CHICAGO INVESTMENT MANAGEMENT CONFERENCE

Private Funds/International Developments

Todd W. Betke, Partner, Washington D.C.
Edward Dartley, Partner, New York
C. Todd Gibson, Partner, Boston and Pittsburgh
Cary J. Meer, Partner, New York and Washington D.C.
Joshua J. Yang, Partner, Chicago

300377042_3
© Copyright 2016 by K&L Gates LLP. All rights reserved.

AGENDA

- Managing Conflicts
- Trends in Fees and Expenses
- Infrastructure and Personnel Demands
- Ability of U.S. Managers to Operate PRC Local Funds
- Recent Developments Affecting Private Equity Investments in India
- Investment Management in Europe, including AIFMD and Brexit

MANAGING CONFLICTS

2017 EXAMINATION PRIORITIES: PRIVATE FUND ADVISERS

- Conflicts and disclosure:
  - Fees and expenses
  - Valuation
  - Trade allocation
  - Use of affiliates
- Never before examined advisers

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

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

K&L GATES

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
- The FCA is expected to be reintroduced within the next month

K&L GATES

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

TRENDS IN FEES AND EXPENSES

SEC'S FOCUS ON FEES AND EXPENSES

- The SEC has found fund 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

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

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

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 or COO and CCO
- What are the regulatory considerations in combining these roles?

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

K&L GATES

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 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

ABILITY OF U.S. MANAGERS TO OPERATE PRC LOCAL FUNDS

U.S. MANAGERS ACCESS CHINA INVESTMENT MANAGEMENT BUSINESS

- QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor)
- QDII (Qualified Domestic Institutional Investor) and QDLP (Qualified Domestic Limited Partner)
- Investment Manager in the form of Sino-Foreign Equity Joint-Venture
- Investment Manager in the form of Wholly Foreign-Owned Enterprise

PRIVATE FUND MANAGER QUALIFICATION REQUIREMENTS

- Applicant must be incorporated in the PRC
- Foreign shareholder and foreign de facto controller are financial institutions approved or licensed by the financial regulators in home country
- The securities regulatory authority in the home country has entered into a memorandum of understanding with the China Securities Regulatory Commission
- Foreign shareholder and foreign de facto controller have not been subject to material punishment by the supervisory or judicial authority in home country during the last three years

RECENT DEVELOPMENTS AFFECTING PRIVATE EQUITY IN INDIA

REVISIONS TO FDI POLICY DESIGNED TO PROMOTE FOREIGN INVESTMENT

- The government of India permits foreign investment in Indian companies through two foreign direct investment ("FDI") routes:
  - Government Approval Route
  - Automatic Approval Route
- In mid-2016, the government of India amended its FDI policy to permit additional FDI investments through the Automatic Approval Route in certain specified business sectors, including:
  - Food Products
  - Defense
  - Broadcast Carriage Services
  - Pharmaceuticals
  - Civil Aviation
  - Private Security Agencies
  - Animal Husbandry
  - Single Brand Retail Trading
- Additional reforms now permit FDI in limited liability partnerships (LLPs) under the Automatic Route, and "downstream investments" by LLPs in sectors where 100% FDI is permitted. Effectively, this now permits investment funds to be organized as Indian LLPs, consistent with international industry practice

ONGOING GOVERNMENT INITIATIVES DESIGNED TO SPUR INVESTMENT

- "Make in India" Campaign
  - Designed to transform India into a global design and manufacturing hub by streamlining regulations and focusing on job training and skill enhancement across 25 key economic sectors
  - Aimed at raising contribution of manufacturing sector to 25% of GDP by 2020
  - Key sector focus on Railways, Defense, Insurance and Medical Devices
  - Additional focus on the renewable energy sector targeting 100 GW of solar power capacity by 2022
- "Start-up India" Mission
  - Includes a number of financial initiatives designed to support start-up businesses, including:
    - 100% deduction of profits for income tax computation for three consecutive years during the initial five-year period following incorporation
    - Exemptions from certain regulations
    - Advantageous treatment under the Bankruptcy Code
  - Startup means an entity, incorporated or registered in India :
    - Not prior to five years,
    - With annual turnover not exceeding INR 25 crore in any preceding financial year, and
    - Working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property

REVISIONS TO INDIA-MAURITIUS DOUBLE TAXATION AVOIDANCE AGREEMENT

- India now has the right to tax capital gains arising upon the sale of an Indian company
- Investments made prior to March 31, 2017 are grandfathered and not subject to tax
- Investments made between April 1, 2017 and March 31, 2019 will be taxed at 50% of the applicable rate
- The foregoing changes also effectively removed the capital gains tax exemption available under the India-Singapore Tax Treaty, which provided for such exemption only for so long as the same exemption was available under the India-Mauritius DTAA
- India has also signed a protocol with Cyprus amending their existing tax treaty, which generally removes the existing capital gains tax exemption for investments made on or after April 1, 2017

INVESTMENT MANAGEMENT IN EUROPE, INCLUDING AIFMD AND BREXIT

BREXIT

HOW DOES THE UK EXIT?

- Article 50 of the Lisbon Treaty
- New Brexit task force created
- Oliver Robbins appointed as the Permanent Secretary to the new team
- EU split roles for exit (EC) and continued access (EU Council)
  - Didier Seeuws, former chief of staff to former European council president Herman Van Rompuy
  - Michel Barnier (and Martin Selmayr, current EC president Juncker's chief of staff)
- European Parliament also has a role
  - Guy Verhofstadt, former Belgian prime minister

ARTICLE 50 PROCESS

- Art 50 of the Treaty on European Union
- Notification in the hands of the UK
  - Recent supreme court decision indicates Act of Parliament required
- Up to two-year period for **withdrawal** to be negotiated and take effect
- Negotiations between the UK and the European Commission, as EU negotiator, based on guidelines issued by the European Council and in accordance with article 218(3) of the Treaty on the Functioning of the European Union (TFEU)
- Can be extended by agreement of **all** EU member states
- If no extension, UK automatically ceases to be a member of the EU at the end of two years

How Could the U K's Relationship With the EU Change?

The UK already opts out from parts of the EU. If it leaves, its future could look like Norway, Switzerland, or Turkey, nonmembers with partial participation in the EU.

● FULL PARTICIPATION

○ PARTIAL PARTICIPATION
Indicates a negotiated special arrangement.

	SINGLE MARKET	FREE MOVEMENT OF PEOPLE	CONTRIBUTE TO EU BUDGET	VOTE ON EU LAW	EUROZONE	"EVER CLOSER UNION"
STANDARD EU*	●	●	●	●	●	●
CURRENT UK MEMBERSHIP	●	●	○	●		
POTENTIAL POST-BREXIT SCENARIOS						
EUROPEAN ECONOMIC AREA (NORWAY)	○	●	○			
BILATERAL DEAL (SWITZERLAND)	○	●				
CUSTOMS UNION (TURKEY)	○					

*Except for the UK Sources: UK Government, *The Economist* Credits: James McBride, David Foster

COUNCIL on FOREIGN RELATIONS

IMPACT OF BREXIT ON FUNDS AND MANAGERS

- UCITS and AIFMs
- Cross-border advisory/management services (MiFid services)
- Solvency II, CRD, myriad of other EU laws and directives incorporated into UK laws (competition, immigration, etc.)
- Potential outcomes
  - EEA (Norway) – Single-market access for goods and services
  - EFTA (Switzerland) – Single-market access – goods only
  - Something else?

BREXIT PRACTICAL CONSIDERATIONS

- NO CHANGE FOR THE TIME BEING, but now is time for detailed contingency planning
- Consider exposure to EU markets
- What is your current licensing strategy and does it rely on passporting?
- Where are your operations and staff based?
- <u>It's not just about passporting</u>! *UK laws are based on EU laws*

K&L GATES

HOW SHOULD THE INDUSTRY RESPOND?

- Raise awareness with EU/Eurozone of the importance of the UK as a partner outside of the EU
- Build coalitions of stakeholders throughout the EU to communicate the importance of a balanced deal with the UK and to reinforce the above
- Promote a set of policies to improve the UK's competitive position (for example, tax, skilled migration, targeted removal of regulations etc.)
- Propose solutions and options that remove uncertainty – what is realistically achievable?
- UK debate should recognize the very real concerns of Eurozone leaders of the risk of contagion from the Brexit result
- The negotiations will be a multi-party process with no one party able to leverage its position
- Work with industry trade groups
- Get involved with the UK's Brexit task force

EXAMPLES

- US or EU manager has Irish ManCo with Ireland-domiciled UCITS passported into UK
- US or EU manager with UK-based UCITS for local market and passported throughout EU
- US or EU manager with UK-based UCITS for local UK market
  - *UK Non-UCITS Retail Scheme (NURS)?*

K&L GATES

NURS 101

- **UK (FCA) authorized fund**
  - *must be organized in the UK as either an open-ended investment company or unit trust*
- **May be marketed to retail investors in UK**
  - *Non-UCITS, so no UCITS passport*
- **Subject to the AIFMD; not UCITS**
  - *Although they have more in common with UCITS, NURS are subject to the AIFMD.*
  - *NURS could benefit from the AIFMD passport to market to professional clients in the EEA outside the UK, subject to NPPRs*
- **Investment powers / restrictions similar to UCITS but with additional flexibility, e.g.:**
  - *Up to 100% NAV in real estate*
  - *Up to 10% NAV in transferable securities of single issuer (cf 5/10/40 rule for UCITS)*
  - *Up to 20% NAV in unlisted securities (cf 10% limit for UCITS)*
  - *Up to 35% NAV in CIS (cF 20% for UCITS)*
  - *For "feeder NURS", up to 100% in a UCITS or other NURS*
  - *For NURS authorized as "fund of alternative investment funds" ("FAIFs", up to 100% NAV in unregulated funds meeting certain criteria)*
- **KIID / PRIIPs**
  - *A NURS will need to produce a short disclosure document accompanying the prospectus*
  - *FCA permits NURS to produce a "NURS KIID", which is effectively the same as the KIID for UCITS*
  - *Both UCITS and NURS are within the scope of the PRIIPs Regulation, but it remains unclear whether NURS will benefit from the same exemption as UCITS which last until 31 December 2019*

UCITS

K&L GATES

UCITS V - REMUNERATION

- Remuneration
  - Alignment of UCITS manager remuneration with AIFMD
  - Applies to all compensation paid to all staff whose activities have a material impact on the risk profile of the UCITS
    - Assessment of potential "material influence" of the staff member on the UCITS's risk profile
    - Executives, directors, senior management, portfolio managers, traders, CIOs
    - What about compliance officers, internal counsel, sales persons, chief risk officer?
  - Application to "delegates" – if not subject to an equivalent regulatory regime (AIFMD/CRD), "appropriate contractual arrangements" should be put in place with the delegate
  - Proportionality applies and may allow for disapplication of some of the restrictions
    - Compliance only required in a way and to an extent that is appropriate to the manager's size, internal organization, and the nature, scope and complexity of activities
  - ESMA to issue additional details in Level 2 guidelines regarding applicability to staff, proportionality

K&L GATES

UCITS V - REMUNERATION

- Remuneration (continued)
  - Variable Remuneration - Shares
    - 50% paid in UCITS shares (or certain other), with vesting periods
    - Does not apply if management of UCITS is less than 50% of the total assets managed by the management company
  - Variable Remuneration – Bonuses
    - 40% deferral over minimum of 3 years (or recommended holding period of UCITS concerned)
    - Deferral higher where variable compensation is a large component of total compensation

UCITS V - PROPORTIONALITY

- General principle requiring managers to comply with remuneration rules "*in a way and to the extent that is appropriate to their size, internal organization and the nature, scope, and complexity of their activities*"
- ESMA consultation proposed to interpret proportionality to allow dis-application of certain requirements in some circumstances (consistent with AIFMD)
  - Inconsistent with EBA application of similar rules under CRD

UCITS V – ESMA FINAL GUIDELINES REPORT

- Issued 31 March
- Most significant change to initial draft was lack of guidance regarding application of proportionality principles
- ESMA sent a letter to EC and EP –
  - Proportionality should apply, but….
  - Legislative changes may be necessary

BECOMING A CHAMPION
PUNTER

AIFMD

AIFMD THIRD COUNTRY UPDATE

- July 2016 – ESMA issues advice in relation to the application of the AIFMD passport to non-EU AIFMs and AIFs
- Twelve countries reviewed
- Follows assessment of six countries in July 2015

AIFMD THIRD COUNTRY REVIEW

Jurisdiction	ESMA Review
Canada, Guernsey, Japan, Jersey, Switzerland	No significant obstacles impeding the application of the AIFMD passport to managers or AIFs
Hong Kong, Singapore	(AIFs only) No significant obstacles impeding the application of the AIFMD passport to AIFs
United States	No significant obstacles regarding investor protection and the monitoring of systemic risk criteria which would impede the application of the AIFMD passport, but with respect to the competition and market disruption criteria, ESMA considers there is no significant obstacle for funds marketed by managers to professional investors which do not involve any public offering
Australia	No significant obstacles regarding market disruption and obstacles to competition impeding the application of the AIFMD passport, provided that ASIC extends to all EU Member States the “class order relief” currently available only to some EU Member States, from some local regulatory requirements
Bermuda, Cayman Islands	No definitive advice with respect to the criteria on investor protection and effectiveness of enforcement (both countries are in the process of implementing new regulatory regimes and the assessment will need to take into account the final rules)
Isle of Man	Absence of an AIFMD-like regime makes it difficult to assess whether the investor protection criterion is met

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

AIFMD UPDATE *(CONTINUED)*

- U.S. Managers' current options when targeting potential EU investors in private funds:
  - 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 likely be eligible
  - Hold up is likely due to Brexit

K&L GATES