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2016 INVESTMENT MANAGEMENT CONFERENCE

Private Funds

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AGENDA

- Trends in Fees and Expenses
- Managing Conflicts
- Update on Tax Developments
- Infrastructure and Personnel Demands
- Non-U.S. Manager Considerations

TRENDS IN FEES AND EXPENSES

SEC'S FOCUS ON FEES AND EXPENSES

- The SEC has found find violations for conduct that occurred prior to the requirement that private equity fund advisers register in enforcement actions such as:
  - *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*, IAA Rel. No. 4131 (June 29, 2015)
  - *In the Matter of Blackstone Management Partners LLC, et al*., IAA Rel. No. 4219 (October 7, 2015)

SEC'S FOCUS ON FEES AND EXPENSES
(CONTINUED)

- *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*, IAA Rel. No. 4131 (June 29, 2015):
  - The SEC took issue with the allocation and disclosure of broken-deal expenses to investors
  - Even though KKR recognized the problem in 2011 and adopted an allocation policy at that time, KKR did not retroactively apply the policy to its funds and other vehicles then under management covering 2006 - 2011

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SEC'S FOCUS ON FEES AND EXPENSES
(CONTINUED)

- *In the Matter of Blackstone Management Partners LLC, et al*., IAA Rel. No. 4219 (October 7, 2015):
  - The SEC asserted that Blackstone failed to disclose to its funds and fund investors, prior to their capital commitment, that their monitoring agreements with its funds' portfolio companies provided for the acceleration of monitoring fees to be triggered by certain events. Additionally, the SEC asserted that from 2010 to 2015, Blackstone had terminated certain monitoring agreements and accelerated the payment of future monitoring fees

SEC'S FOCUS ON FEES AND EXPENSES
(CONTINUED)

- *In the Matter of Fenway Partners, LLC, et. al*, IAA Rel. No. 4253 (November 3, 2015):
  - The SEC asserted that Fenway Partners failed to disclose to a private equity fund and its investors certain conflicts of interest relating to monitoring fees paid by the fund to a Fenway Partners affiliated entity

MANAGING CONFLICTS

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2016 EXAMINATION PRIORITIES: PRIVATE FUND ADVISERS

- Conflicts and disclosure:
  - Fees and expenses
  - Valuation
  - Trade allocation
  - Use of affiliates

FAILURE TO DISCLOSE CONFLICTS OF INTEREST

- *In the Matter of The Robare Group, Ltd., et. al,* IAA Rel. No. 4566 (Nov. 7, 2016):
  - Investment adviser primarily recommended investments in mutual funds that had no transaction fees. The custodian paid Robare between two and twelve basis points for certain eligible mutual funds over which it had custody. The investment professionals did not know which funds triggered payments and which did not, and there was no evidence that a single investment decision had been influenced by the possibility of such payments. The SEC took issue with the disclosures of the arrangement
    - Key Takeaways: Firms need to be extremely careful in drafting their Form ADV disclosures as the SEC is focused on even the most minor conflicts and even those that involve small firms acting in good faith without any harm to investors. In many cases the SEC will equate inadequacy with negligence

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FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(CONTINUED)*

- *In the Matter of JP Morgan Chase Bank, N.A. and J.P. Morgan Securities LLC*, IAA Rel. No. 4295 (Dec. 18, 2015):
  - Broker-dealer and bank preferred to invest client assets in the firm's proprietary investment products without disclosing the preference
  - This included more expensive share classes of proprietary mutual funds and third-party hedge funds where the manager made payments to a J.P. Morgan affiliate
  - $127.5 million in disgorgement, $11.815 million in prejudgment interest and $127.5 million penalty
    - Key Takeaways: Review Form ADV disclosures of conflicts carefully, especially with respect to referrals to proprietary products

FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(CONTINUED)*

- *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*, IAA Rel. No. 4131 (June 29, 2015):
  - KKR allocated broken deal expenses to flagship funds but failed to allocate such expenses to its separate accounts and its own investment vehicles, even though such accounts and vehicles invested alongside the funds and failed to disclose that these expenses would not be allocated to the co-investment funds
  - SEC identified a failure by KKR to adopt policies and procedures governing the fair allocation and disclosure to investors of such expenses. While KKR recognized the problem in 2011 and adopted an allocation policy at that time, KKR did not retroactively apply the policy to its funds and other vehicles then under management covering 2006 - 2011
  - The breach of fiduciary duty was deemed "particularly troubling because a sizeable amount of co-investment capital came from KKR-affiliated vehicles, such that the firm had the funds foot the bill for deal sourcing activity that inured directly to [KKR's] benefit"
  - KKR paid approximately $30 million to settle the charges, including a $10 million penalty

FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(CONTINUED)*

- *In re BlackRock Advisors LLC and Bartholomew Battista*, IAA Rel. No. 4065 (Apr. 20, 2015):
  - In the first SEC case to charge a violation of Rule 38a-1 under the Investment Company Act (requiring the disclosure of "each material compliance matter" to the board), the SEC charged that an adviser to registered funds, private funds, and separately managed accounts should have disclosed to the registered fund's board that one of the adviser's portfolio managers had founded a company that formed a joint venture with a publicly owned company in which the fund had a significant interest. The SEC also charged the chief compliance officer with causing certain violations, which led to a dissent by Commissioner Daniel M. Gallagher. The adviser paid $12 million to settle the matter
    - Key Takeaway: Conflicts of interest created by outside business activities must either be eliminated or be disclosed to the board and advisory clients

IMPLICATIONS OF THE FINANCIAL CHOICE ACT OF 2016 ("FCA")

- Section 450 of the FCA would remove existing registration and reporting requirements for private equity fund managers and require the SEC to promulgate a new rule that requires the managers to keep records "taking into account fund size, governance, investment strategy, risk and other factors, [as the Commission] determines necessary and appropriate in the public interest and for protection of investors"
- The FCA also requires that the SEC define the term private equity fund
- If the managers of private equity funds are no longer required to be registered, it would be harder for OCIE to bring enforcement cases against them

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SEC'S PREVIOUS ATTEMPT TO DEFINE A "PRIVATE FUND"

- In 2004, the SEC tried to define a "private fund" in the "Registration Under the Advisers Act of Certain Hedge Fund Advisers" (the "Hedge Fund Rule")
- The rule exempted an adviser from registration if the adviser: (i) had fewer than fifteen clients, which included "shareholders, limited partners, members, or beneficiaries of the fund" during the preceding twelve months, (ii) did not hold itself out generally to the public as an investment adviser, and (iii) was not an adviser to any registered investment company"
- Requirements:
  - A fund will not be a "private fund" unless it is a company that would be subject to regulation under the Investment Company Act but for the exception from the definition of "investment company," provided in either Section 3(c)(1) or Section 3(c)(7)
  - A company will be a private fund only if it permits investors to redeem their interests in the fund within two years of purchasing them
  - A company will be a private fund only if interests in it are offered based on the investment advisory skills, ability or expertise of the investment adviser
- The "Hedge Fund Rule" was struck down as beyond the agency's authority in *Goldstein v. SEC,* (June 23, 2006), a case brought by a hedge fund manager

CONFLICT RESOLUTION

- Hedge funds: prospective amendments (redeem before effective)
- Private equity funds:
  - LPAC consent: authority, willingness
  - Limited Partner vote
- Form ADV disclosures

UPDATE ON TAX DEVELOPMENTS

TRENDING TAX ITEMS – PARTNERSHIP REPRESENTATIVE

- 2015 Bipartisan Budget Act - change from “tax matters partner” to “partnership representative”
- Effective for partnership returns filed for partnership taxable years beginning after December 31, 2017 (unless the entity elects to apply the rules to its 2016 and 2017 returns)
- The partnership representative has sole authority to act on behalf of the partnership in audits or judicial proceedings and binds the partnership and all partners
- Partners have no statutory right to notice of, or participation in, audit or judicial proceedings
- Partnership audit items generally assessed at the partnership level; partnership liable for any underpayments, but elections available to push liability to partners
- Operating agreements currently being drafted to take into account the new rules

TRENDING TAX ITEMS – TAX REFORM

- Domestic and international tax reform looming
- Domestic Tax Reform
  - Repeal of carried interest:
    - Need to consider impact of repeal against proposed lower tax rates
    - Structuring alternatives? Potential to move management company offshore to a low-tax jurisdiction in which dividends may be brought back as “qualified dividend income” (e.g., Puerto Rico Act 20 Company)
  - Repeal of Obamacare
    - Not a foregone conclusion, but Republicans are focused on repeal of the 3.8% tax on “net investment income”

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TRENDING TAX TOPICS – US INTERNATIONAL TAX REFORM

- Limit inversions
- Move from a “worldwide” to a “territorial” tax system
- Cash repatriation – proposal for one-time mandatory repatriation of foreign-held cash, regardless of whether cash in fact comes back to the US (deemed repatriation)
- Border-adjusted tax

*** International reform may mean that offshore cash comes back to the US which may create a new pool of investable cash**

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TRENDING TAX TOPICS – GLOBAL INTERNATIONAL TAX REFORM (BEPS, OECD, EU)

- Stop treaty shopping – OECD BEPS Action 6 attempts to address treaty shopping through requiring participating countries to adopt "limitations on benefits" standards, specific anti-abuse provisions, and changes to the OECD Model Tax Convention on treaty shopping
- Expansion of "permanent establishment" – In parallel to the OECD BEPS Action 7 aimed at expanding the definition of "permanent establishment," there have been a number of national efforts to capture so-called diverted profits (e.g., UK and Australia)
- Limit availability to claim reduced rates of withholding

INFRASTRUCTURE AND PERSONNEL DEMANDS

INFRASTRUCTURE AND PERSONNEL—GETTING THE BALANCE RIGHT

- Investment managers face competing demands for scarce resources to meet regulatory demands
  - Legal (In house Counsel)
  - Compliance (CCO)
  - Financial (CFO and other financial personnel)
- Meeting these demands sometimes means combining functions

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COMBINING KEY ROLES

- Wearing two hats is a continuing reality for key personnel at many investment managers
  - Combining the roles of General Counsel and CCO
  - Combining the roles of CFO and CCO
- What are the regulatory considerations in combining these roles?

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THE EVOLVING ROLE OF THE CCO

- What it means for a CCO to be responsible for the "administration" of the compliance program has been a subject of continued debate:
  - The SEC's views on CCO liability — which way is it trending?
    - On the one hand, the SEC has recently made efforts to assure the CCO community that they do not have a disproportionate risk of liability if they are doing their job properly
    - On the other hand, a number of recent SEC settlements have included CCOs as respondents
  - Outsourced CCOs:
    - Many investment managers, particularly small and mid-sized managers, have opted for retaining outsourced CCOs
    - The SEC has provided guidance on the use of outsourced CCOs that raised questions with the practice

THE POTENTIAL CONSEQUENCE OF INSUFFICIENT RESOURCES

- *In re Pekin Singer Strauss Asset Management Inc. et al.*, IAA Rel. No. 4126 (June 23, 2015):
  - The SEC charged that an investment adviser to high-net-worth clients and that the fund hired a CCO who had limited prior experience and training in compliance; the CEO at the time failed to provide the CCO with sufficient guidance regarding his duties and responsibilities and did not provide him with staff to assist with compliance; the CCO lacked experience, resources, and knowledge as to how to adopt and implement an effective compliance program; because of his other responsibilities, the CCO was only able to devote 10% – 20% of his time on compliance matters; he failed to complete timely annual compliance program reviews; he told the CEO that he needed help, but the CEO delayed in providing additional resources; and that the lack of resources contributed to delays in completing compliance reviews
  - As part of the settlement, the Commission suspended the former CEO from association in a compliance and supervisory capacity for 12 months, ordered the firm to pay a civil money penalty of $150,000, and ordered the former CEO to pay a fine of $45,000

NON-U.S. MANAGER CONSIDERATIONS

EXEMPTION TO THE ASSETS UNDER MANAGEMENT REQUIREMENT FOR FOREIGN ADVISERS

- Generally, an investment adviser must have a minimum amount of assets under management ("AUM") (subject to exceptions) to qualify for federal investment adviser registration
- This minimum AUM requirement does not apply to an adviser with a principal office and place of business outside of the United States

FOREIGN PRIVATE FUND ADVISERS/EXEMPT REPORTING ADVISERS

- No place of business in the United States from which assets are managed - no AUM limit
- OCIE examinations

PARTICIPATING AFFILIATES

- Prior to the Dodd-Frank Act, the SEC staff permitted unregistered, non-U.S. advisers to provide investment advice with respect to U.S. clients of an SEC- registered affiliate subject to certain conditions (discussed below)
- This guidance was based on staff no-action and interpretive guidance
  - Most widely known of these no-action letters is the “Unibanco” no-action letter – *Uniao de Bancos de Brasileiros S.A.,* SEC No-Action Letter (July 28, 1992)
- This relief is still available and is useful if you set up (or have) a separate U.S. entity and personnel of the foreign management company provide advice to the U.S. clients through the U.S. entity

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PARTICIPATING AFFILIATES *(CONTINUED)*

- Unibanco line of letters requirements:
  - Registered adviser and participating affiliates must be (and act as) separate legal entities
  - Participating affiliate must appoint a U.S. agent for service of process (and must maintain such an agent until six years after it ceases providing advice to the registered adviser's U.S. clients)
  - Participating affiliate must submit to the jurisdiction of the U.S. courts for actions arising under the U.S. securities laws in connection with investment advisory activities for U.S. clients of registered adviser

PARTICIPATING AFFILIATES *(CONTINUED)*

- Personnel of participating affiliate whose duties or functions relate to the determination and recommendation of securities trades made with respect to the U.S. clients, or who have access to any information concerning securities being recommended to U.S. clients prior to dissemination of such recommendations:
  - Are treated as "associated persons" of the registered adviser and
  - Are treated, when applicable, as "supervised persons" or "access persons" under the registered adviser's code of ethics and policies and procedures

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PARTICIPATING AFFILIATES *(CONTINUED)*

- Participating affiliate must maintain certain records required by the Investment Advisers Act (outside of United States)
- To the extent that any books and records are not kept in English, the participating affiliate must translate records into English upon reasonable advance request by the SEC
- Participating affiliate must agree to provide records, and staff (including testimony) to SEC

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ("AIFMD") UPDATE

- Status of the Elimination of National Private Placement Regimes:
  - Before the national private placement regimes can be eliminated, the European Securities and Markets Authority ("ESMA") has to issue a delegated act pursuant to Article 62
  - Due to tax concerns, this act may not occur for at least a year
  - If national private placement regimes were eliminated, they would not go away for at least three years after the delegated act occurs
  - Subsequently, after the three-year period, Article 68 requires assessment of whether to terminate the national PPRs before they can be eliminated

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (“AIFMD”) UPDATE

(CONTINUED)

- U.S. Managers’ current options when targeting the EU:
  - Use national private placement regimes (UK, Netherlands, Scandinavia)
  - Consider a hosting platform
  - Ultimately, if ESMA adopts a passporting regime for non-EU managers and non-EU funds, U.S. registered investment advisers would be eligible
  - Hold up is likely due to Brexit

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