April 2023

SPOTLIGHT Credit Funds

Credit Funds: **Weathering the Economic Storm**

PAUL HASTINGS

Paul Hastings LLP | www.paulhastings.com

SPOTLIGHT Credit Funds

In this issue

Diala Minott
Partner, Editor
+44.020.3023.5181
dialaminott@paulhastings.com

Gabriella Omorphou
Associate, Contributing Editor
+44.020.3023.5242
gabriellaomorphou@paulhastings.com

We are delighted to bring you this bumper edition of Spotlight Magazine in the midst of the choppy times we are all facing.

There is a storm brewing in the economic landscape in which we find ourselves, but these uncertainties often bring out the best bright new ideas and a drive for innovation. Our first article takes us through the rise of artificial intelligence in the funds arena with new fund mechanics such as the MFN process, being automated and then made even smarter.

We will then take you on a road trip through the perfect storm of alternative lending from a small specialist AIFM's perspective, navigating its way through AIFMD II, to a teach in on the energy and renewables sector whose growth is forecast to increase five-fold by 2030 - providing private credit investors with the opportunity to invest in investment grade/crossover assets. We will also delve into the vital terms that lenders should now negotiate to ensure they are fully protected in these troubled waters.

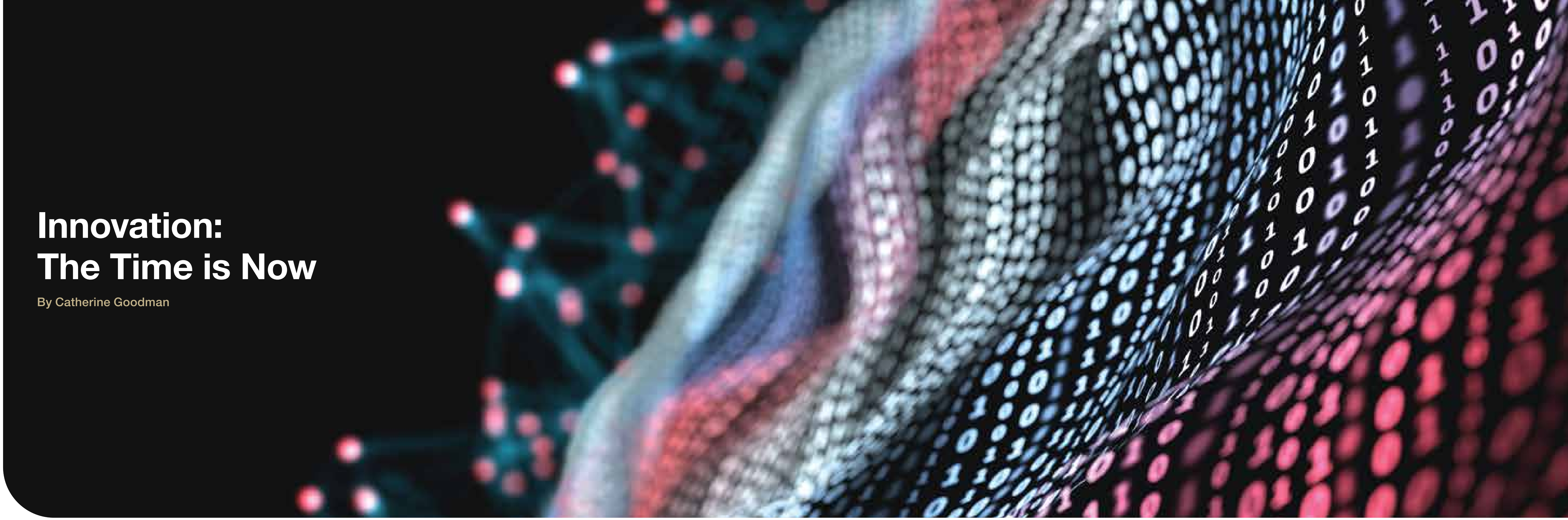
The rise of ESG last year has provoked even more thoughtful debate and we summarise the FCA's new proposal on sustainability disclosure requirements including a general "anti-greenwashing" rule which FCA regulated managers will now have to be wary of.

We then stop-over in the US to grab an update on the new marketing rules targeting SEC registered advisers that has rocked the asset management industry, with managers racing to comply before it took effect at the end of 2022. We pause in Europe for an update on the changes a year on from the implementation of the new Securitisation Law in Luxembourg which has resulted in many CLO managers looking to relocate their CLOs to Luxembourg. Finally, we round off the road trip examining a new vehicle, this time launched by the tax man: the QAHC, a truly innovative vehicle aimed at keeping the UK competitive post-Brexit.

As a souvenir of our road trip, we invite you to download our annual report on Continuation Vehicles which outlines key market terms observed over the last year.

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



Innovation: The Time is Now

By Catherine Goodman

Innovation requires a constantly enquiring mind. What if we do it this way? What if we connect these two things to make something new? And getting to the root of why we are asking these questions is key: do we want to make workload or cost efficiencies in the processes (or both)? Do we want to streamline processes? Do we want to increase transparency, and optimise collaboration across teams? Often, it's a mix of a few, or all, of these factors.

At Paul Hastings, we are seeing a surge in opportunities to collaborate with our clients on tech and innovation projects. We all want to continue to ride on the wave of expedited technology adoption coming out of lockdown, and this makes for exciting times.

Our legal teams work closely with our Practice Innovation (PI) & Knowledge team, (consisting of subject matter legal experts, technologists, project managers, data analysts, and programmers), to explore and execute innovative technology solutions. Paul Hastings won *The Lawyer UK* "Most Innovative Use of Technology" award 2022, for the automated MFN solution created using no/low code automation ("**eMFN**"). The success of the project was down to the tenacity and commitment of our Credit Funds and PI team members, and the interest in, and support for, the solution from our clients. We are now hard at work scaling eMFN, finessing it, making it work for different clients, and leveraging inter-operable technologies including different branches of AI for other parts of the process. We have been testing AI technologies over the last few years on different data sets, for different use cases, to narrow down which AI tools can provide the best outputs within our legal matter workflows. Combining technology with the human, legally trained brain is key to the success of these projects.

The eMFN project was not just about creating a digital solution for the MFN process. It was about looking at the end-to-end workflows involved in this process, and seeing where we could make improvements, using technology, for the benefit of our lawyers working on these matters, and for other stakeholders, such as the fund managers, investors, and other advisors. We transformed this exceptionally time-consuming and laborious process to save our clients significant legal fees, and position the firm as a leader in delivering innovative technology and client value.

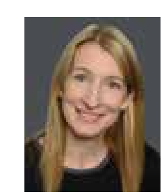
The idea for eMFN was sparked at a hackathon session in Summer 2020, during a Paul Hastings legal technology education session for associates. One of the associates suggested their MFN workflows as a prime candidate for automation, so we began discovery sessions with the funds team to process map the workflows, find out where all the pain points were, and establish the required outputs. Common pain points were identified, such as: too many emails with attachments, the need for instant and transparent status updates, and the need for optimised task management.

These pain points fed into our key areas of focus and our clients appear to share these focus areas — ultimately we're together on the same goals and challenges. These key areas of focus are:

- AI contract intelligence;
- collaboration platforms that facilitate transparent, cohesive and effective working; and
- robust electronic and digital signing.

It is a real honour, and very pleasing, to have these opportunities to partner with funds clients on tech and innovation projects. We are in a stage of exploration with technologies that are advancing and evolving at an ever-increasing rate, so to be able to explore with diversity of thought and experience within the law firm/client relationship means we can achieve optimum results as we iterate on ideas that can become solutions. Whether we are digitalising a solution that improves our internal workflows (for the ultimate benefit of the clients, and other stakeholders in the matter processes), or listening to our clients' digitalisation projects and sharing insights, this collaboration on all sides means that everyone's needs are taken into account whether that's from a solution UX/UI (user experience/user interface) perspective, or to ensure compliance with processes and legal requirements.

The current state of the market means now is the time, more than ever, to find new ways to better and more cost effectively service our clients however we can. Innovation is progress that effects change in new, positive, and effective ways. It is not an easy road. It is sometimes uncomfortable, and difficult questions must be asked and addressed. With our focus on the exploration of state of the art technologies, and ensuring matter security and integrity, we are excited to continue partnering with our clients on these innovation projects, and to be part of what the future holds.



Catherine Goodman
Practice Innovation & Knowledge Counsel
+44.020.3321.1018
catherinegoodman@paulhastings.com

A Perfect Storm for Alternative Lending

A mix of macro and microeconomic events and changes in regulatory and investor attitudes is seeing a sharp rise in alternative lending

By Eamon Lyons

Raising interest rates from traditional banks and the collapse of two leading US Banks have seen cash-strapped companies turn to private lenders for liquidity. However, the wheels for change were already in motion by the EU regulatory decision-makers looking to bolster the Capital Markets Union.

In 2022, global markets saw increased market volatility, inflation, and the inevitable rise of interest rates that have led investment managers to seek fixed returns. Similarly, over-reliance on traditional banks for sector-specific lending, like tech startups with Silicon Valley Bank and real estate and private equity lenders with Signature bank, has seen SMEs look for alternative sources of finance at competitive rates.

Through legislative change, the European Commission (EC) and the Central Bank of Ireland (CBI) have already put the wheels in motion for a framework to create alternative sources of finance.

What you need to know

- Market conditions such as market volatility, inflation and interest rate hikes have increased the demand for alternative lending funds.
- EU and national regulators have implemented changes to debt funds to give access to alternative finance.
- Huge opportunity for start-ups and established alternative lending managers to replace traditional banks.

Building the Capital Markets Union and the introduction of AIFMD II

At the Waystone European Funds Spotlight event, the guest speaker, European Commissioner Mairead McGuinness, discussed the need for a deeper, more integrated Capital Markets Union (CMU). A review of the Alternative Investment Fund Managers Directive (now commonly known as AIFMD II) was identified as one of the main pillars for the CMU to succeed. In particular, the EC wants to harmonise rules for managers of loan-originating funds across the EU. The goal is to support alternative sources of financing for the real economy while fostering financial stability. The market for direct lending outside the banking sector in Europe is growing, but funds currently operate under a set of divergent national rules. The EC plans to address this fragmentation to help create a single market for loan-originating funds in the European Union.

The Governor for the CBI, Gabriel Makhlouf, echoed these comments, noting, "*Firms with fewer outside financing options — SMEs in particular — are more likely to be faced with higher mark-ups on loans by banks who may also be less inclined to pass on interest rate reductions to them. Increased access to finance (bank or non-bank) — one of the goals of CMU — could make pass-through of monetary policy more complete*."

The Governor spoke specifically about AIFMD II, highlighting that "*The AIFMD review also represents a targeted approach to reform. The new loan origination framework will create a common framework throughout Europe for lending activities by investment funds. In an area which has not so far been subject to regulation (except on a limited national basis), this is welcome.*"

The CBI and its procedure for launching a private debt fund

The current CBI Loan Origination Rules (L-QIAIF Rules) and the changes proposed in AIFMD II are similar. Specifically, such similarities include the requirement to maintain effective policies, procedures and processes for granting loans and the need to have diversification on exposure to a certain borrower subject to a ramp-up and ramp-down period are already in place. James O'Sullivan (Head of Funds Authorisation at the CBI) has noted that it is no surprise that the framework is similar. He pointed out that the CBI and Department of Finance lobbied European Securities and Markets Authority extensively before the AIFMD review commenced to build important features into the European framework. The CBI is in a position to do so as one of the first national regulators to introduce legislation for private credit funds.

The CBI has further enhanced Ireland as a domicile for private debt funds by streamlining the application process by removing the requirement to make a pre-submission for an L-QIAIF, ensuring that managers can avail of the 24-hour approval process.

As the EC continues to grow the CMU with the introduction of AIFMD II, managers can look at Ireland as a domicile ahead of the curve, having already introduced the L-QIAIF regime. Furthermore, the similarities between the L-QIAIF Regime and AIFMD II can give managers confidence that any credit funds established in Ireland will have little legislative disruption once AIFMD II is enacted.

Eamon Lyons
Director
+353.86.398.6389
elyons@waystone.com

Power-Full Private Credit

Alternative energy offers investors shelter from the macroeconomic storm

By Derwin Jenkinson

Market context

Rising interest rates and inflation are fundamentally reshaping credit markets. Bonds have been on a 40-year bull market super-cycle — but that is now coming to an end. Cheap and plentiful credit had underpinned the explosion in assets valuations. In particular, the growth of private equity was fuelled by leverage. The 2008 financial crisis unleashed private credit as a major source for acquisition finance and other areas traditionally dominated by commercial banks. Syndicated loan and high yield bond markets have seen much less activity for new money deals over the last 6-12 months, with investors requiring much higher OIDs or yields and improved lender protections in order to clear the market. Geo-political and macro-economic trends have been pointing in the direction of a recession during 2023. The recent bank failures have also depressed activity. However, one segment of the market is thought to be less correlated to wider macroeconomic trends and therefore able to trade through the cycle: power and renewables. The focus on alternatives has led many to pivot towards the energy and infrastructure sector, particularly as real assets are seen as a hedge against inflation. For that reason, private equity houses now include core and core plus infrastructure funds within their stable of traditional leverage and other growth funds.

What you need to know

- Energy sector spending in order to achieve net-zero ambitions is forecast to increase five-fold by 2030.
- “Essentiality” of assets and pricing power means the sector offers better protection against inflation and other macroeconomic and geo-political risks.
- Emerging group of private credit funds active in the sector, alongside traditional long-term institutional lenders.
- However, private credit investors should consider acceptable risk/reward profiles.

Evolution of credit markets in the sector

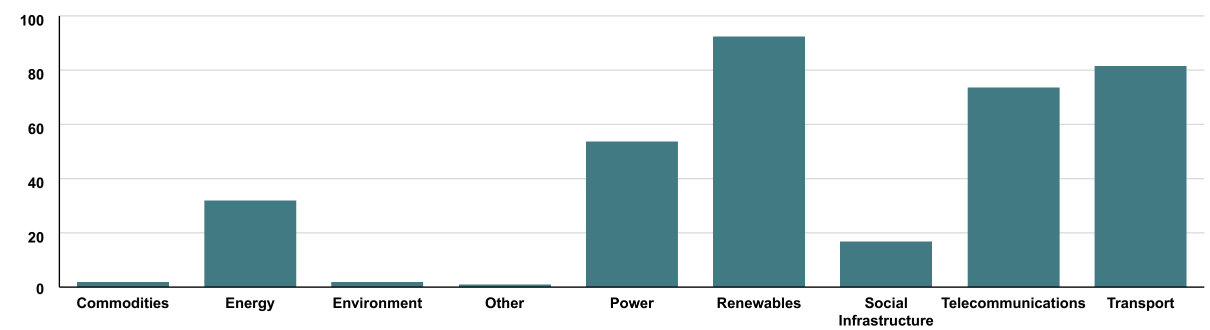
Historically, credit had been provided to energy and infrastructure borrowers by commercial banks and public bond markets. That changed in the aftermath of the financial crisis when new capital adequacy rules made it more expensive for banks to lend long term. Likewise, many of the largest public bond investors realised that they could disintermediate the banks by providing private placement credit directly to the borrower in the form of notes or loans and thereby receive an illiquidity premium as compared to public markets. For borrowers this avoided the execution risks and costs associated with public bond offers, which were subject to the vagaries of market pricing. The economics are attractive for both parties as these institutional investors are buy and hold investors, such as insurance companies and pension funds that have to hold long-dated investments to match against long-dated liabilities. What emerged was a relatively small group of private placement investors that provided a significant proportion of medium and long-term lending in the energy and infrastructure sector over the last decade.

The introduction of private placement credit, often alongside commercial bank facilities, resulted in changes to intercreditor terms in order to accommodate institutional requirements for fixed-rate lending with prepayment makewholes (rather than bank floating rate loans with hedging), fixed drawdown schedules, and voting arrangements to accommodate investors not represented by a facility agent. However, most covenant structures remained consistent with investment grade infrastructure and project finance principles and were priced accordingly.

Recent transactions by sector

In the past two years, direct institutional lenders (i.e. excluding holdings of public bonds) lent $24bn to the energy and infrastructure sector. Of that amount, approximately $10bn was invested in the power and energy sector, with approximately $4.5bn of that amount being invested in renewables. Total borrowings by sub-sector are illustrated below.

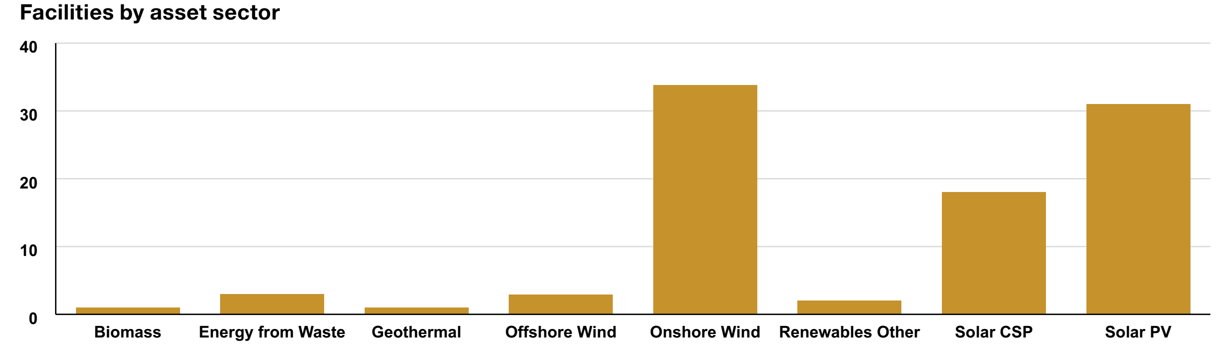
Facilities by asset sector



Source: Inframation

Of those total borrowings, the vast majority of investments by institutional lenders have been made in onshore wind and solar as shown below.

Facilities by asset sector



Source: Inframation

Power-Full Private Credit

As this illustrates, private credit is still only capturing a relatively small amount of the market. Total lending (excluding public bonds) in the last two years to the power and energy sector in Europe was $169bn of which $80bn was to renewables assets. Even before the war in Ukraine led to calls for further investment in energy security, spending on the energy sector in order to achieve net zero ambitions was forecast to increase five-fold by 2030. Clearly, this presents an opportunity for private credit to increase both the total amount and the market share of its investments in the sector.

Exploiting the opportunity

As noted above, most private credit investors to date have been looking for investment grade/crossover assets, meaning they are taking limited merchant revenue risk (i.e., revenue that is uncontracted and economically unregulated) and limited (if any) technology risk. It is well known that analysis by Moody's and others suggests that investment grade energy and infrastructure assets afford better loss-given default recoveries than other comparably rated investments. As a corollary, institutional lenders have been willing to accept commensurately lower margins, which were often priced below 200bps for senior debt (although margins have been widening recently). Some new entrants to the energy sector may be willing to compete for business with insurance companies and pension funds on these terms. For others, with higher target IRRs, those margins will not be sufficient.

So how might new infrastructure debt funds gain a foothold in the market and achieve higher returns? The answer is the same answer as for many equity investors looking for increased yield. Typically, this will involve investing earlier in the lifecycle of a business or sector (such as hydrogen, carbon capture, or biofuels) and thereby potentially taking a greater degree of operational, contracting, or technology risk. Alternatively, it may mean accepting more merchant revenue risk, as with some battery storage projects and other investments that rely on an element of energy trading or pricing arbitrage. Others may prefer to invest in proven technologies with contracted revenues, but take more political risk by investing in emerging markets, which may include an element of currency exposure. The approach taken by most established institutional investors is to invest in holdco/junior debt (typically with a BB rating) that sits just behind stable investment grade debt in the capital structure. However, in the rising interest rate environment there is less headroom for holdco debt, which is resulting in a slowdown in those financings. Finally, we are seeing more private credit fund investors more used to lending in the PE market, looking for opportunities to invest in "special situations". This might be to plug liquidity gaps in distressed credits with technology challenges, or as a bridge financing to a structured take-out.

If private credit does move into providing more non-investment grade debt to the energy sector, then this will impact debt terms. In particular, non-investment grade debt will feature shorter tenors and non-call protection will often feature a premium calculated on the basis of a percentage of the amount prepaid and reducing over time, rather than a make-whole based on the NPV of cash-flows to maturity (as is currently the case to reflect Solvency II principles). If working capital is required then the capital structure may include a super senior or pari passu revolving credit facility provided by commercial banks. Many renewable investors run portfolios of smaller assets, so capital structures may need to accommodate bolt-on acquisitions and incremental indebtedness. Private credit investors will also have to consider whether they are willing to take construction risk (which typically requires enhanced monitoring) alongside other risks referred to above, and whether they can offer flexible utilisations or require a fixed drawdown profile. Finally, the investment grade market usually offers portability of debt, subject to an "acceptable investor" test. As the risk profile increases the identity of the sponsor, as for leveraged loan transactions, becomes ever more critical.

Derwin Jenkinson
Partner
+44.020.3023.5152
derwinjenkinson@paulhastings.com

Documentary Terms: Securing the Ramparts

The vital terms lenders should negotiate to ensure their protection

By Karan Chopra and Rob Davidson

Given the continuing challenging economic environment, specific documentary terms should be negotiated into documents to afford lenders protection in a downside scenario. While there are many such terms, in this article we have focused on key structural points that preserve the senior secured status of the credit fund.

What you need to know

- Single point of enforcement gives creditors the right to own or sell the group as a whole in the event of a downturn.
- Security from the operating companies will provide secured creditors with the option of selling individual assets.
- Debt incurrence parameters can protect a credit fund's controlling position in any creditor vote.

Single Point of Enforcement

A Single Point of Enforcement is the share and receivables pledge which, if enforced, would give creditors the right to either own or sell the group as a whole. In addition to ensuring a single point of enforcement is included in the structure as a condition precedent to funding, a further important consideration is the governing law of the security documents that constitute the single point of enforcement. The steps to enforcement will vary across jurisdictions and should be analysed on a deal-by-deal basis by legal counsel.

The single point of enforcement can also be protected by the definition of "Change of Control." If not all the shares of the entity whose shares are pledged at the single point of enforcement are held by its immediate holding company, it should trigger a Change of Control, which would trigger a mandatory prepayment event (including with call protection, if applicable). If the share and receivables pledge, which is the single point of enforcement, is granted by the entity at the top of the banking group, that entity should also be subject to a holding company covenant so that group assets cannot be transferred to it above the single point of enforcement, as typically there are no restrictions on intra-group transfers between Obligors. Note that there can be adverse tax consequences to releasing debt pursuant to the Intercreditor Agreement upon an enforcement. Ideally, therefore, there would be a single point of enforcement below the borrower entity, such as a pledge over the target entity granted as a condition subsequent.

Security package

In addition to the single point of enforcement, security from the operating companies is equally important to provide the senior secured creditors with the option of selling individual assets and/or parts of the group. This would also restrict the possibility of competing creditors being secured on such assets.

The requirement to provide such security is regulated by the guarantor coverage test which is now often limited to a test calculated either (i) on the EBITDA of companies within the group incorporated in a pre-agreed list of jurisdictions (a covered jurisdiction test) or (ii) on the EBITDA of the group, but discounting companies incorporated in certain jurisdictions (an excluded jurisdiction test). In either instance, it is important to ensure the test covers not only the jurisdictions in which substantive EBITDA is being generated but, given the test applies for the life of the loan, also those jurisdictions where there is the *possibility* of EBITDA being generated in the future, either naturally or through bolt-on acquisitions.

Where there are assets of significant value within the group that could be held by companies that do not generate EBITDA (for instance, intellectual property), the focus should be on where those assets are held. This is because there is the possibility of no requirement to grant security over such assets and no restriction on the assets being transferred to non-guarantors, given the increasing absence of obligor/non-obligor restrictions. One way of addressing this is requiring the specific material assets to be owned by Obligors at all times.

Security is typically required to be granted by all Material Companies, but it is important to note that the material company test is now often limited to individual companies that generate at least five percent of the Group's EBITDA. Given it does not pick-up any direct holding companies, it is important to ensure there is an obligation for the direct holding company to grant share security over the Material Company. Without this, there is the possibility of share security only being provided to the extent a Material Company is owned by another Material Company.

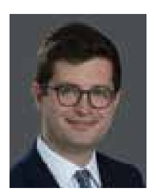
Debt incurrence and competing creditors

With increasing headroom for additional senior secured debt to be incurred through (i) a freebie basket, (ii) the ability to secure the general debt basket on the transaction security, and (iii) an EBITDA grower on all fixed baskets (including the RCF basket), it is obviously important to be clear on the parameters of such debt incurrence.

Where a credit fund is providing all — or a significant portion — of the original financing, there will often be a focus on wanting to protect its controlling position in any creditor vote. This is often addressed by either a right of first offer or right of first refusal on future incremental debt. The specific formulation of either right may differ on a transaction-by-transaction basis, but it essentially gives the credit fund the right to be able to provide the incremental debt, provided it is willing to do so on no less favourable terms than a competitor.

Given there is still the possibility of the incremental debt being provided by a third party, the original credit fund may still want to have an element of control over how the incremental debt interacts with the original financing to preserve their senior secured position. In addition to requiring any incremental debt to (i) be secured *pari passu* on the same security and (ii) to be incurred by the same borrowers to avoid competing structurally senior claims, there is often an additional restriction preventing sidecar debt from being incurred to ensure no event of default can be declared independently of the original facility agreement.

Karan Chopra
Partner
+44.020.3023.5164
karanchopra@paulhastings.com



Rob Davidson
Partner
+44.020.3023.5169
robdavidson@paulhastings.com

Greenwashing to Become a Wash-Out?

By Konstantin Burkov

The FCA is proposing new sustainability disclosure requirements and sustainable product labels that would apply to UK FCA regulated firms, including fund and asset managers (and those that act as delegated portfolio managers for EU AIFMs).

Introduction

The FCA has published its new anti-greenwashing consultation paper ("**CP22/20**"), in which it proposes to introduce sustainable product classifications and disclosure requirements to help investors navigate the increasingly opaque sustainable investment market.

What you need to know

- Firms will be given the choice to classify investment products under three proposed sustainability labels.
- Labels will not be mandatory, but products must meet certain qualifying criteria in order to use them.
- In-scope firms will be required to make disclosures regarding the sustainability features and performance of their products.
- Firms will be restricted from using sustainability-related terms inaccurately in the naming and marketing of products.
- The consultation closed 25 January 2023, with new rules set to be finalised in mid-2023.

The proposals concern sustainability issues relating to both environmental and social issues. The FCA's goal is to introduce a consistent naming, marketing, and classification scheme into the sustainable investment market and make the sustainability profile of products clear and transparent.

Sustainability labels

The FCA is proposing three labels to classify sustainable investment products:

- **Sustainable focus** — products with an objective to maintain a high standard of sustainability in the profile of assets
- **Sustainable improvers** — products with an objective to deliver improvements in the sustainability profile of assets over time
- **Sustainable impact** — products with an objective to achieve a positive, real-world contribution to sustainable outcomes

The above labels are optional, so firms can choose to apply no label to their products if they wish.

The labels are mutually exclusive, and in order to use one of them, products must meet and maintain specific qualifying criteria. Merely employing strategies such as "ESG integration", negative screening or exclusion policies without complying with the above criteria will be insufficient to qualify for a label.

Disclosures

Alongside the labelling scheme are new sustainability disclosure requirements (“**SDR**”) for certain regulated firms. The key disclosures are:

- **consumerfacing productlevel disclosures** covering the key sustainability-related features of a product. These rules will only be mandatory to the extent products are marketed to consumers.
- **detailed disclosures at product and entity level:**
  - **precontractual disclosures** setting out the sustainability-related features of an investment product. Firms providing portfolio management services will not be required to produce pre-contractual disclosures, but will instead be required to provide access to the pre-contractual disclosures for the underlying investment product.
  - **sustainability product-level reports** containing ongoing sustainabilityrelated performance information. In many cases such reports will be required on demand only.
  - **sustainability entity reports** detailing the ways in which firms are managing sustainability-related risks and opportunities. This will be relevant for firms with assets under management (AUM) of £5 billion or more (on a three-year rolling average).

Naming and marketing

The FCA is proposing a general “anti-greenwashing” rule, which requires that claims made about the sustainability of products must be clear, fair, and not misleading. This rule would apply to all FCA regulated firms.

Also proposed are restrictions on the use of certain sustainability-related terms in the naming and marketing of in-scope products which are **offered to retail investors** and do not use a label. Restricted terms include “ESG” (or “environmental,” “social” or “governance”), “climate,” “impact,” “sustainable” and “sustainability,” “responsible,” “green,” “SDG” (sustainable development goals), “Paris-aligned,” and “net zero.”

In addition, firms would be restricted from using the term “impact” in the naming and marketing of products under the “sustainable focus” or “sustainable improvers” label in order to prevent conflation with the “sustainable impact” label.

Scope

The targeted proposals above will initially apply only to asset managers. However, the FCA is considering expanding the scope to include certain FCA-regulated asset owners.

The following entities are classed as in-scope firms with regard to labelling and disclosure requirements:

- firms carrying out portfolio management;
- UK Undertakings for Collective Investment in Transferable Securities (“**UCITS**”) management company;
- investment company with variable capital (“**ICVC”**) that is a UCITS scheme without a separate management company;
- full-scope UK Alternative Investment Fund Manager (“**AIFM”**); and
- small authorised UK AIFM.

All in-scope firms with assets under management of £5 billion or more (calculated on a three-year rolling average) will be subject to the entity-level disclosure regime.

The proposals would also require distributors to make the sustainable investment label and consumer-facing disclosures available to retail investors in the UK.

There will be a subsequent consultation regarding the application of SDR to overseas funds available to UK investors.

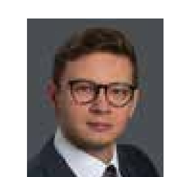
Timeline

The consultation ran until 25 January 2023, with firms advised to review proposals carefully and consider submitting feedback via the FCA’s portal. The FCA intends to finalise the results and publish a Policy Statement (“**PS**”) by mid-2023, with a provisional date of 30 June 2023.

General rules will become effective immediately on publication of the PS, while the first disclosures will become due no sooner than 30 June 2024.

Conclusion

As the investment market is becoming increasingly conscious of social and environmental issues, qualifying funds and products will face more scrutiny from investors and regulators. Whilst many of the new rules will only apply to products offered to retail investors, they provide an indication of regulator’s expectations when it comes to promoting products that claim to have ESG elements in their investment strategy. It is therefore important to scrutinise materials used to market and offer investment products to UK investors to ensure that the ESG related message is consistent, clear and not misleading. To prevent negative press and exposure to additional risks, firms should avoid making exaggerated claims about the sustainability features of products, even before the proposed measures come into force.



Konstantin Burkov
Senior Associate
+44.020.3321.1009
konstantinburkov@paulhastings.com

SEC's New Marketing Rules

New marketing rules targeting SEC registered advisers took effect at the end of 2022.

By Ira Kustin

While new Rule 206(4)-1 under the Advisers Act was announced in late 2020 and effective in May 2021, implementation was not required until November 4, 2022 leading many in the industry to identify ambiguous areas within the new rules in need of clarification.

What you need to know

- The new Marketing Rule replaces pre-existing rules under the Advisers Act and an extensive body of SEC "no-action" letters.
- The Marketing Rule addresses not only marketing materials used by an adviser to private funds but also includes rules addressing the use of placement agents and other paid solicitors or endorsers.
- Certain types of activities are prohibited outright while others will require new or updated disclosures and footnotes.

The U.S. Securities and Exchange Commission (the "**SEC**") adopted new rules in late 2020 (the "**Marketing Rules**") that govern investment adviser advertising and use of solicitors/placement agents. The Marketing Rules are housed in Section 206(4)-1 of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), and required compliance by November 4, 2022. The new Marketing Rules apply to any adviser registered or required to be registered under the Advisers Act.

In advance of the November implementation date, the SEC issued a "risk alert" in September 2022 describing for the adviser community certain areas upon which the SEC would focus in the near term:

1. *Marketing Rule Policies and Procedures*. The SEC will be conducting exams to "review whether investment advisers have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the Advisers Act and the rules thereunder, including the Marketing Rule."

2. *Substantiation Requirement*. The SEC's examination staff "will review whether investment advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in advertisements." This may require advisers to implement additional policies and procedures to confirm all facts included in marketing materials and retain supporting evidence in their records.

3. *Performance Advertising Requirements*. The Risk Alert included a reminder regarding various prohibitions under the Marketing Rule when advertising performance, including the following:

   a. gross performance, unless the advertisement also presents net performance;

   b. performance results, unless they are provided for specific time periods (not applicable to the performance of private funds);

   c. any statement that the Commission has approved or reviewed any calculation or presentation of performance results;

   d. to the extent an advertisement includes the performance of portfolios other than the portfolio being advertised, performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as the portfolio being offered in the advertisement, with limited exceptions;

   e. performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;

   f. hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain additional information; and

   g. predecessor performance, unless the personnel primarily responsible for achieving the prior performance manage accounts at the advertising adviser and the accounts that were managed by those personnel at the predecessor adviser are sufficiently similar to the accounts that they manage at the advertising adviser.

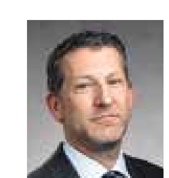
4. *Books and Records*. The SEC will also be focused on advisers' compliance with books and records requirements under the Advisers Act, which require certain materials to be retained for specified time periods.

   Advisers subject to the new Marketing Rules should discuss the following with their counsel and how best to bring into compliance their marketing materials such as private placement memoranda and marketing decks.

   - The definition of what constitutes an "advertisement" subject to the Marketing Rules;
   - A list of advertising practices that are generally prohibited outright by the Marketing Rules;
   - Requirements to be followed in connection with any testimonials or endorsements (which includes compensated placement agent arrangements);
   - The use of third-party ratings by investment advisers;
   - Presentation and disclosure requirements in connection with performance information; and
   - Related impact of the Marketing Rules on books and records requirements and Form ADV.

Investment advisers should be aware, in particular, of the Marketing Rules' requirements on how certain types of performance are shown in any advertisement. Advisers should take special precautions in connection with performance data shown in the marketing materials. In particular:

- Requirement to show net performance with gross performance (which may present challenges when showing performance for individual investments);
- Case studies and "cherry-picking" require special disclosures;
- Related performance — requirement to show all related "portfolios" with some exceptions or a composite meeting certain stated criteria;
- Extracted performance — prohibition on showing a subset of investments in a portfolio unless the adviser shows, or offers to provide promptly, the performance of the entire portfolio;
- Hypothetical performance — includes (1) model performance, (2) backtested performance, (3) target or projected returns, and (4) performance extracted from multiple portfolios. Using hypothetical performance requires the implementation of related policies and procedures to ensure the presentation of such performance is fair and balanced and provides sufficient information to enable the reader to understand the criteria underlying the hypothetical data; and
- Predecessor performance — showing the past track record of a predecessor adviser or personnel while employed by a predecessor adviser also requires careful consideration.



Ira Kustin
Partner
+1.212.318.6094
irakustin@paulhastings.com

Bringing Luxembourg Securitisation Law into the 21st Century: A Year On

Return of experience for CLO managers

By Karl Pardaens and Jean-Bernard Spinoit

One year ago, the Luxembourg law of 22 March 2004 on securitisation (the "**Securitisation Law**") was modernised to strengthen the Luxembourg toolbox for asset managers active in securitisations. Luxembourg already hosted a quarter of all European securitisation transactions, and this number has been increasing following the modernisation of the Securitisation Law.

A key feature of the modernisation has been the new possibility to actively manage debt portfolios held by securitisation vehicles ("**SVs**"), provided that such SVs are reserved for professional investors. This new possibility was targeted for collateralised loan obligations ("**CLOs**") managers. Previously, securitised debt portfolios could only be managed passively, according to a "buy and hold" principle.

The modernisation has therefore made Luxembourg SVs substantially more attractive for CLO managers, who may now frequently adjust their loans and claims composing the portfolio, taking into account price developments and short-term market fluctuations, to ensure the best possible return for the securities issued by the SVs managed by them. The Securitisation Law further allows managers

What you need to know:

- Now possible to actively manage debt portfolios held by securitisation vehicles.
- Luxembourg SVs now substantially more attractive for CLO managers.
- Easier to mitigate credit risk and increase overall performance.

to replace the initial pool of assets of the SV by new securitised assets, following the initial closing, to mitigate credit risks and increase the overall performance of the SV.

Such SVs are also unregulated, which ensures a high level of flexibility and low costs in the running and set-up of the structure.

Since the modernisation, asset managers who already have a strong presence in Luxembourg for their private equity and real estate funds activities are now considering the set-up of CLO SVs, and a certain number of them have already taken the plunge and have set up (or are currently setting up) CLO structures with Luxembourg SVs.

This new opportunity also allows asset managers to consolidate their activities in Luxembourg, and rationalise costs, by repatriating the investment management activity for CLOs, which is, for now, still mostly based abroad.

Service providers in Luxembourg are also picking up this new opportunity by offering services in Luxembourg to CLO managers, using the expertise of their CLO management specialists of their branches abroad, and sometimes even relocating them to Luxembourg.

Luxembourg was already a reference hub for securitisation activities, but its weakness was the CLO market, for which other competitors were more attractive. The modernised Securitisation has turned this weakness into a new strength, providing greater flexibility and legal certainty.

Karl Pardaens
Partner
karlpardaens@elvingerhoss.lu

Jean-Bernard Spinoit
Associate
jeanbernardspinoit@elvingerhoss.lu

Tax Update: QAHC

By Jiten Tank and Abigail Hung

In 2022 as a part of the UK Government's wider and ongoing plans to improve the competitiveness of the UK's fund landscape (and level the playing field with jurisdictions like Luxembourg and Ireland), the Government introduced a new regime known as the Qualifying Asset Holding Companies ("**QAHC**").

What you need to know:

- Ownership condition and the activity condition are to be carefully reviewed when establishing a QAHC.
- Should provide similar benefits without the associated costs of jurisdictions such as Luxembourg.
- Possible tax benefits due to adaptation of existing legislation.

The QAHC regime applies in circumstances where an intermediate asset holding company is used to facilitate the flow of capital, income, and gains between investors and underlying assets. The regime broadly taxes investors as if they had invested directly in the underlying assets, with the objective that the QAHC pays no more tax on its profits than is proportionate to the activities it performs (such profits being determined using transfer pricing principles, the expectation being that this should be minimal for a holding company in a debt fund context).

The QAHC regime adapts existing legislation to provide certain tax benefits, including (amongst others) the following:

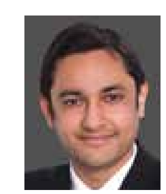
1. No UK withholding tax on interest paid by a QAHC.
2. QAHCs, subject to transfer pricing, receive favourable treatment in relation to interest deductibility. For example, a QAHC may take a deduction for interest paid on profit participating loans which otherwise may be non-tax deductible.
3. A QAHC is exempt from corporation tax on gains on disposal of overseas land and "qualifying shares" (broadly, all shares apart from shares in "UK property rich companies" which derive at least 75% of their value from UK land), and this might prove useful where there is mortgage security over non-UK real estate assets.
4. Subject to certain conditions, the QAHC regime adapts the remittance basis rules for non-domiciled fund managers.

The QAHC regime allows for companies, including already established special purpose vehicles ("**SPV**") (if tax resident in the UK), to elect into the regime.

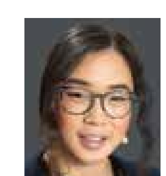
Whilst there are seven conditions which must be met in order to qualify as a QAHC, the ownership condition and the activity condition are likely to cause the most difficulty when establishing a QAHC:

- The ownership condition, very broadly, requires that at least 70% of the QAHC must be owned by "Category A Investors" (i.e., widely held funds, pension schemes, sovereign wealth funds, charities, life insurance companies, or public authorities).
- The activity condition requires that the QAHC's main activity must be an investment activity and any other activities carried out by the QAHC must be ancillary to the main activity and not carried on to a substantial extent. In this regard, HM Revenue and Customs ("**HMRC**") issued guidance mid last year which was helpful in confirming, amongst other things, that loan origination with the intention of holding the credit to maturity (together with related fees) should be treated as investment.

The QAHC regime may be beneficial for UK fund managers from a substance perspective as such fund managers will already have a physical presence (employees and other technical resources) located in the UK. The QAHC regime should provide broadly similar benefits to other jurisdictions such as Luxembourg without the administrative cost of further establishing presence in Luxembourg (for example, board executives will no longer have to travel to Luxembourg to attend board meetings as these can be held in the UK). This is especially important given the current tax landscape and the increased focus surrounding beneficial ownership and entitlement to treaty and (although this would not be applicable to a QAHC) other EU directive benefits. In particular, where the investment strategy of a credit fund is geographically focussed on UK based borrowers/debtors, with the use of a QAHC, any issues with HMRC which a Luxembourg or Irish based SPV might have concerning beneficial ownership or delays in relation to a UK double taxation treaty application which can be more easily avoided since the QAHC itself should generally receive UK source interest from borrowers without any UK withholding tax (or indeed any process to receive gross interest).



Jiten Tank
Partner
+44.020.3023.5133
jitentank@paulhastings.com



Abigail Hung
Associate
+44.020.3321.1004
abigailhung@paulhastings.com

Continuation Vehicles Report

By Ted Craig

Following our inaugural Continuation Vehicle Report in 2022 which clearly showed the growing popularity of continuation vehicles ("**CVs**"), the recently launched 2023 Report shows this popularity has continued through 2022. The report outlines the key terms of the CVs that Paul Hastings advised on between Q1 2022 and Q1 2023, offering a clear insight into the provisions found in CVs' legal documentation. The CVs reported on span a variety of sectors and range in size from \$115m to \$3.2bn, with an average size of \$736m. Total commitments exceeded \$10bn, and approximately 55% of the CVs related to single-asset deals.

For more information and to reach the full Continuation Vehicles Report, please scan the QR code below.

Ted Craig
Partner
+44.020.3023.5211
tedcraig@paulhastings.com

Upcoming Industry Events

PDI Europe Summit
9-11th May, 2023
London

Debtwire and Creditflux's European Direct Lending Forum
18th May, 2023
London

SuperReturn International
6-9th June, 2023
Berlin

Global ABS
13-15th June, 2023
Barcelona

AIMA Alternative Credit Council Global Summit
4th October, 2023
London

Spotlight is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2023 Paul Hastings LLP.

Paul Hastings is a market leader in global private Credit Funds, advising on the structuring and implementation of cross-border and domestic transactions. The breadth of quality and experience in our team enables us to provide technical and commercial advice to meet the needs of sophisticated providers of finance at all levels of the capital structure. We regularly act for leading private equity funds, alternative asset managers, commercial banks, investment banks and debt funds in the credit space through our international network.

We believe that the depth and breadth of expertise that we have in the Credit Funds universe is unique.

For further information, please contact
spotlight@paulhastings.com

A top-ranked firm

In the *Financial Times*' Innovative Lawyers Report across Asia, Europe and North America

PAUL
HASTINGS

Paul Hastings LLP | www.paulhastings.com