K&L GATES

2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Hedge/Private Fund and Institutional Investor Financial Industry Developments

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Custody Rule Hazards

CUSTODY RULE: OVERVIEW

- A registered investment adviser is prohibited from having "custody" of client funds or securities, except in accordance with Advisers Act Rule 206(4)-2 (the Custody Rule)
- "Custody" includes any arrangement under which an adviser is authorized to withdraw client funds kept with a custodian upon its instruction to the custodian, including a general power of attorney

CUSTODY RULE: RECENT DEVELOPMENTS

- IAA No-Action Letter

- SEC IM Guidance Update

NO-ACTION LETTER: BACKGROUND

- The SEC Staff stated that a standing letter of instruction or similar arrangement (SLOA) that authorizes an adviser to disburse funds to third parties designated by the client could confer "custody" on the adviser under certain circumstances
  - The SLOA contemplated in the no-action letter would authorize the adviser to make determinations as to amount and timing of payments but not the identity of payee

IAA NO-ACTION LETTER: STAFF GUIDANCE

- SEC Staff would not recommend enforcement action if an adviser acts pursuant to a SLOA without obtaining a surprise audit if seven conditions are met

SLOA: AVOIDING CUSTODY

- Generally, a SLOA in which an adviser does not have discretion as to the amount, payee and timing of transfers should not implicate the Custody Rule

PRACTICAL APPLICATION FOR ADVISERS

- **Prior guidance re-affirmed**: The limited authority to transfer funds between a client's accounts maintained at one or more custodians does not confer "custody"
  - So long as: the client has authorized the adviser in writing to make such transfers and a copy of the authorization is provided to the custodian(s) specifying the accounts

- **Next steps**: Advisers must include client assets that are subject to an SLOA that result in custody in response to Item 9 of Form ADV beginning with its next annual updating amendment after October 1, 2017

IM GUIDANCE UPDATE

- SEC Staff noted that the terms of an agreement between a client and a qualified custodian might authorize the client's adviser to disburse client funds or securities
- Examples: a custody agreement may:
  - Grant an adviser the right to receive money, securities, and property and dispose of same
  - State that the custodian may rely on client's adviser's instructions without direction from the client

IM GUIDANCE UPDATE (CONT'D)

- Certain custodial arrangements could result in an adviser having "custody" under Custody Rule, even if the adviser:
  - did not intend to have custody
  - was not aware it had been granted the authority that resulted in custody
- Contractual arrangements between the adviser and clients (without custodian) not enough to disclaim custody

PRACTICAL APPLICATION FOR ADVISERS

- SEC Staff suggested that one way for an adviser to avoid having "custody" is to draft a document addressed to the custodian that limits the adviser's authority to "delivery versus payment," notwithstanding any language in the custodian agreement, and to have the client and custodian provide written consent to acknowledge new arrangement
  - However: many advisers direct transfer of funds to counterparties, FCMs, and others in connection with trading of futures, swaps, bank loans, and other instruments. Those transfers not made on a DvP basis.

CUSTODY RULE: NEXT STEPS FOR ADVISERS

- Awaiting additional guidance from SEC Staff, hopefully by year-end

- Review their practices regarding custody of client assets and related compliance policies
  - Pay particular attention to arrangements that may impute custody inadvertently

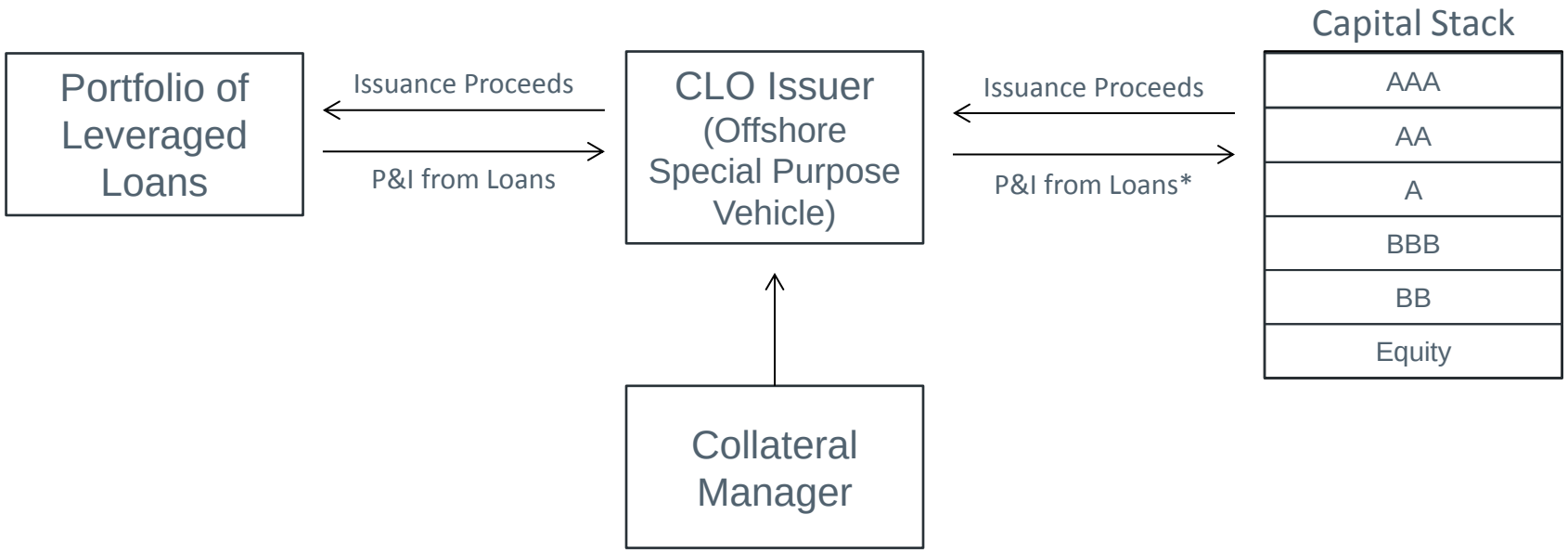

Questions?

Developments in Collateralized Loan Obligations

WHAT IS A CLO?

- Form of securitization containing a pool of loans such as syndicated and/or leveraged loans made to corporate entities and private equity funds
- Tranche structure allows investors to purchase an interest based on risk tolerance
- Most CLOs feature active management in order to maintain and potentially improve portfolio yield

TYPICAL CLO STRUCTURE



* After expenses and fees and in accordance with the distribution waterfall

CLO LIFE CYCLE

- Warehouse Period
  - Collateral manager acquires leveraged loans via warehouse facilities
- Ramp-up Period
  - Collateral manager acquires further assets
- Reinvestment Period
  - Collateral manager trades assets from the collateral portfolio on behalf of the CLO
- Post Reinvestment Period
  - Collateral manager uses proceeds to pay down liabilities

OVERVIEW OF STRUCTURAL PROTECTIONS

- Active management presents CLO investors with potential for both greater risk and greater reward
- Risk of unlimited discretion of collateral manager is tempered by a series of performance metrics, including:
  - Over Collateralization
  - Interest Coverage
  - Weighted Average Life
  - Weighted Average Spread
  - Weighted Average Rating

OVERVIEW OF STRUCTURAL PROTECTIONS (CONTINUED)

- Post-crisis issuances
  - Enhanced subordination
  - Collateral eligibility restrictions
  - Reduction of non-call periods
    - Pre-crisis issuances: 3-5 years
    - Post-crisis issuances: 1.5-2 years
  - Reduction of reinvestment periods
    - Pre-crisis issuances: 5-7 years
    - Post-crisis issuances: 3-4 years
- CLO 3.0 – “Volckerized” CLOs
  - CLOs prohibited from acquiring bonds or structured finance securities

INVESTOR INTEREST

- Five ways investors can participate in CLOs
  - Primary issuance
  - Secondary issuance
  - Active investment
  - Passive investment
  - Risk retention
- Recent trends show increasing interest in CLO mezzanine tranches by institutional investors
  - Moving further down the capital stack in search of higher returns
- Despite some sector stress, five year loss rates for CLOs are favorable compared with other asset classes like CMBS, RMBS, CDOs, and corporate bonds

RECENT REGULATORY DEVELOPMENTS

- Risk Retention
  - Now in place in US and Europe
  - Further European risk retention regulations may result in CLO sponsors choosing to remain active in only the US and Asian markets
  - Signs of some U.S. CLO managers backing away from dual compliance structures

RECENT REGULATORY DEVELOPMENTS (CONTINUED)

- Treasury Recommendations – Risk Retention
  - Broad Exemptions for Qualifying Asset Classes and CLOs
    - Rather than an across-the-board repeal, rulemaking agencies should create a set of loan-specific requirements which, if met, would allow managers to seek relief from the risk retention rule
  - Retention Period
    - Regulators should review mandatory five-year holding period for third-party purchasers and sponsors subject to the requirement
  - Streamlining Regulatory Oversight
    - Congress should designate a lead agency to be responsible for future actions related to the rulemaking, resulting in streamlined issuance of interpretive guidance and exemptive relief


Questions?