



Morgan Lewis

ADVANCED TOPICS IN  
**HEDGE FUND PRACTICES**  
**CONFERENCE**

Manager and Investor Perspectives  
**WEBINAR SERIES**

**SESSION 1** | Tuesday, May 5

**Current Issues with Hedge Fund Operations**  
**A Changing Horizon: TALF and the CLO Market**

[www.morganlewis.com/2020hedgefundconference](http://www.morganlewis.com/2020hedgefundconference)

# CURRENT ISSUES WITH HEDGE FUND OPERATIONS

## SPEAKERS



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# Agenda

01

**Valuations**

02

**Liquidity**

03

**Economics**

04

**Impact of COVID-19  
on Operations**

05

**Communications**

# Valuations

**1**

**Are existing valuation policies and procedures adequate to determine NAV?**

**2**

**The ability to value assets impacts fundamental aspects of fund operations**

- Assets becoming illiquid
- Redemptions
- Management and incentive fees

**3**

**Exercise of fiduciary duties in handling valuation and related issues**

# Liquidity

## SIDE POCKETS

- What are the fund's side pocket capabilities?
  - Formal side pockets
    - Memorandum account or separate class with mechanics for conversion
    - Cap as to percentage of NAV
    - Broad authority (ability to make investments that are side pocketed upon acquisition) or limited authority (only existing investments may be side pocketed)
  - Circumstantial side pockets – springing or synthetic
- Specific terms (e.g., manner in which investments are side pocketed, valued, charged fees, returned to liquid portfolio)
- Are you thinking of investing opportunistically in assets that have limited or no liquidity?

# Liquidity

## REDEMPTIONS

- Does underlying portfolio liquidity align with redemption terms?
- Do limitations/restrictions have hard-wired triggers or are they imposed in the manager's discretion?
  - Gates
  - Payment timing
  - Holdbacks and other reserves
  - In-kind distributions
  - Suspensions
- Does the decision to wind down supersede unfulfilled redemption requests?

# Economics

1

## Side Pockets – Management Fees

- Are side pockets included or excluded in the calculation of management fees?
- If no existing side pockets provision, can side pockets be excluded from the calculation of management fees if manager so desires or if investors so demand?

2

## Side Pockets – Performance Fees

- Are side pockets included or excluded in the calculation of performance fees?
- If no existing side pockets provision, can side pockets be excluded from the calculation of performance fees if manager so desires or if investors so demand?
- If side pockets are excluded from performance fees, what is the mechanism for calculating performance fee once the side pockets become liquid or are realized?

# Economics

3

## Suspensions and Wind-downs

- Do the fund documents provide for a management fee step down or waiver?
- If not, will investors demand a step down or waiver?

4

## Funds with Performance Issues

- Existing investors may demand fee discounts in lieu of redeeming
- New investors may demand fee discounts
- Managers considering new share classes with longer lock-ups or redemptions with less frequency in exchange for lower fees

# Impact of COVID-19 on Operations

## INTERNAL OPERATIONS

- Remote working
- Business continuity and disaster recovery
- Key person developments
- Operational disruptions and challenges
- Remote operational due diligence
- Information security and confidentiality risks
- Reopening the workplace
  - Review federal, state and local orders to determine and prepare for a conservative, moderate or aggressive approach
  - Develop a key action plan for return
  - Work with labor and employment counsel to ensure accurate analysis of applicable laws and orders and to develop and implement an effective plan

# Impact of COVID-19 on Operations

## SERVICE PROVIDERS

- Ensure that key service providers are functioning properly in order to continue to deliver uninterrupted services
- Key service providers include the following:
  - Prime Brokers, Clearing Firms, and Custodians
  - Administrators
  - Auditors
  - Banks
  - Independent Directors
  - Tax Accountants
  - Attorneys
- Ensure that full contact data and authorization for accepting calls, emails, and other correspondence from remote locations is up-to-date and shared

# Impact of COVID-19 on Operations

## MATERIAL AGREEMENTS

- Material agreements with trading counterparties, key service providers, seed and other strategic investors, and investors generally should be carefully reviewed
  - Trading Counterparty and Service Provider Agreements
    - Ensure that notice provisions are current and permit notice to be delivered other than by physical delivery
    - Prepare a list of items that could trigger a default or accelerated termination and periodically review the list
    - Determine whether any NAV or other triggers have occurred and assess the consequences
    - Consider how performance would continue if a particular office of the manager or a counterparty were to close
  - Investor Agreements
    - Confirm whether circumstances have occurred that trigger investor rights
    - Assess whether developments impact fulfillment of any covenants
- Refresh your understanding of force majeure and illegality clauses to assess whether these clauses have been triggered, and to anticipate if they may apply, during the COVID-19 crisis

# Communications

## INVESTOR LETTERS OR OTHER COMMUNICATIONS – MATERIAL UPDATES

- **Operational disruptions and challenges**
  - Remote working by investment and other personnel
  - Key person developments
  - Trading counterparty and service provider issues
  - Technology and cybersecurity issues
  - Return to work plans
- **Material effects on investment program**
  - Performance developments
  - Impact on liquidity of holdings and resulting implications on fund terms
  - Capital outflows and limits on redemptions, such as gates and suspensions
  - Wind-downs
  - Desire to be opportunistic beyond scope of fund investment program

# Communications

## FUND DOCUMENTS

- **Key Provisions Affected**

- Description of Investment Objective and Strategy
  - Does increase in illiquid positions or desire to be opportunistic constitute style drift?
- Are any investment limits being exceeded?

- **Risk Factors**

- Illiquidity of fund assets
- Market impact of COVID-19

- **Potential for Changes to Fund Documents**

- Do fund documents anticipate changed circumstances?
- If not:
  - Is a PPM supplement sufficient?
  - Does the fund operating agreement need to be amended?
  - Do amendments require investor consent?

# Communications

## REPORTING

- **Valuation issues may cause delays in the issuance of reports, including beyond the time frame set forth in fund documents or side letters**
  - Monthly, quarterly or other periodic reports
  - Annual audited financial reports beyond the time frame set forth in fund documents or side letters
  - Investor-specific reports required under side letters
- **Notice requirements under fund documents or side letters may be triggered on account of fair valued assets, valuation issues, illiquid positions, side pockets, key person events, declines in performance and other material developments**

# A CHANGING HORIZON: TALF AND THE CLO MARKET

## SPEAKERS



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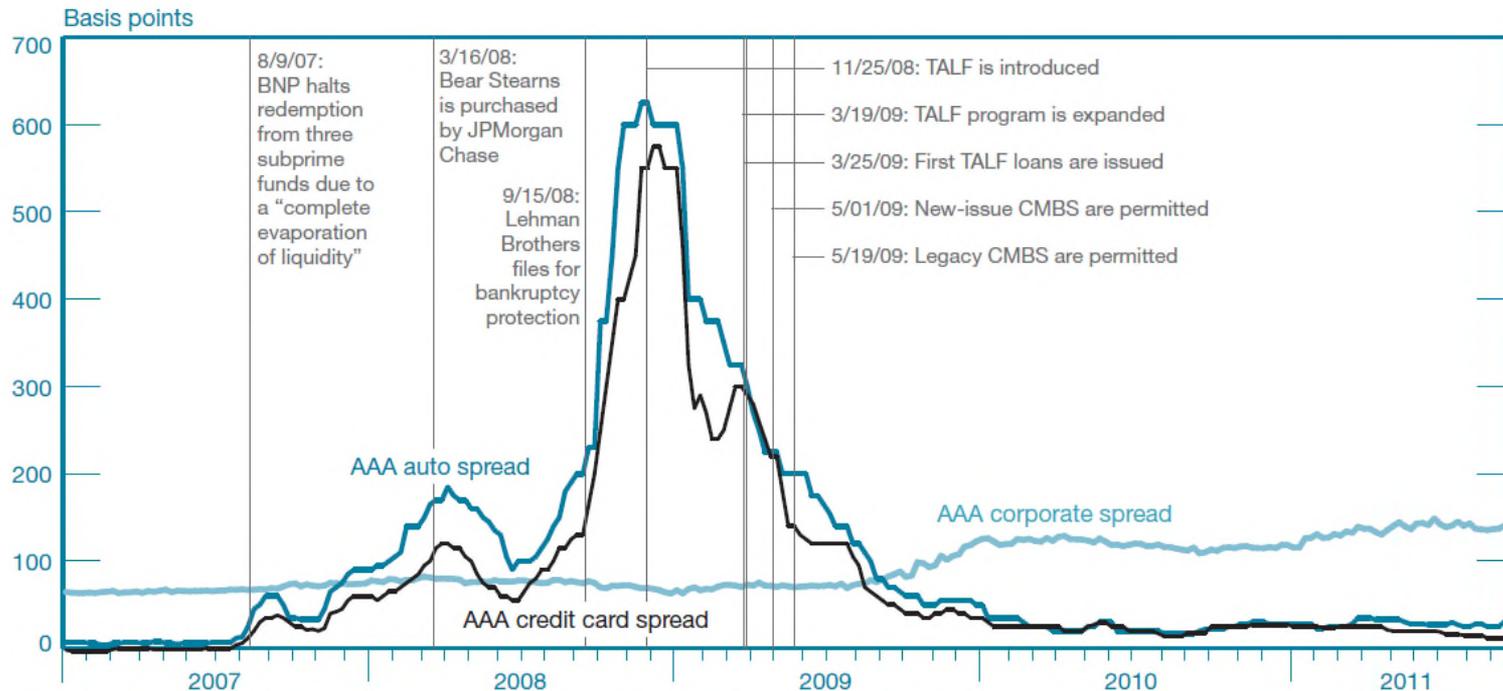
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# Market Impact of TALF 1.0

- Original Term Asset-Backed Lending Facility (TALF) program was announced on November 25, 2008 and began lending in March 2009
- TALF lending was authorized through June 30, 2010 for loans collateralized by newly issued CMBS and through March 31, 2010 for all other collateral
- Purpose was to avert decline of term funding liquidity for nonbank issuers by injecting balance sheet capacity
- Markets started improving immediately on program announcement

# Market Impact of TALF 1.0

## Consumer ABS Spreads, 2007-2011

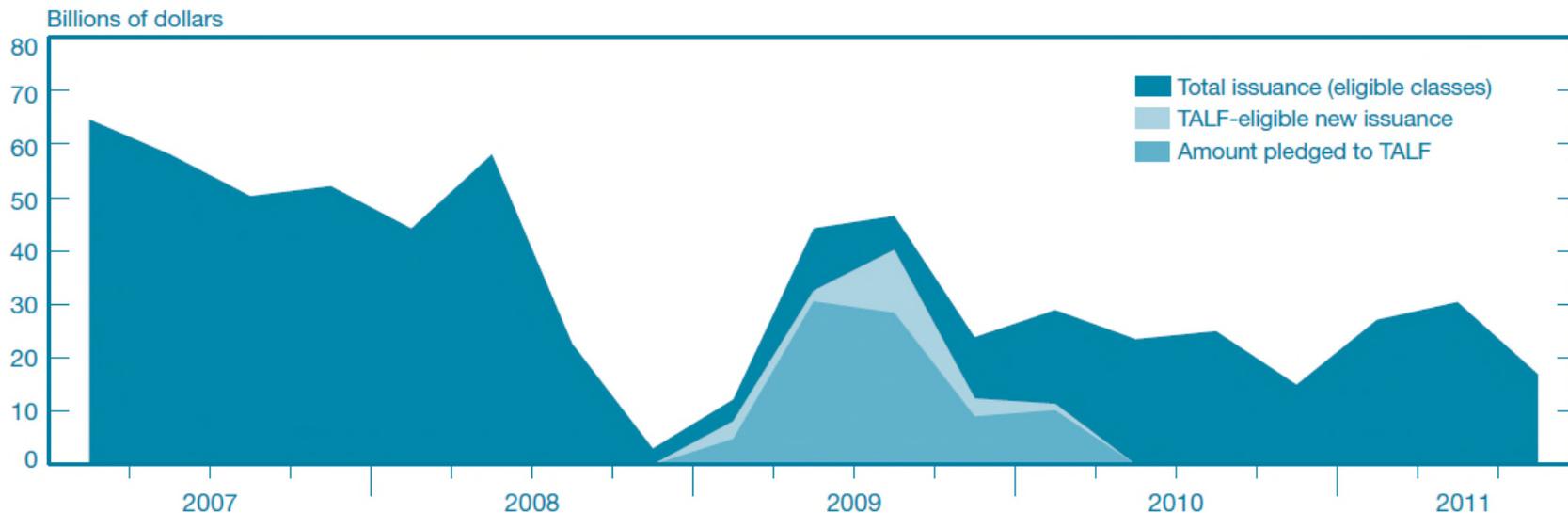


# Market Impact of TALF 1.0

- Numbers for CMBS showed a similar pattern
- Cannot say for certain that TALF was wholly responsible for the improvement in spreads but suddenness of tightening suggests a disproportionate impact
- Lending volume was lower than expected
  - Total of \$71.1B in loans was requested
  - Highest volume of outstanding loans peaked at \$48.2B
  - Program was authorized for \$200B

# Market Impact of TALF 1.0

Total ABS Issuance in TALF-Eligible Classes and Breakdown of TALF Issuance, 2007-2011



FRBNY ECONOMIC POLICY REVIEW / NOVEMBER 2012

# Market Impact of TALF 1.0

- As program went on, there were increases in volume of:
  - TALF-eligible securities marketed without TALF financing
  - ABS structured with TALF-ineligible features
  - Subordinate bond issuance
- Major asset classes ceased needing to rely directly on TALF early in the program

# TALF 2.0 – General Criteria

- Authorized by section 13(3) of the Federal Reserve Act, TALF is intended to facilitate the issuance of, and improve the market conditions for, asset-backed securities.
- Key Parties:
  - TALF Lender – a special purpose vehicle capitalized by a \$10 billion investment by the Department of Treasury and a line of credit of \$100 billion from the New York Fed
  - TALF Agent – primary dealers that will act as agent for eligible borrowers to obtain TALF loans
  - Eligible Borrowers – US companies that own eligible collateral and have a relationship with a primary dealer
- Key Terms
  - Maturity of three years, prepayable in whole or in part at any time
  - Non-recourse to the borrower
  - No new loans extended following September 30, 2020 unless extended by the Fed
  - Administrative fee of 10 basis points of the loan amount

# TALF 2.0 – General Criteria

- Eligible ABS Markets
  - Auto loans and leases
  - Student loans
  - Credit cards
  - Equipment loans
  - Floorplan loans
  - Insurance premium finance loans
  - CLOs
  - Commercial mortgages

# TALF 2.0 – General Criteria

- General Criteria for Eligible Collateral:
  - US dollar denominated cash ABS, rated in the highest long-term or, for non-mortgage backed ABS, the highest short-term rating category from at least two NRSROs
  - All or substantially all of the assets of the ABS must be originated by a US company
  - ABS (other than CMBS) must be issued after March 23, 2020; CMBS must be issued *prior to* March 23, 2020
  - Other than for CMBS, all or substantially all must be “newly issued”
  - Asset class specific haircuts

# TALF 2.0 – CLOs

- CLO-Specific Eligibility Criteria
  - Only static deals are eligible
  - Loan interest rate based on a spread over the 30-day average “secured overnight financing rate” (SOFR)
  - Haircuts range from 20% to 22% depending on the average life of the ABS
    - These are the steepest haircuts of any asset class

# Can TALF Work for CLOs?

- The CLO portfolio has to be static, not actively managed. It is not clear whether this will allow:
  - Sales of credit risk/defaulted assets.
  - Flexibility to sell equity or other securities received in a workout or restructuring.
  - Some ability to vote on amendments of assets.
- Static CLOs can rely on 3a-7 rather than 3(c)(7) for '40 Act purposes.
  - No need for Volcker compliance.
  - No QP requirement for holders.
  - **BUT**: Below investment grade CLO notes cannot be traded in Reg S global form.

# Can TALF Work for CLOs?

- The CLO issuer has to be a US entity (cannot be Cayman).
  - If relying on 3(c)(7), no Reg S global notes (see above for 3a-7 deals).
  - A foreign person otherwise interested below investment grade CLO notes may not want to be treated as a partner in a US partnership.
  - The LSTA has commented to explicitly allow for the typical Cayman issuer coupled with an onshore co-issuer.
- TALF loans secured by CLO notes are based on SOFR.
  - To avoid mismatch costs, AAA tranches might need to be based on SOFR.
  - A short noncall period may be the solution.
  - **BUT**: TALF 1.0 prohibited most redemption features found in the typical CLO. The LSTA has commented to allow optional redemptions directed by the CLO equity.

# Can TALF Work for CLOs?

- Not clear what “newly issued” means.
  - Based on TALF 1.0, we would expect this look back to a date a few months prior to the establishment of TALF 2.0. The cut-off date might vary by asset class.
  - The LSTA has commented to clarify this requirement, including, among others, to allow all leveraged loans issued in 2020.
- Other issues:
  - TALF 1.0 required monthly payments on TALF loans – CLO notes pay quarterly. Not clear what TALF 2.0 will require.
  - Given the typical time needed to ramp up a CLO, the TALF 2.0 program termination date of September 30, 2020 may be too tight.
  - Although CLOs have had strong historical performance (no AAA tranche has ever defaulted), leveraged loans are receiving the largest haircut.
  - Originator/issuer of an asset has to be a US company – more restrictive than obligors on assets needing to be “domiciled” in the US as the typical CLO bucket would require.

# CLO Opportunities in the Current Market

## TALF-related CLO Opportunities

- *Asset Managers:* operating a static CLO platform as a way to obtain cheaper debt financing and continue to increase AUM and generate management fees (in what may otherwise be a sluggish managed CLO market in the near to medium term).
- *Banks/Financial Institutions:* Executing balance-sheet static CLOs as a way to obtain cheaper financing from TALF for their commercial leveraged loan holdings.
- *Investors:* participating as warehouse first-loss providers and/or CLO equity in static TALF CLOs for enhanced returns based on cheaper TALF financing.

## Non-TALF-related CLO Opportunities

- *CLO Market Dislocations:* utilizing distressed funds to take advantage of price dislocation in the CLO secondary markets (driven, among others, by rating agency CLO/collateral downgrades and failures in CLO coverage and quality tests).
- *Acquiring CLO management platforms:* unclear horizon for new issuance of managed/arbitrage CLOs may drive further consolidation in the CLO asset manager space and present opportunities for newcomers in such space.

# Other Structured Finance Hot Topics

- TALF finalization and expansion
- RMBS servicer liquidity support
- PPP secondary market transfers
- Margin calls and credit availability
- Potential early amortization events, defaults, and other deal triggers

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Gregg Buksbaum focuses his practice on domestic and international business transactions, primarily representing private fund sponsors and institutional investors in the formation of, and investment in, various types of private investment funds, including private equity, hedge, venture capital, real estate, infrastructure, mezzanine, credit, distressed debt, special opportunity and funds of funds, among others. He has extensive experience with co-mingled funds and bespoke funds of one, managed accounts and similar investment management arrangements. Gregg also represents clients in private equity and venture capital transactions, joint ventures, financings, entity formation, and other domestic and cross-border transactional matters in developed and emerging markets in a variety of industries.

Gregg works with new fund and fund-less sponsor groups in helping them navigate the challenges of setting up operations and employing best practices, and with established sponsors who have more complex institutional needs, such as succession planning, profit-sharing schemes, and conflicts management due to expanding business platforms. He also advises on joint ventures between sponsor groups seeking to merge platforms and/or raise co-sponsored funds.

His experience also includes negotiating seeding and revenue sharing arrangements, sub-advisory arrangements, placement agent agreements, and providing counsel on investment adviser regulatory and compliance matters at the state and federal levels.

Gregg regularly advises institutional investors—including sovereign wealth funds, public pension plans, family offices, funds of funds, and other similar investors—in negotiating their investments in a variety of private investment funds and managed account platforms, as well as negotiating secondary transactions, co-investments, direct investments and arrangements with transition managers, prime brokers, custodians, and commodities trading advisers.

Notably, Gregg has served as outside counsel to fund managers, advising them on a range of fund management issues, best practices and compliance, as well as serving as outside counsel to private companies, counseling them on a range of corporate governance issues, as well as on issues concerning employment, tax, and regulatory matters. He previously has also counseled clients in the coordination and interplay of business and US foreign policy and has interacted with Congress and executive branch departments and agencies in those endeavors.

# Christopher J. Dlutowski



Christopher J. Dlutowski represents institutional investors—including public and private pension plans, family offices, sovereign wealth plans, universities, endowments, and funds of funds—on their investments in hedge, private equity, venture capital, private debt, real estate, infrastructure, hybrid, and other private funds, funds-of-funds, managed accounts, co-investments, and direct investments, and on governance and compliance issues. Christopher also counsels private investment funds—including US domestic and offshore hedge funds, private equity funds, and funds-of-funds—and investment management firms on the formation and structuring of funds, trading and other investment activities, capital raising, registration and other regulatory issues, and ongoing operations.

Christopher has more than 20 years of experience in customized investment products, including strategic partnerships, captive funds, and co-investment funds, in all asset classes.

Christopher has presented on hedge funds and other private investment funds topics at numerous investment management conferences and training programs. Prior to re-joining Morgan Lewis, Christopher was vice president and corporate counsel at Prudential Financial, Inc. where he advised investment management clients on their hedge funds and other alternative investment products, US and foreign institutional investor mandates, trading activities (including securities, derivatives, lending, and financing transactions), marketing efforts, domestic and foreign registration, and other regulatory issues.

Christopher is the chair of the firm's institutional investors working group, a member of the firm's diversity and inclusion committee, a member of the New York office's recruiting committee, and the head of the New York office's LGBT lawyer network.

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Edmond (Eddie) Seferi focuses his practice on structured finance and securitization, with an emphasis on collateralized loan and debt obligation transactions, including cash-flow and synthetic transactions; asset-backed securities, including mutual fund fee receivables, life settlement receivables, and trade receivables; derivatives; and other structured financial products.

From 1992 to 1994, Eddie served as chief of staff to the president of Albania.

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Charles A. (Charlie) Sweet serves as the practice development leader of the firm's structured transactions group. He advises clients on the federal laws and regulations affecting asset-backed securities and other structured finance products, and his securitization experience encompasses a wide variety of asset classes, including automobile loans and leases, student loans, marketplace loans and residential mortgages. Charlie has worked on many innovative transactions and structures, with sponsors ranging from finance arms of Fortune 500 companies to technology-driven emerging growth companies. He co-authored the fourth edition of the leading industry treatise, *Offerings of Asset-Backed Securities* (Wolters Kluwer).

Charlie is a co-chair of the Legal Counsel Committee of the Structured Finance Association (the trade association for the securitization market), and is a frequent speaker at industry conferences. Charlie has represented the SFA and other financial industry groups in their responses to many of the regulatory changes in the structured finance area since the financial crisis, including LIBOR transition, Regulation AB II, and the Dodd-Frank credit risk retention rules. He was the original author of *The Federal Securities Law of Asset-Backed Securities* (Bloomberg BNA).

Charlie also has a background in other federal securities law and general corporate matters, in industries extending from banking to technology. His corporate practice has emphasized public offerings and private placements of securities, but he also has broad experience in other types of transactions, including repurchase and debt facilities, tender offers, mergers and acquisitions, and partnerships and joint ventures.

At the University of Texas School of Law, Charlie was a member of the Order of the Coif, a member of the Chancellors (the school's highest honorary organization) and an associate editor of the *Texas Law Review*. He is a member of the American Bar Association.

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Members of the international media often seek out Jedd for his views on the hedge fund and private equity fund industries and capital markets. His analysis can be found in US and international publications, including *The Wall Street Journal*, *The Economist*, and *Financial Times*, as well as on television networks such as Bloomberg and CNN.

Jedd lectures and serves as a panelist on private investment fund topics for trade programs and organizations around the world. He has delivered speeches and presentations to numerous private fund conferences such as the Hedge Fund Institutional Forum, Dow Jones Private Equity Analyst Limited Partners Summit, Endowments & Foundations Roundtable, Association of Life Insurance Counsel, National Association of Public Pension Fund Attorneys (NAPPA), West Legalworks, InfoVest21 Hedge Fund Conference, the Annual Euromoney Summit of European Hedge Funds in London, Capital Roundtable Fund Conferences, the Annual International Conference on Private Investment Funds in London, the Wharton Private Equity and Venture Capital Conference, the On Point Investors and Hedge Fund Risk Summit, and the Lazard Capital Markets Hedge Fund Conference.

Jedd is listed in *The US Legal 500*, *Chambers Global: The World's Leading Lawyers*, and *Chambers USA: America's Leading Lawyers for Business*. He serves as an editorial board member of *The Journal of Investment Compliance* and as an editor of the *Morgan Lewis Hedge Fund Deskbook: Legal and Practical Guide for a New Era* published by Thomson Reuters/West. He regularly publishes articles on current hedge fund and private equity fund topics. He co-chairs the Annual Morgan Lewis Advanced Topics in Hedge Fund Practices Conference and chairs Morgan Lewis's Hedge Fund University Web Series.

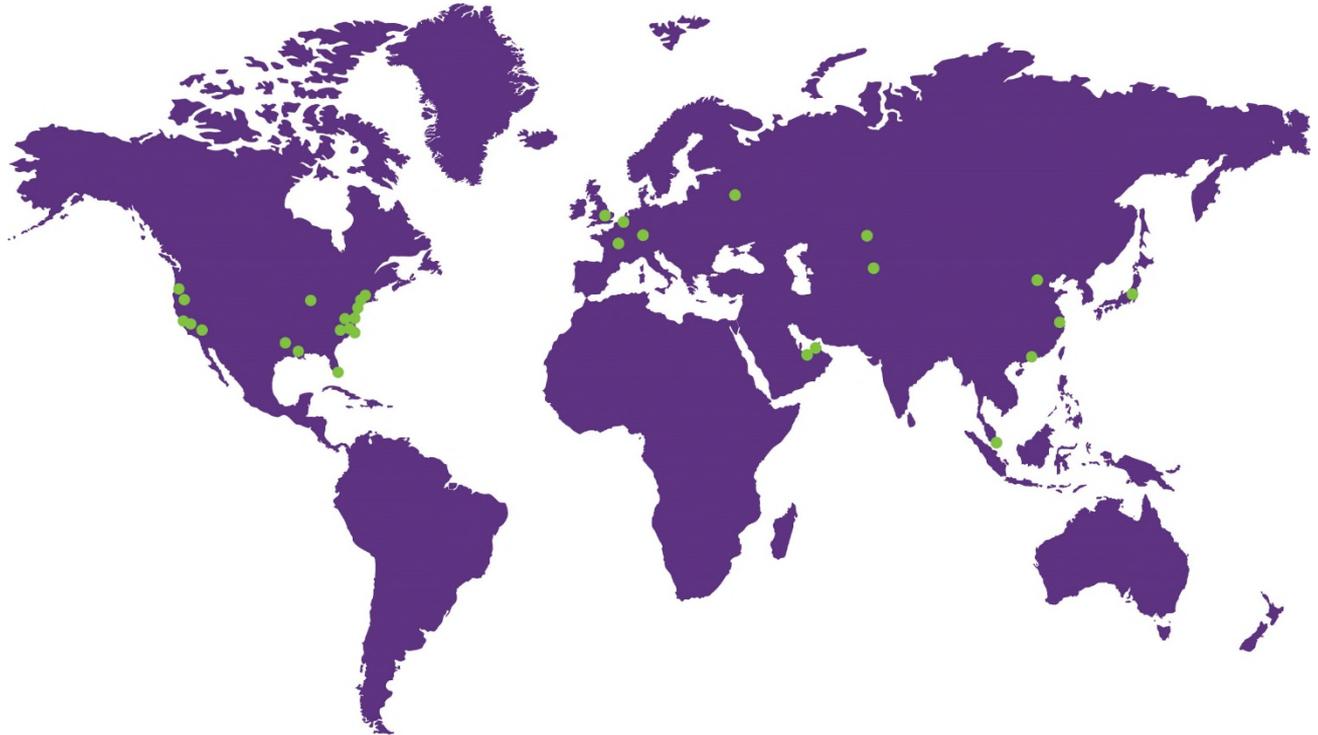
Jedd clerked for Judge Nicholas Politan of the US District Court for the District of New Jersey and for US Attorney Rudolph Giuliani of the Southern District of New York. He is conversant in French.

## Our Global Reach

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