has recommended and we certainly support:

- Offering clients choices among standardized portfolios focused on particular ESG issues, or alternatively, customized separately managed accounts designed to accommodate particular client preferences;
- Including statements on websites, client presentations, and periodic investor reports detailing how they approach the U.N.-sponsored Principles for Responsible Investment or Sustainable Development Goals, including quantitative information on the local impacts of investments;
- Adopting detailed investment policies and procedures addressing ESG investing, including specific documentation they require at various stages of the investment process (e.g., research, due diligence, selection, and monitoring); and

- Requiring compliance personnel to more meaningfully (i) review their firm's public disclosures and marketing materials, (ii) test the adequacy and specificity of existing ESG-related policies and procedures, if any (or assess whether enhanced or separate ESG-related policies and procedures were necessary), (iii) evaluate whether their firm's portfolio management processes aligned with their stated ESG investing approaches, and (iv) test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences. (See https://www.sec.gov/files/esg-risk-alert.pdf)

Asset managers are using new sustainability classification systems developed by governments, international bodies, and NGOs. For example, an institutional investor headquartered in Europe may require its asset manager(s) to incorporate or report on alignment with the EU Taxonomy, regardless of where an asset manager is headquartered. In this context, asset managers must engage their investors to understand their needs and respond accordingly. (Sources: https://www.eyeonesg.com/2022/01/leveraging-taxonomies-how-asset-managers-are-using-new-sustainability-classification-systems-part-iii/)

In a development that has been anticipated for quite a while, on Oct. 13, 2021, the U.S. Department of Labor announced a proposed rule that would remove barriers to plan fiduciaries' ability to consider climate change and other environmental, social and governance factors when they select investments and exercise shareholder rights. Comments closed on Dec. 31, 2021. (Sources: https://www.dol.gov/newsroom/releases/ebsa/ebsa20211013; https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights)

If the Rule is finalized in the form proposed, plan fiduciaries — the individuals or entities that manage an employee benefit plan and its assets — may consider Environmental, Social and Governance factors when they select investments, and many of the barriers to ESG investing by ERISA plans should fall away.

Now going into the third year of COVID, it seems that funds are still finding ways to raise capital albeit remotely. Are there new rules regarding solicitation that affect the industry?

On Dec. 22, 2020, the SEC amended the rules under the Advisers Act governing marketing and solicitation arrangements by SEC registered investment advisers. The amendments create a single Rule 206(4)-1 (the "Amended Rule") that combines the prior advertising rule (Rule 206(4)-1) and the prior cash solicitation rule (Rule 206(4)-3) under the Advisers Act. The Amended Rule went into effect on May 4, 2021 and has a compliance date of November 4, 2022. While its details are beyond the scope of this piece, the overall intent of the new Rule is to allow certain additional avenues and information in keeping with technological advancements, while continuing to prohibit false or misleading information or materials.

In November 2020, the SEC adopted amendments intended to simplify, harmonize and improve the exempt securities offering framework. The SEC also eased certain offering communications rules by (i) providing that certain "demo day" communications are not considered general solicitation or general advertising and (ii) permitting an issuer to use generic solicitation of interest materials to "test-the-waters" for an exempt offer of securities prior to determining which exemption it will use for the sale of the securities. With certain exceptions, this final rule was effective on March 15, 2021. (See https://www.sec.gov/rules/final/2020/33-10884.pdf)