Morgan Lewis

2017 ANNUAL PRIVATE FUND INVESTORS ROUNDTABLE

Securities Regulation, ERISA, and Tax

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SECURITIES REGULATION, ERISA, AND TAX

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SEC Regulatory Update

- Impact of Change in Administration
- New Rulemaking/Proposals/Guidance
- SEC Examination and Enforcement Areas of Focus

Impact of Change in Administration

- Changes in leadership at the Commission and among Senior Staff
  - Chairman of the Commission: Jay Clayton (Sworn in March 2017)
  - Chief of Staff: Lucas Moskowitz (May 2017)
  - Managing Executive in the Chairman's Office: Peter Uhlmann (May 2017)
  - General Counsel: Robert B. Stebbins (May 2017)
  - Director of the Division of Corporate Finance: William Hinman (May 2017)
  - Co-Directors of the Division of Enforcement: Stephanie Avakian and Steven Peikin (June 2017)
  - Director of the Office of Legislative and Intergovernmental Affairs: Bryan Wood (July 2017)
  - Director of the Division of Economic and Risk Analysis: Jeffrey Harris (August 2017)
  - Director of the Division of Investment Management: Dalia Blass (August 2017)
  - Chief Litigation Counsel: Bridget Fitzpatrick (September 2017)
- Impact on existing regulation, rulemaking, examinations or enforcement?

New Rulemaking/Proposals/Guidance

- Custody
  - No-Action Letter on Standing Letter of Authorization (SLOA), dated February 21, 2017 - Limited relief from the surprise examination requirement of the Custody Rule for advisers acting pursuant to a SLOA, provided the advisers meet several conditions.
  - IM Guidance Update on Inadvertent Custody, dated February 21, 2017 - Advisers may have custody of client funds inadvertently due to certain language or provisions in the separate custodial agreements between the advisory client and the custodian, even if the advisers are not parties to such agreements.
  - FAQ Updates on the Custody Rule, dated February 21, 2017 - Clarifies prior guidance regarding transfers among multiple accounts of a single client.
- Cybersecurity
  - Risk Alert by the Office of Compliance Inspections and Examinations (OCIE), dated August 7, 2017 – OCIE summarized its observations from a recent cybersecurity-related examination of 75 firms, including broker-dealers, investment advisers, and investment companies (funds) registered with the SEC. OCIE staff observed common issues in a majority of the firms and funds subject to examination and identified elements of what it viewed as “robust” cybersecurity policies and procedures from its examinations.

New Rulemaking/Proposals/Guidance

- New Form ADV
  - Effective October 1, 2017; the requirements under Part 1A of Form ADV are modified to require:
    1. additional reporting requirements with respect to separately managed accounts;
    2. registration on a single Form ADV of multiple private fund advisers operating as a single advisory business in a "relying adviser" structure (Umbrella Registration); and
    3. additional disclosures about investment advisers and their businesses.
- New Recordkeeping Rules
  - Effective October 1, 2017, advisers are required to comply with two updated recordkeeping requirements of the Investment Advisers Act of 1940:
    1. rule 204-2(a)(16) now requires advisers to document and preserve calculations that support performance claims made in materials distributed, directly or indirectly, to <u>any person</u>. Previously, this reporting only applied to claims distributed or circulated to <u>10 or more persons</u>; and
    2. rule 204-2(a)(7) now requires advisers to maintain originals of <u>all</u> written communications received and copies of written communications sent relating to the performance or rate of return of any or all managed accounts or securities recommendations. Previously, rule 204-2(a)(7) required advisers to maintain only <u>certain</u> categories of written communications received and sent.
- Business Continuity Plan (BCP)/Transition Plans
  - On June 28, 2016, the Commission proposed a new rule that would require registered investment advisers to adopt and implement written business continuity and transition plans designed to ensure that investment advisers have plans in place to address operational and other risks related to a significant disruption in the advisers' operations in order to minimize client and investor harm.

SEC Examination and Enforcement Areas of Focus

- Undisclosed conflicts of interest
  - Related-party transactions
  - Principal transactions
- Undisclosed or misallocated fees and expenses
  - For example, shifting operational expenses, broken deal expenses, and formation expenses from a parallel fund created for insiders, friends, family, and preferred investors to the main co-mingled fund
  - Use of fund assets for pay for adviser-related operating expenses not authorized under fund operating documents
- Valuation
- Co-investment allocation
  - Compliance with policies and procedures
  - Disclosure of negotiated priority co-investment rights
- Performance Advertising
- Custody

SEC Examination and Enforcement Areas of Focus

- Real estate private equity advisers
    - Failure to disclose ancillary services (e.g., property management, construction management and leasing services) or failure to substantiate that they are provided at or below market rate
- Compliance and internal controls
    - Effectiveness of key control functions
- Cybersecurity
- Vendor due diligence

Department of Labor Fiduciary Rule

- New Department of Labor (DOL) rule defining "investment advice" has been in the works since October 2010
- Final rule issued April 2016
- Final rule was originally to apply on April 10, 2017, and was then delayed to June 9, 2017, with full rollout by January 1, 2018
- The President, by Memorandum to the Secretary of Labor on February 3, 2017, directed DOL to examine whether the rule may adversely affect the ability of Americans to gain access to retirement information and financial advice, and to prepare an updated economic and legal analysis concerning the likely impact of the rule as part of that examination
- DOL confirmed in late May that the applicability date will indeed be June 9, 2017; new DOL Secretary Acosta concluded that there is *"no principled legal basis to change the June 9 date"*
- DOL will continue to examine the rule and consider how to revise it in accordance with the presidential directive
- Secretary Acosta noted that he hoped the SEC, with its "critical expertise in this area," would be a full participant in this process
- On August 31, 2017, DOL proposed to delay full implementation until July 1, 2019. Until that time, BIC only requires impartial conduct standards (i.e., duty of prudence, duty of loyalty, reasonable compensation, and no misleading statements).

Broad Impact

- Will have a profound impact on how all types of investment products and services are sold to ERISA plans and IRAs
- In the private funds space, will mostly affect how interests in funds are *marketed and distributed*
- Marketing to the large ERISA pension plans that are the typical plan investors in funds should be manageable, but it may be very difficult to market to or even accept IRA investors not associated with the manager if full BIC exemption is implemented
- Impact on state funds?

Can a Fund Manager's Marketing Activities Make It a Fiduciary?

- **ERISA plan fiduciaries must:**
  - Adhere to prudent expert standard of care
  - Act solely in the interest of plan participants and beneficiaries
- **ERISA plan and IRA fiduciaries** must comply with highly prescriptive **prohibited transaction rules** that (absent an exemption):
  - Forbid a fiduciary from setting its own compensation
  - Bar variable compensation
  - Prevent a fiduciary from using the plan assets for its own benefit
- **Primary impact of new fiduciary rule falls on broker-dealers** who receive variable compensation for "advising" retail IRA clients (e.g., commissions, loads, 12b-1 fees)
- For a **private fund manager**, the primary concern is whether **marketing** one's own funds and investment management services could be considered to involve the provision of investment advice for a fee, making the manager a fiduciary
- **Conundrum** – the manager would then be **unable to act in its own interest** in marketing its wares or even negotiating its own fees, regardless of whether the fund holds "plan assets"
  - Manager's financial interest in earning fee-based compensation from the fund upon being engaged results in a conflict that would itself require exemptive relief

The New Definition of "Investment Advice"

A person renders "investment advice" and becomes a fiduciary if:

- He or she makes a **recommendation** — a **suggestion**; something reasonably considered an **encouragement to act** — to a plan, plan fiduciary, participant or beneficiary, IRA, or IRA owner
- For a **fee or other compensation**, direct or indirect
- He or she acts or refrains from acting with respect to:
  - **Investment decisions:** purchasing, holding, exchanging, or selling investments
  - How to **invest rollovers or distributions** from a plan or IRA
  - **Rollovers, transfers, or distributions** from a plan or IRA, including whether to roll over, in what amount, in what form, and to what destination
  - **Investment management:** investment policies or strategies, portfolio composition, selection of third parties as investment advisers or managers, account types (e.g., brokerage or advisory)
- The person:
  - Acknowledges fiduciary status
  - Renders advice that is based on particular investment needs of the recipient, or
  - Directs advice to a specific recipient regarding the advisability of a particular investment or management decision for a plan or IRA

“Seller’s Exception” to Fiduciary Status

- Allows transactions with **independent plan fiduciaries with financial expertise**
- Sales pitches to an institutional plan client can include fund recommendations, but the advice must be to an independent fiduciary of the plan:
  - with responsibility for AUM of at least $50 million (e.g., investment committee of large plan), or
  - that is a US regulated bank, insurance company, registered investment adviser, or registered broker-dealer
- Applies to “exchange or other transaction related to the investment of securities or other investment property”
- Seller must know or reasonably believe that the independent fiduciary is **capable of evaluating investment risks**, both in general and as to particular transactions and investment strategies
- Seller must reasonably believe that the independent fiduciary is a fiduciary with **respect to the specific transaction** and is **responsible for exercising independent judgment** in evaluating the transaction
- **Seller may rely on written representations** of the independent fiduciary, including through **negative consent**
- The independent fiduciary must be informed that the information provided is not impartial or fiduciary in nature, and of the existence and nature of the person’s financial interest in the transaction
- Seller cannot receive direct compensation from the plan, plan fiduciary, plan participants or beneficiaries, IRA, or IRA owner for **providing investment advice** in connection with the transaction

“Hire Me” – Can a Manager Sell Its Services Without Becoming a Fiduciary?

- DOL says that you can “tout the quality of [your] own advisory or investment management services” without becoming a fiduciary
- But…
  - If the recommendation of one’s own services is coupled with an **investment recommendation**, the exception is unavailable
    - Thus, a fee-based adviser can freely “recommend” his or her services. However, most “hire me” recommendations are made in conjunction with an investment recommendation
    - Can a fund manager use the exception if it has **only one fund**?
    - More difficult to rely on “hire me” where the manager has more than one account type or fund
  - A series of actions that may not constitute a recommendation when viewed individually may be deemed a fiduciary recommendation when considered in the aggregate

Other Important Exceptions for Fund Managers

- **General communications** that a reasonable person would not view as an investment recommendation
  - Offering memoranda and prospectuses
  - General marketing materials
  - Performance reports
  - General circulation newsletters
  - How should fund quarterly reports to investors be treated?
  - What about ongoing communications between fund manager and plan investors? Recommendations to retain securities?

A Way Forward – Large ERISA Plans

- **Use the sophisticated fiduciary exception for plans represented by sophisticated independent fiduciaries:**
  - Most ERISA plans investing in funds will be fairly large, so recommendations to most ERISA plans investing in funds should be covered
  - Blueprint in the final regulations; new set of written representations in subscription documents
  - DOL confirmed in third set of FAQs that you can address through **notice and negative consent**

A Way Forward – IRAs

- **IRAs are a different matter:**
  - Most IRAs, even large ones, are not represented by independent investment professionals, making the seller's exception unavailable
  - DOL has told us that an IRA owner cannot be the "sophisticated fiduciary" of his or her own IRA, even if the IRA is $50 million or more or the IRA owner manages at least that amount
  - Possible approaches, short of the BIC:
    - Only accept an IRA that can represent that it is advised by a qualifying independent fiduciary
    - Only accept an IRA if there are no communications with the owner other than the provision of offering documents — often not feasible
    - Exclude IRAs, other than those of principals and employees of the manager (no fee paid to manager by these IRAs, so no "investment advice for a fee")

Tax Update

- Partnership Tax Audit Rules
- Management Fee Waivers
- FATCA and OECD/Common Reporting Standard Provisions
- Other Tax Developments to Know About

New Partnership Tax Audit Rules

- The Bipartisan Budget Act of 2015 (BBA), enacted on November 2, 2015, replaces the current rules for tax audits of partnerships, effective for tax years beginning in 2018.
- Key changes include (i) potential liability of a partnership itself for taxes as a result of an audit, (ii) limited rules permitting a partnership to push the consequences of an audit up to the level of its partners, (iii) a new "partnership representative" mechanic (in place of a "tax matters partner") as the party with whom the IRS deals on audits, and (iv) removal of provisions requiring notice to partners of partnership audits.
- Most investment funds won't be able to elect out of the new rules (election out is only available if there are fewer than 100 partners, none of which are themselves partnerships, among other requirements).
- Detailed regulations were proposed in January 2017, but were withdrawn with the new administration and re-proposed in basically the same form on June 15, 2017.

New Partnership Tax Audit Rules

Concerns for private funds and their investors:

- Tax-exempt, government plan, sovereign wealth, and other investors that otherwise may be exempt from, or subject to reduced rates of, US tax, will want partnership provisions protecting them from bearing the economic burden of taxes imposed at the partnership level as a result of a tax audit.
- Funds and investors will want to ensure that former partners remain responsible for their shares of any taxes.
- Pending further guidance, fund sponsors will want to retain maximum flexibility, including the possibility of resolving audit results at the partnership level for administrative convenience—implications on economics require careful thought.
- There are practical concerns with multitier structures—e.g., ability of a fund of funds, for example, to be aware of, much less effectively deal with, an audit of an operating partnership below a private equity fund.

New Partnership Tax Audit Rules

- What we have been seeing and requesting:
  - Limited Partnership Agreement (LPA) provisions provide broad powers to the partnership representative to make a number of elections and determinations in its sole discretion.
  - In response, we seek the following on behalf of fund investors:
    - Early on we sought side letter provisions that basically provided that no matter what a partnership representative did, tax-exempt investors shouldn't pay any more tax one way or the other. These provisions were met with significant resistance.
    - Provisions recognizing the status of the investor as tax-exempt and applying the new provisions with that in mind are commonly granted.
    - Fund counsel have started to refine their BBA provisions recently to require limited partners to amend their tax returns. Relief from such provisions for tax-exempts who do not file tax returns should be sought.
    - We expect to see more back and forth on these broad LPA provisions and side letter provisions in response.

Management Fee Waivers

- After several years of study, the IRS on July 22, 2015 issued proposed regulations that, if adopted, would restrict management fee waiver (MFW) mechanics that are used by many private equity funds, and could apply in other contexts as well (e.g., including alternative arrangements for keystone investors sharing in hedge fund economics).
- The IRS had indicated that it would press to finalize these regulations during 2016, but did not do so, and it is unclear whether the regulations remain a priority under the Trump administration.
- Significant tax audit activity has been ongoing, involving various funds and issues that are within or analogous to the topics covered by the proposed regulations, with indications that the IRS may regard some of the principles of the regulations as reflecting its current interpretation of the law.

Management Fee Waivers

- MFW mechanics, in general terms, seek to allow a fund manager or its affiliates to defer recognizing the ordinary income that the manager otherwise would recognize on receiving management fees that are reinvested in the fund and instead recognize long-term capital gains, reflecting the fund’s gains when realized on its investments.
- MFW that don’t meet the requirements of the proposed regulations would be treated as current ordinary compensation income for the fund manager, and could be subject to additional tax under Internal Revenue Code sections 409A and 457A as “bad” deferred-compensation arrangements.

Management Fee Waivers

- The proposed regulations provide six nonexclusive factors to be used in determining whether an arrangement constitutes a disguised payment for services.
- The most important factor is whether the arrangement has significant "entrepreneurial risk." Facts and circumstances suggesting a lack of entrepreneurial risk include (i) allocations of partnership income that are reasonably certain; (ii) allocations of gross income; and (iii) nonbinding waivers.
- The IRS also noted a particular concern with a right to receive an allocation based on an accounting period of 12 months or less, or where fund assets are hard to value and the manager or an affiliate controls the valuation or the entities in which the fund invests.

Management Fee Waivers

- Various approaches to a MFW are more likely to be respected, going forward, including:
  - Hard-wired arrangements, in which the fund manager agrees up front to receive less in the way of management fees in exchange for a larger interest, for the manager or general partner, in fund profits.
  - Waivers of fees for a particular year that are made, on a binding basis, at least 60 days prior to the beginning of that year.
  - Allocations of increased profits that require looking at the cumulative performance of a fund, not just in a single year, with distributions subject to clawback in the event of later losses.
  - Allocations reflecting a pro rata interest in fund taxable income generally (rather than only of "tax-favored" income, e.g., long-term capital gains and qualified dividends).

Management Fee Waiver

- What we have been seeing:
  - More LPAs without MFWs.
  - If a new LPA has a MFW, then we see tweaks to the structure attempting to comply with the new structure.
  - Amendments to existing LPAs to either drop MFWs or tweak them. These amendments can be complicated.
  - Investors seek/confirm that if a MFW results in additional audits or other expenses, then the general partner (GP) should bear those costs.

FATCA

- FATCA provisions have been with us for some time. The OECD has adopted the so-called "Non-US FATCA rules" under the Common Reporting Standards (CRS), which are based on FATCA rules but can be tweaked by each jurisdiction.
- What we have been seeing:
  - Fund counsel have captured the CRS rules by combining them either within the definition of "FATCA" in the LPA or in a separate definition such as "Information Reporting Regimes."
  - Either way, the requirements for providing information by limited partners is expanded broadly to any information that the GP/fund may need to comply with such laws, including the identification of indirect owners of the investor.
  - Noncompliance could result in a number of draconian penalties, including forced redemption from the fund.
  - The issue for state pension plans is that organic law may prohibit the identification of beneficiaries.
  - The result is a stalemate on both sides. Luckily, we don't believe it is a likely probability that a CRS jurisdiction would require information from investors who provide significant capital to the market where there would be no benefit to such information, but it remains a remote risk.

Other Tax Developments You Should Know About

- Possible Tax Reform – I will check this morning's Trump tweet to see where this is, as it changes every day!
- Expanded safe harbors for non-US pension investors in US real estate
- The *Grecian Magnesite Mining* case and its effect on the sale of partnership interests by non-US investors.
- Section 385 Regulations regarding related-party debt.