

The logo for K&L GATES is displayed in white, uppercase letters on a dark blue rectangular background. The background of the entire slide features a complex financial chart with orange and blue elements, including a world map made of dots and various data lines.

K&L GATES


2018 INVESTMENT MANAGEMENT CONFERENCE
New York, October 30, 2018

Regulatory and Industry Initiatives and Trends

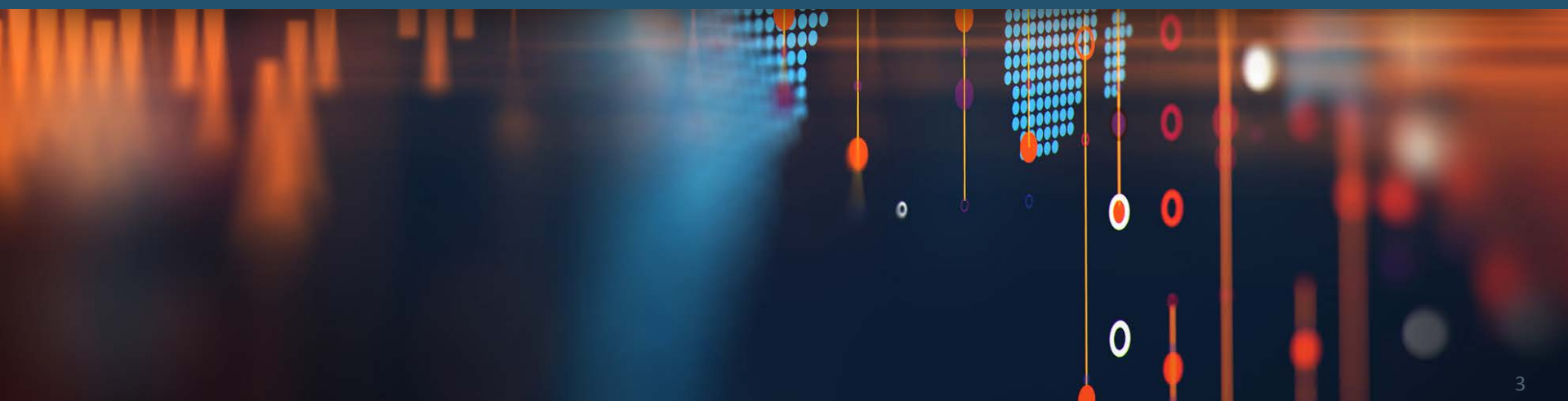
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AGENDA

- Fiduciary Duty of Advisers and Brokers
 - SEC Regulation Best Interest
 - Form CRS
 - Investment Adviser Interpretive Guidance
- GIPS 2020 Performance Advertising
- CFTC Proposal to Expand and Clarify CPO and CTA Exemptions and Other Requirements
- Socially Responsible Investing
 - ERISA Assets
 - EU Parliament Proposed ESG Initiative
 - A Private Fund ESG Example



Fiduciary Duty of Advisers and Brokers – SEC Regulation Best Interest



SEC REGULATION BEST INTEREST

- *Regulation Best Interest, Securities Exchange Act Release No. 83062*, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>
 - **Essentially an SEC ‘Fiduciary Rule’ for Brokers**
 - Background: Rulemaking proposal advanced by the SEC in April 2018 to “enhance the quality and transparency of investors’ relationships with investment advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products”
 - Congressional Mandate: Dodd-Frank Section 913 directed the SEC to study the implications of different standards for broker-dealers and investment advisers and adopt a uniform fiduciary standard. Section 913(f) specifically authorized rulemaking to address “regulatory standards of care ... for providing personalized investment advice” to retail customers

SEC REGULATION BEST INTEREST (CONT'D)

- The proposed rule provides that a broker-dealer will be required to act in the **best interest of its retail customers**
- “Best Interests” is a higher standard of conduct than current “suitability” standards applicable to broker-dealers and associated natural persons, but applies only when making recommendations to retail customers
- Requires that a broker avoid placing the financial or other interest of the broker-dealer or an associated natural person making the recommendation ahead of the interest of the retail customer
- “Best Interest” is assessed **at the time** a recommendation is made

SEC REGULATION BEST INTEREST (CONT'D)

- The proposed rule provides that a broker-dealer will be deemed to have acted in the best interest of its customer if:
 - It **discloses in writing** prior to a recommendation the material terms of the relationship between the broker and the customer, as well as fees and charges and material conflicts related to the recommendation
 - It **exercises reasonable diligence, care, skill and prudence** to evaluate the recommendation and conclude that it is in the best interest of the customer
 - It establishes, maintains and enforces **policies and procedures reasonably designed to** (i) identify and disclose or eliminate material conflicts of interest associated with the recommendation and (ii) identify, disclose and mitigate (or eliminate) material conflicts of interest related to the financial incentives of the broker-dealer and its associated persons



CLIENT RELATIONSHIP SUMMARY ("FORM CRS")

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- *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, Securities Exchange Act Release No. 83063, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>*
- The Client Relationship Summary ("Form CRS") is a proposed form that broker-dealers and investment advisers would provide to their "retail" customers and clients
- Form CRS is intended to provide retail investors with a short disclosure document with information about, among other things, the services the firm offers, the standard of conduct applicable, the fees and costs associated with the services, and conflicts of interest

FORM CRS - INDUSTRY COMMENTS & CONCERNS

- As to proposed Form CRS, commenters have identified the following concerns, among others:
 - Institutional investors should not require delivery of Form CRS or similar disclosures
 - Questions about additional cost and complexity; additional need to engage in investor testing of Form CRS to evaluate usefulness and alternative approaches
 - Disclosure should focus on key aspects of relationship rather than comparisons between broker-dealers and investment advisers
 - Allow firms greater flexibility to tailor content to customer needs and relationship expectations
 - Disclosures must work in tandem with other required disclosures like Form ADV



INVESTMENT ADVISER INTERPRETIVE GUIDANCE

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- *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Rel. No. 4889, available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>
- Proposed investment adviser interpretive guidance was designed to reaffirm and “in some cases” clarify the fiduciary duty that an investment adviser owes to its clients under section 206 of the Investment Advisers Act of 1940 (the “Advisers Act”)

INVESTMENT ADVISER INTERPRETIVE GUIDANCE (CONT'D)

- Also includes three areas of potential “enhancement” where the SEC asserts the broker-dealer framework now provides investors with protections that may not have counterparts in the adviser context:
 1. Federal **licensing and continuing education** requirements for advisory personnel
 2. Mandated delivery of **account statements** to advisory clients and
 3. **Financial statement requirements** for SEC-registered investment advisers, including **fidelity bonds**

INVESTMENT ADVISER INTERPRETIVE GUIDANCE (CONT'D)

- As to the SEC's investment adviser interpretive release, from an industry perspective there are some notable items:
 - Proposed rule does not meaningfully differentiate between retail and institutional clients unlike under securities law (e.g., “qualified clients” and “qualified purchasers”)
 - Assertion that certain conflicts are so extensive and/or complex that disclosure could not cure them without distinctions in type of client, scope and nature of relationship, nature of conflict, and complexity of investments and conflicts
- These items among others have received significant comment from industry participants

INVESTMENT ADVISER INTERPRETIVE GUIDANCE – INDUSTRY COMMENTS AND STATUS

- “Fiduciary duty” is a higher standard than suitability
- There is already established precedent defining “fiduciary duty” and the proposals go beyond this
- The Advisers Act release is too retail focused
- Disclosure may be sufficient to address conflicts in certain circumstances
- Fiduciary duty is always construed in relation to the agreement with the client

INVESTMENT ADVISER INTERPRETIVE GUIDANCE – INDUSTRY COMMENTS AND STATUS (CONT'D)

- Allocation of investment opportunities - fair and equitable over time
- The release will raise investment costs and limit client choices
- Exclude private fund offerings from Regulation Best Interest



GIPS 2020 Performance Advertising



GIPS 2020 OVERVIEW

- **Pooled Fund Reports:** No longer required to create a single-fund composite if a pooled fund doesn't meet any existing composite definition
 - Managers of limited distribution pools (*i.e.*, private funds) must now create and distribute GIPS Pooled Fund Reports, which require specific pooled fund level performance measurements
 - Managers of broad distribution pools (*i.e.*, registered funds) can promote a GIPS compliance claim either through a GIPS Pooled Fund Report or in a GIPS advertisement

GIPS 2020 OVERVIEW (CONT'D)

- **Portability:** Requirement that performance of an acquired firm or investment team be linked with that of the new firm now optional
 - Requirement that any non-compliant assets of an acquired firm or team be brought into compliance within one year of the acquisition relaxed to apply only on a prospective basis
- **Carve-Outs:** In a reversal of previous guidance, firms will now be permitted to allocate cash to carve-outs
- **Return Calculation Methodology:** Allows firms that control external cash flows into a pooled fund or the portfolios within a composite to present money-weighted returns (a/k/a internal rate of return) if the pooled fund or portfolios within the composite meet certain criteria
 - Currently, must present time-weighted returns

GIPS 2020 OVERVIEW (CONT'D)

- **Codification of Guidance Statements:** New structure incorporates all items (e.g., Guidance Statements and Q&As) that must be considered when creating a performance report without need for cross-referencing
- **Asset Owners:** Asset owner requirements for GIPS compliance that are distinct from those requirements applicable to firms

GIPS 2020 TIMELINE

- A general timeline and target effective dates for GIPS 2020 are as follows:
 - **August 31, 2018:** GIPS 2020 Exposure Draft released for public comment
 - **October 31, 2018:** GIPS Verification 2020 Exposure Draft released for public comment
 - **December 31, 2018:** Close of comment period for GIPS 2020 and Verification Exposure Drafts
 - **June 30, 2019:** Final GIPS 2020 edition released
 - **January 1, 2020:** GIPS 2020 effective date



CFTC Proposal to Expand and Clarify CPO and CTA Exemptions and Certain Other Requirements

CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – NEW CPO EXEMPTION

- New Proposed Exemption – Regulation 4.13(a)(4)
 - Codifies Advisory 18-96
 - Conditions:
 - Non-US pool
 - No meetings or administration in the United States
 - No shareholder/participant in the pool is or will be within the United States
 - The pool will not receive, hold or invest any capital directly or indirectly contributed from sources within the United States
 - No marketing in the United States
 - Notice within 30 days of registering or claiming exemption

CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – NEW CPO EXEMPTION (CONT'D)

- Can combine CPO exemptions in Regulations 4.13(a)(3) and (4)
- Registered CPO can rely on exemption in Regulation 4.13(a)(4) for some pools
- Raises issue as to whether Regulation 4.13(a)(3) and 3.10(c)(3) exemptions can be combined

CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS

- All CPO exemptions in Regulation 4.13(a) would require no statutory disqualifications under Commodity Exchange Act Sections 8a(2) and 8a(3)
- Non-U.S. persons added to list of Regulation 4.13(a)(3) pool investors
- Requires communication of conditions of relief to pool participants

CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS (CONT'D)

- Jobs Act relief codified
- Codification of family office relief in Regulations 4.13(a)(7) and 4.14(a)(11)
- BDCs added to Regulation 4.5 with *de minimis* and marketing restrictions
- Codification of investment adviser as CPO for registered funds and BDCs but not for private funds

CFTC PROPOSAL TO EXPAND AND CLARIFY CPO AND CTA EXEMPTIONS AND CERTAIN OTHER REQUIREMENTS – OTHER ITEMS (CONT'D)

- Recordkeeping relief for CPOs to allow records to be held other than at CPO's main business office – still requires filing from third-party recordkeeper
- No Form CPO-PQR and CTA-PR reporting for CPOs with only exempt pools and CTAs with only exempt accounts and non-directed accounts



Socially Responsible Investing - ERISA Assets; European Commission Proposals

SOCIALLY RESPONSIBLE INVESTING

- U.S. based institutional investors considered environmental, social and governance (“ESG”) factors on about \$4.7T in investments in 2016, up by 14% since 2014
- The use of ESG factors has also grown considerably outside of the U.S. as the amount of global assets invested using ESG factors increased from \$18.3T in 2014 to \$22.9T by 2016
- Institutional investors subject to ERISA (e.g., corporate defined benefit plans) are increasingly focused on ESG factors

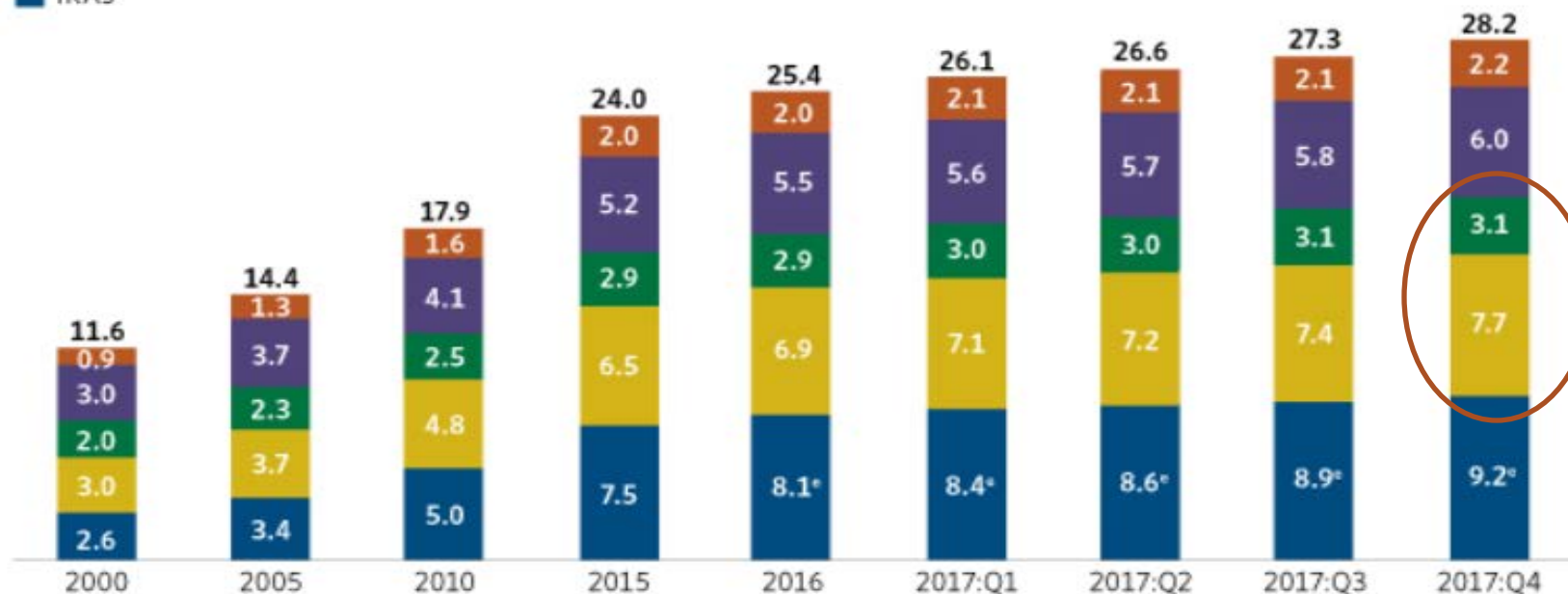
Source: GAO Report 18-398 “Retirement Plans’ Use of ESG Factors”

ERISA INVESTORS

US Total Retirement Market Assets

Trillions of dollars, end-of-period, selected periods

- Annuity reserves
- Government DB plans
- Private-sector DB plans
- DC plans
- IRAs



^e Data are estimated.

Source: Investment Company Institute, "Retirement Assets Total \$28.2 Trillion in Fourth Quarter 2017."

www.ici.org/research/stats/retirement/ret_17_q4

ERISA CONSIDERATIONS

- The Department of Labor has a longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater risks as a means of promoting collateral social policy goals
- Series of guidance, most recently in April (Field Assistance Bulletin 2018-01)
 - Clarification?
 - ESG factors may be a “tie-breaker”
 - ERISA fiduciaries must not too readily treat ESG factors as economically relevant; rather, an evaluation of an investment opportunity should be focused on financial factors that have a material effect on return and risk
- Investment policy statement considerations
 - May address ESG matters
 - Manager has a fiduciary duty to disregard, if the policy is inconsistent with ERISA
- Documentation is ultimately the key

EUROPEAN COMMISSION PROPOSALS

- **January** – European Commission High-Level Expert Group published a report that identified as an imperative, incorporating ESG factors into investment decision-making
- **March** – Commission’s Action Plan on Financing Sustainable Growth laid out a roadmap to deliver on this commitment
- **May** – Commission issued a package of proposals, including:
 - Provide clarity on what is a sustainable investment (i.e., an EU-wide classification system)
 - Ensure asset managers, as part of their duty to act in the best interest of investors, include ESG factors in their investment decisions and advisory processes
 - Asset managers that claim to pursue sustainability objectives have to disclose how their investments are aligned with those objectives



A Private Fund ESG Example

UK SOCIAL IMPACT REAL ESTATE FUND

- \$450m Fund and Manager domiciled in the UK; open to UK and non-UK investors via Cayman Islands feeder
- Fund investment policy is to balance financial return and social impact of each investment
 - Mgmt. Fee: 1.5%; Perf. Fee: 15%
- Credit Committee approves all investments
 - Composed of five senior members of Investment Manager
 - Must have one “Impact Member” who assesses the impact of each investment for the Credit Committee and is nominated by a designated independent philanthropic organization
- Investment Manager conducts annual social impact audit and reports to investors

UK SOCIAL IMPACT REAL ESTATE FUND (CONT'D)

- Investment Strategy
 - Strictly limited to acquiring properties and leasing the properties to regulated social sector organizations and other socially responsible organizations with a clear social mission in England and Wales, Scotland and Northern Ireland
 - Eligible Recipients include:
 - Charitable incorporated organizations registered with the Charities Commission of England and Wales and/or the Office of the Scottish Charity Regulator
 - Community Benefit Societies incorporated and registered under the Co-operative and Community Benefit Societies Act 2014
 - Community interest companies

UK SOCIAL IMPACT REAL ESTATE FUND (CONT'D)

- Investment Restrictions: No investment:
 - Outside of UK
 - Solely for commercial return
 - In properties that do not create positive social outcome for a specific target beneficiary group
 - In property that will not generate any income over the life of the investment
- Amendment of Strategy and Restrictions requires approval of GP and 75% of contributed capital

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