Morgan Lewis

2017 ANNUAL PRIVATE FUND INVESTORS ROUNDTABLE

Global Investing: Limited Partner Perspective

October 5, 2017

GLOBAL INVESTING: LIMITED PARTNER PERSPECTIVE

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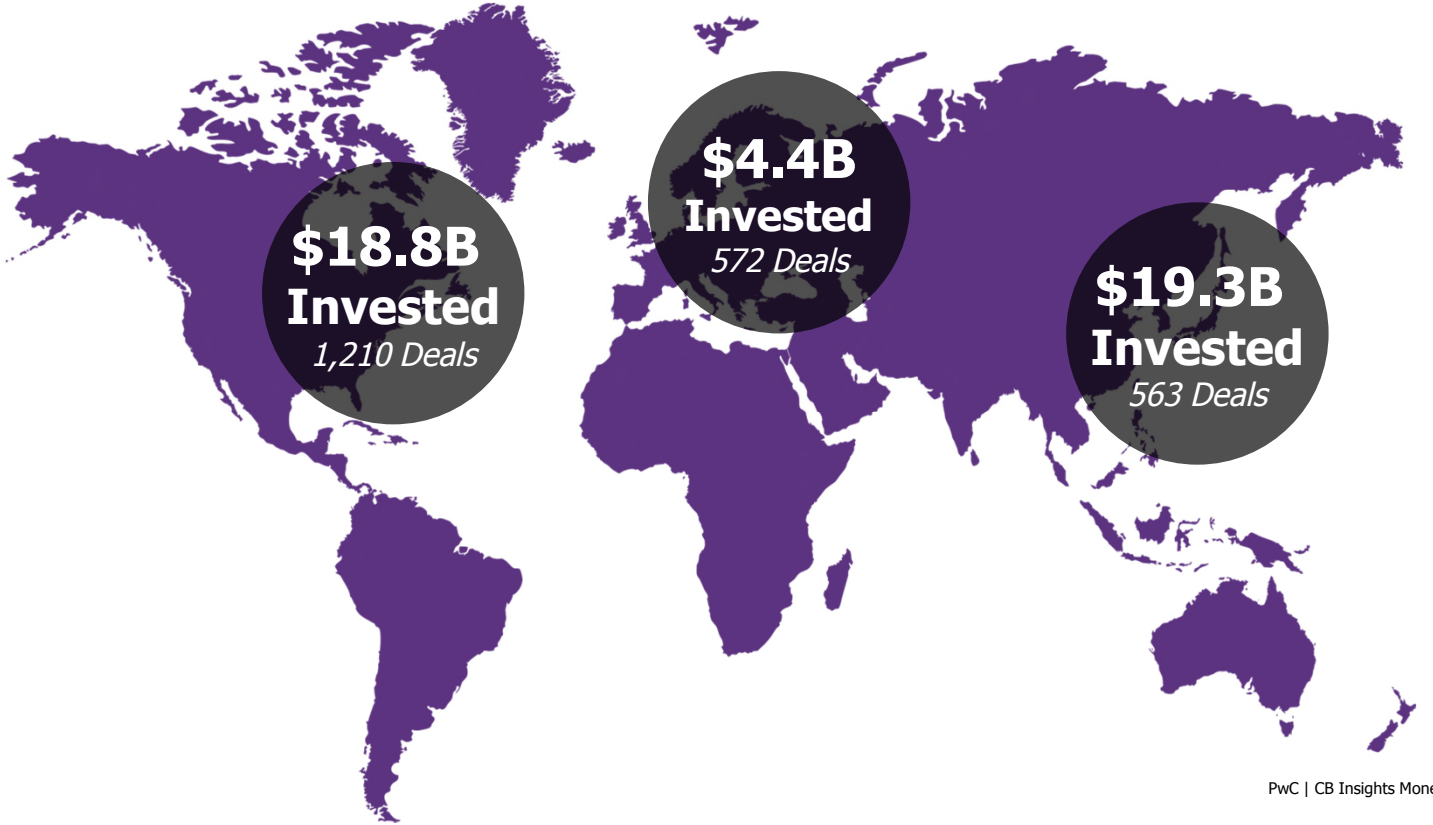
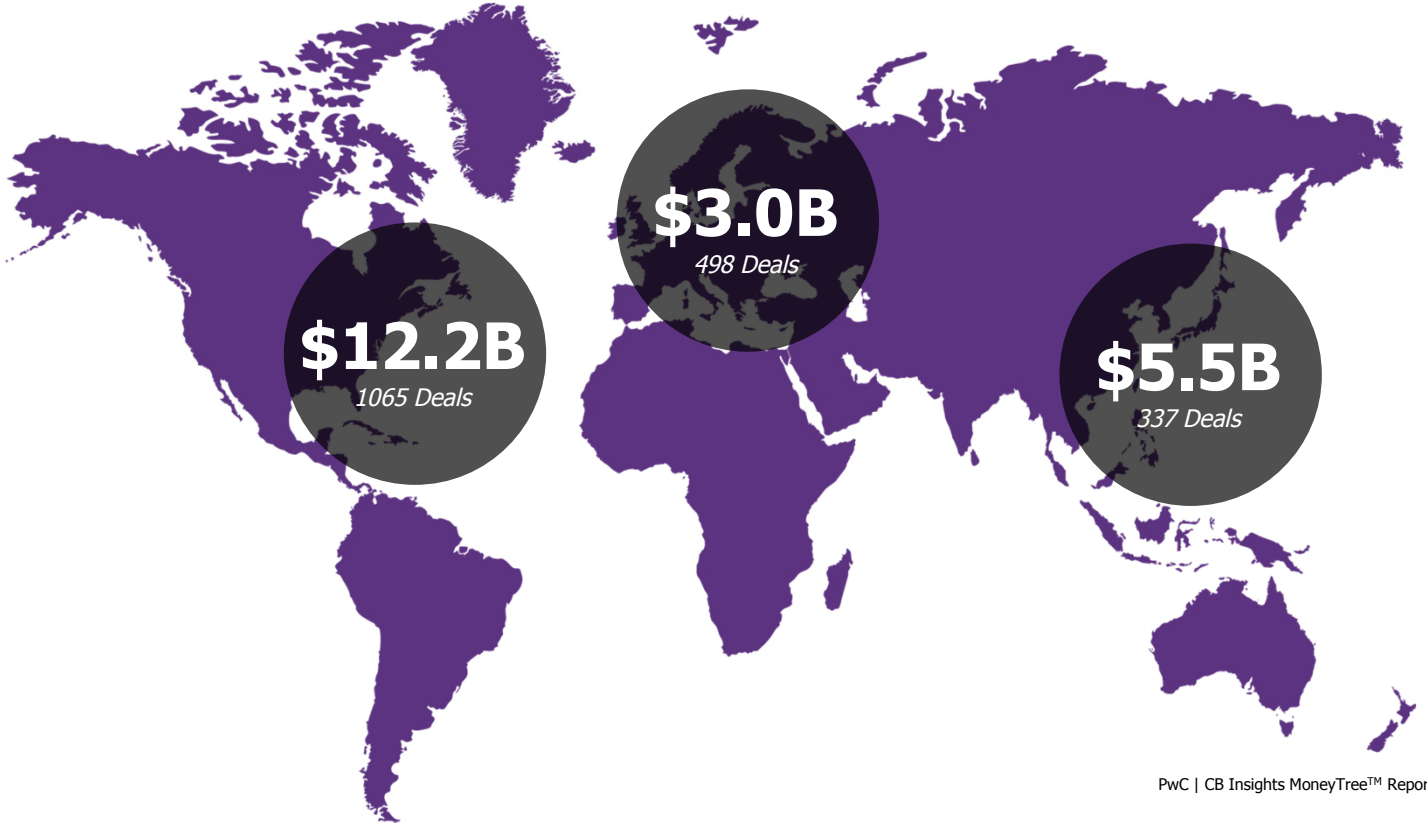
Venture Capital: Q2 ’17 Global Regions Comparison



PwC | CB Insights MoneyTree™ Report Q2 2017

Venture Capital: Full Year 2016 Global Regions Comparison



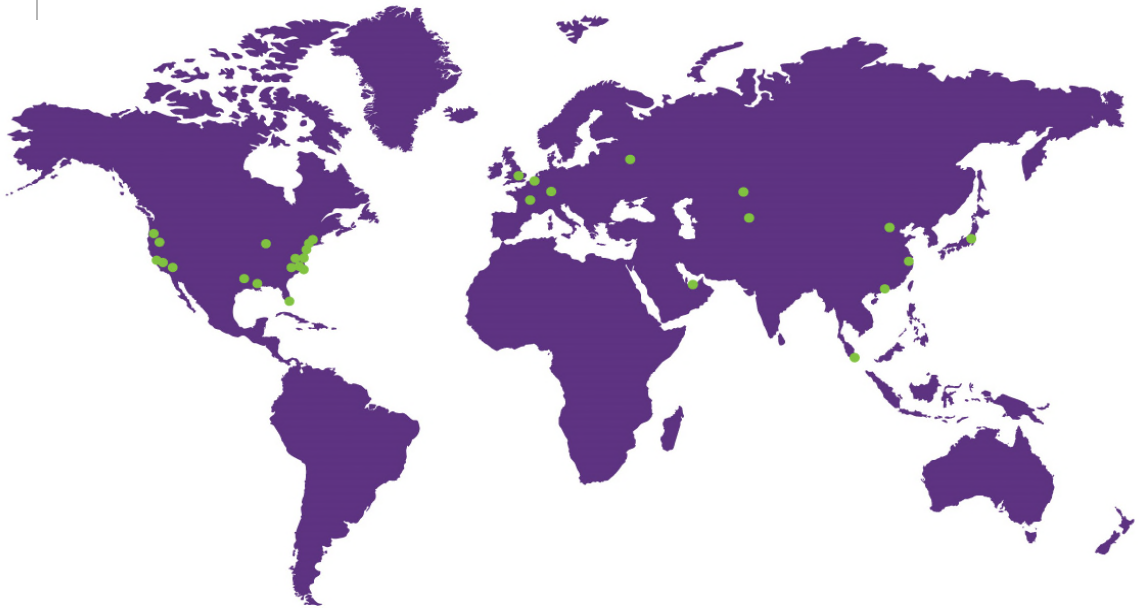
PwC | CB Insights MoneyTree™ Report Q4 and Full-Year 2016

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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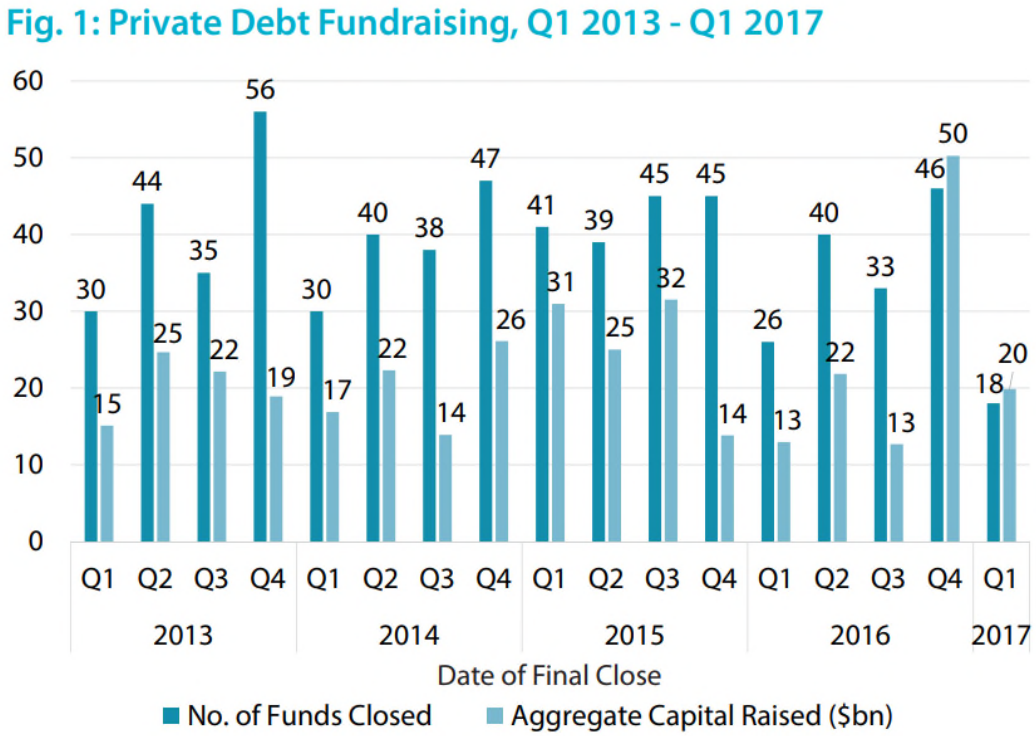
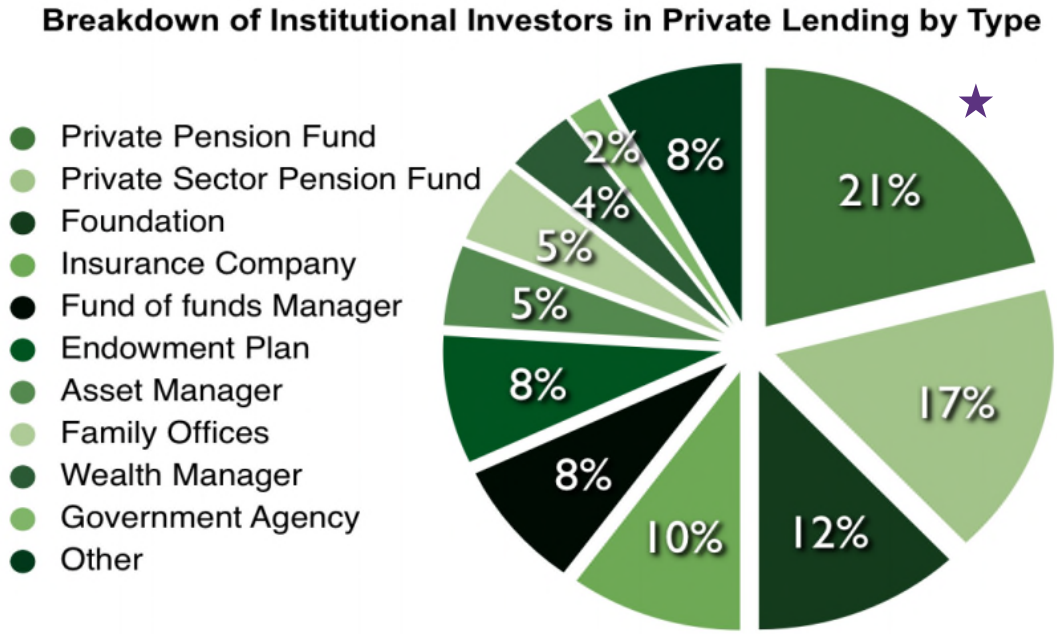
Private Debt



Prequin Private Debt Online

Debt Funds (AKA Private Lending)



Next Edge Private Debt Fund: Private Lending

Real Estate Trends to Track

High Expectations
76% of fund professionals have the same or better expectations for real estate businesses.

Global Investing Up
64% of fund professionals expect foreign investment in US real estate to moderately or significantly increase.

Interest Rate Impact
56% of fund professionals believe interest rate changes will have no impact on real estate prices, or that prices will only moderately decline.

KPMG: Trends to Track

GLOBAL INVESTING: CURRENT REGULATORY ISSUES

Current Regulatory Issues: MLD 4

Implementation of MLD 4

- EU Member States were required to transpose Fourth EU Money Laundering Directive ("MLD 4") into national law by 26 June 2017, which is intended to strengthen the EU's defences against money laundering and terrorist financing
- MLD 4 has been implemented in the UK by the UK Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, which:
  - prescribe when different categories of customer due diligence must be conducted and what steps must be taken
  - require a written assessment of money laundering risk and prescribe features of effective internal controls
  - specify beneficial ownership information that trusts must provide for inclusion on a central register
- Rules on customer due diligence therefore have been substantially tightened

Current Regulatory Issues: Scottish PSC regime

Scottish Partnerships (Register of People with Significant Control) Regulations 2017

- Scottish limited partnerships ("SLPs") must deliver to Companies House (from 24 July 2017) information relating to people with significant control ("PSCs")
- Greater transparency on beneficial ownership for purpose of MLD 4
- PSCs include certain types of limited partners (e.g. individuals, local authorities/ local government authorities and UK companies) whose interest in the partnership represents more than 25% of total interests
- The PSC register regime already applies to all UK companies and LLPs, subject to certain exclusions, but do not apply to English limited partnerships

Current Regulatory Issues: MiFID II

Client categorisation

- Under MiFID II (which enters into force on 3 January 2018), local public authorities and municipalities (which do not manage public debt) will by default be treated as retail clients, but can be opted up to elective professional if qualitative and quantitative tests are satisfied
- Currently under MiFID they can be per se professional clients if they meet size requirements for large undertakings
- Local public authorities, even if large in size, will be unable to access private equity investments as professionals unless their local member states have adopted more flexible criteria than those provided under MiFID II
- The FCA has introduced alternative quantitative criteria for local authorities which have a financial instrument portfolio of > £10 million
- There are more onerous disclosure requirements under FCA rules on fund managers for retail investors and so local public authorities and municipalities may be less attractive to fund managers and may not be able to access the full range of investment products and services if categorised as retail clients
- Even if classified as elective professionals, fund managers will not be able to presume that they possess market knowledge and experience comparable to per se professional clients

Current Regulatory Issues: AIFMD

AIFMD Review

- AIFMD requires the EU Commission to have started a review of its application and scope by 22 July 2017
- The review is required to analyse the experience acquired in applying the AIFMD, its impact on investors, funds and fund managers, in the EU and in third countries, and the degree to which the AIFMD's objectives have been achieved
- The Commission has the power to propose appropriate amendments to the AIFMD as a consequence of the review
- No announcement has been made by the Commission as to how it proposes to approach this review and whether it is contemplating anything fundamental, but the review should be an opportunity to at least seek to address aspects of the existing Directive which are unsatisfactory
- If additional regulatory burdens are imposed on fund managers, this may cause additional costs to be incurred that would likely be passed down to investors
- Given sectoral convergence, it may be that some MiFID II requirements (e.g. those in relation to product governance and inducements) will be worked into a revised AIFMD

Current Regulatory Issues: FCA Market Study

FCA Asset Management Market Study

- The FCA published its final report in June 2017 on its asset management market study ("AMMS"), which it launched in 2015 to understand how UK asset managers compete to deliver value to investors
- The original scope did not include alternative asset classes, but the FCA received some feedback on certain alternative asset classes such as private equity and hedge funds as part of its institutional analysis
- According to the FCA's final report, information about charges is often unclear for those investing through more complex fund structures such as hedge funds and private equity funds and the FCA received comments that private equity is a particularly opaque part of the asset management sector
- The FCA will therefore consider whether any remedies relating to information about charges should apply to hedge funds and private equity

Current Regulatory Issues: FCA Market Investigation Reference – Consultancy and Fiduciary Management Services

Market investigation reference

- Following the FCA's final report on the AMMS, which also flagged the FCA's concerns about how the investment consultant market operates, the FCA made a market investigation reference to the Competition and Markets Authority ("CMA") on 14 September 2017 relating to the supply and acquisition of investment consultancy services and fiduciary management services to and by UK institutional investors/employers
- The CMA has published its issues statement setting out the scope of the market investigation, which will look at whether there are any adverse effects on competition in the investment consultancy services and fiduciary management services market, and, if so, what remedial action should be taken to address these
- Any remedial action may also impact non-UK institutional investors
- Statutory deadline for completion of the market investigation reference is 13 March 2019

GLOBAL INVESTING: CURRENT TAX ISSUES

Current Tax Issues: BEPS

OECD Base Erosion and Profit Shifting

- **Wide range of proposals**
- **Some already being (or have been) adopted, e.g., hybrid rules in the UK and limitations on interest deductions in Germany and the UK**
- **Limited acceptance in the US, but wider adoption of principles in other states that could affect non-US fund and portfolio investment structures**

Current Tax Issues: BEPS

Key Measures

- **Anti-hybrid provisions**
- **Updates to double tax treaties, including limitations on benefits**
- **Interest deductions limited by reference to EBITDA**
- **Scope of permanent establishments**
- **Transfer pricing**

Current Tax Issues: BEPS

Anti-hybrid Rules

- **Aggressive changes proposed by the OECD and already implemented in the UK**
- **Some hybrids are very common in structuring of portfolio investments, e.g., Luxembourg "CPECs"**
- **Ability to structure investments without hybrids and without tax leakage?**
- **Impact on comfort given by fund sponsors**

Current Tax Issues: BEPS

Treaty Abuse

- **Multilateral Instrument (MLI) already signed by more than 70 states, including the UK, Luxembourg, and the Netherlands**
- **Provides a menu of changes to prevent treaty abuse**
- **In particular, a limitation-of-benefits clause similar to that the US already includes in its treaties, or a principal purpose test**
- **Further impact on portfolio structuring**

Current Tax Issues: BEPS

Other Changes

- **Cap on interest deductibility at 10%-30% of EBITDA**
- **Reassessment of presence needed to trigger a permanent establishment**
- **International alignment of transfer-pricing principles to prevent "double non-taxation"**
- **All could have impact on after-tax returns**

Current Tax Issues: FATCA and Tax Reporting

Other Changes

- **FATCA continues largely unchanged**
- **OECD common reporting standard (CRS) now adopted by 101 states, including many common fund states, such as the UK, Cayman Islands, Guernsey, Luxembourg, and Jersey**
- **Complications still arise under CRS for reporting certain entities, including trusts and some pension funds**

Current Tax Issues: Brexit

- Limited direct impact in the UK, where most tax reliefs are domestic, e.g., dividend exemptions and capital gains tax exemptions
- Could increase non-UK withholding taxes
- Could have an impact on treaty benefits
- Will have an impact on fund managers as they need to establish themselves in AIFMD states

SIDE LETTER PROVISIONS TO CONSIDER WHEN INVESTING IN NON-US FUNDS

Issues to Consider for Non-US Side Letters

- **The typical provisions used in US side letters may not address important issues that a US institutional investor should consider when investing in a non-US private equity fund.**
- **These provisions could be inserted into the PPM and LPA but fund sponsors are often reluctant to include US-centric provisions in their fund documents.**
- **In a typical non-US fund side letter many provisions will be familiar to US institutional investors. We will focus in this presentation on those provisions that are unique to non-US side letters and should be considered by US institutional investors in negotiating investments into non-US funds.**

Issues to Consider for Non-US Side Letters

- **The issues to consider include the following:**
  - Addressing US tax issues and choosing the best IRS tax classification for the fund
  - Imposing US Foreign Corrupt Practices Act principles on the fund and manager
  - Imposing US AML principles on the fund and manager
  - Ensuring that ERISA indicia of US ownership for fund assets is respected
  - Making sure that Bad Actor (Rule 506(d)) requirements are satisfied
  - Addressing different standards of liability for advisory committees
  - Disclosing/registering investor names and coordinating multiple investments into a country

Issues to Consider for Non-US Side Letters

- **Capital Account Maintenance**

Not every non-US fund sponsor will be familiar with US capital account maintenance rules even if their funds are organized as limited partnerships or their equivalents. Accordingly, US investors should request that at least once every calendar year the fund manager agrees to provide to the investor an individual capital account statement, which should be printed on the letterhead of the general partner/fund manager and executed by one of its directors. This individual capital account statement should include at a minimum the following information:

- total capital commitment of the investor;
- total capital contributions of the investor;
- total distributions to the investor;
- pro rata share of the investor of total recallable amounts;
- remaining capital commitment of the investor; and
- pro rata share of the net assets and liabilities of the fund attributable to the investor.

Issues to Consider for Non-US Side Letters

- **Trade or Business Income.** A portfolio investment by a fund in an operating partnership or other tax-transparent enterprise that generates income from a trade or business could have adverse tax consequences to a US tax-exempt investor. Therefore, the side letter should procure that the fund will use commercially reasonable efforts, consistent with the fund's objective of maximizing returns on portfolio investments, to structure and manage portfolio investments in a manner that will minimize the likelihood of the investor being allocated this type of income. The fund may retain US counsel or other advisors for advice and/or assistance in respect of these matters. The obligations of this provision in the side letter will not be considered as having been violated as a result of the receipt or deemed receipt of fee income, consultancy fees, or the reduction of the management fee described in the PPM. Any costs or expenses incurred by the fund and the fund manager, including the cost and expenses of US counsel or advisers, in complying with this clause of the side letter, will be allocated to, and borne solely by, the investors that have a similar covenant in their side letters.
- **US IRS Reporting**. The side letter shall require the general partner to use reasonable efforts to provide the investor with sufficient information to enable the investor to file IRS Forms 926, 5471, and/or 8865, as applicable, with respect to the fund's investments (subject to reasonable delays).

Issues to Consider for Non-US Side Letters

- **K-1 Equivalent Information**

The sponsors of non-US funds are often unwilling to undertake the expense and complications of having the funds file US income tax returns and produce Schedules K-1 unless the funds have a significant amount of US investments or investors. Alternatively, the sponsors can provide the investor with such information as would normally appear on a Schedule K-1, thereby facilitating the filing of investors' own returns.

  - **Taxable Income Allocation**
    - Interest Income
    - Ordinary Dividends and Qualified Dividends
    - Short-Term and Long-Term Capital Gains/(Losses)
    - Other Income - Portfolio Income
    - Other Deductions - Interest Expense/Management Fee/Portfolio Deductions
  - **Tax-Exempt Income and Nondeductible Expenses**
  - **Capital Contributed During the Year**

Issues to Consider for Non-US Side Letters

- **Side letters should address the circumstances where portfolio investments and/or fund-holding vehicles may be considered PFICs.**

In the event that the fund makes an investment in a portfolio company, or in the event that the general partner causes the investor to participate in an AIV organized under the laws of any jurisdiction outside of the United States, and the general partner reasonably determines that such portfolio company or such AIV is a "passive foreign investment company" within the meaning of Section 1297 of the Code, the general partner shall notify the investor in writing and provide the investor with any reasonable information in the general partner's possession that the investor requires in order to make an election to treat such portfolio company or AIV as a "qualified electing fund" under Section 1295 of the Code, and, annually thereafter, shall provide the investor with any reasonable information in the general partner's possession and readily available that is required to maintain such election. Where appropriate, the fund may retain US counsel or another reputable advisor to assist in (i) determining whether a portfolio company qualifies as a "passive foreign investment company" and (ii) the provision of information to the investor necessary to make a "qualified electing fund" election. The costs of the fund, the fund manager, and its affiliates (including, for the avoidance of doubt, any costs of US counsel or reputable advisors engaged in connection herewith) relating to the compliance with this clause shall be borne by the investor and any other investors with a PFIC covenant in this side letter.

Issues to Consider for Non-US Side Letters

Side Letters Should Address Foreign Tax-Reporting Issues

- The manager should notify the investor as promptly as practicable of any foreign taxes paid or withheld from receipts of the fund allocable to the investor from any investment by the fund. In addition, if the manager determines, after reasonable inquiry, that the investor will be subject to any obligation to file income tax returns, or pay income taxes, in a jurisdiction other than the United States, solely as a consequence of a proposed investment, the manager will notify the investor promptly of any such obligation.
- The fund and the manager must consult regularly with qualified tax counsel and/or accountants in each jurisdiction in which the fund invests with respect to taxes or other potential risks or liabilities for the fund or investors in such jurisdiction. The manager shall notify the investors as to the outcome of such consultation (by way of disclosure in the fund's offering documents, delivery of memoranda or opinions of such counsel or accountants, or such other form of notice reasonably acceptable to the investor).

Issues to Consider for Non-US Side Letters

- **Disclosure of Investor's Participation**

Disclosure standards can vary from country to country and in some countries it may be necessary for a fund to register its investments and disclose to local authorities the identities of its investors. Accordingly, side letters should provide that the fund manager will not use the name of the investor or any variation thereof in any printed sales materials, offering documents, or written press releases relating to the fund without the prior written consent of the investor, *provided* that the participation of the investor in the fund may be disclosed nonetheless:

- as required by law, regulation, or legal process, pursuant to a governmental order or the terms of the subscription documents;
- to any of the other investors, as well as to prospective investors that in the course of their due diligence require disclosure of the identity of the existing investors in the fund; and
- to third-party service providers of the fund or financing parties to portfolio companies, including legal counsel, financial institutions, accountants, brokers, and lenders.

Issues to Consider for Non-US Side Letters

- **Compliance with US Sanctions Legislation**

Most non-US funds start off life with the view that US sanction rules will only be incorporated if required by US investors. Accordingly, the side letters should provide at a minimum that:

- The fund manager will acknowledge that the investor is restricted from making certain investments that could cause the investor to be in violation of, or in noncompliance with (a) the United States Trading with the Enemy Act of 1917, (b) the United States International Emergency Economic Powers Act of 1977, or (c) certain US federal regulations and executive orders administered by the US Treasury Department's Office of Foreign Assets Control (each, a Restricted Investment). If, in the course of its customary due diligence of a potential portfolio investment, the fund manager becomes aware that such portfolio investment is a Restricted Investment, the fund manager will provide notice to the investor. For the avoidance of doubt, the fund manager will have no obligation to do due diligence into whether a potential portfolio investment would be a Restricted Investment. In the event that the fund makes a Restricted Investment, the fund manager will, at the request of the investor after obtaining the written advice of counsel that the investor's participation in such Restricted Investment would cause the investor to be in violation of applicable law, either (i) treat the investor as an excused investor pursuant to the fund documents in respect of such Restricted Investment or (ii) not unreasonably withhold its consent to a transfer of the investor's interest in the fund and the admission of the transferee as a substituted investor.

Issues to Consider for Non-US Side Letters

- **Foreign Corrupt Practices**

Side letters should provide that the manager shall not, and shall cause the fund and any parallel funds not to, make, authorize, or offer any payment or the giving of anything of value (directly or indirectly) to any foreign official, political party, officer, or agent thereof; candidate for political office; or any third party knowing the payment will be made to someone in the above list to influence that entity to use his or her authority to sway any government act or decision, and will not violate any applicable provision of the US Foreign Corrupt Practices Act of 1977, any similar applicable law or regulation of any other jurisdiction, or any other applicable laws.

Issues to Consider for Non-US Side Letters

- **Addressing Different Standards of Liability.** The limited partnership laws in non-US jurisdictions do not always provide that limited partners may sit on fund committees or otherwise provide consents to actions taken by the general partner or fund manager without acquiring the same level of liability as the general partner or other members of fund management. Accordingly, care should be taken to include satisfactory restrictions and limitations on actions by the general partner or manager, and investors should not rely as heavily on the role of advisory committees. Further, the involvement of limited partners in the decisionmaking process of a fund may expose the fund and/or limited partners to taxation in certain countries, such as Japan. A typical provision would state: "The Manager shall use commercially reasonable efforts to confirm that it is reasonably expected (in light of then existing law) that such investment will not cause the Investor (i) to be subject to tax (on a net income basis) in any non-U.S. jurisdiction (other than taxes imposed with respect to such investor's share of the income and losses of the fund) or (ii) to be required to file an income tax return in such non-U.S. jurisdiction (other than any form or declaration required to establish a right to the benefit of an applicable tax treaty or an exemption from or reduced rate of withholding)."

LIABILITY CONCERNS: SAFE HARBORS FOR LP ACTION AND STATUTORY OVERRIDE OF LP GIVEBACK CAPS

Control of Business – Safe Harbors

- As a diligence matter, determine whether the jurisdiction of organization has statutory safe harbors to protect LPs from jeopardizing limited liability through potential participation in the control of the business (or similar test).
  - **Delaware**: No participation in the control of the business for (i) consulting with or advising the GP; (ii) serving on a committee of the partnership; (iii) voting for the removal or retention of a GP; (iv) voting on LPA amendments; or (v) voting on a transaction involving an actual or potential conflict of interest.
  - **Cayman Islands**: No participation in the conduct of the business for consulting with and advising a GP or consenting to or withholding consent to any action proposed, in the manner contemplated by the LPA (within four corners), with respect to the business of an ELP.

Control of Business – Safe Harbors

- **UK:** There is no whitelist for limited partnerships generally. For Private Fund Limited Partnerships (PFLPs), the whitelist of activities that LPs may take part (if included in the LPA) include: (i) ending the fund and/or extending its term; (ii) reviewing or approving valuations; (iii) consulting with or advising the GP about fund affairs; and (iv) appointing an LPAC designee and authorizing such designee to taken LPAC action, as long as such action would not constitute participation in the management of the business if taken by an LP.
- **Luxembourg:** LPs do not lose limited liability status for opinions or advice given to a partnership or its managers, including participating in an internal committee (such as an LPAC) whose approval must be sought prior to the fund taking certain actions, to the extent set forth in the LPA.
- **Ontario:** Limited safe harbor (for example, regarding the right to inspect books and records), but not expressly for governance rights or LPAC participation. Currently a facts and circumstances analysis, but revisions are under consideration in order to better align with the comfort provided in other more common jurisdictions of formation.

LP Giveback – Safe Harbor

- In addition to LP giveback provisions in the governing partnership agreement, LPs may be subject to giveback provisions under limited partnership law.
  - **Delaware**: Obligation to return distribution received if the LP knew at the time of receipt that the fund was insolvent. Unless otherwise agreed, this limited statutory giveback extends for three years from the date of distribution.
  - **Cayman Islands**: If at the time of payment, (i) ELP is insolvent (or payment causes insolvency) and (ii) LP has actual knowledge of the insolvency, then LP is liable for a period of six months from the date of the payment. Unless otherwise agreed, such amounts shall bear simple interest of 10% per annum, calculated on a daily basis.

LP Giveback – Safe Harbor

- **UK:** For partnerships generally, an LP is statutorily liable for the debts and obligations of a partnership up to the amount of its capital contribution (typically around .001%). For Private Fund Limited Partnerships (PFLPs) - if registered on or after April 6, 2017, there is no statutory liability for a partnership's debts; if registered before, the giveback related to capital contributions applies only to the amount of contributions made before the partnership became a PFLP.
- **Luxembourg:** No statutory exception to the general rule that LPs are not liable for the debts of a partnership; terms of the partnership agreement govern.
- **Ontario:** LPs are liable to fund (or, if dissolved, to its creditors) for any amount, not in excess of the amount returned with interest, necessary to discharge fund liabilities to all creditors who extended credit or whose claims arose before the return of the contribution.

Limited Liability – Practice Points

- Be aware that limited partnership laws in non-US jurisdictions do not provide identical protection with respect to actions that may be taken by LPs, from LPAC participation to the exercise of key governance rights.
- Ensure that partnership agreements expressly incorporate any safe harbor legislation.
- Search for disclosure in the governing documentation related to potential liability issues/pitfalls. Be aware of seemingly boilerplate language like "except as otherwise provided by law" and ask fund counsel for a summary of such requirements.
- Request and review limited liability opinions addressing limited liability, paying careful attention to caveats, limitations, and "reasoned" or "should" opinions.