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2017 WASHINGTON D.C. INVESTMENT MANAGEMENT CONFERENCE

Developments in Private Funds, Separate Accounts and CLOs

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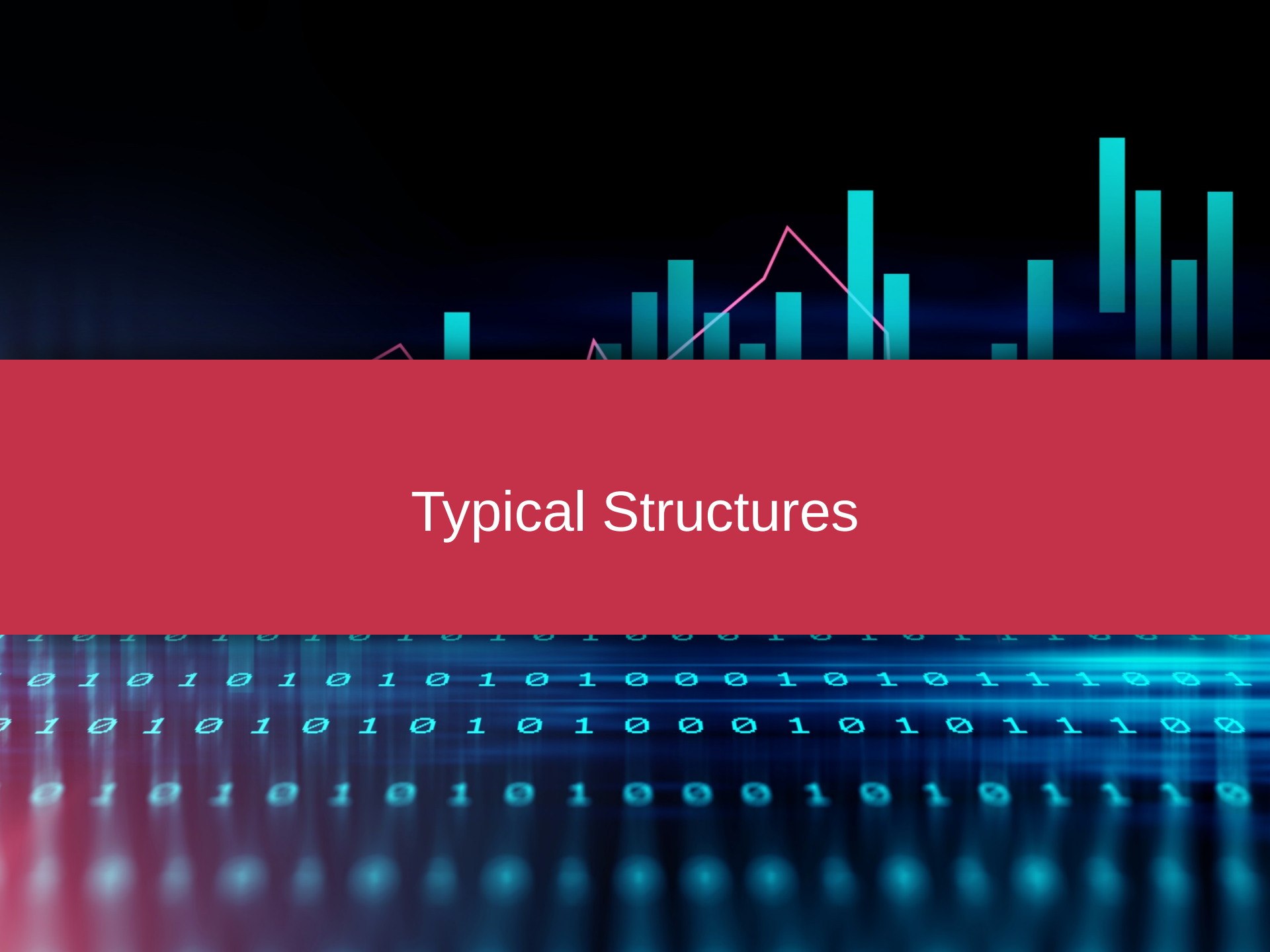
OVERVIEW OF PRESENTATION

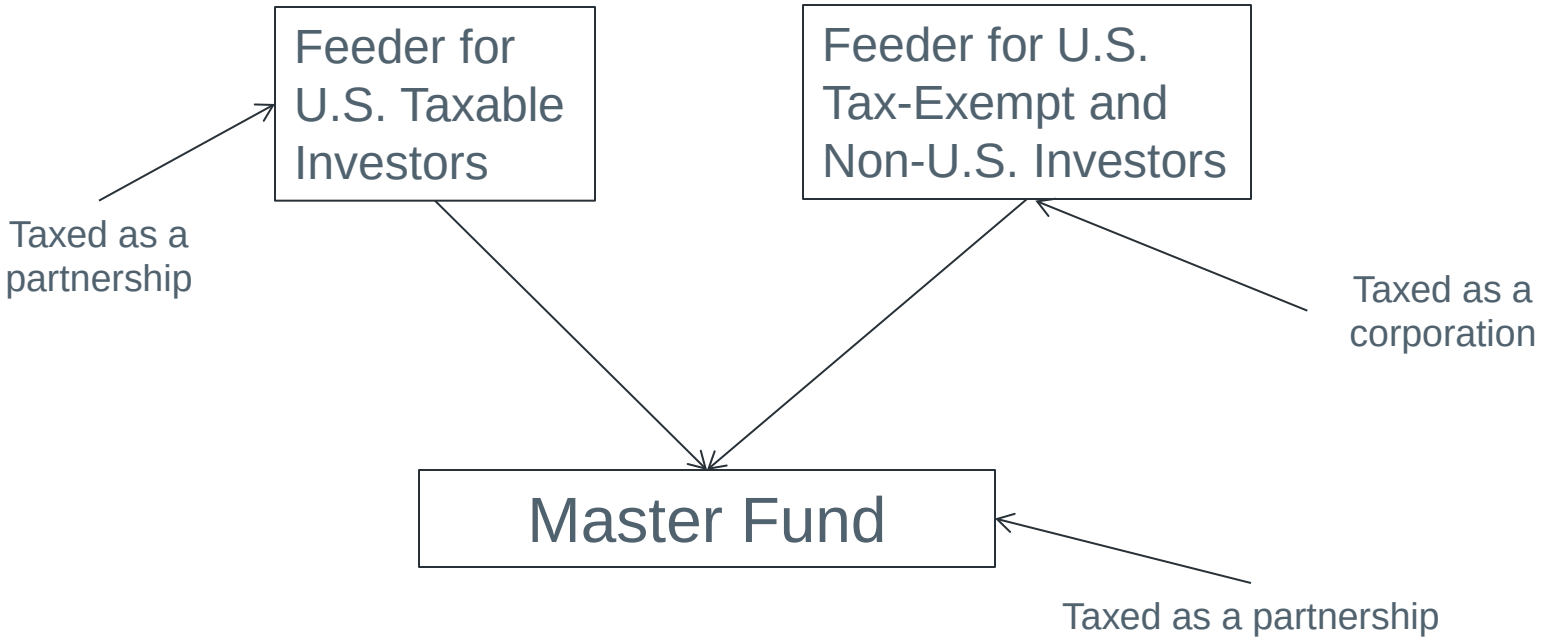
- Typical Structures
- Developments in Seeding Arrangements
- Changes in Fund Terms
- Custody Rule Issues
- New Form ADV
- CFTC Update – Regulation 4.13(a)(4) Reinstatement Status
- Partnership Representative
- Developments in Collateralized Loan Obligations



Typical Structures

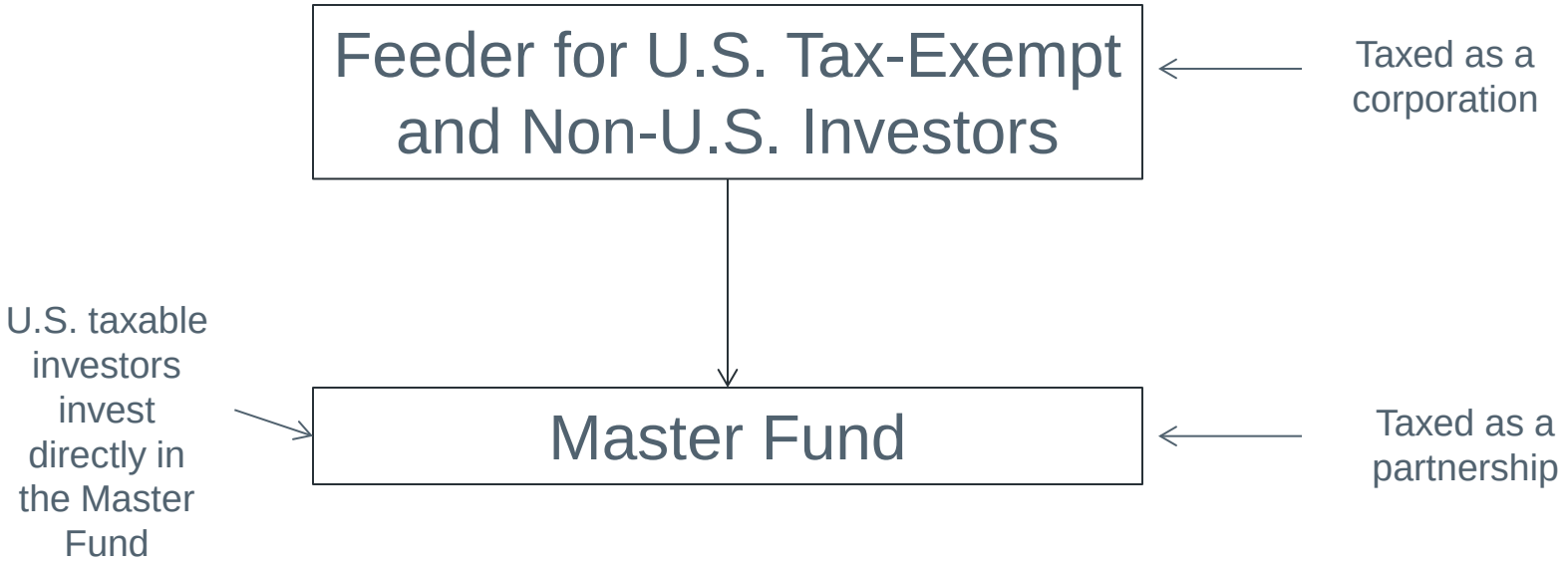
TYPICAL OPEN-ENDED FUND STRUCTURES

- Master-Feeder

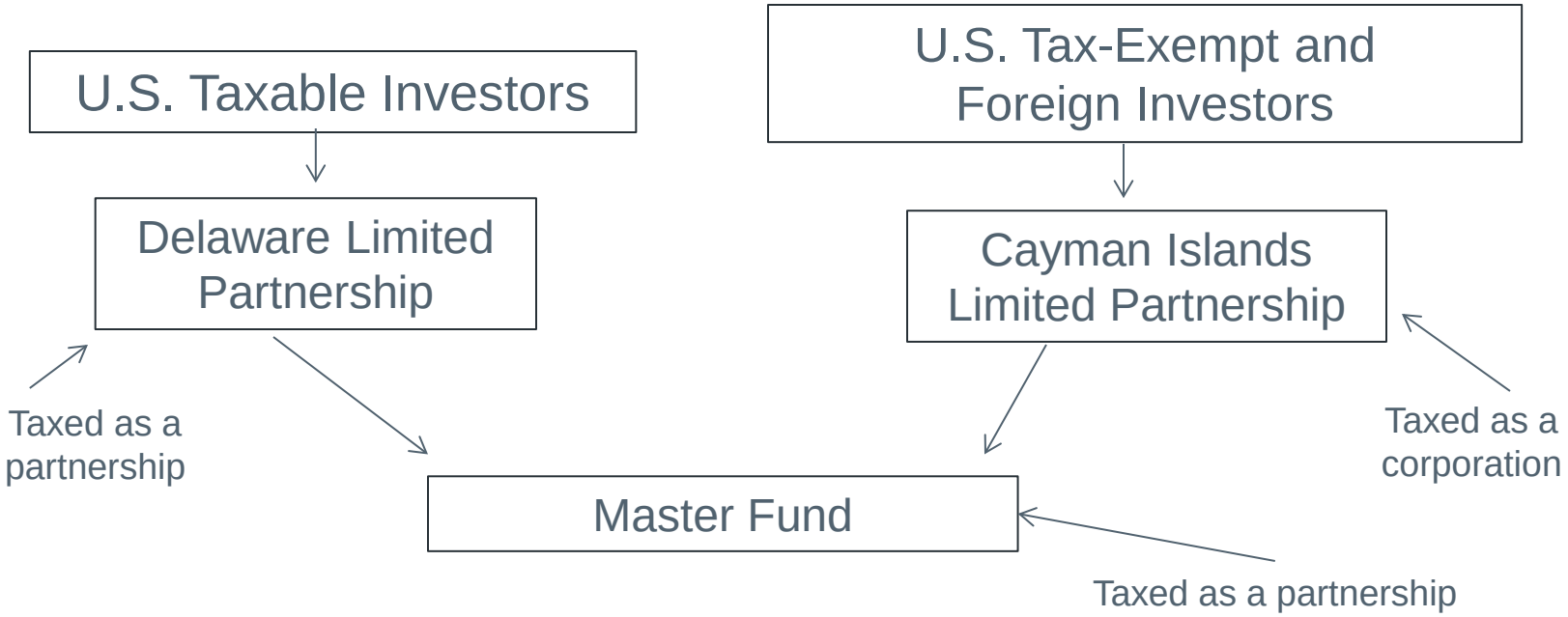


TYPICAL OPEN-ENDED FUND STRUCTURES (CONT'D)

- Mini-Master



CLOSED-END FUND STRUCTURES



TYPICAL FUND STRUCTURES IN DELAWARE

- Delaware LP
  - Benefits: understood around the globe
  - Detriments: general partner has unlimited liability (borrowing)
- Delaware LLC
  - Benefits: manager does not have unlimited liability
  - Detriments: not always understood outside of the United States; tax treatment
- Delaware is preferred jurisdiction because of quality and clarity of statutes and court guidance
- Can create ring-fenced series in both Delaware LPs and LLCs

Developments in Seeding Arrangements

DEVELOPMENTS IN SEEDING ARRANGEMENTS – OVERVIEW

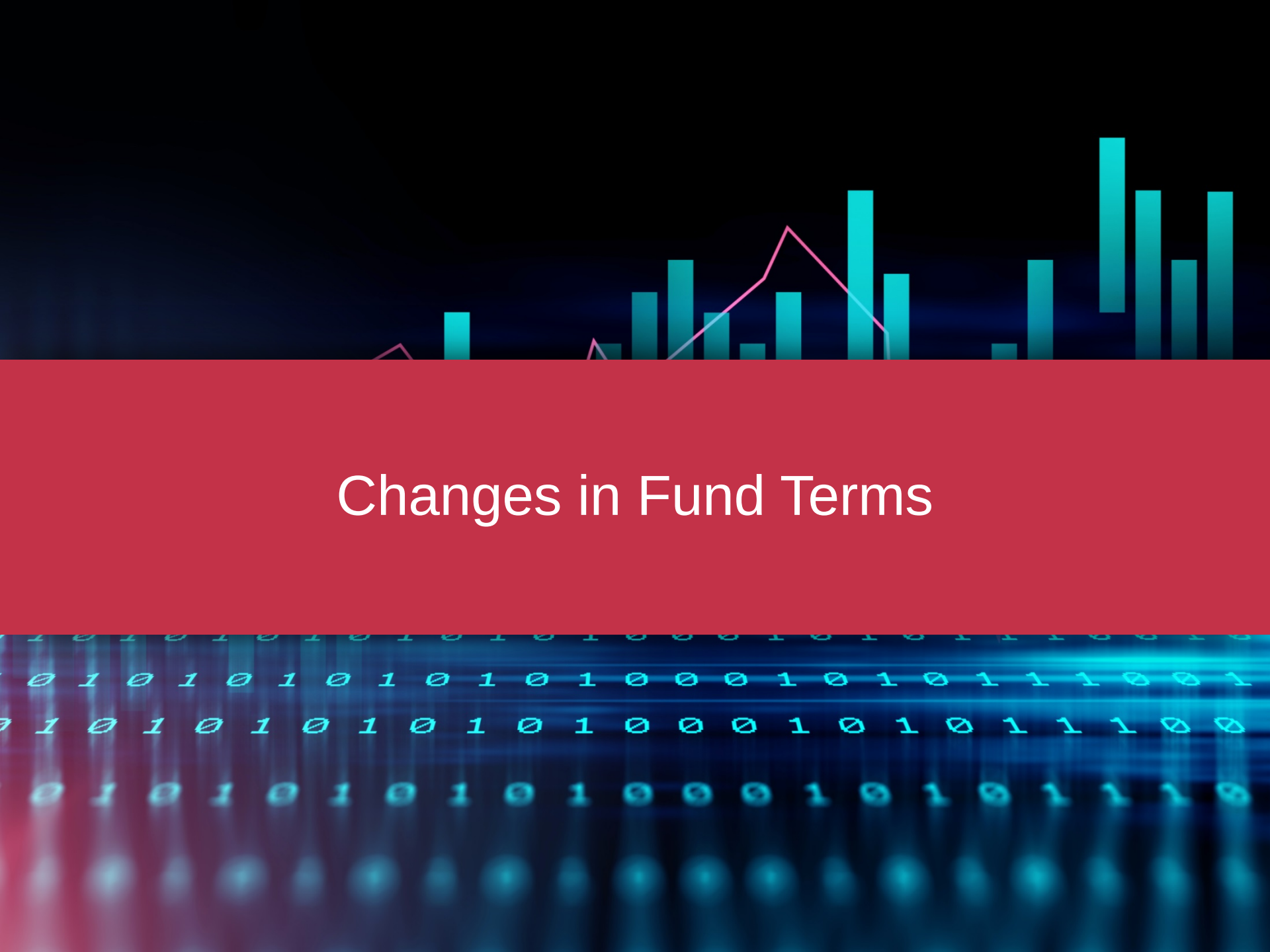
- Seeding Arrangements Generally Involve One or More Seeding Investors:
  - Making a Significant Capital Commitment to a Fund Manager at the Initial Closing of the Fund
  - Assisting with Fund Structuring Issues and Proposing Market Terms and Conditions
  - Assisting with Fundraising and LP Introductions
  - Providing Financing to the Manager for Startup Costs
  - Receiving Certain Economic Benefits in the Initial Fund and in Certain Subsequent Funds

DEVELOPMENTS IN SEEDING ARRANGEMENTS – ECONOMIC BENEFITS

- Seeding Investors Generally Receive:
  - The Right to Invest in the Initial Fund and Certain Subsequent Funds on a No-Fee, No-Carry Basis
  - The Right to Receive a Share of the Management Fee and Other Income of the Management Company
  - The Right to Receive a Share of Carried Interest Payable to the General Partner
  - Governance Rights (including LP Advisory Board and Investment Committee Participation as well as Decisionmaking at GP and Manager Level)

DEVELOPMENTS IN SEEDING ARRANGEMENTS – ADDITIONAL ISSUES

- Commitments from Seeding Investors may be Subject to a Sliding Scale or “Ratchet”
- Seeding Investors may have the Right to bring in Additional “Introduced Investors” upon Preferential Terms
- Seeding Investors may have Put Options, Drag and Tag Rights and other Similar Rights with respect to their Interests in the GP and Manager



Changes in Fund Terms

CHANGES IN FUND TERMS – HEDGE FUNDS

- Fees, Expenses and MFNs
  - Performance allocation (typically 20% but may be lower or higher); often with a hurdle
  - Classes for seed/founding investors
  - Management fee (need to be competitive; 1-2% depending on strategy and manager's overhead)
  - Break points for performance allocation and management fees
  - Discounts for worse liquidity
  - Expenses (clear disclosure what is expensed back to the fund and what management fee should cover)
  - Service providers should be paid directly by the fund and amount clearly disclosed to avoid any conflicts where the manager is incentivized to pick the cheapest provider
  - MFNs: Usually depend on size of investment; can apply across multiple funds
- Key Man and Skin in the Game

CHANGES IN FUND TERMS – PRIVATE EQUITY

- Basic Terms Remain Constant
  - 2% Management Fee
  - 8% Preferred Return
  - 20% Carried Interest
- Some Negotiation Around the Margins
  - Fee and Carry Breaks for Lead Investors and/or Initial Closing Investors
  - Management Fee Stepdowns After Investment Period
  - Preferred Return Calculated on Investments vs. All Contributions
  - Convergence of European and U.S. Waterfalls
  - Carried Interest Subject to Escrow, Interim Clawbacks and Guarantees
- More Detailed Disclosure of Fund Expenses
- Restrictions on Reinvestments

CHANGES IN FUND TERMS – PRIVATE EQUITY

- Developments in Fund Structuring
  - Parallel and Feeder Fund Vehicles
  - Blocker Vehicles
  - Aggregator Vehicles
- Some New Developments Outside of LPAs
  - MFN Provisions in Side Letters Increasingly Complex
  - Co-Investment Opportunities are Key for Some LPs
  - Credit Lines Increasingly Common


The Custody Rule

THE CUSTODY RULE – IN GENERAL

- Rule 206(4)-2
  - Unlawful for an adviser to have custody of client funds or securities unless certain requirements are met
  - Custody defined as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them”
    - Includes arrangements where the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon adviser’s instruction to custodian

THE CUSTODY RULE – FURTHER SEC GUIDANCE

- Inadvertent Custody
  - Adviser may have custody where agreement between client and client's custodian authorizes adviser to disburse client funds or securities, even if prohibited by advisory agreement between adviser and client
    - SEC: Advisers can (1) draft a document to send to the custodian that limits authority to "delivery versus payment," notwithstanding custodial agreement, and (2) obtain client and custodian written consent that acknowledges arrangement
    - The SEC staff's view of what constitutes "delivery versus payment" may be more restrictive than previously understood
- Adviser Authority to Transfer Funds or Securities Between a Client's Accounts
  - Adviser's limited authority to transfer client's assets between client's accounts does not confer custody, provided that client's written authorization is given to both custodians and specifies accounts precisely

THE CUSTODY RULE – SLOA

- Investment Adviser Association Letter to SEC
  - Clarify whether an adviser has custody when it acts pursuant to a standing letter of authorization ("SLOA"), where client instructs a custodian to transfer funds to a designated third party upon future request of adviser
- SEC No-Action Letter
  - Such a SLOA imputes custody to the adviser
  - However, if such adviser does not obtain a surprise examination, the SEC will not recommend enforcement when 7 conditions are met
    - Adviser still required to meet other custody rule requirements and is custodian for AUM/ADV purposes

THE CUSTODY RULE – SLOA *(CONTINUED)*

- 7 Conditions to Avoid Surprise Examination for SLOA:
  - Client provides signed written instruction to custodian with third party information
  - Client authorizes adviser in writing to direct transfers to the third party
  - Custodian verifies the instruction
  - Client maintains ability to terminate or change the instruction
  - Adviser has no authority to designate or change any information about third party
  - Adviser maintains records showing that third party is not related to adviser
  - Custodian sends initial and annual confirmation to client
- Conditions are often not workable for advisers with multiple separate account clients
- Compliance
  - The SEC did not provide a definite timeline, but acknowledged it would take a reasonable period of time to implement compliance procedures
  - Form ADV, Item 9: After October 1, 2017, adviser should include client assets subject to a SLOA that result in custody

THE CUSTODY RULE – IMPLEMENTED

- Charles Schwab
  - Transfers between client accounts (first party)
    - To avoid custody, advisers can remove first party wire authority or retain signed client authorization with destination account details
  - Standing letters of authorization (third party)
    - Follow the 7 conditions in the SEC's no-action letter to avoid annual surprise examination
      - Schwab handling 6 of the 7 - adviser must maintain records showing that third party is not related to adviser

New Form ADV

SEC AMENDMENTS TO FORM ADV

- Compliance date of October 1, 2017
- Other-Than-Annual Amendments
  - Filing an other-than-annual amendment on or after October 1, 2017 but before the next annual amendment is due
  - If a registrant does not have enough data to provide a complete response to a new or amended question in Item 5 or the Schedule D sections related to Item 5, the registrant may enter "0" as a placeholder and note that placeholder in the Miscellaneous Section of Schedule D
  - If a registrant cannot locate the Form D file number for a private fund or chooses to maintain anonymity of the fund, it may enter all nines on Schedule D, Section 7.B.(1) (*e.g.*, 021-9999999999)

SEC AMENDMENTS TO FORM ADV *(CONTINUED)*

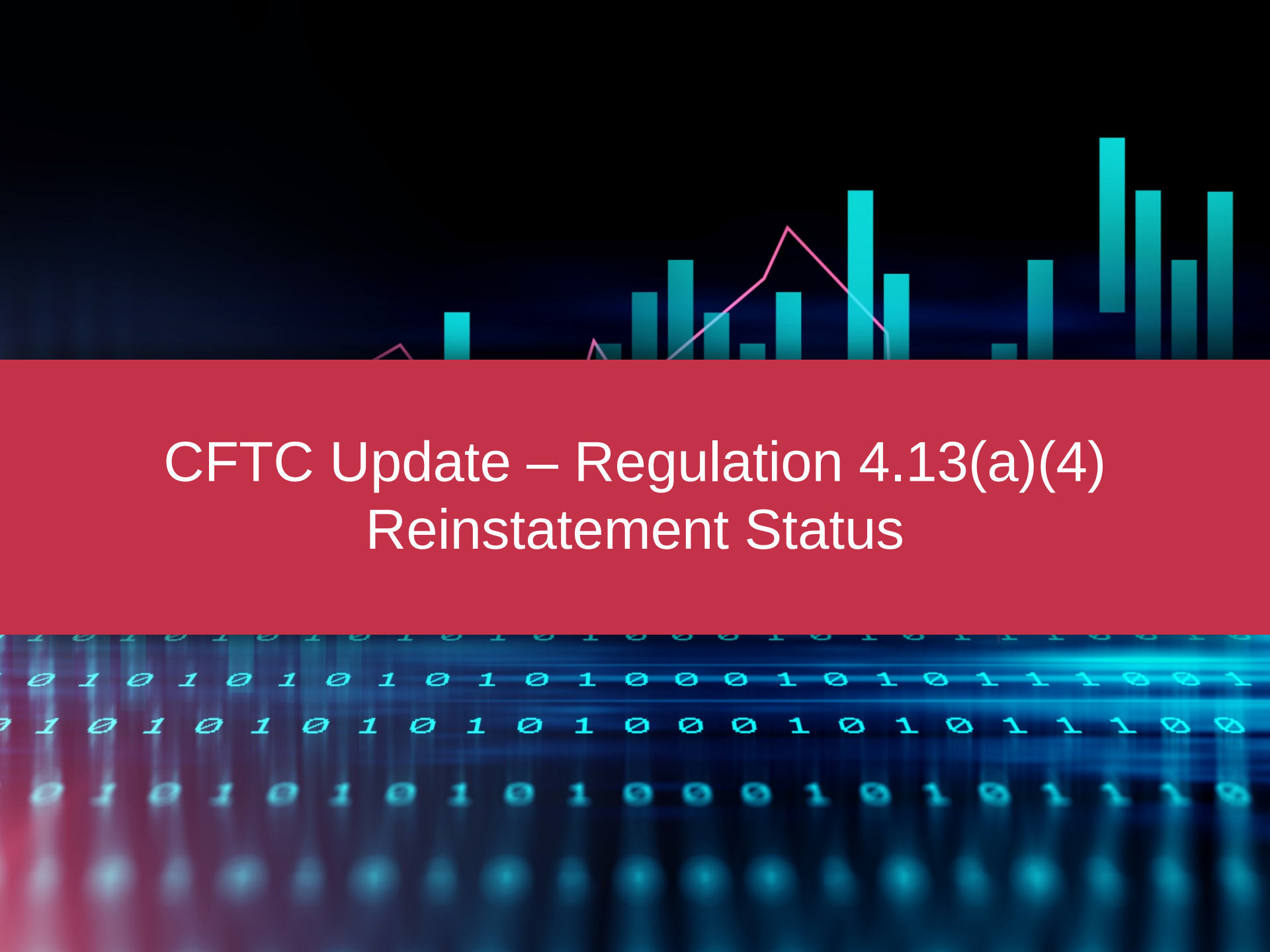
- Collection of Information on Separately Managed Accounts ("SMAs")
  - Neither the Proposing Release nor the Adopting Release clarified the question of whether the SEC considers a "fund of one" a separately managed account for this purpose
- Will need to report annually (or annually with semi-annual data for RIAs with at least $10 billion of regulatory assets under management ("RAUM") attributable to SMAs):
  - Percentage of RAUM attributable to SMAs in 12 broad asset categories (exchange-traded equities, U.S. government/agency bonds) (rather than 10 categories, as proposed)
    - Adopting Release added that advisers may use internal methodologies in determining how to categorize assets, and that investments in derivatives, funds and/or ETFs should be reported in those categories
  - Percentage of SMA assets invested in borrowings and in derivatives (increased reporting for advisers with $10 billion or more of RAUM)
  - Identify custodians that account for at least 10% of RAUM attributable to SMAs and identify amount of RAUM at each custodian

SEC AMENDMENTS TO FORM ADV *(CONTINUED)*

- Information Regarding an Adviser's Business and Affiliations
- Includes:
  - Website addresses for social media platforms
  - Total number of advisory offices and information about the 25 largest offices
  - Whether CCO is employed or compensated by someone other than the adviser (or a related person)
  - If an adviser reports RAUM differently in Part 2A than in Part 1A, the adviser is required to check a box
  - Percentage of RAUM attributable to non-U.S. clients
  - RAUM of all "parallel managed accounts"
  - Additional information regarding sponsors of wrap fee programs
  - Whether the adviser limits sales of the fund to qualified clients (rather than reporting the percentage of private fund assets owned by qualified clients, as proposed)

SEC AMENDMENTS TO FORM ADV *(CONTINUED)*

- Umbrella Registration
  - Changes Form ADV to clarify which questions must be answered by the "filing adviser" and which questions must be answered by "relying advisers"
  - Reporting must be consistent with reporting on Form PF



CFTC Update – Regulation 4.13(a)(4) Reinstatement Status

REINSTATEMENT OF CFTC REGULATION 4.13(a)(4)

- AIMA Petition
- KISS Letters
- Additional Conditions:
  - SEC registration
  - Foreign

Partnership Representative

POST-2017 PARTNERSHIP AUDIT REGIME

- Tax matters partner is out; partnership representative ("PR") is in
  - PR does not have to be a partner
    - If PR is an entity, must name a "designated individual"
  - PR has lots of power
  - PR must have US address, phone number, and tax ID
  - Must be designated on each annual return
  - Or IRS will select

WHAT SHOULD MANAGERS/GPS DO?

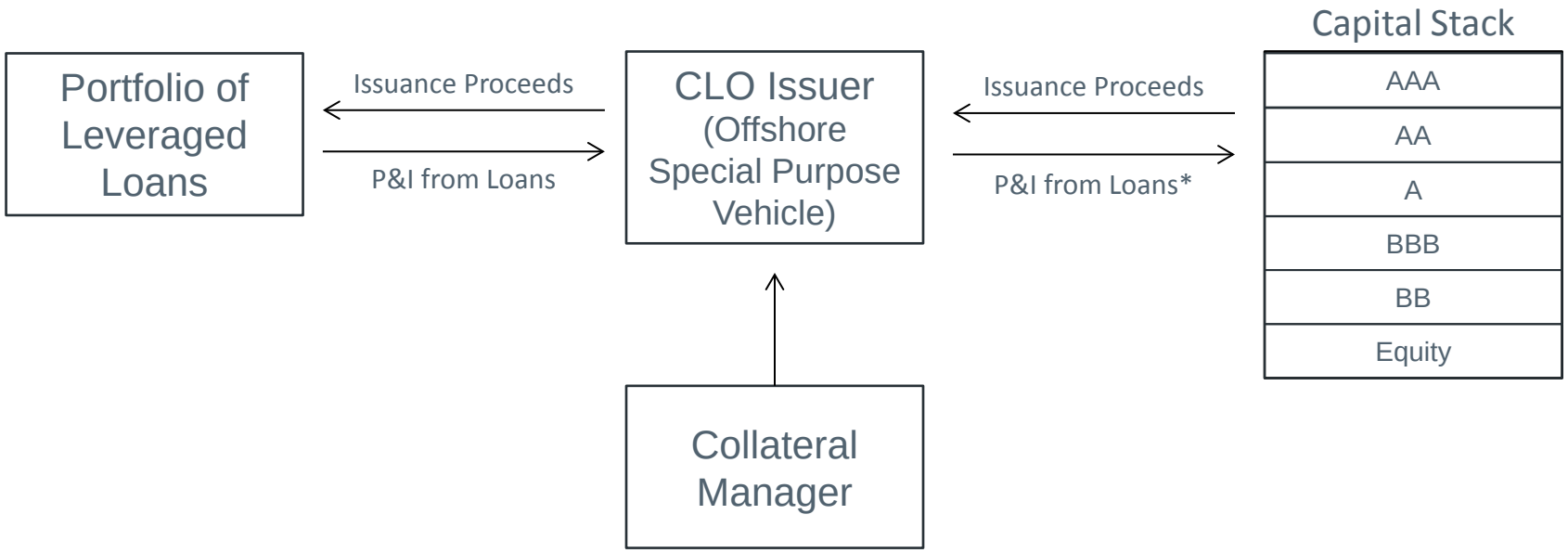
- LPA/LLCA
  - Tax matters section should reserve most rights to manager acting as PR, subject to commercially reasonable discretion
    - PR should be fully indemnified
    - But consider unique needs of some investors – always a business consideration
  - Allocation of audit results to partners that caused an adjustment (due to compliance status, characteristics, etc.)
  - New LPAs/LLCAs should have relevant provisions now – usually no need to wait for final regulations (proposed regs currently available)
  - Existing LPAs/LLCAs should be revised before end of 2018
- Ensure current W-9s, W-8s are on file – likely to be even more important under the new regulations
- Reconsider choice of accounting firm?
  - Audits likely will be more frequent and more expensive going forward

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

- Many ways investors can participate in CLOs
  - Primary issuance
  - Secondary issuance
  - Active investment
  - Passive investment
  - Risk retention
- 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?

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