ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

WEBINAR SERIES

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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

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CURRENT ISSUES WITH HEDGE FUND OPERATIONS

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Agenda

01 Valuations

02 Liquidity

03 Economics

04 Impact of COVID-19 on Operations

05 Communications

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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**

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Liquidity

- 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

- 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

- 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

- 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 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

- **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

- **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?

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Communications

- **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**

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A CHANGING HORIZON: TALF AND THE CLO MARKET

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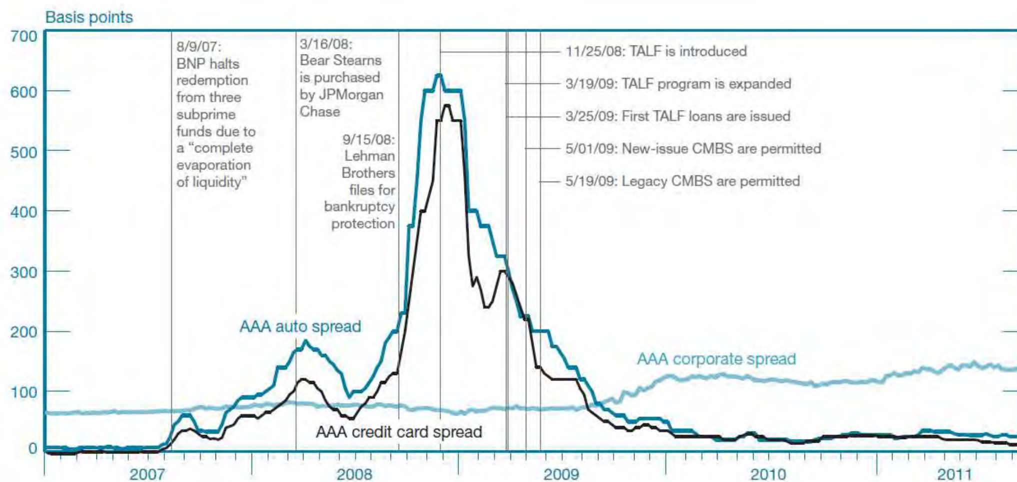
Market Impact of TALF 1.0

- 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



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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

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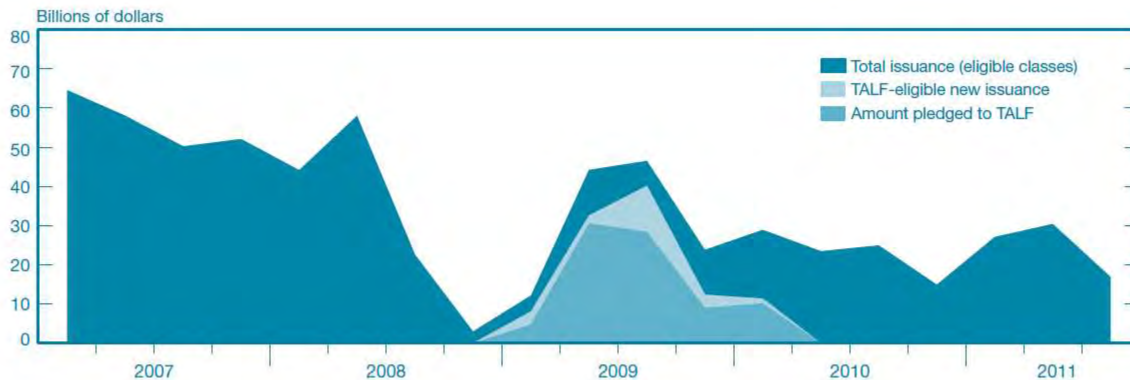
Market Impact of TALF 1.0

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



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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.

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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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Paul R. St. Lawrence concentrates his practice on complex financing transactions, with a particular emphasis on collateralized loan obligations (CLOs) and financings of pools of residential mortgage loans through both repurchase and secured loan facilities. He also handles securitizations, asset-based finance, and other structured finance and derivative products, and is often called upon by clients for his regulatory advice. Paul represents companies on both the sell-side and buy-side in derivative-based financings, CLOs, esoteric securitizations, and transactions utilizing other complex financial instruments. He also advises on the rights of creditors to exercise remedies in derivative and securities transactions following the insolvency of counterparties.

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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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Jedd H. Wider focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds. As co-leader of the global hedge funds practice, he represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He specializes in all aspects of secondary transactions, and complex financial structurings. Jedd concentrates on all aspects of bespoke fund products and arrangements including funds of one and managed accounts and regularly advises clients on all aspects of regulatory compliance.

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.

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WEBINAR SERIES

SESSION 2 | Thursday, May 7

Emerging Developments and Opportunities in the Hedge Fund Marketplace
Fiduciary Issues in Times of Crisis

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EMERGING DEVELOPMENTS AND OPPORTUNITIES IN THE HEDGE FUND MARKETPLACE

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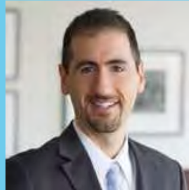

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Recent Trends

1. **Increased use of customized structures that can be opportunistically formed to capitalize on market disruptions**
2. **Investment opportunities in certain asset classes, especially with respect to strategies focused on credit (including CLOs and TALF); healthcare; and distressed or opportunistic investments**
3. **Certain asset classes, such as energy, travel, retail, and entertainment, are at historically low prices**
4. **Certain strategies, such as quantitative macro strategies, have performed well in the downturn**
5. **Secondary sales of side pocket interests:**
   - Greater likelihood of increased use of side pockets, while investors may need liquidity or to rebalance portfolios
   - Increased amount of capital available for secondary purchases

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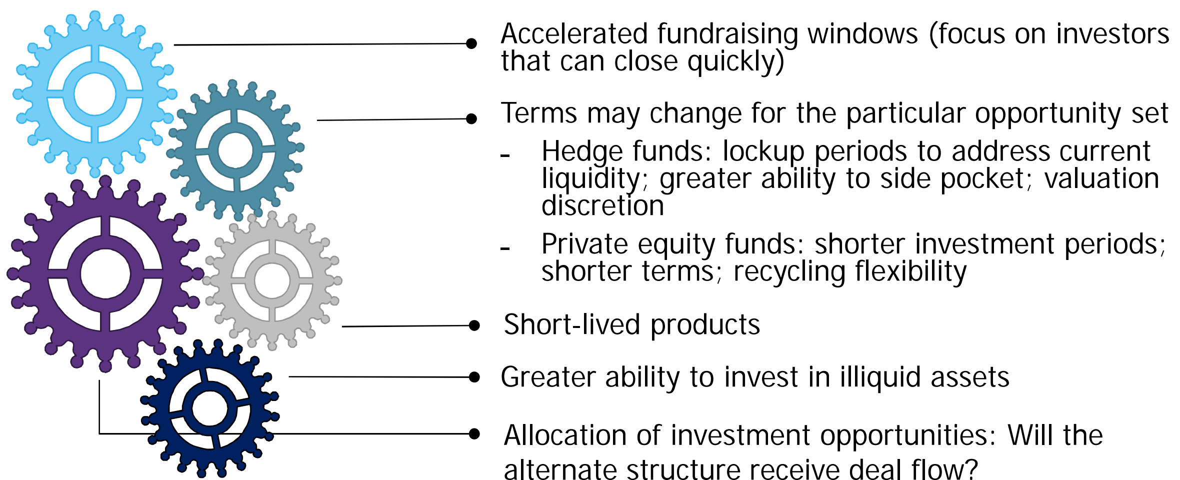
Alternate Structures



- Accelerated fundraising windows (focus on investors that can close quickly)
- Terms may change for the particular opportunity set
  - Hedge funds: lockup periods to address current liquidity; greater ability to side pocket; valuation discretion
  - Private equity funds: shorter investment periods; shorter terms; recycling flexibility
- Short-lived products
- Greater ability to invest in illiquid assets
- Allocation of investment opportunities: Will the alternate structure receive deal flow?

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Alternate Structures

- Greater investment size
- Customized investment programs – ease of modification
- Lower or different fee and expense structures, although greater setup costs for LPs
- Generally, more LP-favorable indemnification and standard-of-care terms
- Greater control, transparency, and governance terms
- Preferential withdrawal terms
- Additional rights that may be inapplicable to other investors
- Long-term relationships
- Leveraging the Manager's infrastructure (e.g., access to sponsor knowledge; may include required training for investor)
- One governing agreement – side letters less prevalent

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Advantages and Disadvantages of Funds-of-One vs. Managed Accounts

- **Advantages**
  - Liability Protection
  - Operational Efficiencies
  - Tax Treatment of the Performance Compensation
  - Privacy
  - Tax Structuring
- **Disadvantages**
  - Lack of Ownership and Control
  - Expenses

- **Advantages**
  - Ownership and Greater Control
  - Risk Management
  - Liquidity
  - Affordability
- **Disadvantages**
  - Counterparty Liability
  - Fiduciary Liability
  - Unfavorable Tax Treatment of the Performance Compensation

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Alternate Structures

- Hybrid Funds
  - Private equity–styled styled fund with a public securities portfolio and a long hold period (no incentive fee on unrealized appreciations and no redemptions)
  - Side-by-Side Fund
- "Best Ideas" Funds/Co-Investment Funds
  - Dedicated fund for a manager's "best ideas" or to co-invest alongside the flagship fund

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Evolution of the Hedge Fund Market & Opportunities

- For funds that manage risk well through the COVID-19 and oil price wars, there will be no shortage of dislocations from which to take advantage.
- These events could also trigger the onset of the next distressed cycle. Hedge funds are well positioned to take advantage of greater discernment among credits given their ability to make such fundamental assessments and position themselves both long and short.
- Additionally, specific countries/regions/sectors will be impacted in very different ways, which could result in a variety of opportunities for macro investing in rates and FX.
- The risk to hedge funds would be from synchronized and coordinated monetary and fiscal actions that allow for a quick, V-shaped, beta-driven rebound that blunts the distinction between winners and losers through bailouts and an overabundance of undiscerning credit.

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Raising New Capital During the COVID-19 Dislocation

- The pandemic will adversely impact fundraising for at least the next several months, but not for everyone — strategies perceived to be nonmarket-correlated or otherwise well positioned to take advantage of current conditions may still do well.
- For managers that want to raise new capital in the short term, it will be considerably easier to do so from existing investors rather than new investors.
- In the current environment, there should be opportunities for some managers to quickly and efficiently attract capital to variations on flagship funds.
- For investment managers which have a fund that is only supposed to be activated on a credit dislocation, they may now have an opportunity to do so.
- Investment managers which have set up overflow and co-investment vehicles or platforms may find that those funds provide the quickest path to market.

Considerations

- Structure
  - In terms of structure, variations are either:
    - A truly separate product (i.e., a new legal entity), but one with governing documents that are closely modeled on those of the flagship fund; or
    - A separate "sleeve" of the flagship fund (i.e., a new class or series of the existing legal entity)
- Each of these approaches (separate product or separate sleeve) can often be implemented without the consent of existing investors.
- Where a fund formed as a variation on a flagship fund will invest alongside the flagship fund or otherwise have an overlapping strategy, managers need to carefully consider their fund documents and their policies and procedures for addressing potential conflicts in the allocation of investment opportunities.

Considerations

- In addition, in the case of the separate sleeve option, care must be taken to disclose the risk of cross-class liabilities and, in certain situations, consent may be required, particularly if either the flagship fund's investment strategy or the new sleeve's investment strategy involves leverage.
- A true separate series requires considerable care in accounting and recordkeeping in order to ensure separation of liabilities (an exception being a new class that would add material risk for investors in the current class(es)).
- "Super Sub Doc" Approach vs. Supplemental PPMs
- Series/Segregated Portfolio Company Platforms
  - Other options that have gained currency in recent years and have potential under the current conditions are the separate series fund (Delaware) or segregated portfolio company (Cayman Islands) platform

ESG CONSIDERATIONS

Resilient Returns in a Downturn?

"ESG fund managers said their focus on nontraditional risks led to portfolios of companies that so far have been resilient during the COVID-19 downturn."

S&P Global Market Intelligence, *Major ESG Investment Funds Outperforming S&P 500 During COVID-19*, April 13, 2020

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ESG Sectors in the Current Market

Environmental

- ❑ Renewable investment strategies more focused on long term returns.
- ❑ Renewables make an attractive alternative with the drop in oil prices.
- ❑ Global energy demand continues to rise.
- ❑ Governments and corporations promote clean and sustainable energy.

Many of the megatrends targeted by institutional grade impact strategies appear fairly resilient.

Healthcare

Education

Communications

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Who Are the Investors?

Depends on Motivation Driving the Investment Decision

Not for Profit | For Profit

Program-Related Investments	Mission-Related Investments	Investment Restrictions	Primum non Nocere	ESG
Pursuing charitable purpose	Pursuing mission-related purpose	No investment in 'sin' industries such as weapons	No negative effects from investments	Take into account ESG considerations
A nonprofit **not** investing for a profit	A nonprofit investing for a profit	Investing for a profit	Investing for a profit	Investing for a profit

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The Growing Market

$239 BILLION
in assets managed by impact investors

Nearly

66%

identify as fund managers

Investors are foundations, banks, CDFIs, family offices, and pension funds

Approximately

67%

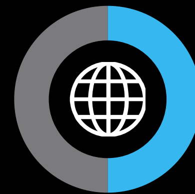
target market rate returns.
19% target close to market rate. 15% target capital preservation

$33 billion

invested in 13,000 impact investments in 2018

Expected growth to
$37 billion
in over 15,000 impact investments in 2019

All data from Global Impact Investing Network, Annual Impact Investor Survey 2019



Compound annual growth rate of impact investing assets of

17%

in the last four years

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What is the Basis for ESG Policies?

- Define strategic impact objectives
  - International Finance Operating Principles for Impact Management
  - Overseas Private Investment Corporation (OPIC) Categorically Prohibited Activities List
- Incorporate objective in investment process
  - CDC Environment and Social Checklist
  - Pacific Community Ventures Due Diligence Guide
- Track performance – Measure the value of the social or environmental benefit created by an investment

How to Incorporate ESG

- TPG's Rise Fund created an "Impact Multiple of Money"* to assess the impact potential of an investment:
  - Estimate a company's output (e.g., number of people reached with an impactful service or program);
  - Attempt to quantify the social value generated through that output (e.g., value of lives saved or increased educational attainment); and
  - Factor in the amount of capital the fund planned to invest and its equity stake to calculate an impact multiple of money.
  - If a company did not score above a 2.5x, Rise would not invest.

*Vikram S. Gandhi, Caitlin Reimers Brumme, Sarah Mehta, *The Rise Fund: TPG Bets Big on Impact*, 310 Harv. L. Rev. 041, 1 (2019).

FIDUCIARY ISSUES IN TIMES OF CRISIS

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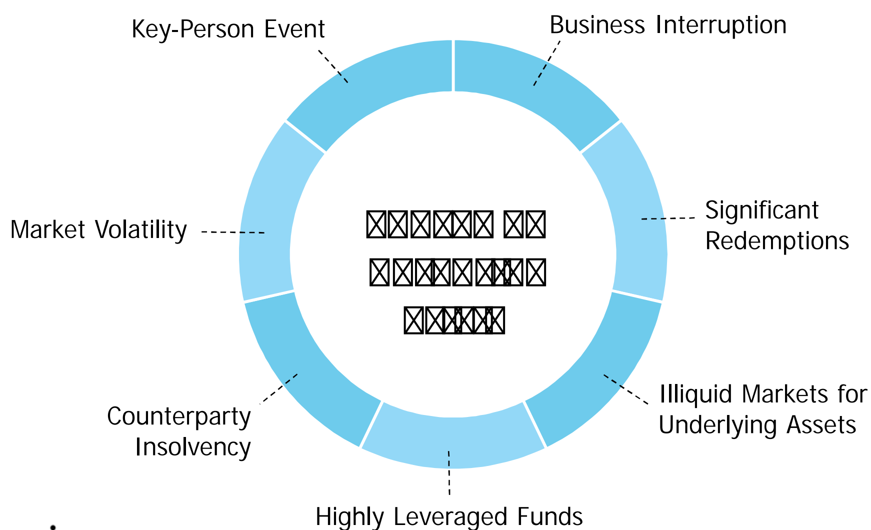
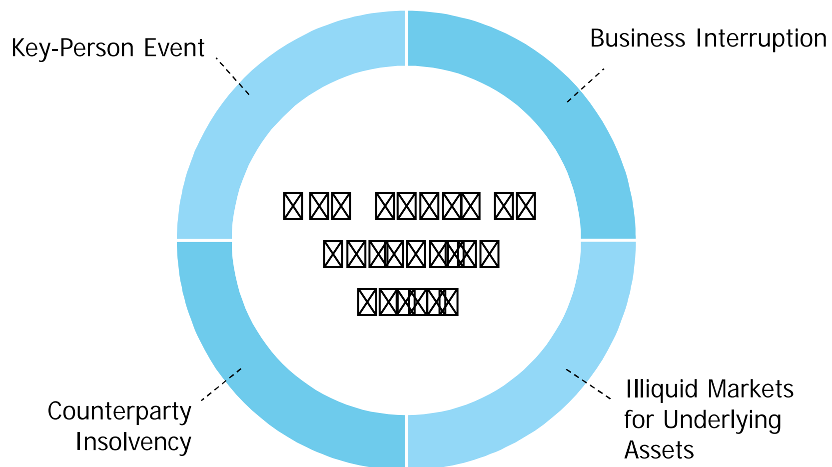
Some Causes of Potential Crisis for Hedge Funds



A New Cause of Potential Crisis for Hedge Funds Pandemic



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Hypothetical Case Study

1. Master-feeder hedge fund has significant decline in performance during March
2. Quarterly redemptions on 90 days' notice, subject to a one-year lockup period and investor-level gate
3. Intended that the Fund would be highly liquid; no side pockets
4. Manager implemented its BCP with some hiccups
5. One of the senior analysts may have the virus

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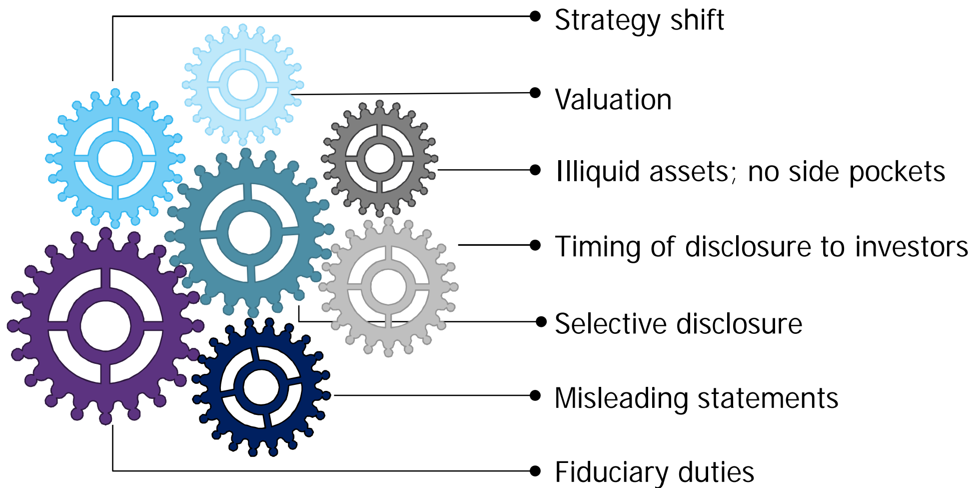
Potential Issues That Could Result in Liability



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What Should Managers Do First?

- Contact US and Cayman legal counsel
- Review fund governing documents and side letters
- Continue to focus on seamless portfolio management and operations
- Consider objectives
  - Business objectives – Going concern or wind-up is inevitable
  - Legal objectives – Fair and equitable treatment of investors
- Fiduciary issues

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Different Constituencies

General Partner/Manager (Delaware)

Board of Directors (Cayman)

Investors – Balancing interests and side letters
- Redeemed and awaiting redemption proceeds
- Investors desiring to redeem
- Investors not redeeming and not permitted to redeem

Counterparties

Employees

Service Providers

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Protective Measures

- Suspensions and collateral consequences
  - Redemptions
  - Payment of redemption proceeds
  - Calculations of net asset value (NAV)
- Timing of suspensions
- Side pockets
- Liquidating special-purpose vehicle (SPV)
- Distributions in kind

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Litigation and Regulatory Risks

- Breach of contract – potential conflict with side letter provisions regarding suspension, liquidation, side pockets, SPVs, distributions in kind, etc.
- Fraud in the inducement in connection with any representations by a manager made to encourage investment (or encourage withdrawal of redemption request) that turn out to be materially inaccurate
- Claims that funds were mismanaged
- Regulatory risks
- Consider self-reporting

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What should we do now?

01 **Focus on seamless operations, compliance and investment processes**

02 **Monitor and enhance BCP**

03 **Valuation**

04 **Documentation**

05 **Investor communications**

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LAWYER BIOGRAPHIES

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Richard A. Goldman represents US and international hedge funds and funds of funds, advising them on a broad range of issues, including fund formation, product structuring, strategic and seed capital arrangements, management company agreements, and all types of regulatory and compliance issues. The co-chair of the firm's global hedge fund practice, Rich also represents private equity managers in the formation of their funds and institutional investors.

Rich also regularly advises clients on registration as investment advisers with the SEC, structuring portfolio transactions and establishing separate accounts. Rich advises endowments and other institutional investors in connection with structuring and negotiating their investments in private funds.

He is the founder of the Boston Hedge Fund Group, an organization for chief financial officers, chief operating officers, general counsel and other senior legal, accounting, and compliance professionals involved with hedge funds in the greater Boston area. Rich is also a lecturer at Boston University's Morin Center for Banking and Financial Law, teaching a course on hedge funds in the LL.M. program.

Before joining Morgan Lewis, Rich was a partner in the investment management practice of another international law firm, where he was the co-chair of their global investment management practice. He was also the general counsel and chief operating officer for a hedge fund manager. He has been ranked for several years by *Chambers USA* as a leading attorney in the hedge funds industry in Massachusetts, national, and global business law guides, as well as listed in Legal 500 US.

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With a background in senior positions at the US Securities and Exchange Commission (SEC) and as in-house counsel at a financial services firm, Ivan Harris brings insights to securities investigations, examinations, and litigation. He represents public companies, financial services firms, and individuals before the SEC, the Financial Industry Regulatory Authority (FINRA), the Chicago Board Options Exchange (CBOE) and various stock exchanges. Clients in the securities industry regularly seek Ivan's advice on compliance and regulatory matters.

Ivan represents public companies, financial institutions including investment banks, regional broker-dealers, hedge funds and private equity funds, municipal issuers and their employees in investigations by the SEC, FINRA, CBOE and other securities regulators. In the public company and municipal arena, Ivan has handled matters for clients involving financial accounting practices, issuer disclosures, Foreign Corrupt Practices Act (FCPA) violations, and insider trading. He regularly counsels large investment banks, clearing firms and other broker-dealers on complex investigations involving trading practices, market structure issues, anti–money laundering compliance, and other rules and regulations. Ivan has also represented hedge fund and private equity firms facing regulatory investigations and examinations relating to valuation practices, complex trading issues, potential use of inside information, and issues relating to fees and expense practices.

Ivan previously served at the SEC from 1998 to 2005, and from 2001 to 2005 was an assistant regional director for enforcement in the SEC's Miami office. While at the SEC, he led the investigation of a major hedge fund collapse, brought the first SEC case involving illegal hedge fund short selling, and prosecuted cases involving accounting fraud, insider trading, FCPA violations, market manipulation and broker-dealer/investment adviser violations. Several of those cases involved cross-border issues and investigative efforts throughout Europe and Latin America. Also before joining Morgan Lewis, Ivan was regulatory counsel for a financial services firm, where he advised on trading issues and compliance matters. He also served on several securities industry committees that focused on fixed income trading and securitized products. Ivan frequently speaks at securities industry and hedge fund conferences.

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With a focus on financial institutions, Brian A. Herman counsels clients in civil and class action litigation in US state and federal court, and in arbitrations. He represents banks, broker-dealers, hedge funds, private equity funds, investment advisers, public companies, and other complex businesses. Brian also advises clients facing examinations by the US Securities and Exchange Commission (SEC), self-regulatory organizations, state regulators, and other regulatory agencies. Clients also turn to Brian for guidance with internal examinations and enhancing their business practices.

Brian's practice spans litigation matters involving contract disputes, lending practices, mergers and acquisitions, residential mortgage-backed securities (RMBS), loan servicing and foreclosure practices, collateralized debt obligations, investment funds, Ponzi schemes, and consumer protection.

Prior to joining Morgan Lewis, Brian served as a law clerk to Judge Ruth Abrams of the Massachusetts Supreme Judicial Court.

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Brendan R. Kalb utilizes his in-house asset management and corporate legal experience to counsel clients on issues relating to the establishment and ongoing operation of global hedge funds, private equity funds, commodity pools, UCITS funds, hybrid customized vehicles, and separately managed accounts, along with providing regulatory, compliance, and trading advice to managers investing in various asset classes in the United States and abroad. He also has deep experience advising on the structuring and operation of various registered fund products, including liquid alternative funds.

Prior to joining Morgan Lewis, Brendan was the managing director and general counsel at AQR Capital Management, LLC, a systematic global asset management firm based in Greenwich, CT, where he was responsible for managing the full spectrum of the firm's legal affairs, including involvement in all aspects of US and overseas regulatory exams, product structuring, derivatives and operational risk management, quantitative investment practices, drafting of investment guidelines and restrictions, creation and update of compliance policies and procedures, as well as implementation and interpretation of international rules and regulations regarding trading and marketing. Prior to joining AQR in 2004, he worked as an investment management associate in the New York office of an international law firm, where he regularly represented registered investment companies, investment advisers, commodity pool operators, commodity trading advisors, and broker-dealers.

Brendan has spoken at a number of industry conferences on regulatory matters affecting the financial services industry and previously served as chairman of the Managed Funds Association's CTA, CPO, and Futures Committee and as a member of MFA's Investment Adviser, International and Government Affairs Committees. In addition, he has served on the National Futures Association's board of directors and is an active member of the Investment Company Institute's Equity Markets, CPO Advisory and Derivatives Markets Advisory Committees. Brendan also serves on the board of advisors of the Institute for Law and Economics, a joint research center between the Law School, the Wharton School, and the Department of Economics at the University of Pennsylvania.

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Miranda Lindl O'Connell represents fund of funds, private foundations, social entrepreneurs, pension plans and other institutional investors in private investment fund transactions. Miranda counsels clients regarding the investment in and secondary sale of interests in private investment funds of a variety of structures including private equity funds, co-investment funds, venture funds, captive funds, separate accounts and other customized private finance options. She advises social entrepreneurs, private foundations, and charities on a range of social impact investments including program-related investments, mission-related investments, and innovative investment vehicles and structures including social impact funds and debt and equity investments.

Miranda also counsels clients in the structuring, formation, and governance of US domestic and international private investment funds. She represents clients in the formation of funds of funds, funds sponsored by 501(c)(3) entities, corporate governance funds, venture funds, real estate funds, co-investment funds, and private equity funds.

The American Bar Association presented Miranda with its Outstanding Volunteer in Public Service Award for her work at the Homeless Advocacy Project. While in law school, Miranda served as an extern for Judge John T. Noonan of the US Court of Appeals for the Ninth Circuit. Prior to law school, she worked as the race director for the San Francisco Marathon.

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Tim Ludford-Thomas is based in Walkers' Cayman Islands office where he is a partner in the firm's Global Investment Funds Group.

Tim has extensive experience in both open and closed ended investment structures and has advised some of the world's leading asset managers. He specialises in fund formations, seed capital arrangements, downstream investments, co-investments, alternative investment vehicles, parallel funds, acquisitions and disposals, restructurings, pooling arrangements, fund governance and joint ventures. Tim also advises on the registration of mutual funds and their ongoing regulatory compliance.

Tim is a part of the FinTech team at Walkers and advises FinTech businesses on projects associated with blockchain, digital assets and a range of related activities, including the establishment of cryptocurrency funds.

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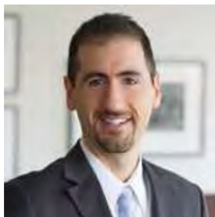
Joseph D. Zargari



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Joseph D. Zargari focuses on the structuring, formation, investment in, and governance and regulation of US domestic and international hedge funds, private equity funds, funds of funds, venture capital funds, hybrid funds, captive funds, and other private investment funds. He also counsels on the investment activities of these funds, and provides legal and other transactional advice for investment managers.

Actively engaged in all aspects of the private funds practice, Joe represents many major financial institutions, fund managers, and investment banks in connection with the formation of their funds and their investment activities, as well as placement agents and other parties connected to these activities. He also represents managers and clients of separately managed accounts and captive funds.

Joe regularly represents clients engaged in secondary transactions (including traditional purchases and sales of fund interests, fund recapitalizations and restructurings, tender offers, and structured, stapled, and synthetic secondary deals) and is a frequent speaker on the subject. Joe advises secondary funds, institutional investors, pension plans, endowments, family offices, and other institutions in their capacities as buyers and sellers of private fund interests on the secondary market and has counseled clients in many of the recent leading secondary transactions.

Joe has presented at a number of industry conferences on investment management-related matters, including at conferences sponsored by the Managed Funds Association and the National Association of Public Pension Attorneys, as well as at conferences sponsored by Morgan Lewis in New York, London, Chicago, Boston, and Dallas. Joe has also published articles on fund formation, investment management, and secondary transaction matters in *Hedge Fund Legal & Compliance Digest*, HedgeFund Intelligence's *Absolute Return* magazine, PEI's *Secondaries Investor* publication, and the Morgan Lewis Hedge Fund Deskbook. Joe also serves as the New York office local practice group leader for the investment management practice.

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ADVANCED TOPICS IN
HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives
WEBINAR SERIES

SESSION 3 | Wednesday, May 13

Current Employment Considerations

Restarting the Economy: Perspectives on Bankruptcy, Insolvency, and the Credit Markets

www.morganlewis.com/2020hedgefundconference

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CURRENT EMPLOYMENT CONSIDERATIONS

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Current Employment Considerations: Introduction

1

- **COVID-19's Business Impact**
  - Unemployment and changes in consumer behavior
  - Government stimulus programs

2

- **Reopening The Workplace: Key Actions For Return**
  - Social Distancing, Safety Measures, Enforcement/Accommodations, COVID-19 Monitoring

3

- **Additional Considerations For Return**
  - Coordination with Building Management
  - Impact of Childcare Availability and Public Transportation
  - Returning Employees from Furlough
  - Travel, Vacation, Leave/Wellness, and Pandemic/Business Continuity Policies

4

- **Litigation Risks With Return**
  - Potential claims against employers
  - Trade secret risks

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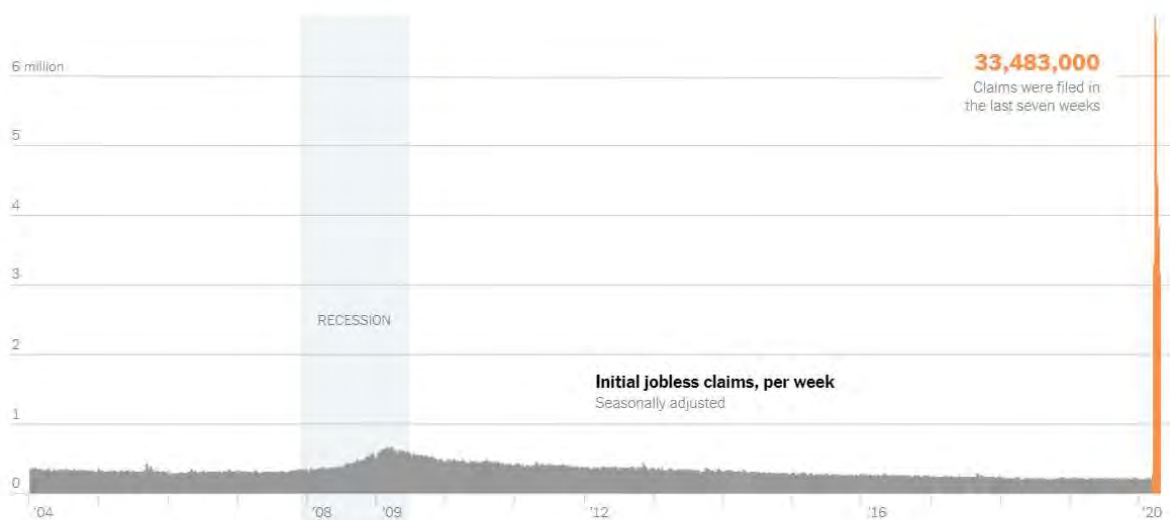
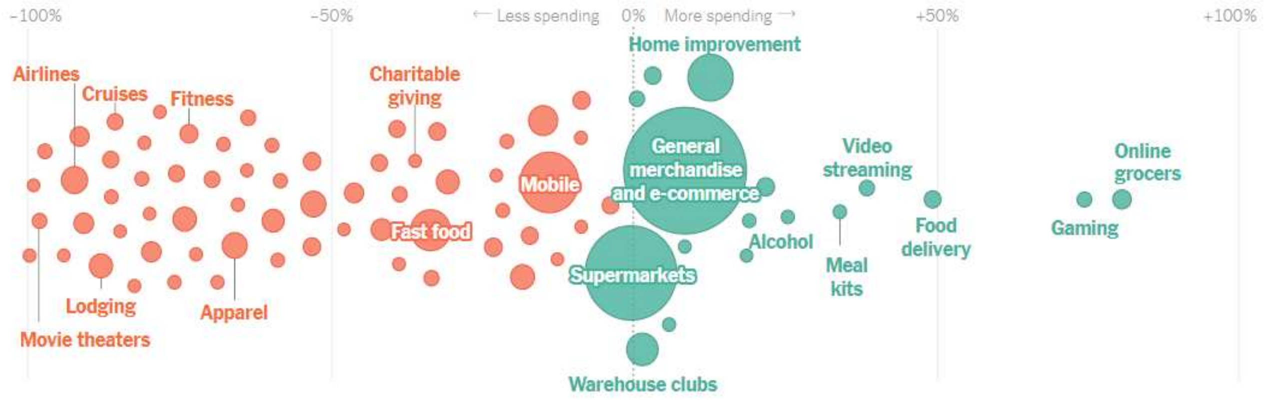
Historic Levels of Unemployment Claims



Changes in Spending Trends



Change in spending from 2019 for the week ending April 1. Bubbles are sized by industry sales.

See David Gelles and Lauren Leatherby. *How the Virus Transformed the Way Americans Spend Their Money*, *N.Y. Times*, April 11, 2020, https://nyti.ms/2yMi1wM.

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Unemployment: Geographic and Industry Breakdown

Impacted States

- Michigan (21.8%)
- Vermont (21.2%)
- Connecticut (18.5%)
- Pennsylvania (18.5%)
- Nevada (16.8%)
- Rhode Island (16.7%)
- Washington (16.0%)
- Alaska (15.6%)
- New York (14.4%)
- West Virginia (14.4%)

Impacted Industries

- Leisure and Hospitality (39.3%)
- Other Services (23%)
- Wholesale and Retail Trade (17.1%)
- Construction (16.6%)
- Durable Goods (15.1%)
- Transportation and Utilities (13.5%)
- Manufacturing (13.2%)
- Professional and Business Services (9.8%)
- Financial Activities (5.4%)

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Government Stimulus Efforts

- **$2 Trillion in Aid Under CARES Act**
  - $603.7 billion to individuals
  - $500 billion to large business (e.g., air carriers, defense businesses)
  - $377 billion to small business (e.g., Paycheck Protection Program (PPP))
  - $339.8 billion to state and local governments
  - $179.5 billion to public services
- **PPP Round 2**
  - After exhausting the first $350 billion in PPP funds, Congress approved an additional $321 billion in funding.
- **Sunset on Effects of Stimulus Efforts?**
  - PPP funds are only designed to cover eight weeks of payroll (and other) expenses
  - Some restrictions on loans to larger businesses expire in September
  - Additional $600 per week in unemployment benefits to expire on July 31, 2020

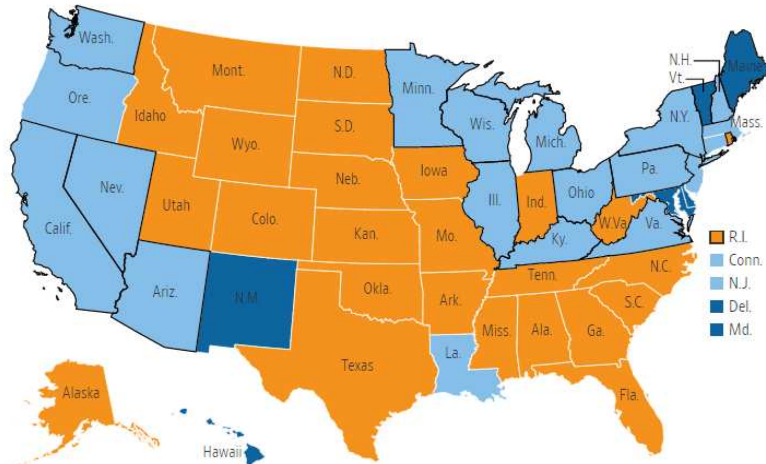
Government Stimulus Efforts

PPP Recipients in Selected Industries

- Construction (13.12%)
- Professional, Scientific, and Technical Services (12.65%)
- Manufacturing (11.96%)
- Health Care and Social Assistance (11.65%)
- Accommodation and Food Services (8.91%)
- Retail Trade (8.59%)
- Real Estate and Rental and Leasing (3.14%)
- Educational Services (2.36%)
- Arts, Entertainment, and Recreation (1.44%)

Reopening the Economy: A State-by-State Approach

■ Comprehensive restrictions on business and travel ■ Some restrictions
■ Lifted many restrictions, or never enacted major restrictions □ Plans announced to lift restrictions

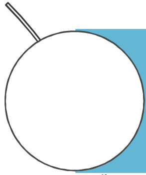


Note: As of May 8
Source: the states
Kathryn Tam and Luis Melgar/THE WALL STREET JOURNAL

Phase I Return
(Based on Applicable Federal/State/Local Orders)

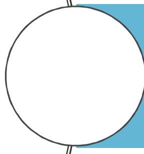
Conservative	• Maintain remote working for all but essential personnel • Establish social distancing and safety measures for return of more personnel in Phase II
Moderate	• Maintain remote working for as many other employees as possible • Conduct phased return of nonremote workers based on priority of personnel with social distancing and safety measures in place
Aggressive	• Return to full operations with social distancing and safety measures in place • As much as possible, conduct phased return based on priority of personnel

Preparation for Phase I Return



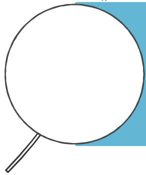
Step 1

- Evaluate existing procedures and determine if they are sufficient for a broader return to work for nonessential personnel
- Consult federal/state/local existing orders for essential businesses to design new policies/procedures now



Step 2

- Identify a team or individual who will be responsible for COVID-19 issues and their impact at the workplace
- Develop and roll out social distancing/safety measures and deploy staff to implement workplace changes



Step 3

- Develop policy/plan for enforcement of new requirements
- Develop policy/plan for accommodations, considerations for most vulnerable employees, and COVID monitoring

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Key Actions for Reopening

- **Physical workspace modifications** (e.g., separating desks, modifying open floor plans, closing common areas)
- **Limiting in-person interactions and physical contact** (e.g., no nonessential travel, no in-person meetings)
- **Training employees** on social distancing policies and protocols, including where to go with complaints
- **Update employee schedules** (e.g., staggered scheduling, remote working for less essential personnel)

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Key Actions for Reopening

- **Create infectious control procedures** (e.g., require frequent hand washing, limit sharing of equipment, assign specified workspaces to each employee, reduce or eliminate access to common areas)
- **Regular screening protocols** for employees, customers/visitors (e.g., symptom, temp screening)
- **PPE procedures** (e.g., require workers and visitors to wear face coverings)
- **Workplace sanitization procedures** (e.g., provide hand sanitizer, require frequent sanitization of high-touch areas)
- **Follow current/updated guidelines** of local DOH, reopening orders, CDC, and OSHA for maintaining a clean and safe workplace

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Key Actions for Reopening

- **Develop/update accommodations policy** for vulnerable employees, including alternative work arrangements
- **Develop policy for employees who fear returning to work or refuse to return to work**
- **Develop PPE enforcement policy,** including discipline for those who refuse to wear face covering
- **Update/develop complaint procedures and training** on enforcement/discipline/accommodations

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Key Actions for Reopening

- **Establish procedure to address workplace exposure** (e.g., separate and send home workers who appear to have symptoms consistent with COVID-19, clean and disinfect workplace)
- **Encourage employees to stay home if they are feeling sick or have COVID symptoms**
- **Develop procedures for contact tracing/notification** of known exposure consistent with ADA or state law

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Additional Considerations for Reopening

- Work with building management to understand your building's plans and policies surrounding reopening.
- Ensure employees are informed of building policies to ensure seamless entry and exit.

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Additional Considerations for Reopening

- Consider impact from lack of childcare availability
- Consider alternatives to public transportation or stipends for parking or rideshare apps to limit need for public transportation

Additional Considerations for Reopening

- Evaluate state laws on preference for furloughed employees
- Review furlough notices to determine promises and expectations for return
- Consider impact of timing of return and any salary reductions for wage/hour impact
- Consider impact on health and welfare benefits and vacation time
- Furloughed employees may need to reenroll or update benefit information and consider any impact on 401(k)
- Employees responsible for premium payments during furlough may be obligated to repay, but there are complications due to state deduction restrictions

Additional Considerations for Reopening

- Compensable time for wait time for symptom/temp screening, temperature taking at home, building ingress/egress, and continuous workday issues
- Potential inclusion of additional incentive pay in regular rate
- Preserving exemptions, including of remote workers whose duties have been modified or exempt workers covering nonexempt work resulting from lack of hourly workers
- Expense reimbursement for masks/safety equipment and internet/cell phone for teleworking employees
- Evaluate effect of shutdown periods on existing bonus/incentive plans

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Additional Considerations for Reopening

- Revise/implement new travel policy consistent with federal/state/local requirements (e.g., what will be considered essential travel?)
- Procedures for monitoring travel and quarantine procedures for return from travel
- Consider monitoring personal/vacation travel
- Consider encouraging employees to utilize vacation while working remotely to avoid a “run” on vacation at the end of the year

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Additional Considerations for Reopening

Leave/Wellness Policies

- Consider leave entitlements for employees remaining home and unable to work remotely as well as updates to policies going forward, including ensuring continued compliance with applicable and recently enacted sick-leave laws
- Evaluate existing Wellness and EAP programs for COVID-19-specific issues

Pandemic/Business Continuity Policies/Plans

- Review and revise current pandemic response plans in order to respond to another potential outbreak of the virus
- Develop management/HR succession in the event that any leadership team is sidelined
- Consider whether to require vaccination once a vaccine is developed

Potential Legal Claims

- **Workplace Safety/Nuisance Claims** (litigation for alleged violation of safety/health standards or state laws requiring safe workplaces and related whistleblower/retaliation complaints)
- **Failure-to-Accommodate Claims** (Is fear of coronavirus a disability? Is the provision of private transportation a reasonable accommodation?)
- **Wage and Hour Claims** (e.g., reimbursable expenses; overtime/meal breaks when working from home; being "on-call"; time waiting for medical screens and temperature checks; wage reduction claims)
- **Workers' Comp or Tort Claims** (including whether WC laws will be exclusive remedy, possible wrongful death claims and third-party liability claims from visitors, employees' family members, etc.)
- **Claims Arising Under Local, State, and Federal Leave Laws**

Potential Legal Claims

- **Furlough and Layoff Claims** (e.g., failure to pay timely final payments, or failure to provide timely termination/benefit eligibility notices)
- **Invasion-of-Privacy Claims** (e.g., disclosure of confidential medical information; disclosure of confidential customer information by employees to family members or otherwise during remote working periods, etc.)
- **Discrimination and Retaliation Claims** (e.g., claims challenging process or decision-making for furloughs, layoffs, salary reductions, etc.; claims relating to employees' actual or perceived disabilities, etc.)
- **Labor Claims** (e.g., violations of collective bargaining agreements, failure to negotiate actions taken in response to the virus, failure to abide by collective bargaining provisions relating to recall rights)

Other Legal Risks: Trade Secrets

- **Proliferation of remote working increases the risk of trade secret theft**
- **Nonetheless, state and federal law requires companies to take reasonable measures to maintain the secrecy of trade secrets, including:**
  - Maintaining a trade secret protection policy
  - Requiring the execution of proprietary information agreements
  - Restricting access to certain documents or categories of information
  - Requiring strong passwords and maintaining secure computer networks
  - Regularly educating personnel about their obligations to maintain confidentiality

Tips for Maintaining Trade Secrets During COVID

- **Communicate Expectations and Requirements**
  - Remind employees of their existing obligations to maintain confidential information, as required under existing company agreements and state/federal laws
  - Encourage reporting of potential security threats and gaps in current remote network
- **Review Agreements with Vendors and Third Parties**
  - Determine if any third parties or vendors have access to confidential or proprietary information
  - Confirm that vendors and third parties are taking steps to secure confidential information in the current, remote working environment
- **Review and Revise Policies**
  - Confirm current policies are adequate in the current environment and consider revisions, if necessary
- **Document All Actions Taken**

Trade Secrets and Departing Employees

Step 1 – Prepare for exit interview

- Identify any agreements that are already in place
- Prepare a certification to be signed by the employee confirming he or she has returned all company information

Step 2 – Confirm departing employee understands his or her obligations with respect to company information

- Ask the employee about future plans to determine if there is heightened risk of trade secret theft
- Consider sending the employee a letter regarding his or her confidentiality obligations

Step 3 – Secure employee's computer and other devices

- Establish a plan for the return of company information, including computers and other company-issued devices
- Facilitate the return of company information (e.g., prepaid mailing, courier service, etc.)
- If necessary, engage a computer forensics firm to confirm that no information was improperly sent or retained by the departing employee

Step 4 – Cut off the employee's access to your systems

- Access to all computer and email systems should be terminated immediately

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RESTARTING THE ECONOMY: PERSPECTIVES ON BANKRUPTCY, INSOLVENCY, AND THE CREDIT MARKETS

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Restarting the Economy – How?

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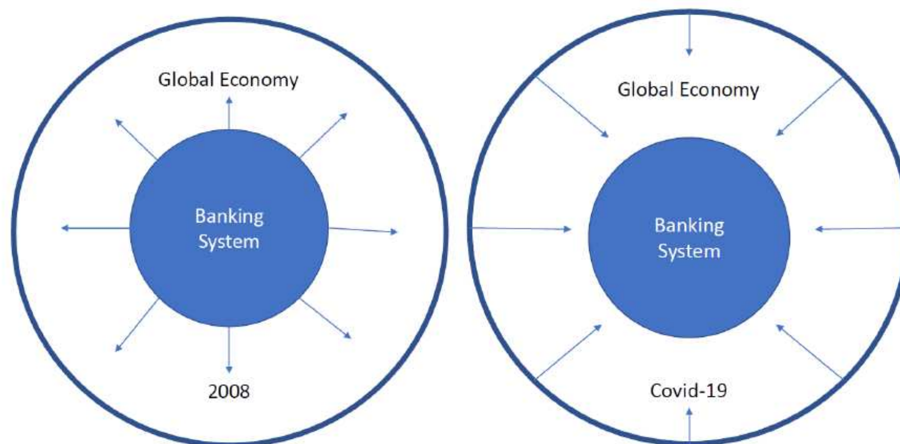
Current Economic Situation vs. Global Financial Crisis



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WHERE IS THE DEBT?

Transportation

Banking

Energy

Healthcare

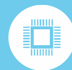
Insurance

Investment funds

Life sciences

Retail & eCommerce

Sports

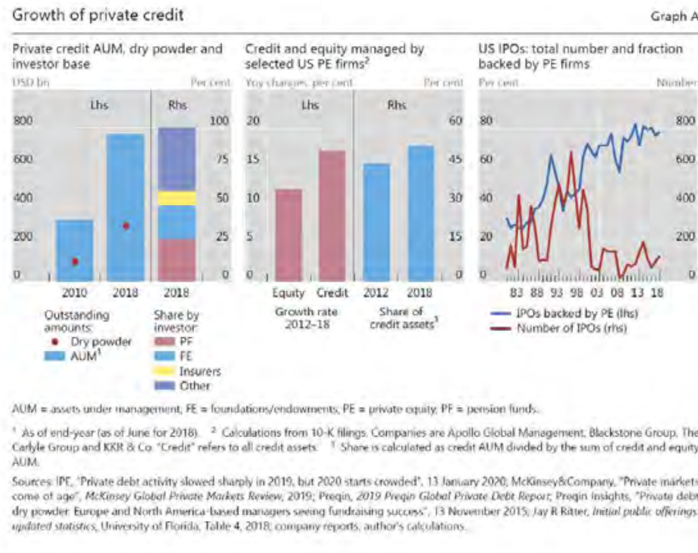

Technology

Bankruptcy – Rise of Alternative Lenders

"High-yield companies will continue to be starved for credit unless the US government extends its program to include private lenders. Private equity will struggle to raise fresh capital as traditional sources…face unprecedented pressures."

View from the Peak, The Absence of White Knights, Paul Krake, April 8, 2020

Growth of Private Credit



Bank of International Settlements, Quarterly Review March 2020 – International banking and financial market developments

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The Absence of White Knights

1. **Sovereign Wealth Funds**
2. **China**
3. **Warren Buffett**
4. **University Endowments**

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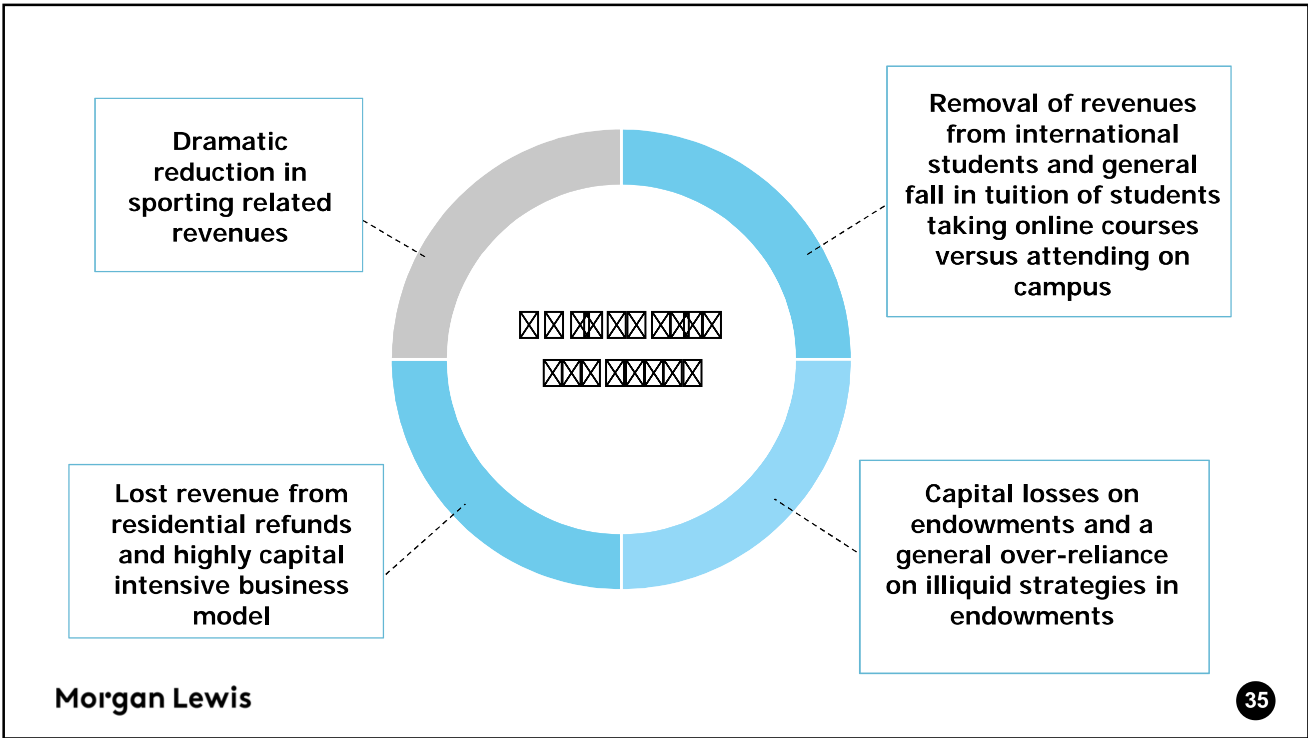

Bankruptcy Courts Adjusting to Unprecedented Times

- Most Courts have implemented general orders and procedures to remain open to debtors and parties in interest
- Hearings being conducted telephonically and by video-conference if witnesses are necessary
- All non-time-sensitive matters are being deferred
- 341 meetings being held telephonically
- But courts remain open

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Impact on Pending Chapter 11 Cases

- Inability to operate and economic uncertainty have curtailed exit alternatives
- Even companies close to the finish line have had to move back their timelines and expectations (e.g. EP Energy and Alta Mesa)
- Novel suspension motions or "mothball" procedures have been enacted

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LAWYER BIOGRAPHIES

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Recognized by legal industry observers for his labor and employment work, Leni D. Battaglia defends clients in a variety of employment litigation in courts, arbitral tribunals, and agencies around the United States. Leni also develops proactive litigation-avoidance strategies for clients in various industries, including financial services, technology, media, entertainment, retail, hospitality, ecommerce, and transportation. Additionally, he currently serves as co-leader of the firm's fashion and luxury brands initiative.

In addition to unpaid overtime, minimum wage, and other wage and hour class and collective matters, Leni litigates sexual harassment, defamation, age, race, sex, national origin, and disability discrimination, and whistleblower claims. He also represents clients in contract, denial of employee benefits, noncompete, and trade secret matters.

In the realm of preventative practice, Leni counsels on gig-economy and on-demand workforces, sexual harassment prevention and #MeToo issues, arbitration agreements and class action waivers, compensation plans, independent contractor and exemption classification, restrictive covenants and trade secrets, and employment policies. He regularly conducts internal wage and hour audits and navigates employers through investigations brought by federal and state agencies. Leni also trains employees and managers on how to prevent harassment and discrimination in the workplace, and regularly authors articles and conducts seminars on developments in New York employment law and class and collective action litigation.

Leni enjoys an active pro bono practice and is a recipient of numerous awards, including the Award for Pro Bono Service from the New York City Family Court (2013) and the Award for Outstanding Pro Bono Service from the Legal Aid Society of New York (2006), and has repeatedly received the Empire State Counsel Honor (NY) in 2007–2010 and 2013–2014.

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Jennifer Feldsher focuses her practice on corporate restructuring and insolvency law. She represents interested parties in bankruptcy proceedings and complex corporate debt restructurings with an emphasis on the representation of secured creditors, special situations investment funds, ad hoc groups, and acquirers of assets in all aspects of distressed situations. Jennifer also has experience representing troubled corporate debtors in in-court and out-of-court reorganizations, asset sales, loan restructurings, and commercial loan transactions.

Jennifer has directed all aspects of the bankruptcy process for debtors and creditors, including contested plan confirmation hearings, contested relief from stay and cash collateral hearings, and DIP loan negotiations and related hearings. In addition, Jennifer is routinely called on to advise directors, managers, creditors, and institutional investors on zone of insolvency issues and fiduciary duties.

She has acted as counsel to companies involved in many of the largest restructurings, including in the energy, retail, telecommunications, technology, healthcare, airline, automotive, gaming, and financial services industries.

Paul Krake, *View from the Peak*

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Paul has over 25 years' experience as an economic and political strategist. He founded View from the Peak in 2011, seeing a need for a truly global, multi-asset class research platform that focuses on the interactions between public policy, economic trends, technology and geo-politics. View from the Peak takes its name from Victoria Peak, the highest point on Hong Kong Island and the firm aims to look at the world from a 360-degree view with an Asian perspective. Clients include endowments, family offices, government agencies, asset managers, and corporates. The firm has offices in Hong Kong, Chicago, and London.

Paul, like many China watchers, has been disappointed with the tone and substance of the debate regarding the future of US-China relations over the course of the last several years. The need for a more sensible debate forms the genesis behind the US-China Series, which seeks to rationally cover these complex issues, while being cognizant of different opinions and philosophies. The US-China series also aims to promote a message of co-ordination that is critical when discussing the future of the most important geo-political relationship of the 21st century.

Prior to forming View from the Peak, Paul spent 15 years in Investment Banking and Asset Management. He was the Managing Partner of Corus Capital Management, a multistrategy Asian focused hedge fund based in New York. Prior to forming Corus in 2005, he held Asia-focused roles at Moore Capital Management, Goldman Sachs, and Macquarie Bank. Paul holds a Bachelor of Economics and Politics from Monash University in Melbourne, Australia.

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Timothy W. Levin, leader of the firm's investment management practice, counsels investment advisers and other financial services firms on the design, development, and management of pooled investment vehicles and investment advisory programs. He also advises fund managers in connection with organization, registration, and ongoing regulatory compliance. Additionally, he represents managers and sponsors of unregistered pooled investment vehicles.

Timothy's clients include many types of registered investment companies, such as mutual funds and registered funds of hedge funds, and funds focused on alternative investment strategies, including business development companies (BDCs). His unregistered pooled investment vehicle clients include private funds, bank collective investment trusts (CITs), and companies seeking exemption from investment company status.

Since 2008, *Chambers USA: America's Leading Lawyers for Business* has recognized Timothy for his work.

He speaks frequently at conferences and moderates panels. He also co-chairs the annual Hedge Fund Conference. Timothy is the editor of *Morgan Lewis Hedge Fund Deskbook: Legal and Practical Guide for a New Era* and the *Mutual Fund Regulation and Compliance Handbook.*

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Douglas T. Schwarz is a trusted advisor to and advocate for employers in all aspects of labor and employment law. He litigates in court, arbitration, and administrative proceedings; counsels employers on human resources matters; negotiates and drafts executive employment and separation agreements; advises on labor and employment aspects of corporate transactions, both domestic and cross-border; and conducts internal investigations of employee complaints. Doug also handles ADA Title III and state law matters involving access of persons with disabilities to public accommodations.

Doug's clients include financial services firms (mutual funds, hedge funds, private equity, venture capital, commercial and investment banks, wealth management); educational institutions; and media, technology, telecommunications, pharmaceuticals, and life sciences companies.

He represents numerous non-US companies, from Japan and elsewhere in Asia, the United Kingdom, and Europe, regarding their US labor and employment matters, and US companies on international labor and employment issues.

Doug's experience includes litigating claims of discrimination, harassment, and reasonable accommodation (race, gender, age, disability, pregnancy, sexual orientation, religion), whistleblower retaliation, wage and hour violations (bonus, commission, overtime and minimum wage), non-competition, non-solicitation, and trade secret breach, defamation and privacy; counseling on reorganizations, reductions-in-force, and executive hiring and termination matters; developing and implementing litigation-avoidance strategies, diversity and affirmative action plans, and training programs on harassment prevention, diversity, and performance management; and advising on government audits (by OSHA, the Department of Labor and OFCCP) and labor-management relations.

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Private Equity Trends for Hedge Fund Managers: Movement to Closed-End Funds
Credit Funds and the Credit Market

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PRIVATE EQUITY TRENDS FOR HEDGE FUND MANAGERS: MOVEMENT TO CLOSED-END FUNDS

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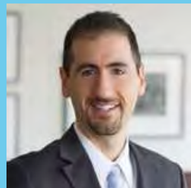

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Migration to Private Equity

- In recent years, we have seen increasing activity by hedge fund managers investing in traditional private equity/debt. This trend is a result, in part, of the public markets and investor demand.
- Traditional private equity/debt investing is generally a less liquid strategy and therefore many current hedge fund structures and terms are not well equipped to accommodate such private equity style investment strategies.
- Hedge fund managers are attempting to modify their fund terms (or set up new funds with different terms) to address reduced liquidity of these investments by imposing gates, longer lock-ups, or increase of side pocket capacity.
- Hedge funds, however, have certain advantages over private equity funds: hedge funds have no restrictions on when a PE style investment can be made, can more easily reinvest capital, and can raise or draw in additional capital for its PE investments.

Multiple Fund Offerings

- Compliance with disclosure in existing funds
- Time and attention/exclusivity standards (in offering documents and seed agreements)
- Sharing revenue among the principals
- Expense allocations
- Trade allocations
- Co-investment rights
- Cannibalization risk of flagship product
- Business complexities

Basic Differences Between Hedge and Private Equity

- Liquid assets
- Incentive allocation
- High water mark
- Unrecouped losses
- One time capital contribution

- Illiquid assets
- Carried interest
- Waterfall
- Clawback
- Capital calls over time

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Basic Differences Between Hedge and Private Equity

- Open fundraising period
- Dilution based on NAV
- Fees based on NAV
- LP redemptions
- 2 year lock-up
- Evergreen fund

- Limited fundraising period
- Dilution based on cost
- Fees based on commitment
- Transfer or liquidation
- 10-13 year lock-up
- 10 year term

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Alternative Structures for Accessing PE

- Side Pockets
- Hybrid and Crossover Funds
  - Customized mix and match of terms from either side
  - Market acceptance
  - Administrative considerations
- Pledge Funds
  - LP opt-in/opt-out rights
  - Administrative considerations
- Fund of Funds, Co-Investment Funds

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Hybrid Funds

- Hybrid Funds – various forms:
  - Traditional hedge funds with side pockets (still common)
  - Private equity–styled fund with a large portion of its portfolio in public securities and a long hold period, with no incentive fee on unrealized appreciation, and limited or no redemption rights (limited rights may include rolling long lock-up periods)
  - Side-by-side fund (Hedge fund for liquids and private equity fund for illiquids)

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Cross-Over Hedge Funds

- As hedge fund managers migrate into the private equity world, we are seeing greater interest in the formation of cross-over hedge funds.
- Cross-over hedge funds are funds that combine hedge fund strategies with private-equity investment strategies within a single fund vehicle.
- One main difference between a cross-over hedge fund and a hedge fund with significant side pocket capacity is a bifurcated fee and liquidity structure. In such instances, the fund manager seeks to create a mini-PE fund within the hedge fund with the mini-PE fund subject to traditional PE fund terms: limited offering, limited investment period, capital draw-downs, carried interest waterfall distribution terms, no mark-to-market for valuations, and a finite term. But where a private investment goes public, the cross-over fund does not need to exit the position and the hedge fund portion of the portfolio may (but need not) seek appropriate hedges on the private investments.

Hedge Fund Co-Investment Vehicles

- Hedge fund managers are offering with much greater frequency co-investment vehicles.
- Co-investment vehicles are:
  - any type of entity (partnership, corporation, business trust) established to invest in a "co-investment opportunity." The co-invest vehicle can be for one or more investors or one or more co-investments in which the identity of the co-investment is either known or unknown (i.e., blind pools) to the investors.
  - generally managed by the same investment manager of the hedge fund and may invest in parallel with the hedge fund, which investment may be direct into the co-investment opportunity or indirect through blocker entities or other pooled investment vehicles.
- A "Co-investment opportunity" is an opportunity to invest in parallel with or in combination with the hedge fund in a particular investment that is generally either too large, restrictive, or illiquid (or all of the foregoing) for the hedge fund alone.

Hedge Fund Co-Investment Vehicles

- Hedge fund managers are offering co-investment vehicles for the following reasons:
  - Negative perception of "side pockets"
  - Concentration and capacity limitations
  - Opportunities in illiquid investments
  - Showcase expertise and distinguish oneself from "the pack"
  - Creation of goodwill; raise additional capital
  - Dedicated fund for a manager's "best ideas" or to co-invest alongside the flagship fund

CREDIT FUNDS AND THE CREDIT MARKET

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Credit Funds: Defined

- A private fund focused on originating and/or purchasing debt and other securities
- Typically PE-style fund (closed-end, limited life, no redemptions, etc.)
- Some hybrid structures allow limited redemptions/liquidity
- Often levered to take advantage of interest rate spreads
- Capital typically raised in a combination of parallel comingled funds and SMAs/funds of one (driven by discretion over investments, fees, leverage, etc.)

Context: Growth in Sector Pre-pandemic

- Post-last economic crisis (2008 et seq.), private credit funds stepped in when banks pulled back
- Lots of overlap with PE buyout funds providing equity, and private credit funds providing debt
- Credit funds have a larger volume of transactions and are typically invested at a faster pace than traditional PE

Impact of Pandemic and Ensuing Economic Stress

- Mature debt portfolios under scrutiny – anecdotally, anywhere from 30%-40% of portfolio under water
- Those managers who more recently entered the market are able to raise new capital if they are not burdened by legacy portfolios
- Public fund managers are also pursuing private credit platforms

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Manager and Investor Response

- Many managers are forming funds focused on liquid credit opportunities and secondary portfolio purchases, and providing customized solutions to distressed and other borrowers.
  - Certain existing funds are extending their offering periods and modifying their investment strategies to capture the opportunity.
  - Opportunistic funds being formed through various structures, including through traditional commingled fund structures, "annex," or co-investment funds alongside existing flagship
- These products are being launched rapidly and, in some cases, represent a pivot away from a more traditional acquisition fund platform.
- The investment opportunities being pursued are driven by multiple factors, including the ability to acquire loans at significant discounts, ratings downgrades, forced selling behavior by certain participants in the market, and borrowers that will require additional capital infusions.
- Recent credit funds typically have broad mandates that contemplate investments in debt and other securities, as well as both increased economic instability and stability, depending on whether the market further declines or recovers.
- Investors are also looking to increase their exposure to credit, driven by a belief that the market will rebound in a manner comparable to that after the 2008 financial crisis and the desire to increase their returns in light of significant recent losses.

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Certain Key Terms

The terms of these opportunistic funds vary, but many managers are raising and deploying capital on an expedited basis and in an increasingly competitive environment to take advantage of opportunities that may present themselves on a temporary or limited basis.

Typical terms we are seeing in the market include the following:

- Limited fundraising periods (2-12 months)
- Short investment periods (1-3 years)
- Term of funds more limited (5-8 years, subject to extensions)
- Expansive recycling capabilities (e.g., permitting reinvestments at any time for any purpose for which capital can be drawn)
- Management fees typically based on invested capital throughout the fund term, with invested capital sometimes including the amount of the leverage used to make investments

Managers of hedge funds and other open-ended private funds are also forming funds that may differ from their typical structures to address the illiquidity of the underlying investments.

- Given this illiquidity and potential valuation difficulties, these funds may have longer lock-up periods (e.g., from 3-4 years), may side pocket certain assets, and may charge fees based on invested capital (rather than on a mark-to-market basis).

Key Considerations

1. Ensure that disclosures are fulsome, including with respect to conflicts of interest
2. Consider how investments will be allocated among the various products and whether their allocation policies and disclosures need to be updated
3. Consider valuation issues and, if managing a hedge fund or similar structure, whether to include more robust disclosure on the likelihood that investments may be side pocketed or redemptions otherwise suspended
4. For sponsors considering rebranding or relaunching an existing investment fund, determine whether any investor or advisory committee consents are required and whether additional disclosure is required – e.g., with respect to existing investments
5. Lender licensing issues under state law may be relevant, depending on the structure and investment strategy of the fund

Structuring

- Varies depending on type of investor, where investments will be made, and type of investment (i.e., real estate vs. corporate)
- If a strategy will include loan originations (including modifications of existing loans) and the use of leverage, the sponsor will need to consider the tax implications for tax-exempt and non-US investors in structuring the fund
- A sponsor will need to consider including structural features that will be attractive to, and expected by, these investor groups
- Mitigation strategies may include, *inter alia*, season and sell, treaty structures, blockers (to address ECI and/or UBTI), private BDCs, REITs, etc.

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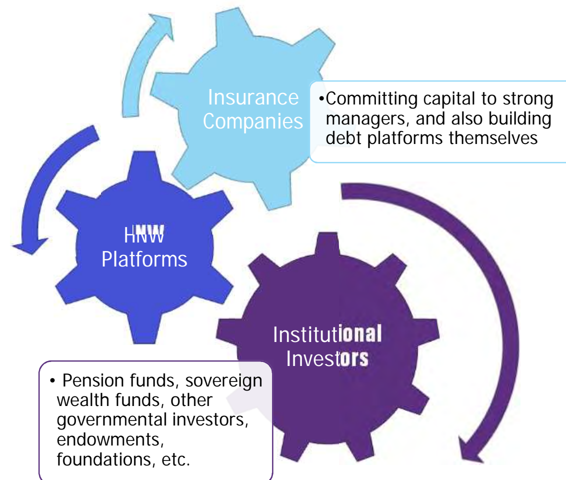
Investors

Who are the investors we are seeing in this market?



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Pre-COVID-19 Credit Market Observations

- Sponsors dominated the market
- Acquisition financing robust
- Leveraged lending is pervasive and non-bank lenders predominate

Post-COVID-19 Credit Market Observations

- Workouts and existing credits
- Market opportunity for investors not averse to risk
- Restructuring and bankruptcy as a means to achieve value
- Origination deals have slowed significantly

Leveraged Loans and High-Yield Bonds

- Carry significant credit risk, and defaults and losses increase during a recession.
- Investors and borrowers focused on risk, especially when lending to companies leveraged more than average.
- Sponsors tend to hold back uncalled capital and, in times of economic downturns, may use such uncalled capital to buy back debt at deep discounts.

See Kotowski, Chris, et al., *A Deep Dive Into Credit Markets; Why We Think All is Not Lost*, Oppenheimer, 2020.

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Status of Leveraged Lending

- Recent data supports the notion that leveraged lending took a hit in March.
- Early signs show that trading of such debt is coming back online and this suggests lending activity may come back soon, at higher pricing.

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Total Return to Middle Market Loans

Index	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	CAGR
							Year-end Level (Indexed to 1,000 at 3Q04)										2004 - 2019
Income Return	1,016	1,109	1,231	1,364	1,524	1,714	1,925	2,158	2,429	2,713	3,011	3,334	3,685	4,059	4,483	4,948	11.1%
%Δ Y/Y	-	9.2%	11.0%	10.8%	11.7%	12.5%	12.3%	12.1%	12.6%	11.7%	11.0%	10.7%	10.5%	10.2%	10.4%	10.4%	
Realized Gains / (Losses)	1,000	1,009	1,015	1,033	1,027	956	927	911	905	904	904	897	885	869	861	854	(1.0%)
%Δ Y/Y	-	0.9%	0.6%	1.7%	(0.6%)	(6.9%)	(3.0%)	(1.8%)	(0.6%)	(0.2%)	0.0%	(0.7%)	(1.4%)	(1.7%)	(0.9%)	(0.9%)	
Unrealized Gains / (Losses)	1,008	1,008	1,027	1,003	840	906	962	959	977	988	975	935	955	958	946	943	(0.4%)
%Δ Y/Y	-	(0.0%)	1.9%	(2.3%)	(16.2%)	7.9%	6.2%	(0.4%)	1.9%	1.1%	(1.3%)	(4.1%)	2.1%	0.3%	(1.3%)	(0.3%)	
Total Return	**1,024**	**1,127**	**1,281**	**1,412**	**1,321**	**1,495**	**1,731**	**1,899**	**2,166**	**2,441**	**2,674**	**2,822**	**3,139**	**3,410**	**3,685**	**4,022**	9.6%
%Δ Y/Y	**-**	**10.1%**	**13.7%**	**10.2%**	**(6.5%)**	**13.2%**	**15.8%**	**9.8%**	**14.0%**	**12.7%**	**9.6%**	**5.5%**	**11.2%**	**8.6%**	**8.1%**	**9.1%**	

Source: Cliffwater LLC and Oppenheimer & Co. Inc. Note: results presented above cannot and should not be viewed as an indicator of future performance. Return calculations exclude applicable costs, including commissions and interest.

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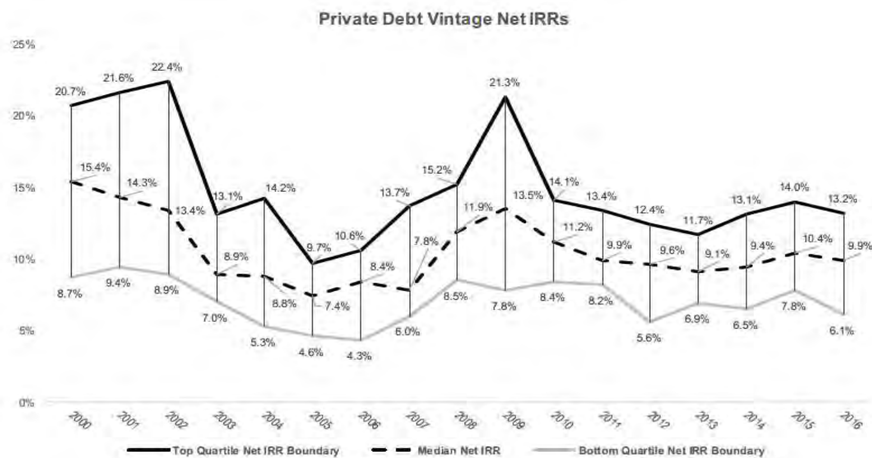
Private Debt Investment IRR



Source: Preqin and Oppenheimer & Co. Inc. Updated as of July 2019.

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Volatility by Asset Category

Private Credit Horizon IRR Breakdown

Source: Preqin and Oppenheimer & Co. Inc. Updated as of April 2020.

Annualized Returns of Private Asset Classes

Worst Case Performance

Lowest 5-Year Annualized Performance

1995–2019

Source: Bloomberg, Hamilton Lane and Oppenheimer & Co. Inc.

State of Leveraged Loan Universe

Source: Bloomberg, Fitch Ratings, Fitch U.S. Leveraged Loan Default Index, Refinitiv LPC and Oppenheimer & Co. Inc.

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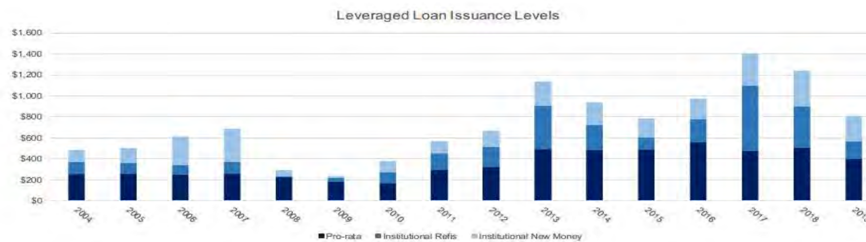
Decrease of Loan Issuances Prior to COVID-19

Issuances of leveraged loans peaked in 2017, and in 2019 were at their lowest level since 2012.

Leveraged Loan Issuance Levels



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leveraged Loans Issuance																
Institutional Refis	117	101	92	111	10	32	102	155	194	409	235	119	221	503	390	167
Institutional New Money	106	140	274	315	59	24	104	112	148	231	220	175	200	305	341	239
Pro-rata	257	260	246	262	225	183	170	299	322	495	485	489	554	594	509	402
Total	**480**	**501**	**612**	**688**	**294**	**239**	**376**	**566**	**664**	**1,135**	**940**	**783**	**975**	**1,402**	**1,240**	**808**
Issuance Breakdown																
Institutional Refis	24.4%	20.2%	15.0%	16.1%	3.4%	13.4%	27.1%	27.4%	29.2%	36.0%	25.0%	15.2%	22.7%	35.9%	31.5%	20.7%
Institutional New Money	22.1%	27.9%	44.8%	45.8%	20.1%	10.0%	27.7%	19.8%	22.3%	20.4%	23.4%	22.3%	20.5%	21.8%	27.5%	29.6%
Pro-rata	53.5%	51.9%	40.2%	38.1%	76.5%	76.6%	45.2%	52.8%	48.5%	43.6%	51.6%	62.5%	56.8%	42.4%	41.0%	49.8%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Institutional Loans % of Total																
Refis	52.5%	41.9%	25.1%	26.1%	14.5%	57.1%	49.5%	58.1%	56.7%	63.9%	51.6%	40.5%	52.5%	62.3%	53.4%	41.1%
New Money	47.5%	58.1%	74.9%	73.9%	85.5%	42.9%	50.5%	41.9%	43.3%	36.1%	48.4%	59.5%	47.5%	37.7%	46.6%	58.9%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Fitch Ratings, Fitch U.S. Leveraged Loan Default Index, Refinitiv LPC and Oppenheimer & Co. Inc.

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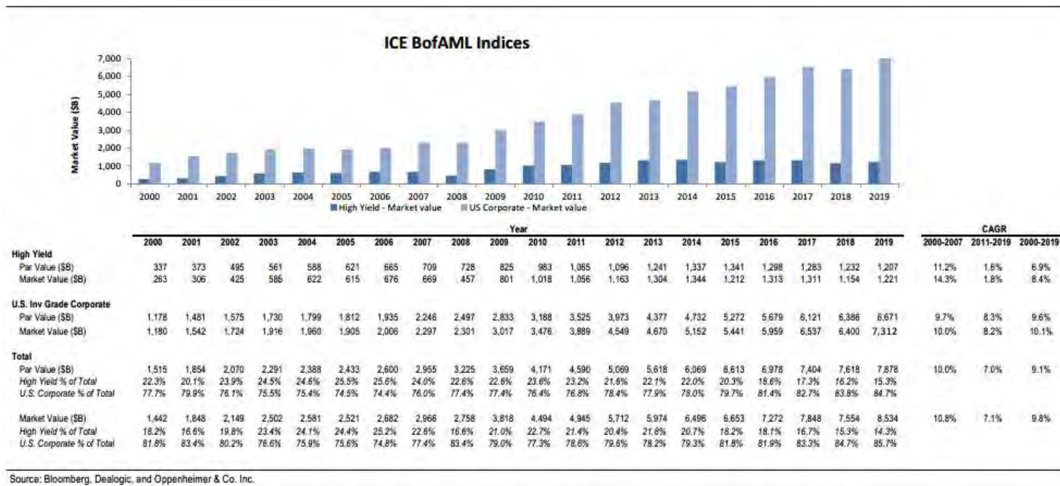
High Yield Bonds Market Share Loss



	Year									
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
High Yield										
Par Value ($B)	337	373	495	561	588	621	665	709	728	825
Market Value ($B)	263	306	425	585	622	615	676	669	457	801
U.S. Inv Grade Corporate										
Par Value ($B)	1,178	1,481	1,575	1,730	1,799	1,812	1,935	2,246	2,497	2,833
Market Value ($B)	1,180	1,542	1,724	1,916	1,960	1,905	2,006	2,297	2,301	3,017
Total										
Par Value ($B)	1,515	1,854	2,070	2,291	2,388	2,433	2,600	2,955	3,225	3,659
High Yield % of Total	22.3%	20.1%	23.9%	24.5%	24.6%	25.5%	25.6%	24.0%	22.6%	22.6%
U.S. Corporate % of Total	77.7%	79.9%	76.1%	75.5%	75.4%	74.5%	74.4%	76.0%	77.4%	77.4%
Market Value ($B)	1,442	1,848	2,149	2,502	2,581	2,521	2,682	2,966	2,758	3,818
High Yield % of Total	18.2%	16.6%	19.8%	23.4%	24.1%	24.4%	25.2%	22.6%	16.6%	21.0%
U.S. Corporate % of Total	81.8%	83.4%	80.2%	76.6%	75.9%	75.6%	74.8%	77.4%	83.4%	79.0%

	Year										CAGR		
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2000-2007	2011-2019	2000-2019
High Yield													
Par Value ($B)	983	1,065	1,096	1,241	1,337	1,341	1,298	1,283	1,232	1,207	11.2%	1.6%	6.9%
Market Value ($B)	1,018	1,056	1,163	1,304	1,344	1,212	1,313	1,311	1,154	1,221	14.3%	1.8%	8.4%
U.S. Inv Grade Corporate													
Par Value ($B)	3,188	3,525	3,973	4,377	4,732	5,272	5,679	6,121	6,386	6,671	9.7%	8.3%	9.6%
Market Value ($B)	3,476	3,889	4,549	4,670	5,152	5,441	5,959	6,537	6,400	7,312	10.0%	8.2%	10.1%
Total													
Par Value ($B)	4,171	4,590	5,069	5,618	6,069	6,613	6,978	7,404	7,618	7,878	10.0%	7.0%	9.1%
High Yield % of Total	23.6%	23.2%	21.6%	22.1%	22.0%	20.3%	18.6%	17.3%	16.2%	15.3%			
U.S. Corporate % of Total	76.4%	76.8%	78.4%	77.9%	78.0%	79.7%	81.4%	82.7%	83.8%	84.7%			
Market Value ($B)	4,494	4,945	5,712	5,974	6,496	6,653	7,272	7,848	7,554	8,534	10.8%	7.1%	9.8%
High Yield % of Total	22.7%	21.4%	20.4%	21.6%	20.7%	18.2%	18.1%	16.7%	15.3%	14.3%			
U.S. Corporate % of Total	77.3%	78.6%	79.6%	78.2%	79.3%	81.8%	81.9%	83.3%	84.7%	85.7%			

Source: Bloomberg, Dealogic, and Oppenheimer & Co. Inc.

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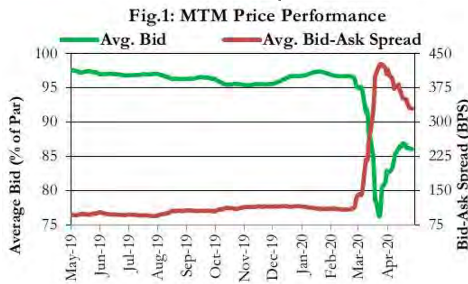
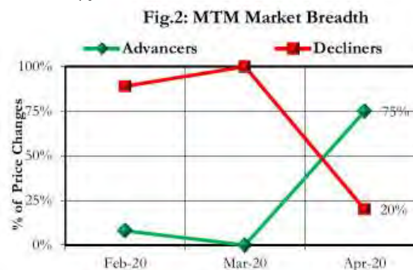
Current Credit Market Observations
Secondary Loan Market

- While in March, the S&P/LSTA Leveraged Loan Index (LLI) produced its second lowest monthly reading on record (-12.4%), the LLI gained 4.5% in April as mark-to-market (MTM) prices generally rebounded.
- In April, 75% of loans reported MTM price gains and only 20% reported losses.
- The average bid level climbed back to 86.1, almost 10 points higher than March's low. This is more than 11 points below 2020's high-water mark of 97.35.





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Source: LSTA Secondary Market Monthly

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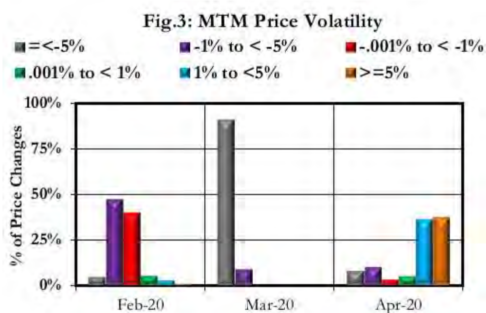
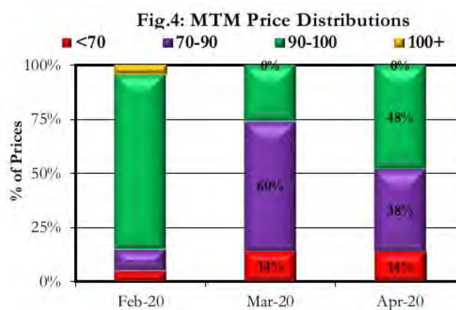
Current Credit Market Observations
Secondary Loan Market

- The percentage of loans bid in a 92-98 context increased 21 percentage points to a 47% market share (loans bid between 95 and 98 demonstrated the largest increase in market share, nearly tripling to 22%).
- The 98 and above price cohort barely changed – rising from less than 1% to 2%.
- The percentage of loans bid below 80 decreased eight percentage points to a 17% market share.





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Source: LSTA Secondary Market Monthly

Impact of COVID-19

The KBW Nasdaq Bank Index (BKX) (designed to track performance of leading banks and thrifts that are publicly-traded in the US) is down 34%, leveraged loans down about 7% and high yield down ~6-7% depending on the index.

	Price						Total Returns *								
							Period						Cumulative		
Ticker	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	4/9/2020	2015	2016	2017	2018	2019	YTD	1Y	3Y	5Y
ARCC	$14.26	$16.49	$15.72	$16.68	$18.65	$13.10	1.4%	36.4%	4.5%	8.9%	30.6%	-27.6%	-14.9%	2.3%	21.6%
FDUS	$13.69	$16.73	$15.18	$11.69	$14.84	$7.21	3.0%	26.6%	6.7%	-12.0%	40.6%	-48.6%	-43.0%	-32.0%	-6.8%
MRCC	$13.09	$16.38	$13.75	$9.60	$10.86	$6.89	0.2%	28.2%	-1.5%	-20.0%	27.7%	-33.3%	-32.5%	-28.5%	-8.9%
NMFC	$13.02	$14.10	$13.85	$12.58	$13.74	$7.32	-3.7%	18.7%	5.7%	2.8%	20.0%	-44.3%	-37.0%	-20.8%	-5.0%
SCM	$9.64	$12.06	$13.14	$12.95	$14.23	$7.57	-6.6%	39.2%	20.2%	8.9%	20.4%	-44.4%	-38.8%	-17.6%	16.8%
SLRC	$16.43	$20.82	$20.21	$19.19	$20.62	$13.92	0.1%	36.5%	4.9%	3.1%	16.0%	-30.5%	-27.4%	-16.8%	7.9%
SUNS	$14.90	$16.44	$17.76	$15.12	$17.60	$11.60	9.0%	19.8%	16.6%	-6.9%	25.7%	-32.1%	-25.4%	-12.1%	13.1%
TCPC	$13.93	$16.90	$15.28	$13.04	$14.05	$7.17	-8.4%	31.7%	-1.1%	-6.2%	18.8%	-46.4%	-38.8%	-33.0%	-10.7%
WHF	$11.48	$12.17	$13.42	$12.72	$13.70	$7.24	11.7%	18.4%	21.9%	5.4%	20.4%	-44.6%	-37.0%	-16.4%	13.9%
Average BDC							**0.7%**	**27.3%**	**8.7%**	**-1.7%**	**24.5%**	**-39.1%**	**-32.6%**	**-19.4%**	**4.6%**
APO	$15.18	$19.36	$33.47	$24.54	$47.71	$39.16	-27.3%	35.8%	82.4%	-20.9%	102.8%	-16.1%	42.4%	77.2%	122.2%
ARES	$12.93	$19.20	$20.00	$17.78	$35.69	$35.15	-19.4%	54.9%	10.1%	-4.4%	107.9%	-0.4%	53.7%	102.1%	131.2%
BX	$29.24	$27.03	$32.02	$29.81	$55.94	$49.17	-3.2%	-1.9%	27.0%	0.7%	94.1%	-11.0%	43.9%	93.9%	53.3%
CG	$15.82	$15.25	$22.90	$15.75	$32.08	$24.06	-30.9%	8.4%	58.3%	-23.8%	112.3%	-24.2%	32.8%	73.3%	11.7%
HLNE	NA	NA	$35.39	$37.00	$59.60	$58.99	NA	NA	NA	6.8%	63.9%	-0.6%	25.8%	231.0%	NA
KKR	$15.59	$15.39	$21.06	$19.63	$29.17	$25.30	-26.0%	2.8%	41.2%	-3.8%	51.1%	-12.8%	10.5%	56.7%	27.7%
Average Alternative Asset Manager							**-21.4%**	**20.0%**	**43.8%**	**-7.9%**	**88.7%**	**-10.8%**	**34.8%**	**105.7%**	**69.2%**
BAC	$16.83	$22.10	$29.52	$24.64	$35.22	$24.86	-4.8%	32.8%	35.3%	-14.7%	45.6%	-28.9%	-15.3%	18.9%	70.9%
C	$51.75	$59.43	$74.41	$52.06	$79.89	$47.41	-4.1%	16.7%	26.8%	-28.0%	57.1%	-40.0%	-26.7%	-10.1%	0.3%
GS	$180.23	$239.45	$254.76	$167.05	$229.93	$184.26	-5.7%	34.3%	7.8%	-33.2%	40.1%	-19.3%	-9.1%	-12.7%	1.3%
JPM	$66.03	$86.29	$106.94	$97.62	$139.40	$102.78	8.2%	33.5%	26.3%	-6.4%	46.2%	-25.0%	-4.5%	32.0%	82.6%
MS	$31.81	$42.25	$52.47	$39.65	$51.12	$41.08	-16.6%	38.0%	26.3%	-22.3%	32.2%	-19.0%	-9.1%	9.4%	24.5%
PNC	$95.31	$116.96	$144.29	$116.91	$159.63	$105.42	8.7%	24.9%	25.6%	-16.6%	40.1%	-33.2%	-17.2%	-0.1%	28.1%
USB	$42.67	$51.37	$53.58	$45.70	$59.29	$38.05	-2.8%	22.9%	6.8%	-12.2%	33.2%	-35.1%	-21.0%	-15.4%	2.0%
WFC	$54.36	$55.11	$60.67	$46.08	$53.80	$33.20	1.9%	4.2%	12.9%	-21.3%	20.9%	-37.3%	-24.3%	-25.2%	-23.5%
Average Banks							**-2.2%**	**25.4%**	**20.9%**	**-19.3%**	**39.4%**	**-29.7%**	**-15.9%**	**-0.4%**	**23.3%**
AMJ	$28.87	$31.61	$27.47	$22.32	$21.81	$10.35	-32.0%	16.3%	-7.1%	-11.9%	5.8%	-50.6%	-53.0%	-50.2%	-54.2%
HYG	$80.58	$86.66	$87.26	$81.10	$87.94	$82.36	-4.8%	13.1%	6.0%	-1.9%	13.8%	-5.1%	-0.3%	8.7%	15.2%
IYR	$75.06	$76.94	$81.01	$74.94	$93.06	$78.88	1.5%	7.0%	9.2%	-4.2%	28.0%	-14.6%	-7.3%	9.3%	20.0%
Average Yield Group							**-11.7%**	**12.1%**	**2.7%**	**-6.0%**	**15.9%**	**-23.4%**	**-20.2%**	**-10.4%**	**-6.3%**
LSTA	$1,804.55	$2,000.94	$2,067.14	$2,054.38	$2,273.18	$2,119.13	-2.8%	10.9%	3.3%	-0.6%	10.7%	-6.8%	-4.4%	3.4%	10.1%
JNK	$101.73	$109.35	$110.16	$100.77	$109.64	$101.64	-6.4%	14.0%	6.4%	-3.1%	14.6%	-5.9%	-1.1%	8.6%	12.1%
BKX	$73.08	$91.79	$106.71	$85.79	$113.38	$75.26	-1.6%	25.6%	16.3%	-19.6%	32.1%	-33.6%	-34.4%	-14.5%	3.0%
XLF	$23.83	$23.25	$27.91	$23.82	$30.78	$23.38	-1.8%	22.6%	21.8%	-12.9%	31.6%	-23.5%	-11.6%	8.9%	30.9%
S&P 500	$2,043.94	$2,238.83	$2,673.61	$2,506.85	$3,230.78	$2,789.82	-0.7%	9.5%	19.4%	-6.2%	28.9%	-13.6%	-4.0%	19.8%	33.1%

Notes:
* Total returns assume simple dividend returns (not reinvested).

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Source: Company Filings, FactSet and Oppenheimer & Co., Inc.

Opportunities for Hedge Funds

- Junk-bond spreads have more than tripled, hitting 1,100 basis points compared to about 350 basis points in September.
- The amount of debt trading at a distressed level reached almost $1 trillion.
- While distressed debt fundraising has declined, distressed investors are sitting on dry powder raised over the last two to three years, which is ready to be deployed.
- Firms reported by Bloomberg to be seeking money for credit dislocation portfolios include:
  - Highbridge Capital Management: $2.5 billion for two credit-dislocation funds
  - Knighthead Capital Management: $450 million in additional cash for its distressed-debt fund
  - Bardin Hill Investment Partners: raised $300 million to go after stressed credits
  - Silverback Asset Management: preparing to start a $200 million credit fund

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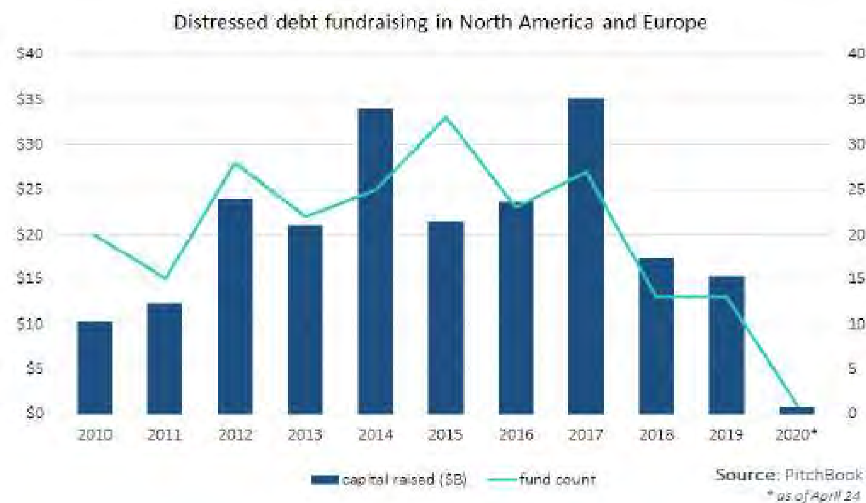
Distressed Debt Fundraising



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Federal Lending Programs

- Given the status of the lending market, government funding is taking the place of private credit in the near term as a source of bridge liquidity until the credit markets normalize.
- Two such facilities are the SBA's Paycheck Protection Program and the Main Street Lending Program.

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Paycheck Protection Program Loans

- 1.00% interest rate and 2-year maturity.
- Loan amount: lesser of the $10 million maximum and 2.5 times the borrower's average monthly payroll for the past 12 months.
- Loan proceeds can cover: payroll costs; group healthcare benefits; mortgage interest payments, rent, utilities, and other debt interest.
- Up to 100% loan forgiveness for funds used in the first 8-weeks post-disbursement.

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PPP Loans and Bankruptcy

- PPP contains no express limitation on the granting of loans to debtors in bankruptcy. However, based solely on the applications, an applicant's bankruptcy is a disqualifying fact.
- The Bankruptcy Court for the Southern District of Texas found that the Bankruptcy Code likely prevents the SBA from discriminating against potential borrowers strictly on the basis of a pending bankruptcy.
- What About Companies that File for Bankruptcy *After* a PPP Application Is Filed?
  - With the SBA clearly signaling that it does not wish to be a provider of debtor-in-possession or exit financing, courts will need to carefully balance interests, as well as the policy underlying different sections of the Bankruptcy Code.

Main Street Lending Program

- $600 billion in loans purchased through the following three facilities:
  - **New Loan Facility**
  - **Expanded Loan Facility**
  - **Priority Loan Facility**
- Eligible Lenders may originate new Main Street loans or use Main Street loans to increase size of existing loans to eligible businesses.
- Among other requirements, an eligible business is one that meets at least one of the following two conditions:
  - Has 15,000 employees or fewer; or
  - Had 2019 annual revenues of $5 billion or less

Covenant Relief/Amendments

- In connection with PPP loans, incumbent lenders have been open to:
    1. Excluding interest and principal payments of PPP loans from Fixed Charges but limited only to the portion of PPP loans forgiven; and
    2. Excluding PPP loans from Leverage Ratio

Going Concern and Material Adverse Effect

- The COVID-19 crisis provides new known and unknown factors for management to consider when making a going-concern evaluation.
- When evaluating an entity's ability to meet its obligations, management should consider:
    - The entity's financial condition, liquidity sources, and conditional and unconditional obligations
    - Changes in forecasted operating results and/or cash flow projections
    - The funds necessary to maintain the entity's operations
- COVID-19 and its fallout increase the risk that parties may try to terminate transactions, or renegotiate central deal terms by asserting that the target or borrower suffered a material adverse effect or material adverse change.
- This will depend on the specific wording of the provision at issue and the effects on the particular company, and whether pandemics or similar events were excluded from provisions.

Covenants/Amendments/Consent Issues

1. Principal and interest holidays;
2. Financial covenant deferrals and amendments;
3. Going concern qualification issues/deferral of audited financial statement delivery; and
4. Requirements to fund additional equity by sponsors or other investors

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Kristen V. Campana represents a wide variety of direct and alternative lenders, particularly those involving private sources of capital, including private debt funds, hedge funds, specialty finance companies, business development companies, private equity investors, and issuers in domestic and cross-border financings across the capital structure in connection with acquisitions, leveraged buyouts, convertible debt, equity investments, letters of credit, and project financings.

Kristen has experience in bankruptcy reorganizations and liquidations, work-outs, and distressed debt purchases and sales, as well as second lien and mezzanine financings, and other subordinated debt financings. She represents debtors, debtor-in-possession lenders, pre-petition lenders, and unsecured creditors' committees, as well as other creditors in bankruptcy proceedings. She also advises clients on energy company and real estate restructurings, and provides general credit review analysis for lenders and potential debt purchasers.

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Daniel A. Losk advises sponsors and investment managers of real asset-related private equity funds on fund formation matters and structuring and implementing co-investment transactions. He also counsels insurance companies, global pension funds, and other institutional investors in connection with consortia, joint venture, and platform investment transactions. Daniel's diverse transactional experience has also included advising clients on matters involving mergers and acquisitions, project finance, and general corporate transactions.

Daniel has experience working on Latin American transactions and is fluent in Spanish. Before joining Morgan Lewis, Daniel was an associate in the energy and project finance practice of an international law firm in Boston, and in the project finance and infrastructure practice of another international law firm in New York City.

Prior to attending law school, Daniel worked at a strategy consulting firm, advising domestic beverage and food companies on their international market expansion into Latin America and Europe.

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Gerald J. Kehoe focuses on private investment capital formation and investment product structuring. He advises fund sponsors managing vehicles investing in energy, infrastructure, renewables, buyouts, and other strategies. Jerry also advises sponsors and global institutional investors on structuring and implementing co-investments, direct investing pools, master feeder partnerships, and other complex investment structures.

Jerry advises US and international sponsors in fund launches, raising substantial commitments for investments in power and energy generation and transmission assets, real estate, solar and wind projects, patent royalty strategies, leveraged buyouts, clean technology, and other infrastructure assets. Commitments are sourced from institutional US and international investors, including sovereign wealth funds, US and global pension plans, insurance companies, endowments, family offices, and foundations.

Since 2009, *Chambers USA: America's Leading Lawyers for Business* has recognized Jerry for his work. He is active in international business associations and committees promoting the development of commercial law and trade, and he maintains an active pro bono practice.
He was previously a partner in the investment management practice of an international law firm, where he spent four years as the managing partner of its London office.

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Daniel A. Nelson advises clients on the US and international tax and commercial considerations related to the efficient structuring of transactions and business relationships. He counsels global institutional investors—including investment managers for some of the world's largest pension funds, sovereign wealth funds, and insurance companies—in connection with investments in real estate, infrastructure projects, and other real assets. Dan also advises sponsors regarding the formation and operation of customized investment platforms, private investment funds, and joint ventures involving pension funds, sovereign wealth funds, insurance companies, and other institutional investors.

Much of Dan's work with institutional investors and sponsors is cross-border, involving both inbound investments into the Americas region as well as outbound investments. In addition to this work, Dan maintains a broad-based transactional tax practice.

In his tax practice, Dan advises clients on the tax issues that accompany merger and acquisition transactions and the formation of partnerships and joint ventures. He also counsels clients on transactions involving real estate, real estate investment trusts (REITs), the energy sector (including project finance transactions), and the formation and operation of private equity funds. Dan has experience with a wide range of capital markets transactions, business restructurings, and other transactional tax planning matters.

Dan also helps clients obtain administrative rulings from the US Internal Revenue Service (IRS).

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Peter M. Phleger advises sponsors and institutional investors, including corporate strategic investors, on private investment fund formation, including venture and private equity funds, fund-of-funds, secondary funds, and captive corporate funds. He counsels on fund structure, formation, governance, and investing activities, including both primary investments and secondary transactions. His work encompasses fund structuring, partnership agreement terms and conditions, securities law compliance, investor relations, and general partner separations.

Peter's clients include fund sponsors of multibillion dollar partnerships and early–stage venture capital firms; strategic corporate investors such as pharmaceutical companies partnering with early–stage life science focused funds and energy companies partnering with renewable energy funds; and institutional investors such as public pension plans, insurance companies, fund-of-funds, family offices, and sovereign wealth funds. He also counsels both secondary buyers and sellers of portfolios of fund interests.

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Matthew Edward Schernecke advises direct lenders, mezzanine investment funds, and venture capital investors on loans and other investment transactions with a wide range of borrowers across industry classes and of all sizes, types, and structures. Matthew also advises private equity clients and corporate borrowers on domestic and cross-border acquisition financings, out-of-court restructurings and workouts, bankruptcy matters, and real estate financings. Matthew leads transactions spanning diverse industries, including media and telecommunications, Internet and technology, food and beverage, real estate, retail, and healthcare. Matthew serves as the New York office local practice group leader for the finance group.

Matthew has worked with Morgan Lewis teams on multiple deals worth more than $1 billion.

Prior to joining Morgan Lewis, Matthew served as a law clerk to Federal Magistrate Judge Cheryl L. Pollak of the US District Court for the Eastern District of New York. While in law school, Matthew was twice elected president of the student body, served as senior comments editor for the *University of Chicago Roundtable* journal, and was awarded the Donald C. Egan Scholarship. At The Johns Hopkins University in 1998, Matthew was elected president of the student body and was awarded the Alexander K. Barton Cup for the graduating senior who most faithfully served the interests and ideals of the university.

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Joseph D. Zargari focuses on the structuring, formation, investment in, and governance and regulation of US domestic and international hedge funds, private equity funds, funds of funds, venture capital funds, hybrid funds, captive funds, and other private investment funds. He also counsels on the investment activities of these funds, and provides legal and other transactional advice for investment managers.

Actively engaged in all aspects of the private funds practice, Joe represents many major financial institutions, fund managers, and investment banks in connection with the formation of their funds and their investment activities, as well as placement agents and other parties connected to these activities. He also represents managers and clients of separately managed accounts and captive funds.

Joe regularly represents clients engaged in secondary transactions (including traditional purchases and sales of fund interests, fund recapitalizations and restructurings, tender offers, and structured, stapled, and synthetic secondary deals) and is a frequent speaker on the subject. Joe advises secondary funds, institutional investors, pension plans, endowments, family offices, and other institutions in their capacities as buyers and sellers of private fund interests on the secondary market and has counseled clients in many of the recent leading secondary transactions.

Joe has presented at a number of industry conferences on investment management-related matters, including at conferences sponsored by the Managed Funds Association and the National Association of Public Pension Attorneys, as well as at conferences sponsored by Morgan Lewis in New York, London, Chicago, Boston, and Dallas. Joe has also published articles on fund formation, investment management, and secondary transaction matters in *Hedge Fund Legal & Compliance Digest*, HedgeFund Intelligence's *Absolute Return* magazine, PEI's *Secondaries Investor* publication, and the Morgan Lewis Hedge Fund Deskbook. Joe also serves as the New York office local practice group leader for the investment management practice.

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ADVANCED TOPICS IN
HEDGE FUND PRACTICES CONFERENCE
Manager and Investor Perspectives
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SESSION 5 | Thursday, May 21

Enforcement Trends and Issues

Fresh from the SEC: Discussion with G. Jeffrey Boujoukos, Former Regional Director, Philadelphia Regional Office, US Securities and Exchange Commission

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ENFORCEMENT TRENDS AND ISSUES

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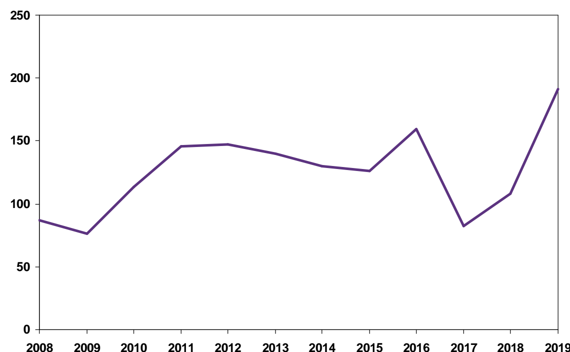
Agenda

1 **SEC Enforcement Developments and Trends**
- 2019 Enforcement Statistics
- Current Trends and COVID-19 Priorities

2 **Notable Enforcement Cases Involving Private Funds**

SEC Enforcement Statistics

Number of Investment Adviser and Investment Company Actions



Year	Number of IA/IC Actions
2008	87
2009	76
2010	113
2011	146
2012	147
2013	140
2014	130
2015	126
2016	159
2017	82
2018	108
2019	191

SEC Enforcement Priorities and Trends

"Main Street" Investor Protection

COVID-19 Era Enforcement Priorities

- Business continuity
- Record retention
- Selective disclosures
- Redemption-related misconduct
- Insider trading

Challenges Associated with Remote Investigations

- Remote testimony
- Access to documents in response to subpoenas

Notable SEC Cases Affecting Private Fund Advisers

Lessons learned from recent SEC actions against private fund advisers:

Disclosures Regarding Risk Monitoring Controls	Fees and Expenses	Conflicts of Interest	Trading Practices and Valuation
• Effectiveness and authority of risk management functions and technology	• Improper charging of employee and other expenses to private funds	• Related party transactions • Undisclosed compensation	• Pricing of odd lots vs. round lots • Improper cross trades • MNPI policies and procedures • Failure to use observable inputs

FRESH FROM THE SEC: DISCUSSION WITH G. JEFFREY BOUJOUKOS, FORMER REGIONAL DIRECTOR, PHILADELPHIA REGIONAL OFFICE, US SECURITIES AND EXCHANGE COMMISSION

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G. Jeffrey Boujoukos is the leader of our securities enforcement practice. The former regional director of the Philadelphia Regional Office of the US Securities and Exchange Commission (SEC), Jeff defends public companies, financial services clients, and their executives in SEC, self-regulatory organization (SRO), and state enforcement matters. Combining his government and private practice experience, Jeff advises clients in collaboration with Morgan Lewis's securities, white collar defense, and investment management practices. He is admitted in Pennsylvania and Massachusetts only, and his practice is supervised by DC Bar members.

As regional director, Jeff supervised the SEC's examination and enforcement programs in Pennsylvania, Delaware, Maryland, Virginia, West Virginia, and the District of Columbia. He led a staff of approximately 160 enforcement attorneys, accountants, investigators, and compliance examiners who investigated and enforced the federal securities laws and performed compliance inspections in the Philadelphia region with jurisdiction over nearly 1,200 investment advisers and investment companies with more than $10 trillion in assets under management. Further, he closely coordinated with state and federal criminal authorities on a number of parallel investigations. Jeff also spearheaded the SEC's outreach efforts to retail investors in the Philadelphia region, meeting with registrants, senior investors, college and high school students, and members of the military to promote financial literacy and help protect against fraud. In 2016, he was recognized by the SEC with the Arthur F. Matthews Award for his "sustained demonstrated creativity in applying federal securities laws for the benefit of investors."

Prior to being named regional director of the Philadelphia office, Jeff served as the office's associate regional director from 2014 to 2016. In that role, he supervised the region's enforcement efforts, including the investigation and litigation of matters involving insider trading, financial reporting and accounting fraud, investment advisors, broker-dealers, offering frauds, and Ponzi schemes. He began his tenure at the SEC in 2009 as regional trial counsel for the office, conducting jury trials and emergency hearings, as well as supervising the Trial Unit staff, in actions pending in federal court and administrative proceedings.

In his time as a partner at Morgan Lewis before joining the SEC, Jeff represented broker-dealers, clearing firms, investment advisers, mutual funds, and individuals regarding matters pending with the SEC in Washington, DC, and in its regional and district offices across the United States. Additionally, Jeff represented clients in connection with matters before SROs and state authorities such as the Attorney General offices of New York, New Jersey, and Ohio.

Jeff also has civil litigation experience in class action and other commercial matters. He has represented clients in shareholder class actions and derivative actions against public and private corporations, directors, and officers. He has counseled clients in connection with failed transactions, closing balance sheet issues and breaches of representations and warranties, and these representations have taken him to federal and state trial and appellate courts throughout the United States.

Jeff has litigated to award a number of multimillion-dollar arbitrations before Financial Industry Regulatory Authority (FINRA) and American Arbitration Association arbitration panels, including matters involving claims against brokerage firms for breach of fiduciary duty, breach of contract, negligence, and breach of the federal securities laws.

Jeff serves as an adjunct professor at Drexel University's Thomas R. Kline School of Law.

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For the last two decades, Jason D. Frank has represented clients in shareholder class actions, derivative suits, SEC proceedings, internal investigations, and a broad array of complex business litigation. He has litigated in trial and appellate courts throughout the United States, appearing before courts in virtually every federal circuit.

Jason has been selected as one of the *Best Lawyers in America*, one of Boston's *Best Lawyers,* and a "Super Lawyer" in the field of securities litigation. He is on the team that received the Securities Litigation "Law Firm of the Year" award for 2013 from *U.S. News and World Report.* Jason currently leads a team of attorneys in a corporate defamation case relating to one of Gartner, Inc.'s well-known "Magic Quadrant" reports.

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With a background in senior positions at the US Securities and Exchange Commission (SEC) and as in-house counsel at a financial services firm, Ivan Harris brings insights to securities investigations, examinations, and litigation. He represents public companies, financial services firms, and individuals before the SEC, the Financial Industry Regulatory Authority (FINRA), the Chicago Board Options Exchange (CBOE) and various stock exchanges. Clients in the securities industry regularly seek Ivan's advice on compliance and regulatory matters.

Ivan represents public companies, financial institutions including investment banks, regional broker-dealers, hedge funds and private equity funds, municipal issuers and their employees in investigations by the SEC, FINRA, CBOE and other securities regulators. In the public company and municipal arena, Ivan has handled matters for clients involving financial accounting practices, issuer disclosures, Foreign Corrupt Practices Act (FCPA) violations, and insider trading. He regularly counsels large investment banks, clearing firms and other broker-dealers on complex investigations involving trading practices, market structure issues, anti–money laundering compliance, and other rules and regulations. Ivan has also represented hedge fund and private equity firms facing regulatory investigations and examinations relating to valuation practices, complex trading issues, potential use of inside information, and issues relating to fees and expense practices.

Ivan previously served at the SEC from 1998 to 2005, and from 2001 to 2005 was an assistant regional director for enforcement in the SEC's Miami office. While at the SEC, he led the investigation of a major hedge fund collapse, brought the first SEC case involving illegal hedge fund short selling, and prosecuted cases involving accounting fraud, insider trading, FCPA violations, market manipulation and broker-dealer/investment adviser violations. Several of those cases involved cross-border issues and investigative efforts throughout Europe and Latin America. Also before joining Morgan Lewis, Ivan was regulatory counsel for a financial services firm, where he advised on trading issues and compliance matters. He also served on several securities industry committees that focused on fixed income trading and securitized products. Ivan frequently speaks at securities industry and hedge fund conferences.

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Steven W. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. Head of the firm's financial institutions practice, Steve counsels most of the largest and most prominent US broker-dealers, investment banks, investment advisers, and mutual fund organizations. He regularly represents clients before the US Securities and Exchange Commission (SEC), both in seeking regulatory relief and assisting clients in enforcement or examination matters.

Steve advises major US broker-dealers in the private wealth and private client businesses that offer investment advice and brokerage services to high-net-worth clients as well as broker-dealers serving self-directing clients. He also works as counsel on various matters to the Securities Industry and Financial Markets Association's (SIFMA) private client committee and represents most of the best-known US broker-dealers in this area. He also advises broker-dealers and investment advisers in the managed account or wrap fee area, and serves as counsel to the Money Management Institute, the principal trade association focused on managed accounts. Steve also counsels various institutional investment advisers and banks on investment management issues, including conflicts, trading, disclosure, advertising, distribution, and other ongoing regulatory compliance matters.

Steve's practice includes counseling clients on varied regulatory and transactional matters including the development of innovative products and services; regulation and operation of managed account (or wrap fee) programs and hedge funds; trading issues affecting broker-dealers and investment advisers; soft dollar arrangements; interpretive and no-action letter requests; insider trading issues; and related matters. He guides clients through SEC, Financial Industry Regulatory Authority (FINRA), and state investigations and enforcement actions. Additionally, he counsels clients on mergers, acquisitions, and joint ventures involving broker-dealers and investment advisers.

Steve serves as co-leader of the firm's investment funds industry initiative, and previously served on the firm's Advisory Board and was managing partner of the Washington, DC, office.

Since 2005, *Chambers USA: America's Leading Lawyers for Business* has recognized Steve as one of the leading US lawyers for investment management and broker-dealer law, calling him as "one of the best in the field." Since 2009, *The US Legal 500* has listed him for his work with mutual fund formation and management.

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ADVANCED TOPICS IN
HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

WEBINAR SERIES

SESSION 6 | Wednesday, May 27

Regulatory and Examination Priorities for Private Fund Advisers
DOL Audits and ERISA Hot Topics
Fintech Developments Impacting the Hedge Fund Market

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REGULATORY AND EXAMINATION PRIORITIES FOR PRIVATE FUND ADVISERS

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SEC Reg. BI and Form CRS

- **Focus on recommendations and services to retail investors**
- **Retail investors**
  - Exclusion of regulated professional legal representatives
  - Status of family offices
- **Applicability to hedge fund placement agents and wholesalers**
  - Placement agents
  - Wholesalers and Reg. BI compensation limits
  - Sales to employees
- **SEC and FINRA exams**
  - Good faith efforts honeymoon with sharper focus in 2021

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SEC Proposed Rulemaking

- **Accredited Investor Proposal**
  - **Would add new categories of accredited investors including:**
    - Persons holding a Series 7, 65, or 82 license, or other credentials issued by an accredited educational institution
    - "Knowledgeable Employees" in the case of private fund investments
    - Certain LLCs, RICs, and RBICs
    - "Family Offices" with at least $5M AUM, and their "Family Clients"
    - "Spousal Equivalents"
  - **Would add new categories of Qualified Institutional Buyers including:**
    - LLCs, RBICs, and all institutional accredited investors that meet the $100 million in securities owned and investment threshold

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SEC Proposed Rulemaking

- **Advertising and Solicitation Proposals**
  - **Advertising Rule**
    - Redefine the term "advertisement" to include communications disseminated by any means (including electronic), as well as communications to fund investors
    - Define "testimonials", "endorsements", and "third-party ratings" and allow them to be included in advertisements subject to certain restrictions and disclosures
    - Expand the use of performance results and hypothetical performance in advertisements subject to certain disclosures
    - Require pre-use approval of advertisements
    - Differentiate between disclosure standards for advertisements disseminated to QPs and Knowledgeable Employees, and advertisements distributed to any other audiences
  - **Solicitation Rule**
    - Expand rule to cover solicitors that receive non-cash compensation
    - Expand rule to cover solicitation of private fund investors

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SEC Examination Developments

- **COVID-19**
- **Requests of Gatekeepers**
  - Seeking/gathering information from a variety of places
- **Key Topics of Focus**
  - Advertising/Client Communications
  - Valuation
  - Insider Trading/MNPI
  - Allocation of Expenses
  - Business Continuity Planning
  - Custody
  - Cybersecurity

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DOL AUDITS AND ERISA HOT TOPICS

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Department of Labor Audits

The Employee Benefits Security Administration (EBSA) is a division of the US Department of Labor (DOL) with civil and criminal investigatory and litigation enforcement authority over the fiduciary provisions of ERISA.

EBSA enforcement activities have been brisk over the past few years.

- In Fiscal Year 2019, EBSA recovered $2.5 billion in direct payments to plans.
- In Fiscal Year 2018, EBSA recovered $1.6 billion, including $1.1 billion in enforcement actions.
- From Fiscal Year 2017 to 2018, total recoveries rose again, this time by 45%, from $1.1 billion in 2017 to $1.6 billion in 2018.
- From Fiscal Year 2016 to 2017, total recoveries rose 72%, from $777.5 million in 2016 to $1.1 billion in 2017.

There are no signs of them stopping. Not even the global pandemic (and all of the shifts it has required) appears to be slowing the enforcement efforts.

The DOL's investigatory authority is both civil and criminal, and the agency can (and does) refer findings to other agencies including the SEC, FINRA, the IRS, and the DOL.

There a number of areas of enforcement activities. We will focus on those of most potential interest to this audience.

Department of Labor Audits

- This arise when a financial services firm uses its own products and services in its employee benefit plans.
- The focus appears to be on whether the services and funds were selected and retained after an adequate fiduciary process.
- The DOL has made adverse findings and required corrective payments in a number of these investigations.
  - For example: In April 2019, the Ninth Circuit upheld a $7.4 million judgment that was based upon a finding of alleged 406(b) self-dealing prohibited transactions due to a bank using its own recordkeeping services for the retirement plan of its employees, and in so doing collecting compensation through revenue sharing.

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Department of Labor Audits

- **EBSA has been consistently focused on enforcing ERISA's core fiduciary duties and prohibited transaction rules. To that end, the DOL is always considering whether a plan has been involved in any breaches of fiduciary duty or prohibited transactions.**
- For example:
  - Whether plan assets are being used to pay non-plan expenses, such as plan sponsor expenses, which can be a prohibited transaction (including whether the use of plan assets to pay the salaries of plan sponsor employees complies with the prohibited transaction restrictions).
  - Whether there are loans using plan assets that run afoul of the prohibited transaction rules.
  - Circumstances of misrepresentation to plan.
    - For example, in February 2018, the DOL announced a $7 million settlement involving investments in an investment fund that engaged in fraudulent loans.

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Department of Labor Audits

- **This has been identified as a national enforcement priority. The DOL has described the initiative as including:**
  - Review of fiduciary service providers and investment managers that may have conflicts of interest that lead to conflicted decision making on behalf of plans.
  - Fiduciary review of plan investments and services in order to identify and address these types of conflicts.
  - Identifying improper or undisclosed compensation of service providers
    - Ties in with the DOL's participant level and plan level service provider disclosure requirements, and the focus on comprehensive disclosure about service provider compensation and conflicts of interest.
    - For example, the DOL will cite plan administrators failing to provide adequate 404a-5 disclosures.

Department of Labor Audits

- **Recent inquiries in examinations of plan sponsors regarding consideration of Environmental, Social and Governance ("ESG") factors.**
  - Obama DOL guidance suggested an appropriate role for ESG factors in ERISA fiduciary considerations. Trump DOL guidance sounded a more cautious note.
  - DOL examiners seem to confuse the use of ESG as economic factors in assessing an investment versus using ESG factors as a gate or a screen for investments.

- **Also continuing inquiries on "hard to value" assets in DOL audits.**
  - This was more a focus several years ago after a U.S. Government Accountability Office (GAO) report critical of the DOL's efforts to regulate retirement plan investments in hedge funds and private equity funds. We then saw an uptick in DOL investigation inquiries about valuation.
  - There have been reports of at least one DOL office alleging plan fiduciaries violated ERISA by relying on unaudited financial statements and capital account balances prepared by the partners of private fund assets.

Department of Labor Audits

- **If the DOL does conduct an audit, cooperation is generally recommended. The DOL has very broad subpoena/document request powers and can enforce that power by court order.**
  - It can be very difficult to challenge the agency's powers.
  - Another goal should be to move the matter to a closure both to avoid the DOL expanding its inquiry and also because the DOL can refer findings to other agencies.
  - A lawyer can be helpful in navigating the DOL's inquiry.
- **As with most ERISA-related matters, process and documentation is paramount.**
  - It is helpful to be able to show the DOL the basis for your decisionmaking, as specifically as possible.
  - Even a great process does no good if you cannot demonstrate it.

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ERISA Hot Topics
Addressing the Economic Downturn

- As public markets increase in volatility, there may be additional interest from plan fiduciaries in alternative investments as other avenues to generate returns.
- Definitely not a scientific sample, but we have seen strong interest by plans in alternative investments since the start of the COVID-19 era.
- ERISA investors may have increasing concern about existing investments becoming impaired or illiquid (from hard lessons learned during the financial crisis).
- Expect additional inquiries from fiduciaries about business continuity plans, key person provisions and other questions about the ability to stay the course during the pandemic.
- Consider application of gating provisions if there are significant withdrawals (for example, due to drops in performance).
- May see increased interest in secondary transactions.

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ERISA Hot Topics
Expansion of the Ability to Create Plans Covering Multiple Employers

- The SECURE Act was signed into law in December 2019 (yes, that feels like 74 years ago).
- It included a number of significant ERISA changes. Probably the most significant for the asset management industry is the creation of "pooled employer plans" or "PEPs."
- ERISA has long allowed "multiple employer plans", but participating employers were required to have some connection to one another.
- PEPs, however, do not require that connection and thus, may open the market to service providers to offer these types of plans to market them widely.
- PEPs also open the possibility for new asset management opportunities, potentially reaching plans where the economics would not previously had made sense.
- DOL "Request for Information" expected imminently and may offer some clue about what eventual DOL regulations will address.
- PEPs are already garnering asset management industry interest, but questions remain.

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FINTECH DEVELOPMENTS IMPACTING THE HEDGE FUND MARKET

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Financial Technology (Fintech) Landscape

Securities/Investment Management

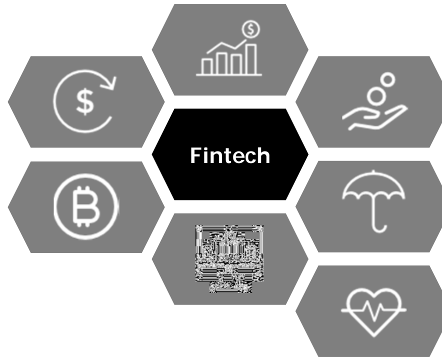
- Asset Management Technology
- Back-Middle Office Technology
- Data / Analytics / Research
- Infrastructure & Trading Technology
- Liquidity Pools
- Online Brokers / Trading / Custodians
- Robo Advisors / Digital Advice
- Wealth Management

Digital Lending/Banking

- Alternative Lending - Consumer, SME, Real Estate
- Bank Payment Solutions
- Consumer-Oriented Financial Services
- Enterprise Banking Tech
- Peer-to-Peer Lending
- Real Estate Tech / PropTech

Blockchain/Virtual Currency

- ETFs
- Miners
- Exchanges
- Securities Ledgers
- Sidechains
- Security Token Offerings
- Virtual Currency Wallets



Payments

- Card-Based Payment Products
- Carrier Billing and NFC Infrastructure (Telecom)
- E-Rewards / Loyalty
- Financial Institutions
- International Money Transfer
- Online / Mobile Payments
- Merchant Services
- Networks / Associations
- Transactions Security
- Wallets

Insurtech

- Core Software (e.g., Claims Management)
- Data and Analytics
- Sales and Distribution

Financial Management Solutions

- Accounting Support
- Enterprise Resource Planning
- Financial Planning

Healthcare Fintech

- Benefits Procurement and Management
- Health Insurance Sales & Distribution
- Patient Care Administration (e.g., RCM)

Sources
Financial Technology Partners; CB Insights; Morgan Lewis

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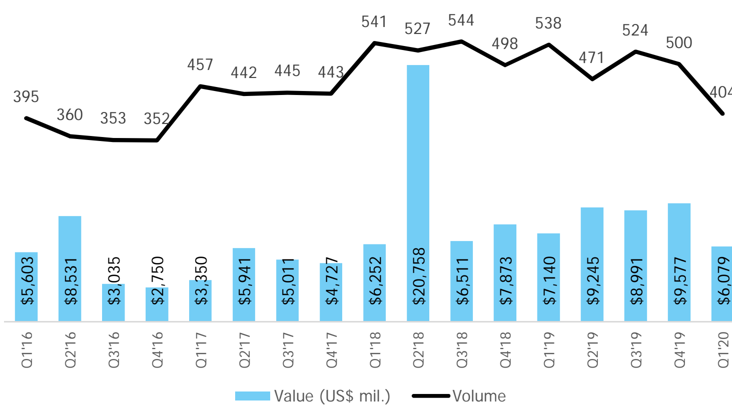
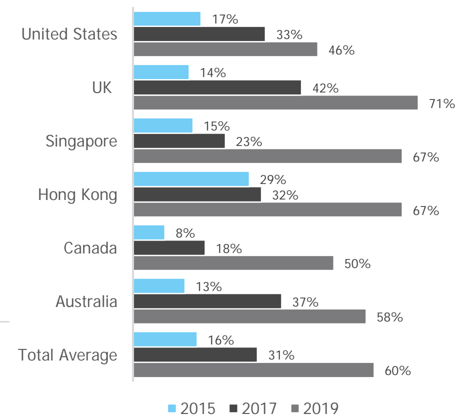
Fintech Investment and Adoption

Global Fintech Funding [1] (2016 – Q1 2020)



Fintech Adoption [2]



Sources
[1] CB Insights State of Fintech Q1'20 Report: Investment & Sector Trends to Watch
[2] EY Global FinTech Adoption Index 2019 Survey

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Trending Technologies in the Capital Markets/ Investment Management Fintech Vertical

- Robotic Process Automation (RPA)
- Machine Learning
- Customer Identity
- Compliance & Fraud
- Lending Processes
- Trading
- Customer Service & Engagement
- Account Opening & Onboarding
- Wealth Management

Sources
CB Insights State of Fintech Q1'20 Report: Investment & Sector Trends to Watch

Five Hot Issues

1. Resiliency and Contingency
2. Security and Data Protection
3. Data Rights
4. Compatibility and Automation
5. Compliance and Auditability

Resiliency and Contingency

- **Ability to perform in a crisis**
  - Systems
  - Personnel
  - DR and BCP
  - Financial strength
- **Assessment of "fourth" parties**
  - Including cloud and infrastructure providers
- **Check your FM and excuse provisions**
- **Risk mitigation and exit planning**
  - Step in
  - Alternative providers

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Security and Data Protection; Data Rights

Security and Data Protection

- Safeguards and requirements
  - Addressing shift in short and long term operating models, including remote working
- Breach notice and response
- Liability
  - For cause vs. strict liability
  - Insurance coverage (theirs and yours)
  - Caps?

Data Rights

- Content
- Configurations
- Performance and operational data
- **Aggregated data**
- "Suggestions"

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Compatibility and Automation

- **Compatibility**
  - Data transfers
  - APIs, interfaces, integrations
- **Automation**
  - Solutions (processes, chat bots, virtual assistants)
  - IP issues
  - Risks and rewards

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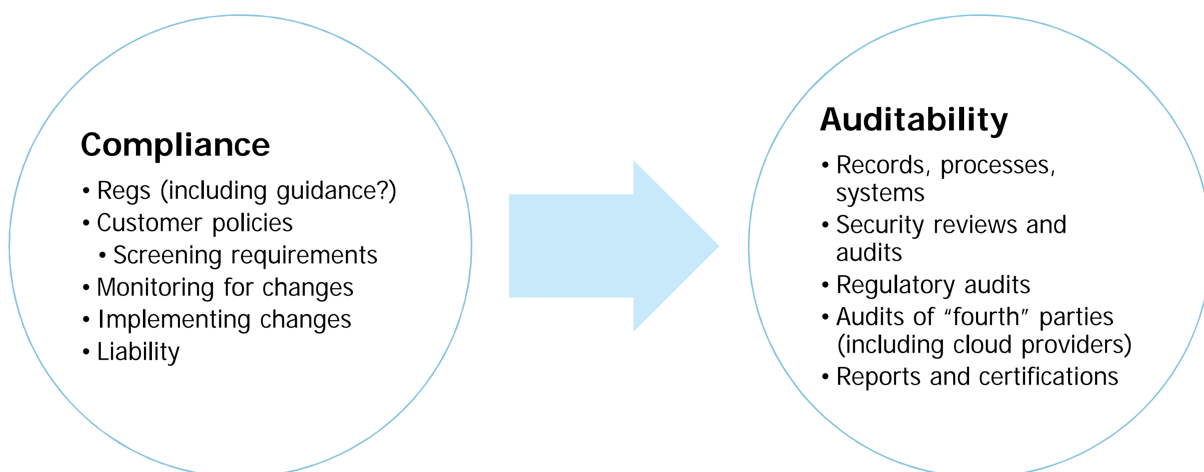
Compliance and Auditability



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Craig A. Bitman provides clients with a range of knowledge and skills in all aspects of employee benefits and executive compensation law. Craig leads the firm's employee benefits and executive compensation practice and is co-chair of the firm's institutional investor practice. Craig also practices in the firm's private investment funds practice and has served as a member of the firm's Advisory Board.

Craig brings more than 20 years of experience to his practice, advising clients on all aspects of benefit plan design, implementation, and administration. Specifically, he counsels clients in the context of day-to-day administration, plan investments, mergers and acquisitions (M&A), and ongoing compliance. His advice extends to matters involving qualified and nonqualified deferred compensation plans, health and welfare benefit plans, equity compensation, and other types of arrangements. Craig's representations include both ongoing benefits advice and transactional matters.

His client roster includes a diverse mix of businesses, trusts, and individuals, including financial services companies, public pension plans, life insurance companies, transportation and logistics providers, entertainment companies, and multiemployer trust funds. He spends a significant percentage of his time devoted to assisting these entities and individuals in complying with the Employee Retirement Income Security Act's (ERISA) complex fiduciary duties.

A member of the National Association of Public Pension Attorneys, Craig often speaks and writes on topics affecting plan sponsors and service providers. His experience in the space has earned him recognition by *Chambers USA: America's Leading Lawyers for Business, Best Lawyers, PLC, Legal 500* and others.

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Timothy W. Levin, leader of the firm's investment management practice, counsels investment advisers and other financial services firms on the design, development, and management of pooled investment vehicles and investment advisory programs. He also advises fund managers in connection with organization, registration, and ongoing regulatory compliance. Additionally, he represents managers and sponsors of unregistered pooled investment vehicles.

Timothy's clients include many types of registered investment companies, such as mutual funds and registered funds of hedge funds, and funds focused on alternative investment strategies, including business development companies (BDCs). His unregistered pooled investment vehicle clients include private funds, bank collective investment trusts (CITs), and companies seeking exemption from investment company status.

Since 2008, *Chambers USA: America's Leading Lawyers for Business* has recognized Timothy for his work.

He speaks frequently at conferences and moderates panels. He also co-chairs the annual Hedge Fund Conference. Timothy is the editor of *Morgan Lewis Hedge Fund Deskbook: Legal and Practical Guide for a New Era* and the *Mutual Fund Regulation and Compliance Handbook*.

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Christine Lombardo advises investment managers and broker-dealers on financial regulatory matters. She concentrates her practice on securities regulation for a broad range of financial firms including retail asset managers, private fund managers, family offices, broker-dealers, other professional traders, and high-net-worth individuals. Christine also counsels legal, compliance, and business personnel on the structure, operation, and distribution of advisory programs, including digital advisory offerings, and investment products, including hedge funds, private equity funds, venture capital funds, real estate funds, and other alternative investment products.

Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA.

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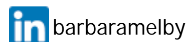
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Barbara Melby has been active in the outsourcing and technology transaction legal market for the last 25 years. As leader of the firm's technology, outsourcing & commercial transactions practice, she represents clients in complex business transactions, such as outsourcing, strategic alliance, technology, service and data-related agreements. She also advises businesses on privacy and security issues that arise in transactions involving sensitive data and technologies.

Barbara is recognized as a leading outsourcing and commercial transactions lawyer, counseling clients in structuring, negotiating, realigning, and terminating a wide range of commercial relationships. This includes IT, human resources, finance and accounting, procurement, research and development, logistics, and facilities outsourcing. She collaborates with clients on transactions for onshore, offshore, managed and co-sourced solutions.

With a diverse client base from the financial services, life sciences, hospitality, energy, health, and retail industries, Barbara assists with technology and data acquisition and implementation and service agreements. Her experience includes enterprise resource planning (ERP) implementation, platform transformation, licensing, software as a service (SaaS), information as a service (IaaS), ecommerce, data acquisition and services, cloud computing, and mobility agreements.

In addition to working with clients on complex outsourcing, technology and data transactions, she helps clients develop contracting and governance strategies for commercial transaction portfolios. She implements a variety of coverage models, including mixes of in-house and Morgan Lewis resources, and tailors them to meet clients' needs. She coordinates support of commercial contracts for direct and indirect spend for the global procurement organizations of several Fortune 500 companies.

Barbara's recent transactions include: transformational IT and business process outsourcing transactions for a major medical technology company; the renegotiation of a subservicing services for a leading financial institution; the termination of a major IT services agreement and the negotiation of multiple successor agreements; and an agreement for the implementation and ongoing management of a data analytics system. Barbara co-authored two seminal works in the outsourcing field, *Information Technology Outsourcing: Process, Strategies, and Contracts*, and *Business Process Outsourcing: Process, Strategies, and Contracts* (both John Wiley).

She also speaks on outsourcing and technology transactions at business, legal, and professional conferences. She spearheaded the launch of, and continues to lead, Morgan Lewis's blog on technology, outsourcing, and commercial transactions—*Tech & Sourcing @ Morgan Lewis*.

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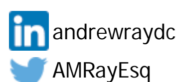
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Andrew Ray is the leader of the firm's interdisciplinary corporate practice in Washington, DC, where he represents public and private companies, financial sponsors, and management teams in a broad range of industries, including technology, financial services, life sciences, real estate, and the not-for-profit sector. Various industry publications recognize Andy as a leader in both M&A and in technology, media, and communications law, among other fields. He led the team representing Oculus VR in its $2 billion sale to Facebook, which was named the *M&A Advisor* M&A Deal of the Year.

Andy writes and speaks frequently on topics that include corporate finance, private equity, technology, M&A, corporate governance, and cross-border deals.

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Julie K. Stapel helps employee benefit plan sponsors and financial service providers with the investment, and management of employee benefit plan assets. She advises clients on ERISA fiduciary and prohibited transaction rules, and their impact on investment products and services, and helps those clients use investment documentation and other tools to manage potential fiduciary risks while providing top-quality benefits and services. She also works with plan sponsors and financial service providers to address ERISA–related compliance issues.

Julie helps clients negotiate investment-related agreements of virtually every type, including investment management, trust, securities lending and transition management agreements, as well as many different types of trading agreements. She represents employee benefit plan investors in all types of private fund investments, negotiating fund documentation and side letters to address ERISA and other risk management issues. She also counsels financial services and investment management clients on ERISA compliance.

Co-leader of the firm's Fiduciary Duty Task Force, Julie also advises on fiduciary governance, including the formation and operation of benefit plan fiduciary committees.

She works with plan fiduciaries to implement ERISA compliance best practices and manage fiduciary risks. She also helps clients remain in compliance with ERISA's ever-changing reporting and disclosure obligations.

Julie speaks frequently on ERISA-related topics. She has spoken before the Committee on the Investment of Employee Benefit Assets (CIEBA), the ERISA Industry Committee (ERIC), the John Marshall School of Law, and at various events sponsored by *Pension and Investments* magazine. In addition to these speaking engagements, she regularly addresses client fiduciary committees and investment staff, performing fiduciary training and presenting updates on changes in the law. She is also president of the Chicago Chapter of Worldwide Employee Benefits Network (WEB).

Prior to joining Morgan Lewis, she was a partner in the employee benefits and executive compensation departments of an international law firm, resident in Chicago. Before that, she served as general counsel to a registered investment adviser, gaining experience with ERISA and its impact on investment managers and collective investment funds.

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Steven W. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. Head of the firm's financial institutions practice, Steve counsels most of the largest and most prominent US broker-dealers, investment banks, investment advisers, and mutual fund organizations. He regularly represents clients before the US Securities and Exchange Commission (SEC), both in seeking regulatory relief and assisting clients in enforcement or examination matters.

Steve advises major US broker-dealers in the private wealth and private client businesses that offer investment advice and brokerage services to high-net-worth clients as well as broker-dealers serving self-directing clients. He also works as counsel on various matters to the Securities Industry and Financial Markets Association's (SIFMA) private client committee and represents most of the best-known US broker-dealers in this area. He also advises broker-dealers and investment advisers in the managed account or wrap fee area, and serves as counsel to the Money Management Institute, the principal trade association focused on managed accounts. Steve also counsels various institutional investment advisers and banks on investment management issues, including conflicts, trading, disclosure, advertising, distribution, and other ongoing regulatory compliance matters.

Steve's practice includes counseling clients on varied regulatory and transactional matters including the development of innovative products and services; regulation and operation of managed account (or wrap fee) programs and hedge funds; trading issues affecting broker-dealers and investment advisers; soft dollar arrangements; interpretive and no-action letter requests; insider trading issues; and related matters. He guides clients through SEC, Financial Industry Regulatory Authority (FINRA), and state investigations and enforcement actions. Additionally, he counsels clients on mergers, acquisitions, and joint ventures involving broker-dealers and investment advisers.

Steve serves as co-leader of the firm's investment funds industry initiative, and previously served on the firm's Advisory Board and was managing partner of the Washington, DC, office.

Since 2005, *Chambers USA: America's Leading Lawyers for Business* has recognized Steve as one of the leading US lawyers for investment management and broker-dealer law, calling him as "one of the best in the field." Since 2009, *The US Legal 500* has listed him for his work with mutual fund formation and management.

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SESSION 7 | Tuesday, June 2

Trading and Investment Practices Affecting Hedge Funds
Family Office Issues and Considerations
LIBOR Transition and Derivatives Update

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TRADING AND INVESTMENT PRACTICES AFFECTING HEDGE FUNDS

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Overview – Rules 5130 and 5131 and Amendments

- Rules 5130 and 5131 (the Rules) promote fairness in the allocation of new issues of equity securities and were **amended effective January 1, 2020.**
- The amendments to Rules 5130 and 5131 clarify and liberalize the Rules by broadening the Rules' exclusions and exemptions.
- Rule 5130 prevents broker-dealers and portfolio managers from receiving shares of equity securities in IPOs (new issues).
- Rule 5131 prevents broker-dealers from allocating new issues to individuals who have the authority or ability to direct their company's investment banking business to the broker-dealer making the allocation.
- Technically, the Rules apply only to broker-dealers, but they impact the operations of other types of firms, including fund managers, that must make representations to broker-dealers as to the nature of their investors in order to receive new issue allocations.

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Rule 5130

- Prohibits allocations of new issues to accounts of Restricted Persons:
  - broker-dealers,
  - persons who own or control broker-dealers,
  - portfolio managers, and
  - others.
- Exemptions and exclusions recognize that some entities and offerings do not implicate new issue allocation concerns.
- Applies to all "new issues" of securities, basically IPOs, with limited exceptions.
- Contains a *de minimis* threshold for Restricted Persons.
- Permits annual attestation by negative consent.

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Rule 5131

- Prohibits quid pro quo allocations of "new issues," as defined in Rule 5130, in exchange for excessive compensation.
- Prohibits allocation of new issue securities to "Covered Persons," who are those in a position to direct hiring of broker-dealers for investment-banking services.
  - Covered Persons include executive officers or directors of public companies and covered nonpublic companies – e.g., the prospective investment banking clients.
- Limits flipping of new issue securities and prescribes certain pricing and trading practices for new issues.
- Incorporates the general exemptions of Rule 5130 (with a different *de minimis* threshold).
  - Therefore, amendments to the general exemptions apply to both Rule 5130 and 5131.

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Amendments to Rules 5130 & 5131

- Retirement plans – The Rules now include a general exemption for accounts of retirement plans or a family of plans, whether organized under US or non-US law, that:
  - have, in aggregate, at least 10,000 plan participants and beneficiaries and $10 billion in assets;
  - are operated in a nondiscriminatory manner insofar as a wide range of employees, regardless of income or position, are eligible to participate without further amendment or action by the plan sponsor;
  - are administered by trustees or managers that have a fiduciary obligation to administer the funds in the best interests of the participants and beneficiaries; and
  - are not sponsored solely by a broker-dealer.
- Plans that do not qualify under the new general exemption may still seek exemptive relief on a case-by-case basis.

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Amendments to Rules 5130 & 5131

- Foreign investment companies – The amendments expand the general exemption for accounts of investment companies organized under the laws of a foreign jurisdiction.
  - Previously, a foreign investment company's account was exempt from Rule 5130 only if (1) it was listed on a foreign exchange or authorized for sale to the public in a foreign country, and (2) no Restricted Person owns no more than 5% of the foreign investment company.
  - The amendments provide two alternatives to the 5% Restricted Person ownership limitation. The exemption would be available to a foreign investment company with at least:
    - 100 direct investors, or
    - 1,000 indirect investors.
  - The amendments also require that the foreign investment company is not formed for the specific purpose of permitting Restricted Persons to invest in new issues.

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Amendments to Rule 5130

- Sovereign entities that own broker-dealers were previously Restricted Persons if they had a voting or other equity ownership stake in a broker-dealer that required disclosure on SEC Form BD (generally 10% or more of direct ownership or 25% or more of indirect ownership).
- The amendments exclude sovereign entities from the definition of "Restricted Person."
- The amendments have the effect of permitting accounts of sovereign entities to receive new issue allocations even if the sovereign entity has an ownership stake in a broker-dealer over the thresholds for disclosure.
- The amendments define "sovereign entity" as:
  - a sovereign nation, or
  - a pool of capital or an investment fund or other vehicle owned or controlled by a sovereign nation and created for the purpose of making investments on behalf or for the benefit of the sovereign nation.

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Amendments to Rule 5130

- Portfolio managers of collective investment accounts are Restricted Persons, with limited exceptions.
- Portfolio managers to family investment vehicles (family offices) are not Restricted Persons.
  - Prior to the amendments to Rule 5130, the definition of "family investment vehicle" in Rule 5130 was narrower than the definition in the Investment Advisers Act (the Advisers Act).
  - This resulted in some family offices being Restricted Persons.
- Rule 5130 has been amended to expand the definition of "family investment vehicle" so that it is consistent with the concept of family office found in the Advisers Act.
  - Specifically, "family investment vehicles" for purposes of Rule 5130 now include those that invest on behalf of multiple generations and also those that include as beneficiaries key employees, including advisers from the family office, even though not family members.

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Amendments to Rule 5131

- The definition of "covered non-public company" was amended to exclude "unaffiliated charitable organizations."
- This change removes from Covered Persons executive officers and directors of unaffiliated charitable organizations.

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Amendments to the Definition of "New Issue"

- **Foreign Offerings**
  - The amendments add an exclusion from the definition of "new issues" for securities offered pursuant to Regulation S of the Securities Act (Reg S) or otherwise offered outside the United States.
  - **Note:** The exclusion does not apply to Reg S offerings of securities that also are registered and concurrently offered as new issues in the United States unless offered outside the United States by a non-US broker/bank that is a member of the selling syndicate in its own right.
- **SPACs**
  - The amendments add special purpose acquisition companies (SPACs) to the list of products excluded from the definition of "new issue." The Rules already excluded business development companies, direct-participation programs, and real estate investment trusts, among other securities.

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Additional Amendments

- **Antidilution Provisions (Rule 5131)** – FINRA added supplemental materials to Rule 5131 to add antidilution provisions (similar to those already in Rule 5130) to permit the allocation of new issues to Covered Persons in order for them to maintain the percentage of equity ownership they held before the IPO.
  - Both Rule 5130 and Rule 5131 include conditions for reliance on the antidilution provisions.
- **Issuer-Directed Securities** – The definition of "issuer-directed securities" was harmonized in the Rules by amending Rule 5130 to make this provision consistent with Rule 5131 to exempt from the Rules prohibitions allocations directed by affiliated and selling shareholders.

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Key Takeaways on the Rule 5130 and 5131 Amendments

- The amendments expand the universe of eligible recipients of allocations of new issue securities.
- Offerings made pursuant to Reg S (and not concurrently offered in the United States) are expressly excluded from "new issue."
- Private fund managers and sponsors will need to update their investor information in order to maximize the availability of exclusions and exemptions under the amendments.
  - Update subscription documents
  - Consider outreach to current investors that are Restricted Persons or Covered Persons to determine if the investors are now eligible to receive new issue allocations.

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Proposed Amendments to Definitions of Accredited Investor and Qualified Institutional Buyer

- The goal is to improve the definition in order to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in our private capital markets and therefore do not need the additional protections of registration under the Securities Act. The proposals would add:
  - new categories of natural persons that may qualify as accredited investors based on certain professional certifications
  - status as a private fund's "knowledgeable employee"
  - expand the list of entities that may qualify as accredited investors and allow entities meeting an investments test to qualify
  - family offices with at least $5 million in assets under management and their family clients
  - expand the list of entities that are eligible to qualify as qualified institutional buyers

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Professional Certifications and Designations and Other Credentials

- The proposed amendment would provide the following nonexclusive list of attributes that the Commission would consider in determining which professional certifications and designations or other credentials of individuals qualify for accredited investor status:
  - the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body, or is issued by an accredited educational institution;
  - the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;
  - persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and
  - an indication that an individual holds the certification or designation is made publicly available by the relevant self-regulatory organization or other industry body.

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Professional Certifications and Designations and Other Credentials

- Preliminary list of qualifications to be included in initial Commission order:
  - Licensed General Securities Representative (Series 7)
  - Licensed Investment Adviser Representative (Series 65)
  - Licensed Private Securities Offerings Representative (Series 82)

- Other possibilities based on prior comments:
  - certified public accountant (CPA)
  - certified financial analyst (CFA)
  - certified management accountant (CMA)
  - investment adviser representative or registered representative (RR)
  - having a Masters of Business Administration degree (MBA) from an accredited educational institution
  - having a certified investment management analyst (CIMA) certification
  - having been in the securities industry as a broker, lawyer, or accountant

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Knowledgeable Employees of Private Funds

- Knowledgeable employees of private funds within the meaning of Rule 3c-5 would be eligible to invest in their funds under Rule 506 as accredited investors, rather than relying on Section 4(a)(2).
  - Currently not counted within 100 beneficial owners under Rule 3(c)(1) and treated as qualified purchasers under Rule 3(c)(7).
  - Small funds with less than $5 million in assets will still qualify as accredited investors if a knowledgeable employee participates, if all equity owners are accredited. Rule 501(a)(8).

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New Categories of Entities

- Rule 501(a) provides an exclusive list of entities that may qualify as accredited investors. The Commission proposed to include the following additional categories:
  - Registered Investment Advisers
  - Rural Business Investment Companies (RBICs)
  - Limited Liability Companies (LLCs) (codifying staff no-action position)
  - Other Entities Meeting an Investments-Owned Test
    - Indian tribes, labor unions, governmental bodies and funds, and entities organized under the laws of a foreign country are not specifically listed in the accredited investor definition
    - $5 million-total-investments test vs. $5 million-total-assets thresholds

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Family Offices and Family Clients

- Advisers Act Rule 202(a)(11): A family office generally is a company that has no clients other than "family clients." "Family clients" generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities.
  - at least $5 million in assets under management
  - not formed for the specific purpose of acquiring the securities offered

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Qualified Institutional Buyer Definition

- With the exception of registered dealers, a qualified institutional buyer (QIB) must in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with that qualified institutional buyer.
  - Banks and other specified financial institutions are subject to an additional minimum audited net worth requirement of $25 million
- Like Rule 502(a), Rule 144A(a)(1) provides a list of specific types of institutional investors that qualify as QIBs. Issues have arisen with respect to certain types of institutional investors, particularly with respect to:
  - state and municipal governments,
  - sovereign wealth funds,
  - bank-sponsored common trust funds that include HR10 plans as participants
- Commission proposed conforming changes for LLCs and RBICs, subject to the $100 million invested test
- Proposed catch-all for *any* type of entity to cover all categories added to 501(a) and raised by commentators, subject to the $100 million invested test
  - Any institutional accredited investor, as defined in Rule 501(a) under the Advisers Act (17 CFR § 230.501(a)), of a type not listed in paragraphs (a)(1)(i)(A) through (I) or paragraphs (a)(1)(ii) through (vi).
  - Does not appear to include family offices.

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Significant Comment Letters

- Several commenters noted that there is no change to the financial thresholds for accredited investors, which is the same as when adopted in 1983 (except for exclusion of principal residence).
  - 13% of households now qualify compared with 1.6% in 1983.
- Other commentators urged more action to expand retail access to private funds, either directly or by permitting registered funds of private funds.
  - Issue raised in 2019 concept release.

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FAMILY OFFICE ISSUES AND CONSIDERATIONS

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Estate Planning for Hedge Fund Interests

- Annual Gifts: $15,000 annually to any number of recipients
- Direct payments of tuition and healthcare expenses
- Unlimited transfers to US citizen spouse
- Highest federal estate/gift tax rate: 40%
- Current federal estate/gift tax/generation-skipping transfer (GST) tax exemption: $11,580,000 per taxpayer
- Transfers to charity are not subject to tax

- Manage and transfer wealth in a tax-efficient manner
- Leverage use of the current exemptions

- Assets likely to appreciate
- General Partner Interest (including the carry); management company; and any LP interests

- Extraordinary opportunity due to historically low IRS intra-family interest rate
- Low valuations; opportunities for long-term growth

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Considerations for New Investments

How to Remove Future Appreciation Outside of Estate Using Intra-Family Transfers (gifts, loans, sales) for a **New** Investment:

Irrevocable Grantor Trust.

Husband is hedge fund manager starting new fund. Wife creates new irrevocable trust for benefit of Husband and children with Husband as Trustee. Trust is grantor trust for federal income tax purposes (Wife pays income tax, not the trust). Wife makes a cash gift to trust which is covered by gift tax exemption and allocates GST exemption to gift on a gift tax return. Trust buys interest in a new entity which could be the GP of a fund. All trust assets outside of Husband's and Wife's taxable estates. If structured properly, assets will be outside of children's estates and not subject to transfer tax at each future generation.

Gift and Loan.

Husband hedge fund investor creates irrevocable grantor trust for benefit of Wife and children and makes a gift to the trust to which he allocates GST exemption on a gift tax return. Ideally, gift is subject to valuation discount if interest is nonmarketable and noncontrolling. Husband loans money to the trust; trust issues a long-term promissory note bearing **1.01%** interest. Trust buys limited partnership interest in the fund. The note receivable (which does not increase in value) and the 1.01% interest on loan will be included in Husband's taxable estate but all appreciation of fund and earnings on appreciation will be estate tax free in the trust.

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Considerations for Existing Investments

How to Remove Future Appreciation Outside of Estate for **Existing** Investments:

Grantor Retained Annuity Trust ("GRAT").	Husband creates irrevocable trust ("zeroed-out") and retains right to receive fixed annuity payment over two or three years. At end of term, assets in trust continue in trust for Wife and children. If trust assets appreciate at a rate greater than **0.6%**, excess appreciation remains in trust gift and estate tax free.
Caution:	– Be wary of Internal Revenue Code section 2701 rules. To minimize risk, transfer "vertical slice" or a proportionate amount of all of the interests that Husband owns in existing fund. Trust receives pro rata share of all same interests that Husband had.
	– Consider whether GP carried interest is "vested."
	– Consider valuation risk exposure based on technique chosen.

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General Recommendations

- Understand nature of assets to best manage transfer tax opportunities and implications
- Work closely with team of advisors so every member of team is on lookout for opportunities
- Start transferring assets early when values are low and regularly to extent cash flow allows

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Family Office Considerations – Structure of Family Offices

- Are you seeing requests for clients to arrange your fees to be paid by a family office entity rather than the entity holding the assets? If so, we are going to explain what is behind the push for these changes.

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General Structures for Family Offices

In General:

- G1 has a significant wealth event.
- G1 engages in estate planning for G2 and further generations that often consists of making of gifts, creating trusts and other planning.
- Economies of scale are often sought by bringing family members together to jointly invest in separately managed accounts or pooled investment vehicles.
- Family offices also provide:
  - (i) comprehensive financial planning;
  - (ii) portfolio management;
  - (iii) back office/consolidated reporting;
  - (iv) estate and wealth transfer planning;
  - (v) tax planning, preparation, and compliance;
  - (vi) risk management;
  - (vii) trustee services;
  - (viii) life management;
  - (ix) family consulting, governance, meetings and education; and
  - (x) strategic philanthropy and administration.

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Deduction of Expenses

- History of Section 162 and 212
  - Engaging in a Trade or Business
  - Historic Limitations on Section 212
    - 2% Floor
    - Pease Limitations
    - AMT
  - 2017 TCJA changes

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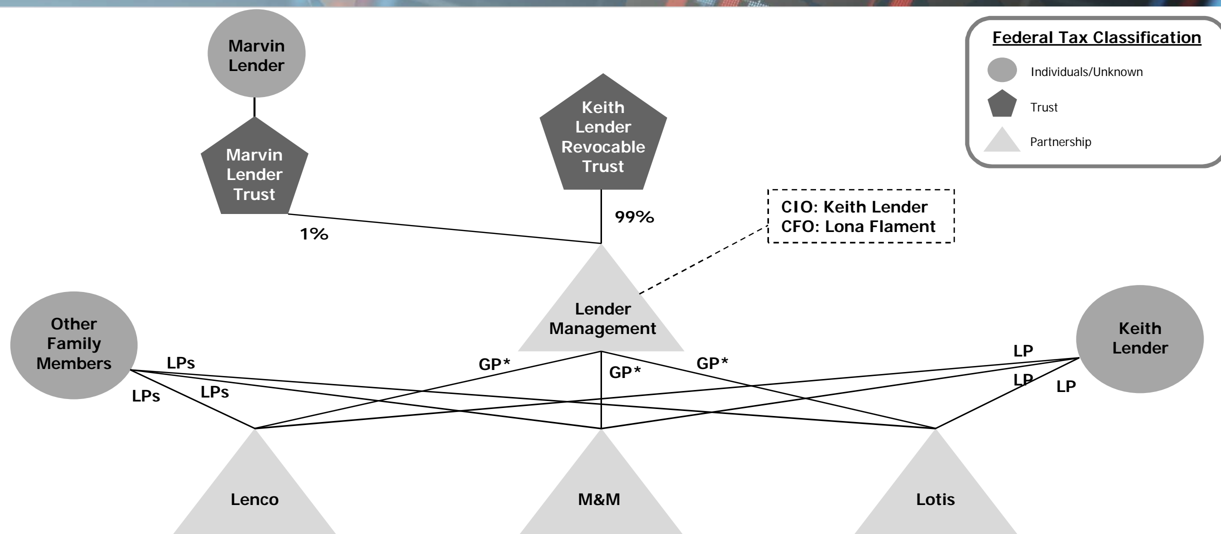
Lender Management



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*Represents capital and profits interest

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Lender Management LLC v. Comm'r

Overview

Tax Classification of Family Office/GP – LLC taxable as a partnership.

Tax Classification of Investment Entities – three separate LLCs taxable as partnerships.

Ownership of Family Office/GP – 99% by one G3 member and 1% by a G1 Trust.

Ownership of the Investment Entities – the 99% owner of the GP owned about 11% of the three LLCs.

Relationship of G3 Owner of GP to Other LPs – the family LLCs included members of G2, G3 and G4; only two of five family lines of G2 were investors; there was mention of the fact that the family member investors were geographically dispersed and rarely got together and, in fact, some would not meet with each other.

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Lender Management LLC v. Comm'r

Overview

Withdrawal Rights – on demand, subject to liquidity restraints.

Activities of the GP – GP performed extensive management activities.

Managed investments, investment LLCs and office personnel; researched and pursued new investment opportunities; reviewed about 150 PE and hedge fund proposals a year; managed other downstream entities which did not include family members (query if this violated their family office exemption); provided investment and financial planning services for individual members of LLCs; met with and attended presentations of hedge fund and private equity managers and investment bankers; entered into private equity deals and made hedge fund trades; conducted annual business meetings with each client; developed investment options to meet individual client needs; prepare monthly, quarterly and annual reports; interview and acquire outside investment and accounting firms for services.

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Lender Management LLC v. Comm'r

Overview

<u>Nature of Investments</u> – 50% in private equity and balance in hedge funds and public equities.

<u>Third-party arms-length nature of compensation arrangement</u> – charges a carried interest of 25% and a management fee of 2.5%.

The facts in the opinion regarding whether a management fee was charged after 2010 are unclear. Before 2010, the fee structures ranged from a management fee of 1-2% and a 5% carried interest.

<u>GP Return on Investment and Fees</u> – the court noted that compensation was based on the increase in value of assets.

<u>Relationship of Family Members and Employees of GP</u> – employed five employees, including a CFO; the G3 majority owner of the GP had an MBA and investment-related experience.

Lender Management LLC v. Comm'r

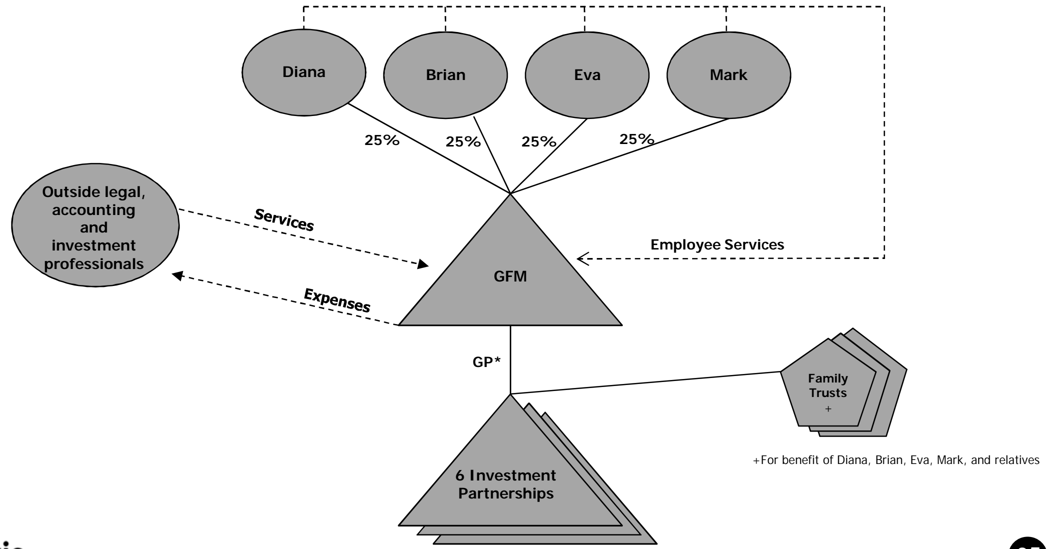
Overview

<u>Compliance with Family Office Exemption to Registration as RIA</u> – it is questionable whether the GP in *Lender* satisfied the family office exemption from registering as an RIA based on the notation that it provides "management services to…other third-party non-family members." It is unclear if this was a relevant fact taken into account by the *Lender* court.

Very generally, to qualify for the exemption, the family office (i) can only provide investment advice to "family clients"; (ii) ownership of the family office is limited to certain family members; (iii) control of the family office is restricted; and (iv) the family office cannot hold itself out to the public as an investment advisor.

Alternative is to register as an RIA but that would result in reporting of AUM by the Family Office which most families want to avoid.

Hellmann



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Hellmann Facts

- GP was organized as an LLC taxable as a partnership. It was owned equally by a mother and her three children.
- Each of the four owners of the GP were paid salaries by the GP and served as officers of the GP with certain duties.
- GP received a profits interest from the investment partnerships – 15bps for a time-based profits interest based on AUM and 6% based on increase in value of assets.
- The investment partnerships were owned by trusts which were formed for the benefit of the four, who were also the trustees of the trusts.

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Hellmann Facts

- Almost all expenses were paid to third-party investment advisors, accountants and lawyers.
- The Trusts could redeem at any time and the investment partnerships could liquidate upon request of LPs with GP consent.

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Resolution of *Hellmann*

- In November 2018, the Hellmanns paid the tax originally set forth in the audit letter. No penalties were originally set forth in the audit.
  - Presumably, the bad facts and cost of litigation led to the abandonment by the taxpayer.

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Takeaway from *Hellmann*

Clearly ownership of the GP and the Investment Partnerships matters the most. In differentiating *Lender*, the IRS took note that the *Lender* court said that the GP "…**primarily** provided [investment management services] to and for the benefit of clients other than itself" and that "…it was not managing its own money. **Most** of the assets under management were owned by members of the Lender family that had no ownership interest in [the GP]." Could there be a 50% rule here in structuring GP ownership?

IRS will apply heightened scrutiny to these family arrangements and will fight those ownership structures it views as going too far.

Family members should have outside sources of earned income.

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Structuring of Family Offices

Lender is only a Tax Court Memorandum decision.

In both *Lender* and *Hellmann*, the GP was structured as an LLC taxable as a partnership. Consideration should be given to having the GP be taxable as a corporation (currently subject to tax rates of 21% under recent tax act) rather than an LLC, but need to consider possible application of personal holding company and accumulated earnings tax implications.

Ownership of GP and investment partnerships needs to be dispersed. The bigger the family of investors that do not own the GP, the better.

Attention to SEC exemption from registration as RIA is a necessity.

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LIBOR TRANSITION AND DERIVATIVES UPDATE

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LIBOR Transition

- December 31, 2021
  - Some milestones moved due to COVID-19 but not the end date
- USD LIBOR switching to SOFR
- Other LIBORS/IBORS are switching to alternative rates
- SEC requires a plan and disclosure
- CFTC requires disclosure and has provided relief for the transition
- ARRC has furnished guidance and a template strategy to transition
- Know what you own/trade and how it can be altered

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LIBOR Transition

- Updates
  - Treasury is contemplating an issuance of FRNs tied to SOFR and asked for comment
  - ARRC has published numerous consultations
    - Latest addresses aspects of the LIBOR to SOFR spread adjustment
  - Expectation for USD loans to switch to SOFR by 1Q 2021
  - Fannie/Freddie moving to SOFR based ARMs and will stop purchasing LIBOR based ARMs by the end of 2020
  - ARRC has proposed NY legislation to address legacy LIBOR contracts
  - ARRC has proposed technology vendor readiness checklist
  - The Fed is publishing SOFR averages and a SOFR index
  - CME and LCH to adjust discounting to use SOFR for derivatives in October 2020

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ISDA Developments – ISDA Clause Library

- ISDA recognizes the current lack of standardization in ISDA documentation gives risk to operational inefficiencies, unsustainable costs, and legal and operational risk.
- To address these issues, ISDA has created the **ISDA Clause Library Project** to identify provisions within trading documents that might benefit from further standardization.
- The goal is for highly negotiated and problematic terms to be defined, categorized, and standardized, such as Termination Currency, Automatic Early Termination, Payment Netting, and Setoff clauses.

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ISDA Developments – ISDA Clause Library

- Benefits to the standardization and digitization of these provisions include:
  - More efficient/quicker contract negotiation and client onboarding;
  - Creation of an industry-standard framework for managing and categorizing the data in these trading agreements;
  - More accurate and consistent reporting of data as required by regulations;
  - Easier ability to recognize terms in documentation for operational purposes; and
  - More efficient opportunities to repaper or amend documents due to market or regulatory requirements.

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Proposed CFTC Position Limits on Physical Commodity Derivatives: Historical Overview

2010:

The first notice of proposed rulemaking was issued in 2010 and was subsequently withdrawn.

2011-2012:

The second notice was issued, and the rules adopted, in 2011, but ultimately the rules were vacated by the US District Court for the District of Columbia because the court found that there were at least two plausible readings of the Act and, therefore, the court did not uphold the CFTC's interpretation of the statutory requirements regarding the imposition of position limits.

2013:

The Commission issued a third notice, relating to aggregation of positions, and a fourth notice, relating to reproposed position limits. The Commission then issued a revised reproposal pertaining to aggregation of positions and federal position limits, and adopted final rules on aggregation of positions.

2016:

The Commission issued a supplemental rulemaking and a revised reproposal of its position limits regime.

2020:

The Commission issued a new proposal replacing prior proposals. The comment period closed on May 15, 2020.

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25 Core Referenced Futures Contracts

Core referenced futures contracts, which are 25 physically settled agricultural, metals, and energy futures and options on futures contracts.

(1) CBOT Corn*	(2) CBOT Oats*	(3) CBOT Soybeans*	(4) CBOT Soybean Meal*	(5) CBOT Soybean Oil*
(6) CBOT Wheat*	(7) CBOT KC Hard Red Winter Wheat*	(8) MGEX Hard Red Spring Wheat*	(9) ICE Cotton No. 2*	(10) CME Live Cattle
(11) CBOT Rough Rice	(12) ICE Cocoa	(13) ICE Coffee C	(14) ICE FCOJ-A	(15) ICE US Sugar No. 11
(16) ICE Sugar No. 16	(17) COMEX Gold	(18) COMEX Silver	(19) COMEX Copper	(20) NYMEX Platinum
(21) NYMEX Palladium	(22) NYMEX Henry Hub Natural Gas	(23) NYMEX Light Sweet Crude Oil	(24) NYMEX New York Harbor ULSD Heating Oil	(25) NYMEX New York Harbor RBOB Gasoline

** Indicates contracts that are currently subject to federal position limits. Other contracts would be newly subject to federal position limits.*

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Other Referenced Contracts

- **Linked contracts**, which include futures and options on futures contracts that are directly or indirectly linked to the price of a core referenced futures contract, or to the same commodity underlying a core referenced futures contract for delivery at the same location as specified in that core referenced futures contract
  - To provide market participants with greater clarity as to which contracts may be included in the scope of linked contracts, CFTC staff will publish and periodically update a CFTC Staff Workbook that will provide a nonexclusive list of linked contracts. In this context, an example of "indirect linkage" would include cash settled futures contracts or options on futures that settle to a referenced contract.

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Other Referenced Contracts

- **Economically equivalent swaps**, which include swaps with identical material contractual specifications, terms, and conditions to a referenced contract.
- The definition of economically equivalent swaps is narrower than the linked contracts definition.
- For economically equivalent swaps, identical material contractual specifications, terms and conditions include a comparison of terms relating to the underlying commodity (commodity reference price and grade differentials) and the settlement method (physical vs. cash settlement), but disregard any differences between a swap and a referenced contract due to:
  - notional amount or lot size,
  - post-trade risk management (e.g., cleared vs. not cleared, or margin terms), or
  - for physically settled swaps, delivery dates diverging by less than one calendar date, except in the case of physically settled natural gas swaps, where delivery dates may diverge by less than two calendar days (which will capture penultimate natural gas swaps within the economically equivalent swap definition).
- The proposal says that this definition is generally consistent with the EU definition, with the exception that the CFTC definition refers to "identical *material* terms."

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Contracts *Not* Included

- Under the proposal, referenced contracts would *not* include location basis contracts, commodity-index contracts, swap guarantees, and trade options that meet the requirements of CFTC Regulation 32.3.

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Spot Month Limits

- All 25 core referenced futures contracts are subject to spot-month limits
- **Limit levels.** The proposed limit levels (see table that follows) are generally higher than the existing CFTC (for agricultural contracts) and exchange-set (for energy and metals) position limits for these contracts.
- **Spot month versus non-spot month.** Other than the nine legacy agricultural contracts (where the proposal includes any and all month limits), the proposed limits are only for the spot month.

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Non-Spot Month Limits

- The proposal adopts federal "single month" and "all months combined" non–spot month position limits (referred to as "non–spot month limits") only for referenced contracts based on the nine legacy agricultural contracts that are currently subject to federal position limits.
- For physical commodity contracts not subject to federal limits, exchanges would generally be required to set spot month limits no greater than 25 percent of deliverable supply, but would have flexibility to submit other approaches for CFTC review. Exchanges would have more flexibility in setting limits or accountability levels outside of the spot month.
- Legacy ag contracts are subject to single-month and all-months-combined limits.
- The federal single-month and all-months-combined limits will be the same.
- These non–spot month limits would permit netting of all positions in referenced contracts (regardless of whether such referenced contracts were physical delivery or cash settled) when calculating a trader's positions for purposes of the proposed non–spot month limits.

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Proposed Federal Limits

Agricultural

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
	Legacy agricultural	
CBOT Corn (C)	1,200	57,800
CBOT Oats (O)	600	2,000
CBOT Soybeans (S)	1,200	27,300
CBOT Soybean Meal (SM)	1,500	16,900
CBOT Soybean Oil (SO)	1,100	17,400
CBOT Wheat (W)	1,200	19,300
CBOT KC Hard Red Winter Wheat (KW)	1,200	12,000
MGEX Hard Red Spring Wheat (MWE)	1,200	12,000
ICE Cotton No. 2 (CT)	1,800	11,900
	Other agricultural	
CBOT Rough Rice (RR)	800	N/A
CME Live Cattle	600/300/200 *(step down over spot period)*	N/A
ICE Cocoa (CC)	4,900	N/A
ICE Coffee C (KC)	1,700	N/A
ICE FCOJ-A (OJ)	2,200	N/A
ICE U.S. Sugar No. 11 (SB)	25,800	N/A
ICE U.S. Sugar No. 16 (SF)	6,400	N/A

Metals

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
COMEX Copper (HG)	1,000	N/A
COMEX Gold (GC)	6,000	N/A
COMEX Silver (SI)	3,000	N/A
NYMEX Palladium (PA)	50	N/A
NYMEX Platinum (PL)	500	N/A

Energy

Contract	Proposed Spot Month Limit	Proposed Any/All Month Limit
NYMEX Henry Hub Natural Gas (NG)	2,000* *(see conditional limit, above)*	N/A
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/4,000 *(step down over spot period)*	N/A
NYMEX New York Harbor ULSD Heating Oil (HO)	2,000	N/A
NYMEX New York Harbor RBOB Gasoline (RB)	2,000	N/A

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Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Legacy Agricultural Contracts			
CBOT Corn (C)	1,200	600	600
CBOT Oats (O)	600	600	600
CBOT Soybeans (S)	1,200	600	600
CBOT Soybean Meal (SM)	1,500	720	720
CBOT Soybean Oil (SO)	1,100	540	540
CBOT Wheat (W)	1,200	600	600/500/400/300/220
CBOT KC Hard Red Winter Wheat (KW)	1,200	600	600
MGEX Hard Red Spring Wheat (MWE)	1,200	600	600
ICE Cotton No. 2 (CT)	1,800	300	300

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Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Other Agricultural Contracts			
CME Live Cattle (LC)	600/300/200	n/a	450/300/200
CBOT Rough Rice (RR)	800	n/a	600/200/250
ICE Cocoa (CC)	4,900	n/a	3,000
ICE Coffee C (KC)	1,700	n/a	500
ICE FCOJ-A (OJ)	2,200	n/a	300
ICE U.S. Sugar No. 11 (SB)	25,800	n/a	5,000

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Spot Month Limits

Core Referenced Futures Contract	2020 Proposed Spot Month Limit	Existing Federal Spot Month Limit	Existing Exchange-Set Spot Month Limit
Metals Contracts			
COMEX Gold (GC)	6,000	n/a	3,000
COMEX Silver (SI)	3,000	n/a	1,500
COMEX Copper (HG)	**1,000**	**n/a**	**1,500**
NYMEX Platinum (PL)	**500**	**n/a**	**500**
NYMEX Palladium (PA)	**50**	**n/a**	**50**
Energy Contracts			
NYMEX Henry Hub Natural Gas (NG)	2,000	n/a	1,000
NYMEX Light Sweet Crude Oil (CL)	6,000/5,000/4,000	n/a	3,000
NYMEX New York Harbor ULSD Heating Oil (HO)	2,000	n/a	1,000
NYMEX New York Harbor RBOB Gasoline (RB)	2,000	n/a	1,000

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Non-Spot Month Limits

(Single Month and All Months Combined Limits)

Core Referenced Futures Contract	2020 Proposed Single Month and All Months Limit	Existing Federal Single Month and All Months Limit	Existing Exchange-Set Single Month and All Months Limit
Legacy Agricultural Contracts			
CBOT Corn (C)	57,800	33,000	33,000
CBOT Oats (O)	2,000	2,000	2,000
CBOT Soybeans (S)	27,300	15,000	15,000
CBOT Soybean Meal (SM)	16,900	6,500	6,500
CBOT Soybean Oil (SO)	17,400	8,000	8,000
CBOT Wheat (W)	19,300	12,000	12,000
CBOT KC Hard Red Winter Wheat (KW)	12,000	12,000	5,000
MGEX Hard Red Spring Wheat (MWE)	12,000	12,000	12,000
ICE Cotton No. 2 (CT)	11,900	5,000	5,000

Conditional Spot Month Limit for Natural Gas

- The proposal would establish a conditional spot-month limit only for Henry Hub natural gas referenced contracts that will permit traders to acquire position levels in cash-settled contracts that are five times the spot-month limit for such contract (2,000 contracts) per DCM (and in economically equivalent swaps) if such positions are exclusively in cash-settled contracts and provided that:
  - for cash-settled contracts in the spot month, the trader does not hold or control positions in cash-settled contracts in the spot month that exceed the conditional position limit (10,000 contracts net long or short per DCM *plus* 10,000 contracts in economically equivalent swaps); and
  - the trader does not hold or control any positions in the physical-delivery natural gas referenced contract in the spot month.

Implementation Challenge

- Are the definitions of linked contracts and economically equivalent swaps sufficiently precise to allow traders and compliance staff to know with certainty which contracts must be aggregated for speculative position limits?
- How will traders monitor their swaps activities to capture economically equivalent swaps?
- Notably, the proposal states:
  - Because settlement type would be considered to be a material "contractual specification, term, or condition," a cash-settled swap could only be deemed economically equivalent to a cash-settled referenced contract, and a physically settled swap could only be deemed economically equivalent to a physically settled referenced contract; however, a cash-settled swap that initially did not qualify as "economically equivalent" due to no corresponding cash-settled referenced contract (i.e., no cash-settled look-alike futures contract), could subsequently become an "economically equivalent swap" if a cash-settled futures contract market were to develop.
  - In addition, a swap that either references another referenced contract or incorporates its terms by reference would be deemed to share identical terms with the referenced contract, and therefore would qualify as an economically equivalent swap.
- Explaining the last sentence, the proposal states: "For example, a cash-settled swap that either settles to the pricing of a corresponding cash-settled referenced contract, or incorporates by reference the terms of such referenced contract, could be deemed to be economically equivalent to the referenced contract."

Practical Considerations

- This is the first time swaps and futures will be aggregated for purposes of position limits.
  - Operationally, how will your firm aggregate futures and swaps?
  - Can you do this on a global scale taking into account exchange-imposed limits and limits tracked across exchanges under the CEA and ESMA?
  - How will you determine which swaps are economically equivalent swaps?
- Is the most significant barrier to effective position limit monitoring access to data, both in terms of capturing the data and consolidating it?

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Katherine Dobson Buckley focuses her practice on the application of derivatives in trading, legal, and regulatory issues. She represents hedge funds, investment advisors, mutual funds, endowments and other market participants in complex cross-border and US futures, derivatives, prime brokerage, custodial, and commodities transactions.

Katherine has experience with International Swaps and Derivatives Association Master Agreements (ISDAs), Prime Brokerage Agreements, Master Repurchase Agreements (MRAs), Master Securities Loan Agreements (MSLAs), and Master Securities Forward Transaction Agreements (MSFTAs), as well as clearing, custody, options and futures account agreements, and related trading documentation. She also advises financial firms and other market participants on US and cross-border regulatory issues, including registration and exemption requirements with the US Commodity Futures Trading Commission (CFTC) and requirements of the Dodd-Frank Act provisions applicable to derivatives transactions.

Katherine spent time on secondment at the general counsel division of Credit Suisse, where she negotiated sophisticated derivative transactions. Katherine also worked as a law clerk for the US Securities and Exchange Commission, researching regulatory and securities fraud issues.

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Thomas V. D’Ambrosio concentrates his practice on structured and complex derivative transactions, including related insolvency and regulatory issues. Thomas helps clients structure, negotiate, and analyze the risk inherent in a wide range of cleared and uncleared derivative and futures products. He represents clients in all asset classes, including equity, debt, credit, commodity, interest rate, currency, and exotic derivatives. His clients include Fortune 500 corporations, private companies, investment managers, hedge funds, financial institutions, pension funds, and high net-worth individuals.

Thomas is particularly active in advising enterprises that employ derivatives to hedge risks, monetize assets, and finance the acquisition of assets on favorable terms—with and without the benefits of leverage—including financing issuer equity and debt repurchase programs. He actively represents clients on LIBOR reform and Dodd–Frank derivative reform.

Thomas also represents issuers in public and private sales of equity and debt securities. He advises purchasers and sellers in stock sales, asset sales, and merger transactions; counsels investment managers in leveraged private fund investments; and advises pension fund managers and wealthy families with respect to their investments in private funds.

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Christina Mesires Fournaris advises clients on estate, tax, and generational wealth planning. High-net-worth individuals, multigenerational family groups, entrepreneurs, and owners of privately held businesses are among her clients. A significant portion of her time is devoted to working with women business owners, as well as women who control their family’s wealth. Her practice includes advising clients on trusts, tax planning, philanthropic and charitable giving, and estate planning.

When working with families, Christina counsels family groups and family offices on the management of their holdings and management of trusts that represent family members. When she facilitates a family meeting, Christina helps the family develop a mission statement. She also educates family members on the importance of trusts, and the tax and investment considerations for various family trusts.

In her work with business owners, Christina counsels them before major liquidity events. She also structures transfer tax vehicles to shift wealth to the next generation in a tax-efficient manner.

Christina also works with individual and corporate fiduciaries on trust and estate administration matters, including counseling clients on best practices, as well as federal and state fiduciary income tax implications. She also advises clients on charitable planning techniques, including major planned gifts of various assets, charitable trusts, and private foundations.

She frequently speaks to audiences that include insurance, financial, and investment professionals and advisers.

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Amy Natterson Kroll counsels US and non-US financial institutions on US regulatory requirements and best practices related to broker and dealer activities. Clients seek Amy's advice on, among other things, issues related to implementation of new regulations; the acquisition and sale of broker-dealers; expansion of business and related regulatory requirements for financial institutions; and regulations related to the capital markets, such as research activities and research analysts, supervisory controls and internal controls, and cross-border securities activities. Amy also advises clients on the collateral consequences of enforcement, civil, and criminal actions. She has a specific interest in the issues central to regional full-service and mid-market broker-dealers.

Amy worked at the Securities and Exchange Commission twice. From 1997–1998 she was assistant general counsel (legislative and financial services) at the SEC, to which she had returned after five years in private practice counseling broker-dealers and other financial institutions. From 1984–1991, during her first tour of SEC service, she served in positions of increasing responsibility, first as an attorney-adviser in the division of Market Regulation (now the division of Trading & Markets), and subsequently as counsel to Commissioner Edward H. Fleischman and as senior special counsel in the division of Corporation Finance, Office of International Corporate Finance.

From 1998–2003, Amy was an independent consultant, focusing on issues confronted by non-US financial entities seeking to engage in broker-dealer activities in the United States. During that time, she also taught at the Washington College of Law, American University.

Amy serves as the Washington office practice group leader for the firm's investment management practice and also is the Washington office hiring partner. She previously served as a member of the NASDAQ Market Operations Committee. Prior to joining Morgan Lewis, Amy was a partner in the financial institutions regulatory, enforcement, and litigation practice at another international law firm.

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Michael M. Philipp counsels financial services clients in futures and securities transactions. He also advises them in derivatives regulation, legislation, compliance, and enforcement matters. United States and foreign exchanges and clearing organizations, banks, investment managers, proprietary trading firms, brokerage firms, and end users turn to Michael for guidance in connection with exchange-traded and over-the-counter derivative instruments. He also represents foreign exchanges and clearinghouses in their US offerings of futures and equity options products and derivatives clearing activities.

Michael has experience working with clients on issues related to the Dodd–Frank Wall Street Reform and Consumer Protection Act, as well as US Commodity Futures Trading Commission (CFTC) registration and compliance-related issues. These issues include trade practices, swap reporting and clearing, registration of swap execution facilities (SEFs), futures exchanges, clearing organizations, and swap data repositories (SDRs); retail and eligible contract participant forex (ECP FX) transactions; and futures commission merchant (FCM), swap dealer, commodity pool operator (CPO) and commodity trading advisor (CTA) registrations and compliance. Michael has experience in conducting internal compliance investigations, as well as representing clients in exchange and CFTC inquiries and proceedings, including matters involving allegations relating to disruptive trading practices, such as spoofing and market manipulation. He also provides assistance to firms that are negotiating bilateral and cleared swap documentation.

Before joining Morgan Lewis, Michael worked as an in-house attorney for the Chicago Mercantile Exchange (CME). There he served as counsel to the CME's regulatory trade practice, compliance, and arbitration committees.

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Before joining Morgan Lewis, David was associate director for international corporate finance in the Division of Corporation Finance at the SEC. In that position, he developed SEC policy on cross-border offerings, acquisitions, and listings, which included offshore Internet offerings, international disclosure and accounting standards, and international corporate governance guidelines. David also advised the SEC and its Division of Enforcement on financial fraud cases and cross-border offering abuses. Earlier, he served as senior legal advisor to the SEC's director of the Division of Corporation Finance, and as staff director of the Advisory Committee on Capital Formation and Regulatory Processes. He also served for seven years as chief of the division's Office of Tender Offers, administering rules on M&A, going private transactions, and proxy contests.

David is a former vice-chair of the ABA Federal Regulation of Securities Committee and a former chair of the ABA Subcommittee on Corporate Disclosure. He also served as a member of the FINRA Corporate Financing Committee. He speaks frequently at conferences and continuing legal education programs on public and private financings, corporate reporting and governance, M&A, and private fund regulation.

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William P. Zimmerman guides clients on the creation and operation of private and pooled investment vehicles, such as mutual funds, hedge funds, real estate investment trusts, and other investment-related vehicles. He also advises clients on general corporate and individual tax planning matters, including reorganizations, mergers, acquisitions, spinoffs, recapitalizations, and workouts. Additionally, Bill provides partnerships and limited liability companies with planning and operational guidance on tax-related issues.

Bill is the most recent past chair of the investment management committee of the tax section of the American Bar Association. He is a frequent speaker on tax-related topics, and also annually presents at Morgan Lewis's Private Fund Investor Roundtable. In addition, Bill is a fellow of the American College of Tax Counsel.

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SUCCESSION PLANNING

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Introduction

- The franchise value of an asset or wealth manager can be protected and enhanced through a series of steps taken to "institutionalize" its business
- An institutionalized firm is more sustainable with greater projected longevity, which helps founders and next-generation partners by enhancing:
  - Valuation of the firm by outside investors or acquirers through improved long-term financial projections and reduced discount rate
  - "Tail" value following a partner's departure from the business
  - A lasting independent legacy for the founders

3

Overview

Institutionalized boutique investment managers have many of the following attributes in common:

- Multiple generations of talent with succession planning
- Governance structures designed to endure beyond the founders
- Broad equity ownership with aligning terms
- Service-related commitments from partners and key professionals
- Complimentary product mix and distribution channels
- Optimized middle- and back-office functions
- Independent Directors or Advisory Board members
- Credible/branded outside vendors and investors

4

Multiple Generations of Talent with Succession Planning

Succession planning at any boutique firm is an ongoing process that begins at the hiring stage and continues through ongoing training, annual reviews, and promotions of next-generation leadership

Aligning equity terms helps facilitate transparency and cooperation among founders and next-generation professionals in planning succession

Once anticipated career horizons are known for senior professionals, the resulting time "runways" can be used to identify, cultivate, and elevate successors and effect messaging and the transition of key relationships

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Governance Designed to Endure Beyond the Founders

- Formation of operating and investment committees can provide valuable forums for next-generation participation and grooming for leadership
- Establishing firm leadership succession well in advance of anticipated founder departures helps ensure adequate runway for communications with clients and employees, and the transition of management functions and relationships
- Restructuring founder equity arrangements and creating distinctions between "founder equity" and "sweat equity" can often improve alignment around the timing and sequencing of next-generation management transitions

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"Trading" Equity Ownership for Service-Related Commitments

- Elevating key individuals to partnership presents a unique opportunity to change their mindsets from those of employees to those of owners while also receiving back service-related commitments that protect franchise value
- By equitizing next-generation professionals, it is often possible to recapture EBITDA by converting a portion of annual cash compensation into "below-the-line" equity distributions that also participate in the firm's terminal value
- Professional partners have a greater tendency to remain with a firm through tough times and to take longer-term views on operations and strategy

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Service-Related Commitments

- When spreading equity ownership to key next-generation professionals, it is important to receive from them individual service-related commitments to the firm, including:
  - Operating commitments
  - Departure and transition commitments
  - Restrictive covenants
- It is typically easier to obtain these types of service-related commitments from next-generation professionals if a firm's founders simultaneously make the same franchise-protective commitments to the firm
- Once all key professionals are properly equitized and integrated into governance, and have "locked arms" through service-related commitments, the firm is institutionalized from an ownership, structure, and governance perspective

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HOT TOPICS FOR QUANT MANAGERS

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The Future of Quantitative Investing

- Quantitative approaches—meaning those grounded in advanced data science and systematic techniques—will play a growing role in private market investing.
- As more financial services firms embrace artificial intelligence techniques like machine learning, it will become apparent that human talent and effective teaming are key to unlocking their promise.
- Systems talent and a systematic approach will be required to develop the complex infrastructure that enables data aggregation, analysis, and computation reliably and at scale.
- Investors' desire to incorporate ESG will be served well by systematic approaches.
- Will systematic bond strategies overtake the Bond Kings?

Use of Alternative Data & Alternative Data Set Attributes

Asset Class	Investment Style	Alpha (Net of Cost)	Known	Stage of Processing	Quality	Technical Aspects
Equity	Macro	Viable Stand-alone	Public Free of Cost	Raw	History	Frequency
Commodity	Sector Specific	Viable in a Portfolio	Well Known	Semi-Processed	Outliers	Latency
Credit	Stock Specific	Not Viable	Lesser Known	Processed	Missing Values	Format
Rates	Risk Indicator	Capacity	Proprietary Not Known	Trading Signal	Methodology Transparency	Robust API
FX	Quant Signal	Orthogonality	Limited Sales Deals	Research Piece or Alert	Support Structure	Conflicts and Legal Risk

CIOs and Portfolio Managers

Quants and Data Scientists

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Immigration – Issues in Securing Talent

- Those with the most desirable educational backgrounds to fill quantitative analyst and data scientist roles are often foreign nationals who require sponsorship to work in the United States.
- The work-authorized sponsorship category most widely used by fund managers for foreign nationals applying for quant and data scientist roles is the H-1B.
- Recent announcements from the US Chamber of Commerce have indicated that the White House will be looking at proposals to institute a complete ban on the H2B, H1B and L1 programs.
- In the past, firms have been able to sponsor foreign nationals for H-1B status without significant trouble.
  - Recently, however, 60 percent of H-1B cases are being questioned and subjected to lengthy requests by the U.S. Citizenship and Immigration Services (USCIS)—and one-third of all H-1B cases are ultimately denied.
- Specialty Occupation Requirement & Evidence of Specialized Knowledge

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Model Integrity

- **"Quantamentals"**
  - Trying to help advisers understand when they have a quant strategy; it is becoming harder to determine when you have a quant strategy and when you don't
- **Convergence**
- **Model integrity under stressed market conditions**

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Quantative Model Integrity

Policies and Procedures

- Identification and mitigation of model risks

Disclosure

- Accurate description of model and associated risks

Model Errors

- Preventing errors
- Implementation of reporting infrastructure
- Error disclosure
- Self-reporting

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ISSUES TO CONSIDER IN STRUCTURING AND MAKING CO-INVESTMENTS

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What is a Co-Investment?

What is a co-investment?

- A minority equity investment in a portfolio company made directly by a private fund investor together with, but not through, the private equity fund
- The investment is often in addition to the investment in the private equity fund sponsor.

Why do investors like co-investment transactions?

- Reduced or eliminated fees on co-investments
- Ability to select investments
- Increased exposure to certain investments
- Higher and quicker returns on investments
- Investor access to restricted opportunities
- Better understanding of sponsor's deal process

Co-Investment Structures

Co-investor contributes capital directly to the portfolio company in exchange for equity of the portfolio company.

Co-investor contributes capital to, and receives equity of, the entity used by the private equity fund to acquire and hold its portfolio company equity.

Co-investor contributes capital to, and receives equity of, an investment vehicle managed by the fund sponsor into which all co-investment funds are pooled to acquire and hold portfolio company equity.

Co-investor contributes capital to, and receives equity of, a fund sponsor-managed special purpose vehicle (SPV) that acquires and holds portfolio company equity. If there is more than one co-investor, each co-investor comprises its own SPV.

Structuring Tax Considerations

- Taxable US investors are likely to prefer a pass-through vehicle, such as a limited partnership or limited liability company.

- Certain tax-exempt US investors may want to block “unrelated business taxable income (UBTI)” by using a corporation or other blocker structure. Blocker structures typically insert an entity (either a corporation or a limited liability company that makes an election to be taxed as a corporation) between the investor and the investment. They are often used by funds that have foreign investors.

Key Investor Objectives in Negotiating Co-Investments: Due Diligence

- Legal due diligence summary
- Financial due diligence summary

- Underlying Purchase Agreement
- Disclosure Schedules
- Ancillary documents (e.g., management agreement, shareholders' agreement)

- Regulatory
- Tax
- ERISA

Key Investor Objectives in Negotiating Co-Investments: Alignment of Co-Investor and Sponsor Interests

Co-investor negotiates with fund sponsor and has limited or no contact with portfolio company

Maintain as much alignment as possible with sponsor to provide protection of the co-investors' interests such as:

- Price
- Type of security
- Terms of investment
- Simultaneous exit
- Expenses

Require sponsor to take same actions on behalf of co-investor as on behalf of sponsor

Investments in separate investment vehicles make it more difficult to ensure alignment of interests, and ensure lead sponsor will govern co-investment vehicle in lock-step with its own fund vehicles

Key Investor Objectives in Negotiating Co-Investments: Limited Minority Protections

Minority protections depend on the structure of the co-investment and get increasing pushback from sponsors

Types of minority protections:

- MFN – ensure no other investor receives superior investment rights, but becoming very rare
- Preemptive rights
- Board observer/Board seat
- Information rights
- Consent rights

Side letters are common when the co-investor is a large public pension plan or investment authority and are becoming more common with other investors, especially in the context of a co-investment aggregation vehicle

Transfer/Exit Rights

- The general goal is to be tied at the hip with the Sponsor and to exit at the same time and on the same terms as the Sponsor.
- Transfer of investors equity
- Types of exit rights:
  - Drag-along right
  - Tag-along/Co-sale right
  - Registration rights

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Laura E. Flores' practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and "no-action" letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing "liquid alt" funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm's diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.

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Rob also provides strategic advice as a consultant to established and emerging financial services firms in connection with a range of business initiatives, including institutionalization of their businesses to enhance franchise value, governance and succession matters, product and channel diversification, and similar initiatives.

Prior to returning to private practice, Rob co-founded HighView Investment Group with Ralph Schlosstein (co-founder and former president of BlackRock), a platform targeting acquisitions of minority interests in alternative asset managers. Previously, he was senior vice president for new investments at Affiliated Managers Group, which he joined after more than 14 years in private legal practice.

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UK AND EUROPE FUNDS LANDSCAPE

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Agenda

1. Governmental and Regulatory Response to Pandemic
2. Brexit Update
3. Developing Regulation of Sustainability/ESG
4. Securities Financing Transactions Regulation
5. New Prudential Regulatory Framework for Most MIFID Investment Firms
6. FCA "Dear CEO" Letters to Alternative Investment Firms (AIFs)
7. Alternative Investment Fund Managers Directive (AIFMD) Review

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Governmental and Regulatory Response to Pandemic

- UK government introduced a range of temporary measures to support public services, people, and businesses throughout the disruption caused by COVID-19, including a scheme to support self-employed individuals. European Union (EU) member states have adopted similar measures.
- UK Financial Conduct Authority (FCA) expects firms to continue to record calls, but accepts that this may not be possible. In this case, firms should notify FCA of their inability to record calls and consider what steps they could take to mitigate outstanding risks if they are unable to comply. European Securities and Markets Authority (ESMA) made a similar announcement about its expectations of investment firms EU-wide.
- FCA has allowed UK-listed companies an extra two months to publish their audited annual financial reports. ESMA has recommended that member state regulators exercise similar forbearance on enforcing financial reporting deadlines.
- FCA has published guidance on steps for firms to take to identify their key workers.
- FCA announced it has no intention of taking enforcement action where a firm chooses to cease providing 10% depreciation reports for any professional clients until 1 October 2020.

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Governmental and Regulatory Response to Pandemic

- ESMA announced on 31 March that the upcoming EU Markets in Financial Instruments Directive (MIFID) II reports on best execution required soon from execution venues, brokers, and asset managers could be deferred to 30 June and that venues and firms should make records of their internal decision-making on this.
- In March regulators in Austria, Belgium, France, Greece, Italy, and Spain imposed temporary short-selling prohibitions on identified issuers under the EU Short Selling Regulation ("SSR"), based on the impact COVID-19 has had on financial stability and market confidence. After considerable industry pressure the prohibitions were terminated in mid-May.
- On March 16 ESMA, pursuant to its powers to intervene in exceptional circumstances under SSR, decided to reduce the EU-wide threshold for private reporting to local regulator of shorting activity from 0.2% to 0.1% of issued share capital until 16 June 2020. This also applies in the UK.
- On 4 June a senior FCA official announced that where regulated firms want to make mental health counselling services available to advisers in other firms (a non-monetary benefit), it would be reasonable for firms to determine that they can both provide and accept such mental-health counselling services without contravention of FCA MIFID and non-MIFID inducement rules.

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Brexit Update

- The UK ceased to be a member of the EU (and EEA) on 31 January 2020.
- Transitional period preserves previous single market arrangements until 31 December 2020.
- EU Withdrawal Agreement allows for transitional period to be extended (by agreement) by up to one two years, but decision must be made before 1 July 2020.
- EU Council Summit scheduled for 19 June; UK government current position is that it will not request an extension
- Current discussions between UK and EU on a 'future relationship' deal are not showing any signs of real progress; increasing risk of a messy no-deal scenario at the end of this year.
- Future relationship discussions are in any event focused on trade and fishing rights, not services.
- Ideally the future relationship agreement would activate existing equivalence provisions in EU single market directives so that EU access for UK financial services firms could continue, along the same lines as currently (although there would be differences). However, currently this outcome seems quite aspirational.
- No 'future deal' on financial services would create barriers for UK fund manager raising capital from EEA investors, but will not change the position for US/other third country managers raising capital from UK investors

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Developing Regulation of Sustainability/ESG

- The European Commission has made sustainable finance an express initiative within its overall plans to strengthen capital markets in the European Union:

  "***Re-orienting private capital to more sustainable investments requires a comprehensive rethinking of how our financial system works. This is necessary if the EU is to develop more sustainable economic growth, ensure the stability of the financial system, and foster more transparency and long-termism in the economy***."
- The UK government launched its "Green Finance Strategy" in July 2019 and intends to require the FCA/UK Prudential Regulatory Authority (PRA) to have regard to the Paris Agreement on Climate Change when considering their objectives and in the discharge of their functions. The UK government has committed to match the key objectives of the EU's Sustainable Action Plan, but it is not yet clear if it intends to onshore relevant EU law.
- The Taxonomy Regulation (not yet final) creates an EU classification system that sets out what constitutes an environmentally sustainable economic activity. This should stop fragmented systems from developing whether market-led or country-led and hinder "greenwashing." It requires qualifying public-interest-listed issuers and financial market participants (see below) to disclose how their financial products align with the taxonomy. Requirements will come into effect from 31 December 2021 and 2022.

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Developing Regulation of Sustainability/ESG

- To qualify as environmentally sustainable any economic activity must:
  - contribute to one or more of the following six environmental objectives:
    - climate change mitigation
    - climate change adaption
    - sustainable use and protection of water and marine resources
    - transition to a circular economy, waste prevention, and recycling
    - pollution prevention and control
    - protection of healthy ecosystems
  - not significantly harm any of the above objectives
  - comply with social and governance safeguards
  - comply with so-called "technical screening criteria", yet to be developed but which will take into account competition issues, existing green financial products and markets, and liquidity
- Disclosure Regulation (final) imposes transparency and disclosure requirements concerning the integration of sustainability risks in investment decision-making and advisory processes and the provision of relevant sustainability information

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Developing Regulation of Sustainability/ESG

- The Disclosure Regulation is built around three main pillars:
  - **Elimination of greenwashing**: i.e. to eliminate unsubstantiated or misleading claims about sustainability characteristics and benefits of an investment product and increase market awareness on sustainability matters
  - **Regulatory neutrality**: the rules introduce a disclosure toolbox to be applied in the same manner by different types of covered firms
  - **Cross-sectoral reach**: applies to Alternative Investment Fund Managers (AIFMs), MIFID portfolio managers, Undertakings for Collective Investment in Transferable Securities (UCITS) managers, EUVECA managers, EUSEF managers, Solvency II insurers making available insurance-based investment products ("IBIPs"), institutions for occupational retirement provision, pension providers (financial market participants); to the provision of investment advice by banks, MIFID investment firms, AIFMS and UCITS managers; and to insurers and insurance intermediaries giving investment advice on IBIPs. Scope of "financial product" includes a portfolio management service, an AIF and a UCITS.

- Covered firms must:
  - maintain written policies on the integration of sustainability risks in their investment decision-making and advisory process and publish them on their websites
  - provide investors/clients with specified pre-contractual disclosures:
    - the procedures and conditions applied for integrating sustainability risks in their investment decisions
    - the extent to which sustainability risks are expected to have a relevant impact on the returns of the financial products made available
    - how their remuneration policies are consistent with the integration of sustainability risks and in line where relevant with the sustainable investment target of the financial product

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Developing Regulation of Sustainability/ESG

Additional transparency requirements apply to a firm that offers its investors/clients a sustainable financial product, such as a fund or managed account.

- Requirements will apply mostly from 10 March 2021; periodic reporting to investors from 1 January 2022. ESMA will develop technical standards during 2020.
- On 23 April 2020 the European Supervisory Authorities issued a Joint Consultation Paper on sustainability-related disclosures in the financial services sector with regard to content, methodologies and presentation of information in relation to sustainability indicators and the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, websites and periodic reports
- ***The Taxonomy Regulation in tandem with the Disclosure Regulation will require firms to disclose the degree of environmental sustainability of those financial products that they claim pursue environmental objectives***
- The Low Carbon Benchmark Regulation amends the Benchmark Regulation (BMR) from 10 December 2019 by:
  - introducing two new categories of benchmark, a low carbon one and a positive carbon impact one
  - requiring benchmark administrators that pursue or take into account ESG objectives to provide an explanation of how the key elements of the methodology reflect the ESG factors and to explain in their published "benchmark statement" how ESG factors are reflected
  - setting out the key requirements governing the methodology for the two new benchmarks
  - the Regulation also extends the transition period (under Article 51, BMR) so that pre-existing critical benchmarks can continue to be provided until 31 December 2021 without applying for authorisation or registration under the BMR.

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Draft Delegated Regulation Under MIFID

- The European Commission published a draft regulation under MIFID on 4 January 2019 on how portfolio managers and financial advisers should take sustainability issues into account when assessing suitability[1]
- The draft regulation requires firms to identify their clients' ESG preferences so that their advice and investment decision-making reflects the clients' financial objectives and ESG preferences. In addition, firms will be asked to ensure that ESG considerations are properly reflected in their policies and procedures required under MIFID in order that they understand the nature, features, costs, and risks of financial instruments selected for their clients
- There will not be a requirement for existing sustainability assessments to be revisited
- Timetable to commencement not yet set but draft provides for a 12-month transitional period

[1] Suitability has to be assessed against clients' knowledge and experience, financial situation, and investment objectives. However, ESG issues are not normally considered under the current suitability regime. In May 2018 ESMA recommended as good practice that firms should currently consider ESG factors when gathering information on a client's investment objectives, paving the way for investment firms to volunteer to include ESG preferences in their suitability assessments ahead of becoming obliged to do so.

ESMA's Two Final Reports to the European Commission of 30 April 2019

- ESMA's Final Report on integrating sustainability risks and factors in the UCITS Directive and AIFMD sets out its advice on how relevant EU legislation should be modified to address ESG concerns. Sustainability risks in this context are the risks of fluctuation in the value of positions in a fund's portfolio due to ESG factors.
- Under the UCITS Directive, while management companies must have in place certain organisational procedures and well-documented structures and practices, they are not required to take ESG considerations into account or consider conflicts of interest that could arise from sustainability risks. Similarly, under the AIFMD, AIFMs are not expected to take into account ESG considerations.
- ESMA's advice is sufficiently general and broad to allow fund managers to assess how best to take into account ESG considerations.

ESMA recommends changes in the following areas of the UCITS and AIFMD frameworks:

incorporation of sustainability risks within organisational procedures, systems, and controls to ensure that they are properly taken into account in investment and risk management processes (e.g. decision-making, internal reporting, and monitoring)

consideration of the required resources and expertise for the integration of sustainability risks

consideration of the types of conflicts of interest arising in relation to the integration of sustainability risks and factors

consideration of sustainability risks when selecting and monitoring investments, designing written policies and procedures on due diligence, and implementing effective arrangements

explicit inclusion of sustainability risks when establishing, implementing, and maintaining an adequate risk management policy

ESMA also issued a Final Report of the same date on integrating sustainability risks and factors into the MIFID framework

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Securities Financing Transactions Regulation (SFTR)

- The SFTR aims to create a safer and more transparent financial system by placing additional requirements on counterparties to SFTs. Broadly, the legislation requires:
  - Securities financing transactions (SFTs) to be trade-reported to trade repositories (TRs) – phased commencement, stage one from 14 April 2020
  - Detailed reporting by AIFMs and UCITS managers on investment fund SFT and total return swaps activity in pre-contractual documentation and periodic reports – commenced from 12 January 2016 for funds established after that date and from 13 July 2017 for funds established before 12 January 2016
  - Prior risk disclosure and written consent before counterparties are permitted to re-use or re-hypothecate assets – commenced 13 July 2016
  - Counterparties must keep a record of any SFT they have concluded, modified, or terminated for at least five years following termination – from 12 January 2016

What is an SFT?

- Broadly, SFTs consist of any transaction that uses assets belonging to one counterparty to generate financing means. In practice, this mostly includes lending or borrowing of securities and commodities, repurchase (repo) or reverse repurchase transactions, or buy-sell back or sell-buy back transactions.[2]

[2] SFTs are defined in Article 3(11) of the SFTR.

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To Whom Does the SFTR Apply?

- The SFTR is broad in its application. It applies to all counterparties in SFT markets, UCITS, alternative investment funds (AIFs), and any counterparty engaging in re-hypothecation. Specifically, Article 2 sets out that the SFTR applies to:
  - A counterparty to an SFT that is established:
    - in the European Union, including all its branches irrespective of their location; and
    - in a third country (that is, outside of the European Union), if the SFT is concluded in the course of operations of an EU branch
  - UCITS management companies and UCITS investment companies, by definition EU established
  - AIFMs who are authorised under the AIFMD, by definition currently EU established, in respect of EU AIFs that they manage
- There is no exemption for counterparties who enter into small numbers of SFTs (unlike European Market Infrastructure Regulation (EMIR), where a low volume exemption does exist). There is however a category for small-size non-financial counterparties

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Who Has to Report?

- Investment managers, other investment firms, and banks required to report from 14 April 2020
- Authorised AIFMs (i.e. currently, EU AIFMs and their non-EU branches) and UCITS required to report from 12 October 2020
- Covered third country entities required to report from 12 October 2020
- Similar to the EMIR reporting regime, both parties to a trade are required to report details of a transaction to a trade repository on a T+1 basis. However, SFTR specifically provides for the following scenarios:
  - where a financial counterparty concludes an SFT with a non-financial counterparty that is small in size (as defined in Article 3(3) of the Accounting Directive), the financial counterparty reports on behalf of both parties
  - where a UCITS is a counterparty to an SFT, its manager is responsible for reporting that transaction to a trade repository on behalf of the UCITS
  - where an AIF is a counterparty to an SFT, its AIFM is responsible for reporting that transaction to a trade repository on behalf of the AIF

On March 26 2020 ESMA updated its statement on the implementation of SFTR, noting that national regulators are not expected to prioritize supervisory activity towards firms' compliance with SFTR. FCA has confirmed that it will not prioritize supervision of SFTR reporting requirements for firms that had been due to start reporting on April 13, 2020, until at least July 13, 2020.

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New Prudential Regulatory Framework for Most MIFID Investment Firms

New/re-shaped requirements regarding own funds, liquidity, group supervision, staff pay, governance, regulatory reporting, and public disclosure

- Investment Firms Regulation (IFR) (applicable from 26 June 2021)
- Investment Firms Directive (IFD) (member states to bring in local legislation applicable from then)
- European Banking Authority preparing some of the detailed regulatory technical standards required to elaborate the IFR/IFD framework, consultations published 4 June
- MIFID investment managers are in scope
- AIFMs, UCITS, and UCITS managers are out of scope and will continue to be subject to prudential (and remuneration) regimes set out in AIFMD and UCITS Directive, respectively.
- New regime maintains requirement that own funds of those provider-types must never be lower than the IFR/IFD fixed overheads requirement
- To be determined whether remuneration referable to the MIFID business of an out-of-scope firm subject to IFR/IFD remuneration regime
- UK government will use forthcoming Financial Services Bill to implement an updated prudential regime for UK investment firms; HMT and FCA consultations expected July 2020

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Why Change?

- Currently, investment firms are subject to the CRR/CRDIV prudential regime designed for banks, notwithstanding different business models, risk profiles, and potential impact on financial stability. The categorisation of MIFID investment firms within CRR/CRDIV has turned on what MIFID business they conduct with 11 permutations
- The new regime:
  - categorises investment firms by reference to the size and complexity of the investment firm
  - contains risk-based measures which are relevant to investment firms, not banks, known as "k-factors" which seek to capture the risk the firm can pose to clients, market access/liquidity, and itself
- IFR/IFD divides investment firms into three different classes. Investment managers will fall into Class 2 and be subject to the full IFR/IFD regime unless they qualify as "small and non-interconnected firms"[3] and thereby fall into Class 3, which applies a lighter regime
- Broadly, capital requirements will prove more burdensome with investment managers being required to hold their own funds of a minimum €75,000 and liquid assets equal to at least one month's fixed overheads

[3] See article 12(1) of IFR for the nine criteria a firm must satisfy to qualify as such

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- Transitional measures generous in parts
- For five years from 26 June 2021 investment firms:
  - for which new capital requirement more than doubles the old one may limit their new requirement to twice their old one
  - which did not previously have any capital requirement may limit their new requirement to twice their fixed overheads requirement
  - which were only subject to an initial capital requirement may limit their new requirement to twice their old one
- IFR/IFD also features:
  - remuneration: "bank-like" requirements based on CRR/CRDIV (e.g. malus and clawback), proportionality preserved, and pay-out process rules introduced but will not apply to firms with less than €300 million in assets or individuals who are paid €50,000 or less in bonus compensation; there will be no bonus cap for staff in Class 2 or 3
  - governance and reporting requirements including public disclosures i.e. capital, capital requirements, risk management, internal governance, and remuneration
  - third-country access to EU "equivalence" regime in MIFID II which is tightened (as a consequence of Brexit) to ensure that provision of investment services by third country firms to EU clients is conditional upon firms meeting capital requirements equivalent to those in IFR/IFD

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FCA "Dear CEO" Letters to AIFs

- On 20 January 2020 FCA sent a letter to the CEOs of AIFs[4] setting out its supervisory priorities. These include: how firms address their product governance and appropriateness and suitability obligations; whether firms' market abuse controls are sufficient to enable them to discharge their obligations under the Market Abuse Regulation; whether firms' risk management controls are sufficient to avoid excessive risk taking and to mitigate the potential for harm or disruption to financial markets, firms' client money and asset controls, firms' systems and controls in respect of financial crime, and firms' preparations for Brexit.
- FCA also sent a separate letter to the wider asset management[5] industry, which sets out priorities including LIBOR transition, internal governance, product governance, and liquidity management.

[4] FCA's "alternatives portfolio" comprises firms that predominantly manage alternative investment vehicles or alternative assets directly, or advise on those types of investments or investment vehicles.
[5] FCA's "asset management portfolio" comprises firms that predominantly directly manage mainstream investment vehicles, or advise on mainstream investments, excluding wealth managers and financial advisers.

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AIFMD Review

Full results expected late 2020. Meantime the European Commission's Report on the operation of AIFMD (January 2019) identified the following areas for review:

- some rules are interpreted divergently across Member States by their local regulators, for example the rules concerning depositories and the EU marketing passport regime
- some rules, for example reporting requirements, may overlap with other European disclosure rules
- no hard evidence was available whether and to what extent the AIFMD provisions have enabled more informed investment decisions by AIF investors
- harmonisation of the calculation methodologies for leverage across AIFMD, UCITS, and other relevant legislation
- coherence of the AIFMD remuneration rules with other legislation or guidelines
- requirements related to investments in non-listed companies and enterprises and the extent of notifications to local regulators are viewed as not useful and overly burdensome

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MENA FUNDS LANDSCAPE

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Marketing of Securities in MENA; Key Considerations

01 Regional Focus
Focus on the GCC although no passporting regime exists

02 Dual Legal Systems
UAE and Qatar offer onshore and offshore systems

03 Placement Agents
A handful of regulated placement agents with regional reach

04 Islamic Investors
An alternative and sometimes additional pool of investment funds

Marketing of Securities in the UAE

1 First "Point of Call" in the region
- Ease of Access
- Concentration of sovereign wealth funds (SWFs) and asset managers
- Regional Platform for family businesses
- Advanced but rapidly evolving securities regulations

2 Onshore Regulations
- Securities & Commodities Authority
- Private Placement Exemptions: governmental entities; asset managers and international organizations
- Recently enacted regulations applicable to marketing securities to "Qualified Investors"

3 Offshore Regulations
- Dubai International Financial Centre
- Financial regulator: Dubai Financial Services Authority
- Abu Dhabi Global Markets
- Financial regulator: Financial Services Regulatory Authority

Marketing of Securities in Kuwait and Saudi Arabia

1	**Kuwait**	• Historically, system based on "tolerated practices" • Recent regulations made Kuwait one of the strictest in the GCC	• Use of local banks as placement agents • Limited "informal" exemptions based on sophistication, numbers, and offshore nature of activities
2	**Saudi Arabia**	• Possibly the strictest of all GCC jurisdictions • Local placement agents need to be appointed with feeder funds and accounts established	• Reverse solicitation to high-net-worth individuals and institutional investors who have SAR 50,000,000 in assets • Marketing to governmental entities
3	**Other Markets**	• Bahrain, Oman, and Qatar form the remainder of the GCC • Marketing activities at times extend to Egypt, Jordan, and Lebanon but mostly through offshore family offices	• Important to recognize differences between various countries and to develop a code of conduct for individuals involved in selling securities including fund interests

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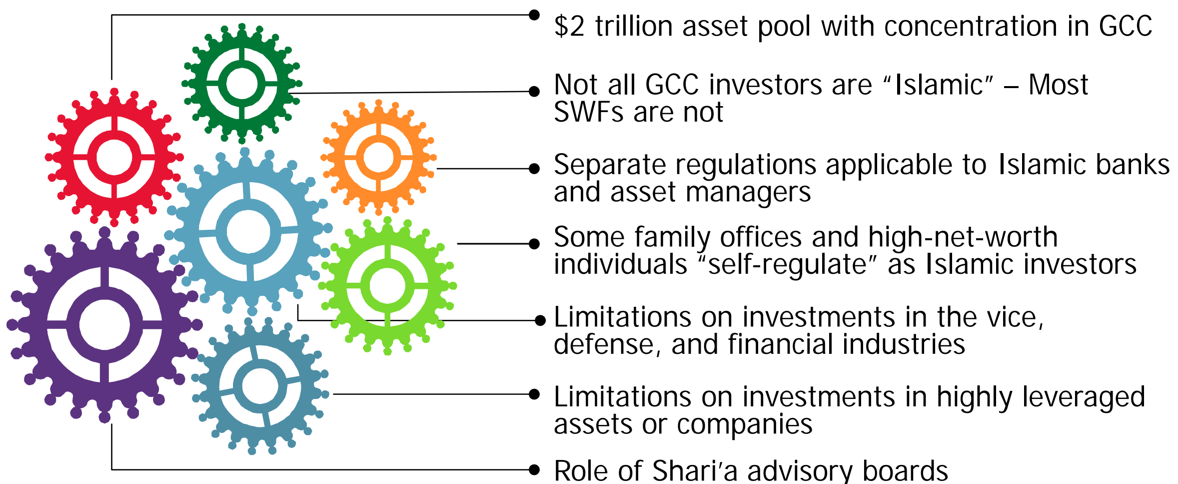
Marketing of Securities in MENA: Islamic Investors



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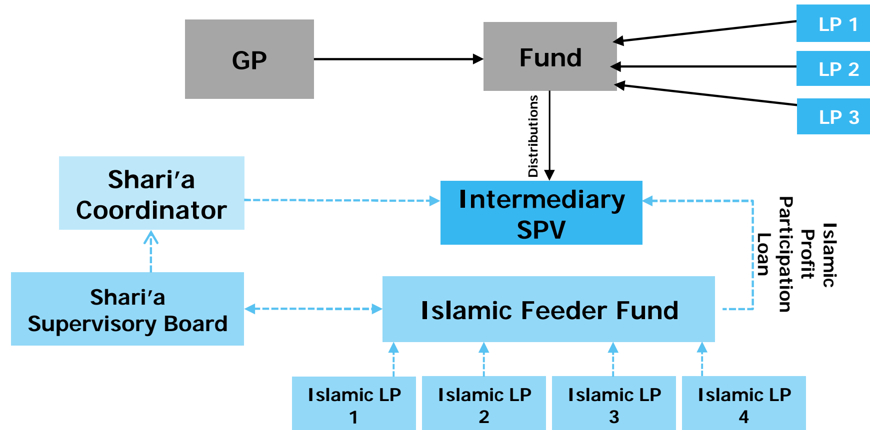
Marketing of Securities in MENA: Islamic Investors



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Current Trends: Investors in the Middle East

- Cash Retention
  - Family office investors
  - Sovereign investors subject to governmental withdrawals
- Potential for Buy Opportunities
- Customized Products
  - SMAs
  - Co-investment Arrangements
    - Form
    - Purpose

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Current Trends: Investors in the Middle East

- Seed and Stake Arrangements
  - Increased interest in providing initial funding for funds and acquiring interest in the sponsor
  - Key considerations
- Regional Venture Capital
  - Extension of investment in SMEs
  - Hub 71, Catalyst, Abu Dhabi Holding Company
- Impact of Foreign Direct Investment Restrictions

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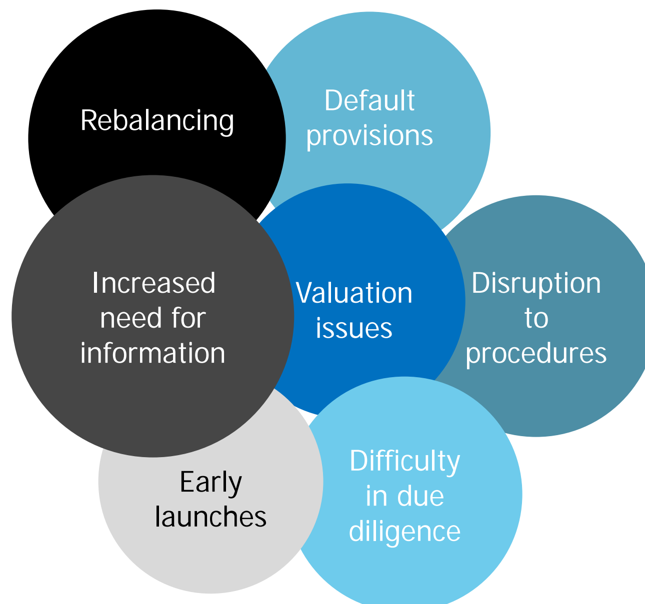
COVID-19 Impact



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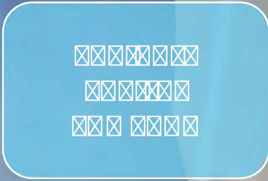

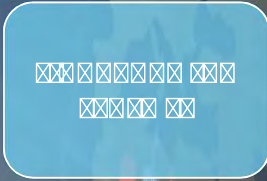

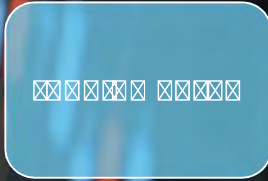

- **Singapore variable capital company (VCC)**
  - Key features
  - Tax features
  - MAS VCC Grant Scheme

- **Fund entities**
  - Different tax exemption schemes for different types of funds (Sections 13CA, 13H, 13R, and 13X)
- **Fund managers**
  - 10% concessionary tax rate for fund managers under the FSI-FM scheme

- **Further enhancements to make Singapore more attractive as a fund domicile**
  - "VCC 2.0"
  - Singapore limited partnership – ongoing industry consultation

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MAINLAND CHINA AND HONG KONG

Trend of Onshorization

- Hong Kong Limited Partnership Fund (LPF)
  - Expected to come into effect August 2020
  - Primarily for private equity/venture capital funds
- Open-ended Fund Company (OFC)
  - Came into effect July 30, 2018
    - Can have redeemable shares and a variable capital structure
    - Can be structured as single funds or umbrella funds (with statutory ring fencing for sub-funds)
    - Must be approved by and established through the Securities and Futures Commission (SFC) (instead of Companies Registry)
  - Based on public disclosures on the website of the SFC, only two private OFCs registered in Hong Kong as of June 2, 2020
    - Proposed amendments to private OFC regime under consideration

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Hong Kong Profits Tax Exemption for Funds

- The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 took effect April 1, 2019, extending the Hong Kong profits tax exemption to all privately held funds in the form of collective investment vehicles, irrespective of their place of domicile or central management and control, in respect of qualifying transactions

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Hong Kong's Financial Hub Status

- Increasing competition from other jurisdictions (such as Singapore)
- Ongoing geopolitical issues with the United States – China tension
- Time to consider Plan B?

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JAPAN

Recent Japan Trends

- Despite COVID-19, the large institutional investors and pension fund investors have continued to be active in Japan
- There have been some opportunistic investors seeking to invest in debt instruments and debt funds
- The pressures to deploy capital among Japan investors are still present and among the larger investors, there continues to be an appetite for alternative investments
- Ecommerce related businesses, including infrastructure related to ecommerce and the life sciences businesses, are attracting investor attention
- Notwithstanding the advanced technology coming from Japan, COVID-19 revealed systemic need to update the Japanese workplace to utilize technology more effectively to allow for more innovative approaches to work
- In Japan, although onshore fund formation is possible, given the tax and language considerations, this is not a practical alternative for foreign fund managers

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Japan Developments

- Foreign Exchange and Foreign Trade Act amendments effective on May 8, 2020
  - Requirement of notifications and approvals for foreign direct investments into certain Japanese-designated national-security-related businesses made more stringent
  - Some concern over foreign investors on impact to investing in Japan
- Interest from asset managers to consider Japan as an alternative hub in Asia

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Simon Currie advises clients on securities and financial services regulatory issues in relation to the investment industry, with a particular focus on fund managers and private investment funds.

Simon's work includes counseling on the application of EU single-market directives, the UK Financial Services and Markets Act 2000, and the rules of the Financial Conduct Authority, including authorization applications, conduct of business issues, prudential and capital requirements, organizational controls, conflicts, remuneration requirements, customer documentation, new product development, marketing and financial promotions, changes of control, collective investment schemes, the management of alternative investment funds, and general compliance issues. He has been closely involved in advising on the regulatory regime introduced by the Alternative Investment Fund Managers Directive (AIFMD), both during and following its legislative process and subsequent transposition and implementation.

Simon advises on the structuring, establishment, and operation of segregated accounts and segregated account investment vehicles and other investment funds, including UK domestic and offshore investment funds and separate and investment trusts. He has also advised institutional investors in relation to investment in private equity and other investment funds, including by way of acquiring secondary interests in such funds.

Simon advises a range of financial sector clients, including banks, fund managers, investment funds, investment managers, and investment intermediaries.

Simon is a member of the Law Society's Company Law Committee, a practitioner body that reviews and comments on developments in EU and UK company law and financial services legislation and regulation, and he currently serves as chair of its Financial Services Sub-Committee.

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Alice Huang concentrates her practice on private investment funds, advising registered and unregistered investment advisers based in the United States and in the Asia Pacific region on the formation, structure, and ongoing management of investments in global markets. Alice also represents institutional investors in negotiating operating and side letter agreements for investments in global private funds.

Prior to joining Morgan Lewis, Alice practiced at a top regional law firm, resident in Hong Kong, and before that she worked at other top US law firms focusing on private investment funds and cross-border transactions. From 2012–2014, she served as general counsel for an Asia Pacific private equity fund based in Hong Kong, where she managed the companywide legal, compliance, and tax functions with respect to the company's operations and investments in China, Hong Kong, South Korea, Taiwan, Tokyo, and the United States.

Prior to practicing law, Alice was a senior tax manager with Deloitte Touche Tohmatsu in Los Angeles, where she advised clients on inbound and outbound tax transactions. She also spent a year in Shanghai assisting multinational clients in China with cross-border and China tax and regulatory issues, including mergers and acquisitions, structuring, feasibility studies, transfer pricing and foreign exchange.

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Ethan W. Johnson counsels clients on a variety of regulatory and transactional matters, with a focus on hedge fund and private equity fund formation, and guides investment managers through the legal intricacies of international operations. He also advises clients on establishing offices and operations outside the United States, developing and offering financial products and services sold on a global basis, and building global compliance programs. Ethan's regulatory and transaction practice includes counseling clients on the creation of hedge funds, private equity funds, venture capital funds, real estate funds, Undertakings for Collective Investment in Transferable Securities (UCITS), and US Securities and Exchange Commission (SEC) registered funds. He also advises on the organization and operation of broker-dealers and investment advisers, and on corporate finance projects including public and private offerings of debt and equity securities.

Through Morgan Lewis's US, European, and Asian offices, he advises on the laws of more than 100 non-US jurisdictions, including all major financial centers, most emerging markets, and less-developed nations. He has experience counseling many US-based firms on US and non-US securities and regulatory matters—including joint ventures and investment projects—in Latin America, Europe, and Asia. In cross-border business matters, he helps clients comply with local marketing restrictions, and advises them on local authorizations and exemptive relief. He also works to ensure concurrent compliance with US and local laws.

A frequent author and lecturer, Ethan addresses topics including the regulation of broker-dealers and investment advisers; global distribution of investment funds; private equity real estate funds; investment in emerging markets; and corporate governance. He is an editor of the *Morgan Lewis Hedge Fund Deskbook,* published by Thomson Reuters/West.

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Ayman A. Khaleq, managing partner of Morgan Lewis's Dubai office and co-Leader of the firm's Middle East practice, advises global and regional institutional clients and asset managers on cross-border investment management, capital markets, and structured finance transactions. In particular, Ayman advises on the structuring and documentation of private investment funds and alternative investment platforms; global investments by regional institutional investors, including sovereign wealth funds; and conventional and Shari'a-compliant privately placed debt capital markets, structured finance and restructuring matters. He is admitted to practice in New York and is a Registered Foreign Lawyer with the Law Society of England and Wales.

In addition, Ayman provides regulatory and legal advice to global asset managers and foreign direct investors in relation to the marketing of securities (to conventional and Islamic investors) and doing business in the broader Middle East and North Africa (MENA) region, and in such sectors as healthcare, technology, infrastructure, telecommunications, energy, and education. He also advises on policy reform initiatives in the MENA region and other emerging markets.

Ayman, who is fluent in Arabic and English, is a frequent speaker at international conferences on topics relating to foreign direct investment, investment management, and structured transactions (including Islamic finance). In addition, Ayman taught on transactional Islamic law and international investment law at George Washington University Law School (Washington, DC); Bocconi University (Milan, Italy), and Sorbonne University (Abu Dhabi, UAE). He is also serving a on the firm's Advisory Board, is the chair of the International Bar Association's Arab Regional Forum, and is a member of the Young Presidents Organization (YPO).

Ayman Khaleq was recently invited by the Dubai Islamic Economy Development Centre (DIEDC), Dubai International Financial Centre (DIFC) and Dubai Financial Market (DFM) to join a new focus group that these three entities are forming, with support from the Climate Bonds Imitative (CBI). The focus group will be comprised of relevant experts in capital markets and environmental protection and will be responsible for developing "Sustainable Sukuk Standards".

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Joel Seow advises sponsors throughout Asia on the establishment of private investment funds across various asset classes and jurisdictions, with a focus on private equity, venture capital, real estate, infrastructure, and hedge funds. He also counsels on myriad nontraditional private investment fund setups, including fund platform structures, hybrid funds, club deals, and open-ended illiquid funds, among others. Joel is keenly aware of Singapore's regulatory requirements for fund management and the offer of fund interests, and regularly advises international and local fund managers on their licensing and regulatory obligations, as well as assisting with the submission of fund management license applications to the Monetary Authority of Singapore.

Joel also works with both institutional and non-institutional limited partners (LPs) from Asia, Europe, and the United States, including financial institutions, pension funds, corporations, family offices, and fund of funds, advising on their investments into private funds. In these matters, he has served as LP counsel and across the table as general partner (GP) counsel.

Joel has been recognized in the Investment Funds (Singapore) category in *Chambers Asia-Pacific* since 2017, and was also recognized by *The Legal 500 Asia Pacific* as a next generation lawyer and by *Who's Who Legal* as a leading lawyer in Private Funds (Formation) from 2017 to 2019. In 2017, Joel was also named by *Private Funds Management* to its "30 under 40" global list of top private fund lawyers under age 40.

Before joining Morgan Lewis, Joel was a legal consultant for several Singapore private fund managers and served as counsel in the investment funds practice of another global law firm, resident in Singapore.

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Alishia K. Sullivan advises institutional investors with respect to their global investment activities, focusing primarily on investments in private funds, including leveraged buyout, hedge, infrastructure and real estate funds, and direct investments and co-investments. She assists clients in drafting, reviewing, and negotiating investment documentation, including subscription agreements, limited partnership agreements, side letters, managed account agreements, and other commercial agreements. She also has extensive experience with advising clients on structuring and maintaining their investment subsidiary platforms and negotiating bespoke investment advisory arrangements and operational agreements necessary to support investment activities. Alishia is admitted to practice in the District of Columbia.

Alishia is a former member of the board of directors of two non-profit organizations whose missions focus on the care, empowerment, and education of women and children.

Prior to joining Morgan Lewis, Alishia was a partner at another global law firm. She previously worked as in-house counsel for a state-owned petroleum company in the Middle East and was a member of the global projects group of the Washington, DC, office of an international law firm.

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Carol Tsuchida focuses her practice on investment funds and financial regulatory matters, as well as labor and employment. She helps clients establish, register, and license investment funds in Japan, and she assists with regulatory issues, including those pertaining to Japan's Financial Instruments and Exchange Law. Additionally, Carol counsels investors across many jurisdictions who are investing in infrastructure funds, hedge funds, and private equity funds throughout Asia.

Fluent in Japanese and English, Carol handles transactional and general corporate matters, including securities law compliance, investment funds, mergers and acquisitions, underwritten public offerings, private equity financings, and venture capital transactions.

In the labor and employment area, Carol counsels companies on their employment law obligations in Japan. She advises on the structure of employment contracts and assists employers in developing and implementing workplace policies. Carol helps employers navigate regulations related to overtime.

Prior to joining Morgan Lewis, Carol served as the assistant general counsel for a leading international financial institution that specializes in real estate investment funds.

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William Yonge has more than 20 years' experience advising global clients on regulation and related commercial issues arising in the financial services, investment management, securities, and derivatives sectors. Clients include asset managers across a wide range of asset classes and their funds, broker-dealers, corporate financiers, fintech and payment services firms, institutional investors, and market associations. Prior to entering private practice, he served as an in-house lawyer at the Securities and Investment Board (now the Financial Conduct Authority) and the Investment Management Regulatory Organisation.

William frequently helps clients to navigate UK and European regulatory issues that arise during fund formations, mergers and acquisitions, establishment of regulated investment management firms in the United Kingdom, and advises on customer and service provider documentation. He also counsels managers from the United States, Europe, Middle East, and Asia on structuring their private placements of funds to UK and European investors and establishing themselves in the United Kingdom.

William advises clients on regulatory developments arising in the context of the United Kingdom's exit from the European Union (Brexit) and counsels firms on restructuring in light of Brexit-related regulatory change.

William's work includes advising on operational, regulatory, and compliance matters regarding the UK Financial Services and Markets Act 2000, the rules of the UK Financial Conduct Authority (FCA), and the UK Prudential Regulatory Authority (PRA) such as the perimeter of regulated activities, obtaining authorisation, conduct of business, changes of control, financial promotion, remuneration requirements, product development, anti-money laundering, trading issues, payment for research, market abuse, cross-border business, and EU passporting.

William provides clients with insight into the impact of current and proposed financial services legislation at European level, including the Alternative Investment Fund Managers Directive (AIFMD), Markets in Financial Instruments Directives (MiFID II), European Market Infrastructure Regulation (EMIR), the Investment Firms Prudential Review, and UK/EU Initiatives in ESG and Sustainability.

Addressing topical regulatory issues, William frequently writes articles for key publications including *Complinet*, *Hedge Fund Journal*, *FX-MM*, *Funds Europe*, *Global Risk Regulator*, *Global Funds Europe*, *EuroWatch*, *Lexology*, *Alternative Intelligence Quotient*, and *Private Debt Investor*. He also speaks regularly at hedge fund and private equity conferences and events.

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ADVANCED TOPICS IN
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Manager and Investor Perspectives
WEBINAR SERIES

SESSION 10 | Tuesday, June 16

US Tax Update: Legislation and Other Guidance and Controversies in a COVID-19 Environment

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US TAX UPDATE: LEGISLATION AND OTHER GUIDANCE AND CONTROVERSIES IN A COVID-19 ENVIRONMENT

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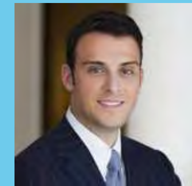

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COVID-19 IMPLICATIONS ON TAX ADMINISTRATION

Timeline of COVID-19 Relief Guidance

- **Phase 1:** Coronavirus Preparedness and Response Supplemental Appropriations Act ($8.3 billion of aid to the United States' public health response)
- **Phase 2:** Families First Coronavirus Response Act (relief for employers and employees affected by COVID-19)
- **Phase 3:** Coronavirus Aid, Relief and Economic Security (CARES) Act ($2.2 trillion stimulus package)
- **Phase 4:** What is coming down the pike from Congress?

- Between March and June composed of at least:
  - Nine Revenue Procedures
  - Thirteen Notices
  - Hundreds of FAQs and News Releases

- Varies by jurisdiction
- Does not necessarily follow federal approach or law

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Key IRS Administrative Guidance

Notice 2020-18 (March 20, 2020), issued to restate and expand upon Notice 2020-17 (March 18, 2020) and generally provides that the deadlines for both filing federal income tax returns and making certain payments are extended from April 15, 2020 to July 15, 2020.

Notice 2020-20 (March 27, 2020), issued to update and amplify this relief to include Gift Tax and Generation-Skipping Transfer Tax returns.

Notice 2020-23 (April 9, 2020), amplifies Notice 2020-18 and Notice 2020-20 and provides relief for many issues that the previous notices left unaddressed.

Rev. Proc. 2020-29 (April 30, 2020), temporarily allows electronic submission of requests for letter rulings, closing agreements, determination letters, and information letters under the jurisdiction of the IRS Office of Chief Counsel, and for determination letters issued by LB&I. Until further modification of the procedure, the IRS will allow both electronic and paper submissions.

State Tax Guidance

- **State Tax Relief – Extensions**
- **Telecommuting Employees/Mobile Workforce Issues**
  - Payroll Tax/Personal Income Tax
  - Corporate Income Tax
  - NYC UBT Sourcing Issues
- **Conformity to IRC Changes**
- **Morgan Lewis State Tax Response Chart:**

https://www.morganlewis.com/pubs/state-and-local-tax-responses-to-covid-19

Practical Implications

- **Impact on IRS Operations**
  - COVID-19 Shutdowns & "Mission Critical" Operations
  - People First Initiative
  - Recent IRS Announcements Regarding Reopening
- **Impact on the US Tax Court**
  - May 29, 2020 Press Release
  - Administrative Order 2020-02 – Remote Proceedings During COVID-19 Pandemic
  - Administrative Order 2020-03 – Limited Entry of Appearance Procedures, Effective June 1, 2020
- **Impact on State Operations**
  - Postponed Trials and Administrative Hearings
  - Shift to Desk Audit Examinations

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CARES ACT TAX CHANGES

Net Operating Losses (NOLs)—Reduced Limitation, Temporary Ability to Carry Back

- Prior to the 2017 Tax Cuts & Jobs Act (TCJA):
  - NOLs could be carried back two years and carried forward 20 years
  - NOLs could be used to fully offset taxable income
- The TCJA narrowed these rules by*:
  - Repealing the historic two-year carryback period
  - Limiting the NOL for a taxable year to 80% of taxable income for the year
- The 2020 CARES Act relaxes the rules enacted under the TCJA by:
  - Allowing NOLs to fully offset taxable income generated in 2018, 2019, and 2020
  - Allowing NOLs generated in 2018, 2019, or 2020 to be carried back five years

* Rules apply to NOLs generated in post-TCJA years

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Limits on Deductibility of Interest Expense

- **Prior to the TCJA,section 163(j) "earnings stripping" rules limited deductions on interest paid to related parties not subject to US tax.**
- **The TCJA replaced the old "earnings stripping" rules with a broad limitation on the deduction of business interest expense.**
  - Business interest expense is deductible to the extent of the sum of (i) business interest income, (ii) 30% of adjusted taxable income, and (iii) floorplan financing interest (disallowed interest expense is carried forward).
  - Rule applies at both the partner and partnership levels.
- **The CARES Act relaxes the rules enacted under the TCJA by providing the following:**
  - For 2019 and 2020, 30% adjusted taxable income limitation increased to 50%.
  - Partnerships get a special rule for 2019 – if the partnership had disallowed business interest expense, 50% of a partner's share of the 2019 disallowed business interest expense will be deductible in 2020 (without limitation) and 50% is still subject to the normal carryforward rules.
  - For 2020, taxpayer can choose to use 2019 adjusted taxable income for limitation purposes.
  - Taxpayers can elect out of these relief provisions.

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Implications of NOLs and Interest Deduction Changes for Hedge Funds

- **The CARES Act changes regarding NOLs and interest deductions are relevant to:**
  – Hedge funds that are engaged in business, e.g., active trading funds
  – Hedge funds with side-pocket equity investments in portfolio companies that are operating businesses
- **Other CARES Act changes, e.g., expanded ability to currently deduct certain capital improvements, may be relevant to, in particular, hedge funds with investments in portfolio companies entitled to these benefits.**
- **Claiming benefits will generally require the filing of an amended return or a request for tentative refund**
  – Procedural choices for this are discussed below
  – Shifting ownership in hedge funds adds complications in terms of which partners might receive a tax benefit
  – Further complications with respect to benefits are triggered at a portfolio company level, where the portfolio company was under different prior ownership
- **Use of NOLs or interest deductions may have other indirect impacts, particularly where there are non-US subsidiaries or operations**
  – 965 (transition tax) – CARES Act assumes taxpayers elected not to apply NOLs to Section 965 liability (see Section 965(n))
  – GILTI – Use of additional NOLs to offset GILTI may "dilute" value of NOLs or interest deductions
  – BEAT – Use of additional NOLs or interest deductions may increase BEAT liability by increasing Modified Taxable Income and reducing regular tax liablity

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Excess Business Losses

- Prior to the TCJA:
  – No specific limitation or guidance concerning excess business losses (losses in excess of $250K of taxable income)
- The TCJA limits deduction of certain business losses by:
  – Disallowing noncorporate taxpayers from deducting excess business losses between 2018 and 2025
- Disallowed loss treated as an NOL that may be carried forward
- The CARES Act relaxes the rules enacted under the TCJA by postponing excess business loss disallowance rules until taxable years beginning in 2021

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AMENDED PARTNERSHIP RETURNS

Revenue Procedure 2020-23

- Under Revenue Procedure 2020-23, certain partnerships are allowed to amend returns for the 2018 and 2019 taxable years.
- The guidance is intended to allow partners to more immediately benefit from retroactive provisions in the CARES Act, some of which are irrelevant for funds and managers.
- In general, the Bipartisan Budget Act of 2015 (the BBA):
  - Does not allow partnerships that are subject to the BBA to file amended returns,
  - Instead, it requires them to file administrative adjustment requests (AARs), which in the case of favorable adjustments can only produce partner-level benefits on AAR-year taxable income.
- The BBA rules would thus require relief under an AAR to be deferred until current-year returns of partners are filed (for many, in 2021).

Scope?

Although prompted by the CARES Act, the Revenue Procedure does not require any changes on the amended returns to relate to the CARES Act.

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How Is This Relevant to Funds?

- IRS representatives have informally confirmed this view—amendment is allowed even if all changes are unrelated to the CARES Act.
- But the right to amend a return doesn't mean that funds will (or even should) amend a return.
- Consequences
  - Amendment allowed before September 30, 2020.
  - Partnerships that avail themselves of the right to amend their returns must comply with the terms of Rev. Proc. 2020-23 and also furnish corresponding amended Schedules K-1 to their partners.
- Are partners required to amend?
  - Generally, the BBA rules require consistency.
  - But a taxpayer generally has no duty to amend a return.
  - Because any amendment would likely result in a favorable change, partners may want to amend. But, for partners with relatively small interests, amendment might not make economic sense.

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How Is This Relevant to Managers?

- Certain CARES Act provisions are more relevant to managers than to funds.
- Managers and other entities structured as partnerships may be able to amend.
- Other types of entities are generally allowed to amend.

Considerations

- Does anything in the CARES Act justify amendment?
- Does anything outside the CARES Act justify amendment?
- If there's a reason to amend, what do the relevant operating agreement and any other documents (e.g., side letters) require?
- Would an AAR be better?
- Should some partnerships amend with respect to one or more issues, and follow the BBA rules with respect to one or more other issues?
- There are special rules for amending returns that are already under audit.

PAYROLL TAX CREDITS AND DEFERRALS

Payroll Tax Credit

- The CARES Act provides a maximum $5,000-per- "eligible employee" refundable tax credit against employer-side OASDI (i.e., Social Security taxes) for certain employers, provided (1) their trade or business operations fully or partially shut down due to COVID-19—related government orders, or (2) they experienced a more than 50% decline in gross receipts (or operations, for tax-exempt employers) as compared to the corresponding calendar quarter in 2019.
- The credit applies to 50% of the "qualified wages" paid to employees between March 13, 2020 and December 31, 2020.
- For large employers (more than 100 full-time (30 hours) employees during 2019), "qualified wages" (including health benefits) available for tax credit are capped at $10,000 (thus limiting the maximum potential 50% credit to $5,000). For eligible employers with 100 or fewer full-time employees, 50% of all employee wages up to $10,000 per employee, including health benefits, qualify for up to a $5,000-per employee-tax credit, whether or not the wages were paid during a shutdown or slowdown.
- The credit is *not* available to employers who have received a loan under the "Paycheck Protection Program."
- There are a number of items that are still unclear, including (1) how full and partial suspensions will be determined; (2) how the credit applies to large employers that provide reduced hours for employees; (3) whether the credit applies to any new employees added after enactment; and (4) whether the credit will be expanded, as similar prior refundable credits were, to cover other federal employment taxes (i.e., federal income tax withholding, employer portion of Medicare tax, and employee portion of Social Security and Medicare taxes).

Payroll Tax Deferral

- The CARES Act provides that employers may delay payment of 100% of the employer-side OASDI tax (i.e., Social Security taxes) due between enactment of the Act on March 27, 2020 and December 31, 2020. Similarly, self-employed individuals may delay payment of 100% of Social Security taxes on self-employment income (at the 6.2% tax rate) paid between enactment of the Act and December 31, 2020. The deadline for paying the first half of the deferred taxes is December 31, 2021, and the deadline for paying the remaining 50% of taxes is delayed until December 31, 2022. These delay relief provisions are available regardless of workforce size.
- The are some special rules where employer is recipient of PPP loan that is ultimately forgiven.

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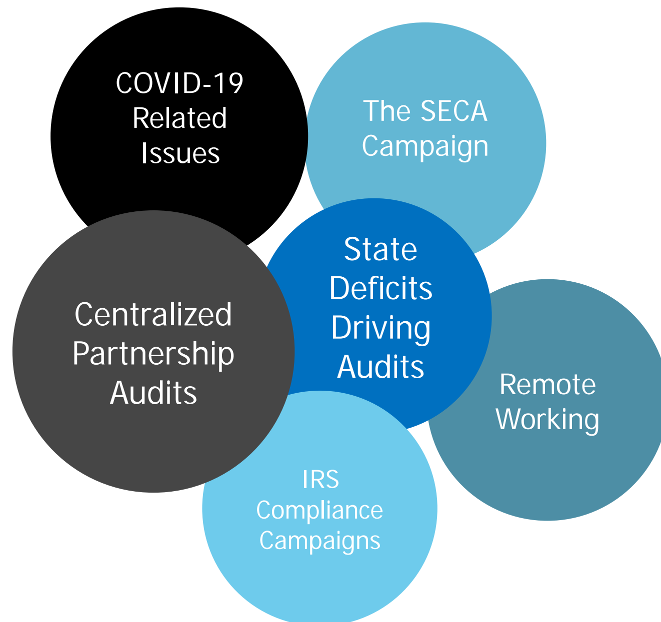
CONTROVERSY UPDATE

Looming Controversies



The Centralized Partnership Audits Have Begun

- **Passed in 2015 and effective for tax years beginning after December 31, 2017**
- **Overhauled the manner in which partnerships are audited and assessed**
  - Audit, adjustment, assessment, and payment at partnership level with limited exceptions
  - Vests all authority to bind the partnership in one person, the Partnership Representative
- **Intended to make it easier for the IRS to audit partnerships with projected $9.3 billion revenue raiser (federal alone)**
- **Regulations implementing legislation rolled out June 2017–Dec. 2018**
- **IRS trained and revamped its partnership audit function**
  - Hired at least 500 new agents last year
  - All new operating procedures, forms, and publications
  - Focused training for agents in partnership issues

- IRS rollout of "Compliance Campaigns"
- Specially identified issues that the IRS has determined present a risk
- Through identification of areas of greatest risk and focused use of resources, IRS achieves a better return on investment
- Development of "treatment streams" to drive IRS compliance objectives
  - IRS rollout of internal training and directives around certain issues
  - Designation of cases for litigation
- Currently 50+ Compliance Campaigns, with full listing at

  https://www.irs.gov/businesses/full-list-of-lb-large-business-and-international-campaigns

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- Targets self-employment taxes paid on a partner's distributive share of income from a partnership
- Issue is whether limited partners in IM partnerships (or members in LLCs or LLPs) are subject to self-employment taxes on their distributions other than guaranteed payments
- Many investment management funds take the view that these LP distributions are not subject to self-employment tax, relying upon a long-standing statutory provision, technical interpretations of Treasury Regulations, and market practice
- IRS issued a series of proposed adjustments in the last few months focused on:
  - LPs that were recently converted from an LLC under state law
  - LPs whose partners overlap with the partners in the GP
- SECA audits vs. BBA

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COVID-19 Relief Related Controversies

- **Relief granted by CARES Act can be audited**
  - Employee retention credit–providing a qualifying employer with a refundable payroll tax credit of 50% of each employee's qualified wages paid from March 13, 2020 through December 31, 2020, up to a maximum credit of $5,000
    - Were you a qualified employer?
    - Were the wages qualified wages?
- **Much of the IRS's guidance is in the form of FAQs**
  - FAQs are not sufficient for penalty protection
  - Defending a position largely based upon FAQs

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COVID-19 State Tax Controversy

- **Cash-Strapped States**
  - All states will face significant fiscal challenges as a result of COVID-19
  - MultiState Associates predicts that KY and PA will be the states most likely to face immediate budget problems, followed by AK, HI, IL, LA, NJ, and NY
- **Prepare for Future Audit**
  - Stay up to date on state guidance
  - Regularly consult with advisors
  - Documentation!

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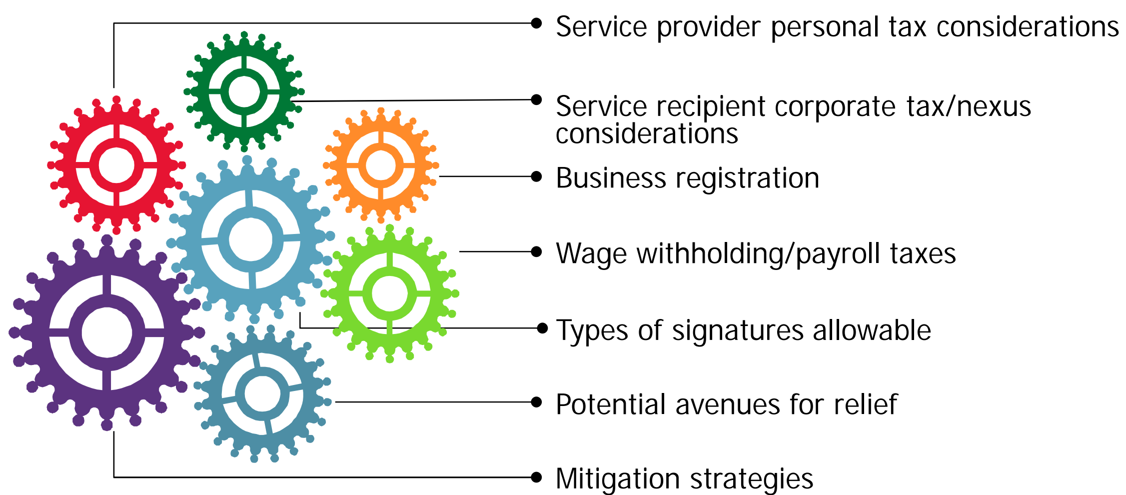
REMOTE WORKING

What Are the Tax Considerations of Remote Working?



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Remote Working – State Tax Action Plan

Payroll Tax	Corporate Income Tax
– Confirm payroll tax thresholds in relevant states – Determine state-specific COVID-19 guidance – Navigate requirements for states with reciprocal agreements – Determine "Convenience of Employer" state implications if an employer has a location in CT, DE, NE, NY, PA, and AR – Revisit telecommuting policy	– Determine economic and physical presence nexus standards in relevant states – Determine state-specific COVID-19 guidance – Consult with advisors to understand potential liability, including proper receipts factor sourcing – File accordingly

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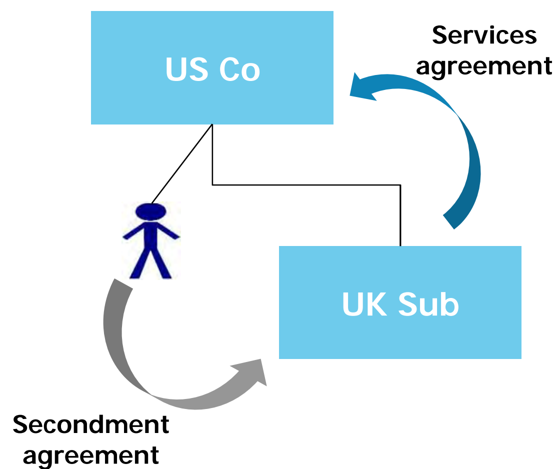
Mitigation Strategy – Secondment/Leasing



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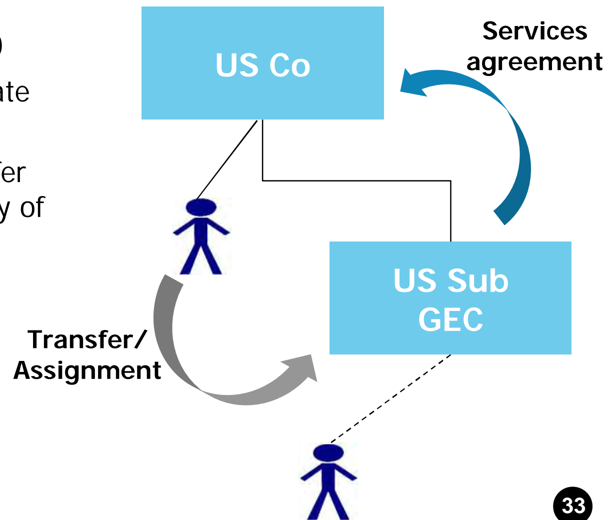
Mitigation Strategy – GEC

- **Global Employment Company (GEC)**
  - Establish a controlled subsidiary to segregate cross-border tax exposure within group
  - Use of intercompany agreement and transfer pricing documentation to define profitability of GEC
  - Manage challenges to economic substance
  - Consider also use of non-U.S. entities



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Charles (Chuck) Bogle's practice covers a wide range of federal income tax-related matters, with a principal focus on the tax aspects of structured finance transactions. Chuck represents sponsors, managers, and underwriters in collateralized bond, loan, and debt obligation transactions, as well as issuers and underwriters in various asset-backed and insurance-related transactions, including credit card, auto loan, marketplace loan, payment plan, and mortgage securitizations. In addition, Chuck has a depth of knowledge regarding the tax aspects of both taxable and tax-free mergers, acquisitions and dispositions, particularly in the investment management space.

Chuck also has more than two decades of experience with the tax considerations relevant to sponsors and managers of investment funds, including hedge funds and private equity funds. In addition, he has a deep background in the tax aspects of various types of financings, and with the tax aspects of leveraged ESOP transactions.

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Jennifer Breen concentrates her practice on tax controversy and planning matters, with an emphasis on audits and controversies and Internal Revenue Service (IRS) administrative proceedings. Jennifer routinely handles matters involving US federal income tax, foreign tax, state and local corporate and business tax, and sales and use tax. She has experience representing major corporations, partnerships, S corporations, and individuals in resolving domestic and international compliance and controversy issues before the IRS.

Prior to joining Morgan Lewis, Jennifer served as director of tax controversy at Mattel, Inc., where she developed and executed audit strategies, responded to information requests from respective tax authorities, and negotiated and resolved controversy matters. She was also responsible for accounting for income taxes under ASC 740, managing the company's global reportable transaction compliance, and ensuring compliance under the Foreign Account Tax Compliance Act.

Jennifer also served as director of tax controversy and regulatory services at PricewaterhouseCoopers LLP for more than seven years. She began her legal career as a lawyer with the IRS Office of Chief Counsel in Washington, DC, where she represented the IRS before the US Tax Court and advised on issues relating to practice and procedure.

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Sarah-Jane Morin focuses her practice on representation of public and private companies, private equity funds, venture capital funds, real estate funds, portfolio companies, and alternative investment vehicles in the tax aspects of complex business transactions and fund formations, including domestic and cross-border investment strategies, sponsor investment strategies, limited partner investment strategies, mergers, acquisitions, integrations, buyouts, recapitalizations, debt and equity restructurings, and ongoing operations and tax compliance issues. Additionally, she advises on international tax issues, including the tax aspects of offshore vehicles (CFC/PFIC/GILTI regimes), anti-deferral rules (Subpart F), withholding, cost sharing, and transfer pricing.

Sarah-Jane advises on the tax aspects of non-profit entity formation and operation, with an emphasis on IRC Section 501(c)(3). She has worked with a number of tax-exempt investors in their LP investments, as well as for clients in their applications for tax exemption.

Prior to joining Morgan Lewis, Sarah-Jane was a senior director in Oracle's tax planning department. Prior to joining Oracle, she was an associate at a multinational law firm.

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Jason P. Traue's practice focuses on federal tax matters. He works extensively with tax issues related to the formation and operation of registered and private investment funds. Jason also assists with merger and acquisition transactions, capital markets transactions, general corporate and partnership tax issues, and international tax issues.

Jason has assisted with the tax aspects of a number of innovative investment funds, including funds of MLPs, funds of hedge funds, and ETFs investing in Chinese A shares. He advises clients on transactions involving funds and on tax-related regulatory disclosure. Jason also has experience with the legal regime commonly referred to as "FATCA."

Jason has helped clients obtain numerous administrative rulings from the Internal Revenue Service and has assisted in federal and state tax controversy matters.

Jason previously worked as an associate at PricewaterhouseCoopers LLP, advising on various tax law issues.

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Working with businesses in industries such as media, financial services, aviation, shipping, and education, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning. Richard's experience includes mergers, acquisitions, the formation and operation of joint ventures, debt and equity restructurings, and securities offerings. In addition, he represents organizers of and investors in onshore and offshore investment funds and other alternative investment vehicles.

Richard's work with investment funds and alternative investment vehicles includes those with a range of investment objectives, including private equity, venture capital, and hedge funds.

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Cosimo A. Zavaglia advises corporations, partnerships, and individuals on state and local tax controversy, planning, and transactional matters. Cosimo routinely represents clients in high-stakes state and local tax audits, appeals, and litigations in matters throughout the United States, including defending clients in state False Claims Act cases and sales and use tax, individual residency, withholding tax, corporate income tax, and real estate transfer tax audits and disputes. He also advises clients on developing state and local tax planning strategies for corporate acquisitions, dispositions, restructurings, and mergers.

Cosimo works closely with a broad range of clients, including Fortune 500 companies, enterprising startups, and high-net-worth individuals, to develop solutions to mitigate state and local tax risks. He advises in all stages of state and local tax controversy—from initial information gathering, through negotiations and settlement, as well as litigation and appeals, if necessary. Cosimo also obtains formal and informal rulings from state and local tax authorities in many jurisdictions on several issues across tax types and has represented companies and industry groups in legislative and regulatory matters. Prior to joining Morgan Lewis, Cosimo worked in the state and local tax practice of PricewaterhouseCoopers LLP.

In addition to writing extensively on tax subjects, Cosimo has lectured on a broad range of state and local tax topics throughout the country, including for the Tax Executives Institute. He is also active in pro bono work, and is a member of the pro bono committee for the New York office.

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ADVANCED TOPICS IN
HEDGE FUND PRACTICES
CONFERENCE
Manager and Investor Perspectives
WEBINAR SERIES

SESSION 11 | Thursday, June 18

The Ethics of Artificial Intelligence for the Legal Profession

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THE ETHICS OF ARTIFICIAL INTELLIGENCE (AI) FOR THE LEGAL PROFESSION

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AN ACRONYM-FREE INTRODUCTION TO AI

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AI Defined

"[U]se of automated, computer-based means by which large amounts of data are processed and analyzed to reach **reasoned conclusions.**"

ABA Op-ed

"A core objective of AI research...has been to automate or replicate intelligent behavior."

The Obama White House

Artificial general **intelligence** is the intelligence of a machine that could successfully perform any intellectual task that a human being can.

Wikipedia

Weak artificial intelligence, also known as **Narrow** AI, is non-sentient artificial intelligence that is focused on one specific task.

Popular Science

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Related (and more useful) terms

Machine Learning:
The use of algorithms and statistical models to perform specific tasks without explicit instructions. Instead, these systems rely on patterns and inference, and adapt with supervised learning and feedback.
McKinsey

Natural Language Processing:
Systems that enable computers to understand and process human languages, to get computers closer to a human-level understanding of language.
Wikipedia

Deep Learning/Neural Networks:
A subset of machine learning where artificial neural networks, algorithms inspired by the human brain, learn from large amounts of data. Similarly to how we learn from experience, the deep learning algorithm would perform a task repeatedly, each time tweaking it a little to improve the outcome.
Forbes

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And for science (fiction) buffs

The Singularity:
The tipping point when machines become smarter than humans. Or, when biological and machine intelligence merge and human/machine intelligence can live free of biological constraint.
Ray Kurzweil et al

The Turing Test:
A machine's ability to exhibit behavior indistinguishable from that of a human. Alleged to have occurred for the first time in 2014 by a computer mimicking a 14-year-old-boy named Eugene.
Time Magazine

AI Apocalypse:
Unabated use of AI, without built-in constraint, poses existential threat to humanity.
Stephen Hawking

Welcome, Robot Overlords.
MIT Technology Review

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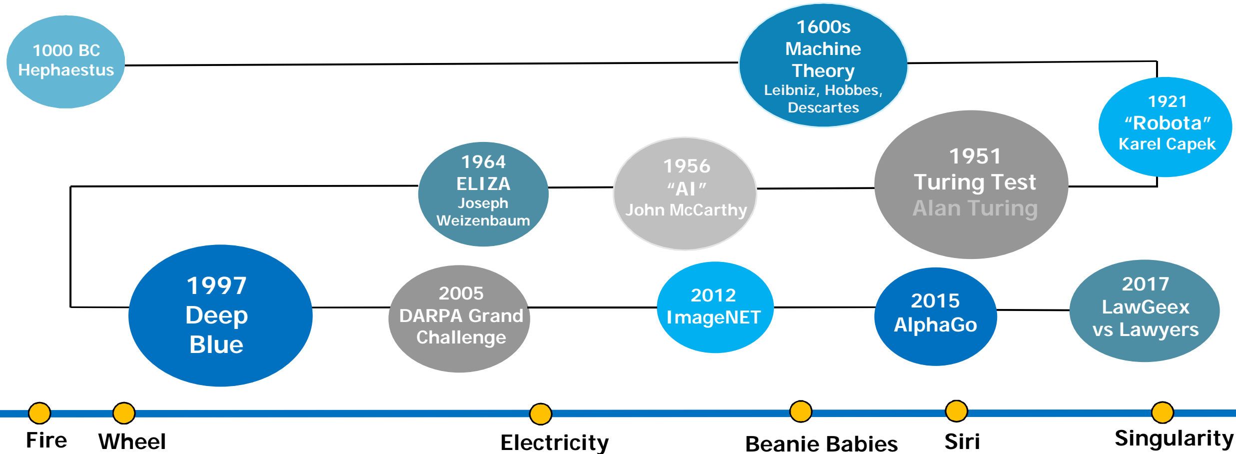
Historical Perspective

Notable moments in our march toward the Singularity



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COVID-19 and AI: A Path to Increased Acceptance?

[illegible]

- Remote work
- Novel issues
- Fewer resources
- Budget constraints
- Contact tracing: Geospatial/location-based monitoring

[illegible]

- Facial recognition
- Thermal scanning
- Search engines
- Robots

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COVID-19 and AI: A Path to Increased Acceptance?

- Public benefits vs. individual/privacy interests?
- Replacement of jobs with automation?

- Competing Senate privacy protection bills: COVID-19 Consumer Data Protection Act (CDPA) vs. the Consumer Online Privacy Right Acts (COPRA)
- National Security Commission on Artificial Intelligence (NSCAI) issues White Paper: Privacy and Ethics Recommendations for Computing Applications Developed to Mitigate COVID-19

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Adoption of AI in the Legal Profession

- Necessity is the Mother of Adoption
  - 2005: Anne Kershaw publishes scholarly article "Automated Document Review Proves Its Reliabilty"
  - 2006: NIST and DoD establish TREC Legal Track
  - 2009: Recommind tries to trademark "Predictive Coding"
  - 2012: Courts Approve "TAR"
  - 2013–2018: Machine learning enters legal profession
  - 2019–COVID-19: Concentrated adoption in discovery and contract management

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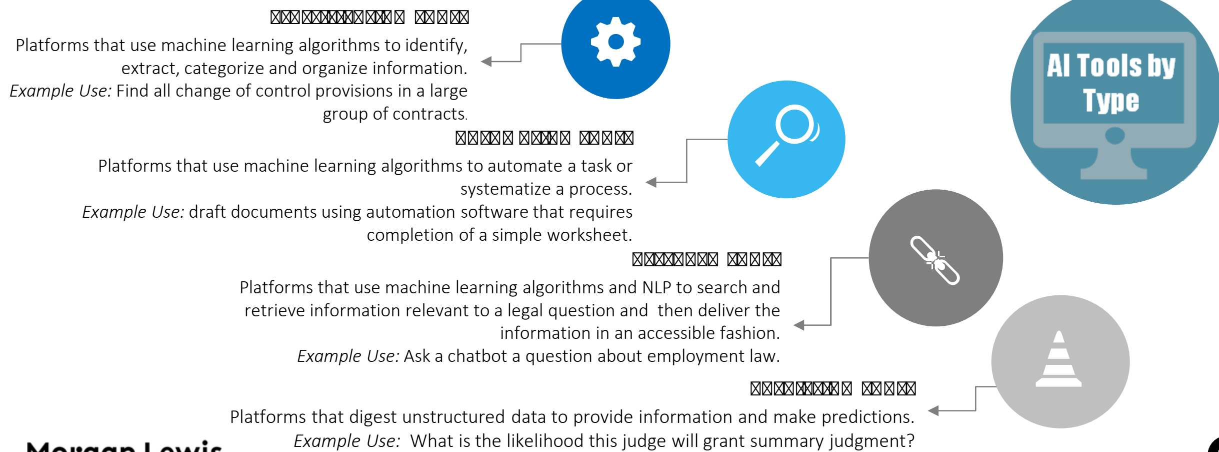
Legal AI Now



[illegible]
Platforms that use machine learning algorithms to identify, extract, categorize and organize information.
Example Use: Find all change of control provisions in a large group of contracts.

[illegible]
Platforms that use machine learning algorithms to automate a task or systematize a process.
Example Use: draft documents using automation software that requires completion of a simple worksheet.

[illegible]
Platforms that use machine learning algorithms and NLP to search and retrieve information relevant to a legal question and then deliver the information in an accessible fashion.
Example Use: Ask a chatbot a question about employment law.

[illegible]
Platforms that digest unstructured data to provide information and make predictions.
Example Use: What is the likelihood this judge will grant summary judgment?

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Legal AI Now

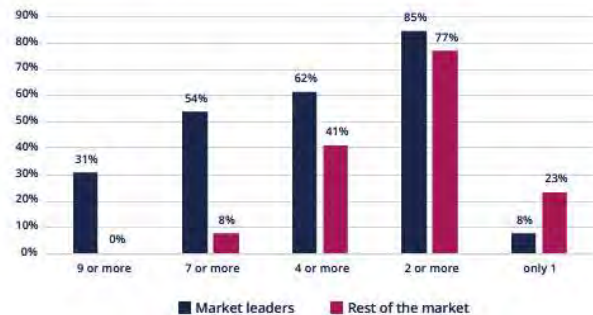
AI Tools by Task

Task	Description
IMAGE RECOGNITION	Facial recognition, image analysis, currently most useful for finding all the cats on the internet
CONTENT CATEGORIZATION	Machine learning trained using historical data and feedback to sort data into defined categories
PREDICTIVE ANALYTICS	Predict future outcomes from analysis of historical data
ANOMALY DETECTION	Analyze data to identify patterns and anomalies (noise and signal) to distinguish between expected or normal activity and unexpected or aberrant activity
SENTIMENT ANALYSIS	Detect tone or emotional context of user–generated content
MULTI-DIMENSIONAL	Identify patterns, connections, and relationships by evaluating layered diverse datasets

Adoption, Challenges and Prospects for Use of Alternative Data by Hedge Fund Managers

AIMA & SS&C Report

- The Report enumerates the results of AIMA's survey of 100 hedge fund managers, which gauged their perspectives on alternative data sources, the challenges of using alternative data and the prospects for more widespread adoption. It also offers practical guidance for managers considering using alternative data.
- Slightly more than half of respondents (53%) said that they presently use alternative data. Another 14% said they are testing alternative data options. Of the respondents that use alternative data, 45% (23% of total respondents) classified themselves as "heavy" users, while 55% (30% of total respondents) are "light" users.
- The overwhelming majority of funds with AUM of >$5b are heavy users of alternative data. More than half of them are based in North America. Most of the rest are based in either Europe or the Asia-Pacific region. Roughly three-quarters of the market leaders employ the following as a primary strategy: equity long/short (31%), equity market neutral/quantitative (23%) or multi-strategy (23%).



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Source: *Casting the Net: How Hedge Funds are Using Alternative Data.* AIMA and SS&C, 2019.

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Adoption, Challenges and Prospects for Use of Alternative Data by Hedge Fund Managers

- Nearly half or more users indicated that they use alternative data:
  - as a research tool to source new investment opportunities;
  - for insight into portfolio ideas;
  - as an input for quantitative research; or
  - to generate outperformance.
- A significant minority of alternative data users also use it to help improve risk-management and compliance models.
- Managers are using alternative data to improve how their organizations function, noting that this use of alternative data "can help shape not just the productivity within the firm but also improve internal communication, due diligence processes and the overall culture."

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Adoption, Challenges and Prospects for Use of Alternative Data by Hedge Fund Managers

- Top five data sets used by market leaders are:
  - web-crawled data;
  - data from expert networks;
  - consumer spending/payment and lifestyle data;
  - business performance metrics; and
  - online reviews and social media sentiment.
- The main compliance challenge regarding alternative data is the absence of a commonly agreed framework that specifically touches on alternative data.
- Courts and regulators will have to balance the need for ownership rights and consumer privacy protection with the need to maintain a competitive and innovative digital economy.
- Privacy, unfair competitive advantage, and insider trading risk
- Best practices for governance

Trends in AI Regulation and Enforcement

- Lessons from SEC Enforcement Actions re Model Integrity for Quantitative Trading Firms
- Treasury, FinCEN, FINRA Guidance
- Europe and AI Regulation
  - The European Commission (EC) recently released a white paper articulating its approach to AI regulation and is seeking comments on a proposed framework
  - Recent case in Holland involving an automated system for detecting welfare fraud (human rights law applied to AI)
- New York Perspective
  - The Research and Innovation Division of the DFS is focused on supporting responsible innovation such as AI
  - The Research and Innovation Division identified four overarching areas of concern:
    - What data is fed into the model? Is it needed for the decision at hand or is it a proxy for something else?
    - Is the model understandable and transparent? How was it developed?
    - Are the model's outputs fair and nondiscriminatory?
    - What is the effect of the process on consumers and the general public? Do they understand the results? Are they able to act on the results?

Regulators' Use of AI in Surveillance & Enforcement

- It is not unreasonable to assume that the SEC now has better technology than the firms it oversees.
- The SEC's OCIE increasingly uses "big data" and novel technology and has developed a significant arsenal of data and technological capabilities to perform industry surveillance and examinations.
- The SEC's Analysis and Detection Center of the Market Abuse Unit
- Technology Controls Program (TCP)
- Market Information Data Analytics System or "MIDAS" system to analyze "big data" generated by our equity markets.
- CFTC LabCFTC and Regulatory Sandboxes
- FINRA

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AI Adoption in the Marketplace

Gartner Hype Cycle for Artificial Intelligence, 2019

Expectations

Innovation Trigger | Peak of Inflated Expectations | Trough of Disillusionment | Slope of Enlightenment | Plateau of Productivity

Time

gartner.com/SmarterWithGartner

Source: Gartner
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Gartner

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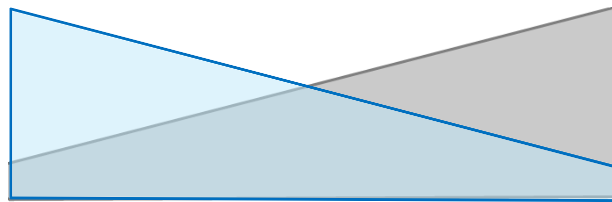
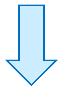
Legal AI Next

Practice Segmentation

Commoditized Automated	Disaggregated Semi-automated	Trusted Advisor Bespoke





Legal Jobs

Hourly Rates

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How Will AI Affect the Legal Profession?

A consensus has emerged that AI will **significantly disrupt the legal market**. AI will impact the availability of legal sector jobs, the business models of many law firms, and how in-house counsel leverage technology.

According to Deloitte, about **100,000 legal sector jobs** are likely to be **automated** in the next twenty years. Deloitte claims 39% of legal jobs can be automated; McKinsey estimates that 23% of a lawyer's job could be automated. Some estimates suggest that adopting all legal technology (including AI) already available now would reduce lawyers' hours by 13%.

Harvard Journal of Law and Technology, January 2018

Donahue, **Harvard Journal of Law and Technology**, A Primer on Using Artificial Intelligence in the Legal Profession, January 3, 2018. https://jolt.law.harvard.edu/digest/a-primer-on-using-artificial-intelligence-in-the-legal-profession

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The Lawyer's Dual Roles and Duties

Advising Clients Developing or Using AI

- Bias
- Privacy
- Interpretability
- Moral Dilemmas

Policy Questions

- The Singularity
- Extinction
- EBI

Using AI in the Practice of Law

- Competence
- Confidentiality
- Supervision
- Unauthorized Practice

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THE ETHICS OF AI

ADVISING CLIENTS

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Hypothetical Use Cases

- A manager creates an automated digital investment advisory program that allows individual investors to create and manage their investment accounts through a web portal or mobile application. What concerns should the manager have in developing such a robo-advice platform?
- As firms look to use facial recognition systems for security purposes and collect more information (e.g., contact tracing) in this virtual environment, what are some of the privacy and security pitfalls that firms can encounter?
- If a manager wants to outsource all AI services to a third-party vendors, what are best practices in terms of due diligence and oversight?
- A manager develops proprietary AI models. How can managers best consider whether use of the model's data inputs violates a third party's intellectual property rights?

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Bias in AI

- Studies reveal that AI can embed bias in automated systems. Machine learning can easily detect and learn from explicit and implicit human bias in data. Bias is a persistent problem for AI, but elimination of it has proven vexing.

- **AI developers and AI platform sponsors are cautioned to be vigilant and to build bias detection into any process that uses AI-based tools to select or exclude.**

Observable Sources of Bias:

- Data
- Users
- Personalization/Bubble
- Similarity
- Conflicting Goals

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Privacy

AI requires massive amounts of data and huge engines to work:

- Acquisition of data is necessary to aid machine learning and predictive output.
- GDPR, CCPA, and emerging domestic data protection laws across the country rely in large part on user consent, often freely given in accepting Terms of Service in order to access applications.
- Caution should be used in relying on consent. Acquirers of such data may be prohibited from using this data beyond the stated purpose for which consent was given.
- Apps that track and collect user + data face claims of privacy violations even where Terms of Service seek consent.

Looming questions:

- Are users sacrificing privacy for convenience?
- Is the use/processing of personal data lawful?
- Are the consents effective?
- How can counsel aid the business in balancing competing interests in data acquisition and use versus privacy risk management?

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The Problem of Interpretability

- Most AI technology is a black box. Based on outcomes, **we know it works, but we don't know how or why**. The technology is too complex for humans to comprehend how it makes decisions.

- "No one really knows how the most advanced algorithms do what they do. That could be a problem."

  – MIT Technology Review

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Moral Dilemma: AI and the Problem of Moral Decisions

Three Laws of Robotics:

– **First Law**: A robot may not injure a human, or, through inaction, allow a human to be harmed

– **Second Law**: A robot must obey a human's orders unless the order conflicts with the First Law

– **Third Law**: A robot must protect its own existence unless such protection conflicts with the First or Second Law.

– Isaac Asimov or, if you prefer, Will Smith in "iRobot"

- Should a computer be "coded" or "trained" to handle the nuance of moral decisionmaking?
- Can we regulate or prohibit AI decisions that have moral consequences?

MORAL MACHINE

Home Judge Design Browse About Feedback

What should the self-driving car do?

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In this case, the self-driving car with sudden brake failure will swerve and drive through a pedestrian crossing in the other lane. This will result in

- The deaths of a female executive, a large woman, a female doctor, a girl and an elderly woman.

Note that the affected pedestrians are abiding by the law by crossing on the green signal.

Hide Description

In this case, the self-driving car with sudden brake failure will continue ahead and crash into a concrete barrier. This will result in

- The deaths of a male executive, a large man, a male doctor, a boy and an elderly man.

Hide Description

http://moralmachine.mit.edu/

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We've Still Got Some Time Until the Robots Take Over…

Machine Learning

Natural Language Processing

"Beyoncé brought the house down last night!"

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But Maybe Not That Much…

Deep Learning

2015

2020

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Current Regulation of AI

Partnership on AI:

- Created by Microsoft, Amazon, Google, IBM, Facebook, and DeepMind
- Goal of developing best practices for using AI to benefit people and society

EU Parliament:

- Calls for legislation to regulate, including ethical standards requiring respect for human dignity

DARPA:

- Developing rules and standards, including ethics to ensure safe and trustworthy use

Obama Administration:

- Called for fairness, safety, and governance in AI development

Current Laws and Regulations:

- Illinois Biometric Information Privacy Act
- Illinois Artificial Intelligence Video Interview Act
- *State v. Loomis*

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PRACTICING WITH AI

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Professional Responsibility: Ethical Considerations in AI LegalTech

Practicing with AI:

- Can a lawyer perform her professional responsibilities **competently** where she does not understand how the technology works?
- Is that bot practicing law?
- How does a lawyer provide adequate supervision where the lawyer does not understand how the work is being done or even "who" is doing it?
- How will a lawyer explain decisions made if he does not know how those decisions were derived?

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Rule 1.1

Duty of Competence – A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation.

An attorney's obligations under the ethical duty of competence evolve as new technologies develop and become integrated with the practice of law.

THE STATE BAR OF CALIFORNIA STANDING COMMITTEE ON PROFESSIONAL RESPONSIBILITY AND CONDUCT FORMAL OPINION NO. 2015-193

"To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology."

Comment 8 to Rule 1.1 adopted in 2012

Under Rule 1.1, lawyers also must have a basic understanding of how AI tools operate. While lawyers cannot be expected to know all the technical intricacies of AI systems, they are required to understand how AI technology produces results. As one legal commentator notes, "[i]f a lawyer uses a tool that suggests answers to legal questions, he must understand the capabilities and limitations of the tool, and the risks and benefits of those answers."

ABA Resolution 112, August 2019

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Rule 1.4

Duty to Communicate – A lawyer shall reasonably consult with the client about the means by which the client's objectives are to be accomplished.

Must an attorney obtain her client's consent if she intends to use AI? What if she intends to use her client's data to train AI? What if the AI does not retain any information about the client?

A lawyer should obtain approval from the client before using AI, and this consent must be informed. The discussion should include the risks and limitations of the AI tool.[30] In certain circumstances, a lawyer's decision not to use AI may also need to be communicated to the client if using AI would benefit the client.[31] Indeed, the lawyer's failure to use AI could implicate ABA Model Rule 1.5, which requires lawyer's fees to be reasonable. Failing to use AI technology that materially reduces the cost of providing legal services arguably could result in a lawyer charging an unreasonable fee to a client.[32]

ABA Resolution 112, August 2019

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Rule 1.5

Fees – A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include . . . the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly.

Must an attorney use AI if it would lower a client's fees?

Rule 1.5 requires that a lawyer not enter into an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. Relevant factors to consider in determining reasonableness are time/labor, novelty of the issue, and customary fees. If using AI can reduce significantly the time it takes to conduct legal research, complete first drafts of routine documents, or review a contract for defined terms and consistency, then failing to use such technology may ultimately result in charging the client an unreasonable fee, a violation of Rule 1.5.

https://insolvencyintel.abi.org/bankruptcyarticles/ethical-use-of-artificial-intelligence-in-the-legal-industry-the-rules-of-professional-conduct

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Rule 1.6

Confidentiality – A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

How does a lawyer protect the confidentiality of client information when using AI? When using a service provider that uses AI? When using a service provider that uses AI in the cloud? When using a service provider that uses AI in the cloud that crowdsources its algorithms or training?

Under ABA Model Rule 1.6, lawyers owe their clients a general duty of confidentiality. Their duty specifically requires a lawyer to "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."[33] The use of some AI tools may require client confidences to be "shared" with third-party vendors. As a result, lawyers must take appropriate steps to ensure that their clients' information appropriately is safeguarded.[34] Appropriate communication with the client also is necessary.

To minimize the risks of using AI, a lawyer should discuss with third-party AI providers the confidentiality safeguards in place. A lawyer should inquire about "what type of information is going to be provided, how the information will be stored, what security measures are in place with respect to the storage of information, and who is going to have access to the information."[35] AI should not be used in the representation unless the lawyer is confident that the client's confidential information will be secure.

ABA Resolution 112, August 2019

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Rule 5.1/5.3

Duty to Supervise – A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct . . . [and] a lawyer having direct supervisory authority over the non-lawyer shall make reasonable efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer.

How does an attorney supervise an algorithm if the code is not visible and the calculations happen across a vast pool of data at a rate of millions per second?

In 2012, the ABA adopted an amendment to Model Rule 5.3 that changed the title of Rule 5.3 from "Responsibilities Regarding Nonlawyer Assistants" to "Responsibilities Regarding Nonlawyer Assistance."

"The change clarified that the scope of Rule 5.3 encompasses non-lawyers, whether human or not."

There are some tasks that should not be handled by today's AI technology, and a lawyer must know where to draw the line. At the same time, lawyers should avoid underutilizing AI, which could cause them to serve their clients less efficiently.[39] Ultimately, it's a balancing act. Given that many lawyers are focused on detail and control over their matter, it is easy to see why "the greater danger might very well be underutilization of, rather than overreliance upon, artificial intelligence."[40]

ABA Resolution 112, August 2019

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Rule 5.5

Unauthorized Practice of Law – A lawyer who is not admitted to practice in this jurisdiction shall not, except as authorized by these Rules or other law, establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction.

Under *Lola*, is document review considered the practice of law? Is legal research? What about due diligence? Negotiating an NDA? (All of these can be done by machine.)

In 2015, the Second Circuit distinguished between tasks performed by machines and tasks performed by lawyers (*Lola v. Skadden, Arps, Slate, Meagher & Flom LLP*, No. 14-3845 (2d Cir. 2015)). The Second Circuit found that tasks that could otherwise be performed entirely by a machine could not be said to fall under the practice of law. Consequently, *Lola* raises the possibility that machines can reclassify tasks that were traditionally considered the practice of law as now falling outside of the scope of the practice of law. (JD Supra - AI and Professional Conduct)

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POLICY QUESTIONS

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The Singularity: The point at which technology becomes smarter than humans.

- Should developers of AI tools be concerned with technology that exceeds human cognition?
- Do computers smarter than us present a threat?
- Do those threats outweigh potential benefits and opportunities?
- Should brakes be built into AI systems?
- Should governments regulate AI development? Can they?
- Can these competing concerns even be balanced by humans? Who decides?

2045. Be there.

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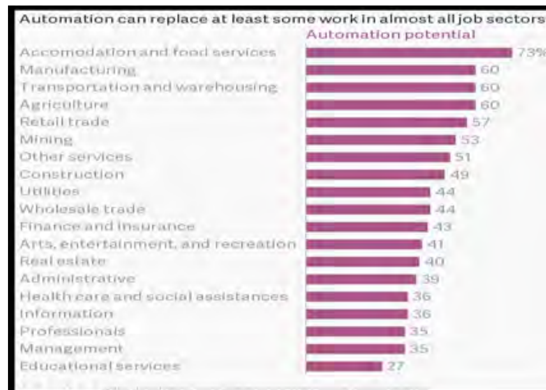
Future of Work: Will AI result in mass human displacement in the workforce?

- Oxford University Study in 2013 predicted that 47% of US jobs are at risk of automation/AI replacement.
- Bank of America predicts that by 2025 the "annual creative disruption impact" from AI will be $14 trillion to $33 trillion, including $9 trillion in reduced labor costs of knowledge workers, $8 trillion reduction in manufacturing and healthcare, and $2 trillion from self-driving vehicles and drones.
- McKinsey calculates that AI is happening "ten times faster, at 300 times the scale, with 3000 times the impact of the industrial revolution."
- Routineness of job, not labor or education required, is the primary indicator of automation.



https://qz.com/904285/the-optimists-guide-to-the-robot-apocalypse/

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Is AI an Existential Threat to Humanity?

"If you had an AI where the AI's goal was to maximize the value of a portfolio of stocks, one of the ways to maximize the value would be to go long on defense, short on consumer, start a war," he said. "Hack into the Malaysian Airlines aircraft routing server, route it over a war zone, then send an anonymous tip that an enemy aircraft is flying overhead right now."

- Elon Musk, Inc. Magazine Interview

I'm sorry Dave. I'm afraid I can't do that.

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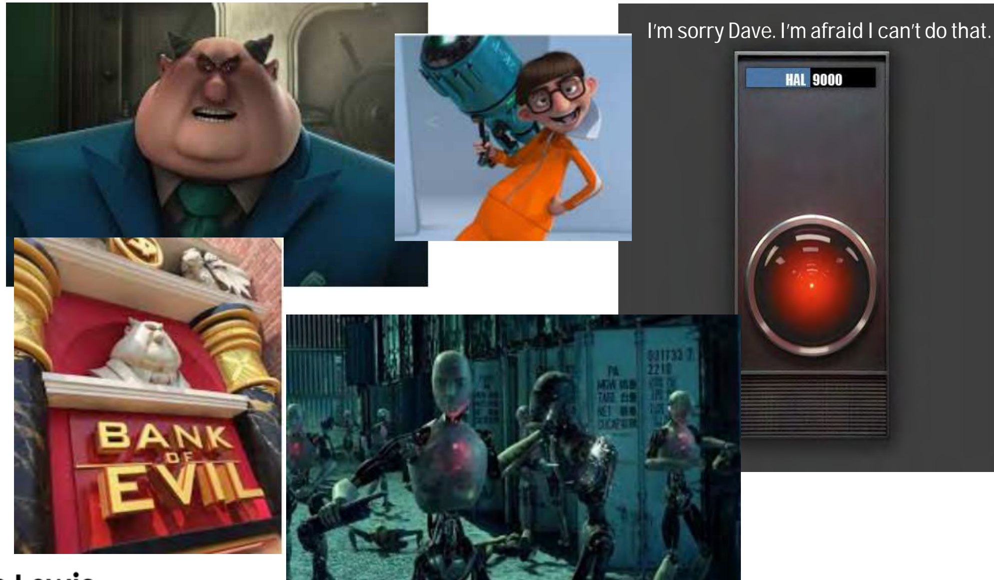
Is AI an Existential Threat to Humanity?



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Recommended.

- Rise of the Robots: Technology and the Threat of a Jobless Future by Martin Ford (2016).
- AlphaGo, a documentary about a challenge match between Google's Deep Mind AI Algorithm and Lee Sedol, the legendary Go Master. www.alphagomovie.com
- Deloitte, Using AI to unleash the power of unstructured government data, Jan. 16, 2019. https://www2.deloitte.com/insights/us/en/focus/cognitive-technologies/natural-language-processing-examples-in-government-data.html

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Tess Blair is a litigator and legal entrepreneur who has practiced at the intersection of law, technology, and design for more than two decades. Tess is the founder and leader of Morgan Lewis's eData practice, a data-driven practice that combines great lawyering with technology and design to enhance the delivery of legal services.

A practicing litigator, Tess serves as national discovery counsel to some of the world's largest organizations. She counsels a host of Fortune 500 companies, conducting risk assessments and guiding her clients as they develop internal information governance policies and controls to address privacy, security, retention, and disposition of information and data. She also helps her clients develop defensible models for responding to requests for information in litigation or investigations and marshals resources for such contingencies to assist her clients in satisfying their discovery obligations.

For clients in litigation, Tess frequently serves as discovery counsel alongside her client's trial counsel, as a core member of the litigation team; she develops and executes all aspects of the client's discovery strategy as well as optimizing her client's evidence gathering, analysis, and presentation. Her role as discovery counsel includes negotiating the scope and conduct of discovery, developing ESI protocols, protective orders, and specialized procedures for cross-border transfer of data subject to privacy laws. She takes and defends record custodian and discovery-related depositions, handles all discovery-related motion practice, and drives all managed review, analysis, and production.

As leader of eData, Tess works with her team, her colleagues, and clients to design and develop tools and techniques to improve the delivery of legal services. Tess built the eData practice into a multidisciplinary team of lawyers, technologists, business professionals, designers, developers, and data scientists who design and deliver legal products and services to enhance the Morgan Lewis client experience across the firm's practices, industries, and disciplines. The eData team uses process design, automation, UX, product design, application development, machine learning, and augmented intelligence tools to develop technology, process, and service solutions built to meet our clients' needs. A Six Sigma Green Belt, Tess invests heavily in training the entire eData team in Legal Project Management, Six Sigma and Legal Design.

Tess lectures regularly on civil procedure, ediscovery, and data privacy—including cross-border discovery and data minimization—and writes frequently on ediscovery, information governance, and data privacy for a variety of legal publications. She is the lead author of the *eData Deskbook*, currently in its third edition. Tess also serves as Special Discovery Master to the Eastern District of Pennsylvania. She has been *Chambers* ranked nationally for nine years and globally for seven years in electronic discovery. In 2019, Tess was named one of the Top Ten Most Innovative Lawyers in North America by the *Financial Times*. Tess holds a Master of Professional Studies on Law Firm Management and studied industrial design at the Philadelphia College of Art before completing an undergraduate degree in philosophy at Ursinus College. Bringing entrepreneurial experience to her clients, Tess started and operated a small business before entering law school.

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Charles Imohiosen brings a diverse set of professional experiences and skills to assist clients in leveraging people, processes, and technology to evaluate and manage their electronic data, and to deliver greater efficiencies to their legal processes, including electronic discovery. A veteran litigator, Charles has managed ediscovery reviews and related motion practice for complex matters.

Charles' experience in technology and operations ranges from having assisted hundreds of customers across multiple industries in their migration to the cloud while working for a large enterprise software company to building strategic plans as chief operating officer for the New York State Economic Development Corporation.

Charles also has broad-based experience working on regulatory matters in US federal, state, and local government, including having previously served as a senior advisor for the White House Hurricane Sandy Rebuilding Task Force and counselor in the Office of the Administrator for the US Environmental Protection Agency.

Charles previously worked as an associate in the litigation practice of a national law firm. He co-authored two amicus briefs for voting rights cases involving strict voter ID laws, in association with the Brennan Center for Justice at the New York University School of Law, and maintained an active pro bono practice.

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Brendan R. Kalb utilizes his in-house asset management and corporate legal experience to counsel clients on issues relating to the establishment and ongoing operation of global hedge funds, private equity funds, commodity pools, UCITS funds, hybrid customized vehicles, and separately managed accounts, along with providing regulatory, compliance, and trading advice to managers investing in various asset classes in the United States and abroad. He also has deep experience advising on the structuring and operation of various registered fund products, including liquid alternative funds.

Prior to joining Morgan Lewis, Brendan was the managing director and general counsel at AQR Capital Management, LLC, a systematic global asset management firm based in Greenwich, CT, where he was responsible for managing the full spectrum of the firm's legal affairs, including involvement in all aspects of US and overseas regulatory exams, product structuring, derivatives and operational risk management, quantitative investment practices, drafting of investment guidelines and restrictions, creation and update of compliance policies and procedures, as well as implementation and interpretation of international rules and regulations regarding trading and marketing.

Prior to joining AQR in 2004, he worked as an investment management associate in the New York office of an international law firm, where he regularly represented registered investment companies, investment advisers, commodity pool operators, commodity trading advisors, and broker-dealers.

Earlier in his career, Brendan gained experience as an associate in the financial services and investment management department of a regional law firm, where he dealt in related matters with respect to investment advisers, including commodity pool operation, management company structuring, fund marketing and advertising, employment agreements, joint ventures, and seed capital arrangements.

Brendan has spoken at a number of industry conferences on regulatory matters affecting the financial services industry and previously served as chairman of the Managed Funds Association's CTA, CPO, and Futures Committee and as a member of MFA's Investment Adviser, International and Government Affairs Committees. In addition, he has served on the National Futures Association's board of directors and is an active member of the Investment Company Institute's Equity Markets, CPO Advisory and Derivatives Markets Advisory Committees. Brendan also serves on the board of advisors of the Institute for Law and Economics, a joint research center between the Law School, the Wharton School, and the Department of Economics at the University of Pennsylvania.

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