AIMA Hong Kong: Double Header Event

Thursday, June 6, 2019

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THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

The End of LIBOR – Are the Buy-Side Ready?

Speakers:

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Transitioning LIBOR to risk free rates is

…a $450,000,000,000,000 problem

2022 central banks and regulators will no longer support the IBORs

- GBP LIBOR
- JPY LIBOR/TIBOR/Euroyen
- EUR LIBOR/EURIBOR/EONIA
- USD LIBOR
- CHF LIBOR

will 'cease' and be replaced by Risk Free Rates (**RFR**)

- SONIA GBP
- TONAR JPY
- ESTER EUR

unsecured overnight rates

- SOFR USD
- SARON CHF

secured overnight repo rates

- The base cost of money: it affects everything
- RFRs are conceptually different to LIBOR:
  - repricing/spread adjustment is required to avoid value transfers
  - compounding overnight in arrears (CORA) v. forward looking term rates – deal mechanics and systems must change
- By 2022 every document referencing LIBOR must be amended – to include fallbacks on cessation or to change to RFR plus a spread adjustment
- January 2020: starting gun for amendments is publication of ISDA 2006 Definitions Protocol

"Libor is an anachronism: it is measuring the rate at which banks <u>don't</u> lend to each other" (Megan Butler, Exec Dir FCA, Feb 2019)

Barclays, JPM, UBS, RBS and Deutsche have all been fined for conspiring to fix LIBOR

"Work must therefore begin in earnest on planning transition to alternative reference rates..." (Andrew Bailey, CEO of the FCA, July 2017)

LIBOR transition: state of progress

Product market use of RFRs as at Q1 2019

Volumes	USD	GBP	EUR	JPY	CHF
RFR	SOFR	SONIA	ESTR	TONAR	SARON
Swaps [OIS]	Traded notional Q1 2019: $22.6bn (including $3.0bn basis swaps; trade count: 69, incl. 23 basis swaps)	Traded notional Q1 2019: $1.7tn (including $41.0bn basis swaps; trade count: 2881, incl. 300 basis swaps)	[No data found]	US$230m (total notional outstanding)	Traded notional Q1 2019: $1.1bn (trade count: 8)
Loans	[No data found]	[No data found]	[No data found]	[No data found]	[No data found]
Bonds	Approx. $1.7bn issued in Q1 2019	Approx. £25bn issued since June last year	[No data found]	[No data found]	[No data found]
Securitisation	Freddie Mac? Fannie Mae?	April 2019: first public SONIA benchmarked RMBS transaction was marketed and notified to ESMA	[No data found]	[No data found]	[No data found]
Structured Products	[No data found]	SPIRE	[No data found]	[No data found]	[No data found]

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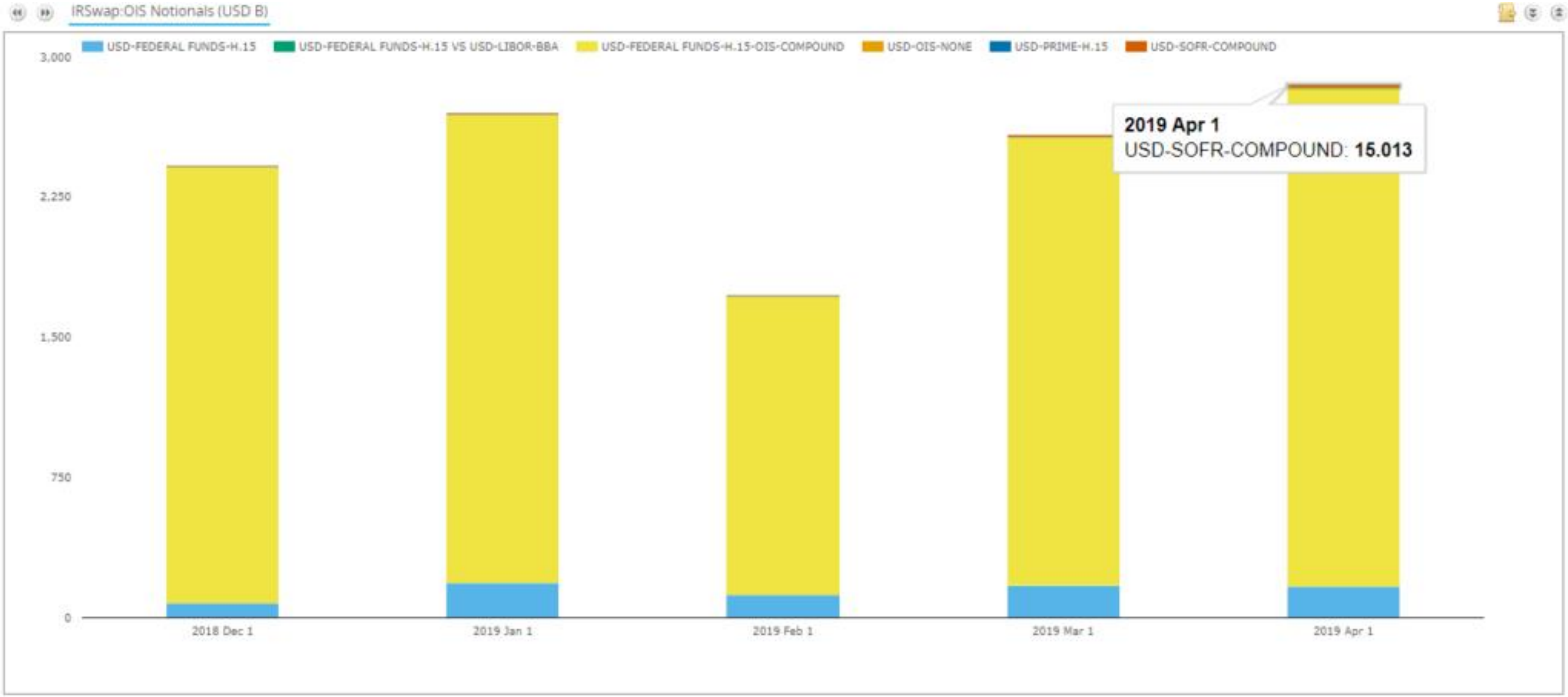
LIBOR transition: state of progress

Market conventions and forward looking rates

	USD	GBP	EUR	JPY	CHF
RFR	SOFR	SONIA	ESTR	TONA	SONAR
Publication and fixing	T+1BD 08.00 EST (fix 15.00) Averages by mid 2020	T+1BD 09.00 London WG investigates publishing CORA	T+1BD 09.00 CET	T+1BD 10.00 Tokyo	Same day 18.00 CET
ISDA 2006 accrual basis	CORA +/- adjustment spread. Pricing Spread is non-compounding				
OIS	Fixed Rate v Floating CORA for a fixed period and payment delay +2BD CCP clearing for specific tenors only				
Futures	Fixed Rate v Floating average RFR for calendar months and quarters				
X Currency	NONE				
FRNs (in arrears)	• Simple average • Following BDC payment • 2-5 day lock-out	• CORA • Following BDC payment • 5 BD lookback (or 2?)	?	?	?
Forward looking term rates	Expected end 2021 1, 3, 6, 12 M? OIS/Futures hybrid ARRC warns not to delay transition	In development OIS based? No expected date 1, 3, 6 M?	WG conclusions late 2019?	WG conclusions late 2019?	Not expected to develop

Hedging capacity: OIS volumes - SOFaR, so good?



- A total notional of $8.795bn traded in April 2019 of outright OIS
- Maturities ranging from 2 months to 3 years
- 3 month was the most traded tenor – 13 times
- 14 trades longer than one year maturity

LIBOR transition: state of progress

Fallbacks and amendment mechanisms (UK/US)

	Historic fallbacks	LIBOR Cessation (new business)	Historic amendment	Proposed amendment (new business)	Switch to forward looking term rates?
ISDA	• Reference Banks • Definitions applicable to trade • Calculation Agent	• BMR Protocol • CORA plus adjustment spread	Bilateral	2006 Definitions Protocol (expected end 2019)	N/A
FRNs	• Reference Banks • Last interest period • Calculation Agent	• Hardwired, or • Similar to LMA	• UK - Extraordinary Resolution • US - unanimity	Negative consent? ICMA draft ARRC draft	ICMA - Yes
LMA Syndic-ated Loans	• Screen rate • Interpolated rate • Historic [pre-2014] • Reference Banks • Cost of funds	• Screen Rate Replacement Event • + Replacement Benchmark • ‘appropriate changes’	Unanimity	Majority Banks	Yes
Secur-Itisation ICMA	As per FRNs	Similar to LMA	Basic Terms Modification - Extraordinary Resolution	• Senior Class 10% negative consent • Party consent	Yes

LIBOR Transition – what the regulator expects

- Increased supervisory focus – Dear CEO Letters
  - FCA disappointed by responses
  - Will ramp up with buy-side too – e.g. SMCR from end 2019
- Regulatory focus
  - Firms should be able to quantify LIBOR exposure
  - Update fallback arrangements (legal disputes more likely where fallbacks uncertain) – "*you should not rely on fallbacks, but they are a good seatbelt*"
  - Active transition from LIBOR to replacement benchmarks
- Role of regulators driving timetable
  - Do not expect a change of course
  - Before end-2021, liquidity in LIBOR referencing contracts to dry up
  - Concerns over representability of 'zombie rates'
  - Risk of 'pre-cessation triggers'

Impact on IM's #1 - Product Exposure

- LIBOR Exposure : LIBOR-based products in portfolios
  - Long dated IRS
  - FRNs and private debt (eg syndicated loans)
  - Securitised products
- Fallback failures creating value shifts
  - Unfeasible on cessation - designed for short-term interruptions
  - Mismatches between swaps and underlying assets
- Hedging mismatches
  - Uncoordinated amendments triggering mismatches
  - Rating impact
  - Accounting impacts
- Exposure to illiquidity and market risks as 2022 approaches
- Timing of amendments dependent on:
  - Exposure to multicreditor / 3P consents
  - Rate reset dates

Impact on IM’s #2 - Performance Measurement

- Disclosure to customers and counterparties
  - Managers usng an IBOR as a benchmark or performance target
    - 20% of alternatives funds*
    - 10% of MMFs*
  - Consider risk warnings around LIBOR more generally
- Need to avoid artificially inflated performance
  - New benchmark and communications around it must be carefully managed
  - Should not trigger higher performance fees

*IA survey 2018

Impact on IMs #3 - Ops & Admin

- Not just agreement terms: use of LIBOR as an input into
  - Valuation curves, for discounting and asset valuation
  - Risk measurement – eg in stress testing
  - Pricing and asset allocation models
- Finance systems, models, front office systems (eg OMS, trading platforms, Loan IQ), service providers contracts will need to be updated
- Contracts with service providers often reference LIBOR (eg late payments)
- Custodians and administrators likely to use LIBOR for valuation, discounting and risk assessment
- Use of LIBOR mandated by regulation, eg
  - Solvency II liability discounting
  - GAAP hedge accounting

Impact on IMs #4 - Own Funding

- Currency exposure referencing IBORs
  - The fewer currencies, the easier to manage remediation
  - No cross-currency swaps in RFRs (yet)
- Maturity and roll dates
  - Tenors longer than > 2021 at risk
  - 3 month LIBOR = 8 possible reset dates for transition (post 2020)
  - 6 month LIBOR = 4 possible reset dates for transition (post 2020)
  - 1 month LIBOR = 24 possible reset dates for transition (post 2020)
- Bilateral funding or exposure to multicreditor groups?
  - Swaps: protocol applicable?
  - Swaps : material amendments – effect on clearing and collateral thresholds?
  - FRN funding: trustee? extraordinary resolution or unanimity?
  - Syndicated Loans: agent bank? majority banks or unanimity?
  - Securitisation: … feasibility?

The remediation process: what does ‘active transition’ look like to a bank?

What documents do we need to amend for a trade?

[L]IBOR References

Maturing > December 2021	▪ or last reset date in 2021?
Extension options	▪ none ▪ exercised ▪ expired
Is there a RFR-[L]IBOR conversion mechanism or fallback	▪ triggers ▪ automatic or subject to CPs? ▪ default position

- calculations
- defined terms with [L]IBOR
- clauses with the above
- spreads
- procedures for rate setting / notices / reset and payment dates
- industry protocol process or bespoke?
- exclude non-material references
- see also possible cures under “Governing Law”

Operative terms for Model Amendment

Exclude or develop Implementation Plan and execute?

What do we need to do legally to amend the trade?

Governing law

Legal form and jurisdiction of parties	▪ lex situs issues ▪ corporate authority ▪ filings/registrations ▪ re-perfection formalities ▪ tax (real property)
Secured/unsecured and asset related issues	

Red Flags

- legal form of agreement
- witnesses / notarisation
- stamp duties
- filings/registrations

Form of Model Amendment wet signatures or incorporate website terms by reference?

- statutory cures available?
- scope to imply terms
- commercial custom
- frustration/force majeure

Possible cures
Legal liability issues
Red Flags

What dictates the process and timing we need to follow to trigger an amendment?

Third party consents and who controls the process	▪ Identify the universe of documents controlling amendment of a Trade based on:
Commercially linked contracts	▪ hedges ▪ repacks ▪ securitisations

Agree spread adjustment as of reset date when all CPs are satisfied

Venue-related issues	▪ disclosure ▪ MTF/OTF Rules ▪ Announcements ▪ trade depository
Filing/registrations	

- parties
- third party beneficiaries
- guarantors
- beneficiaries of direct or indirect covenants not to amend [L]IBOR References or related clauses
- multiple creditors
  - majority banks
  - noteholders
- agents and trustees
- regulators
- market authorities
- other governmental bodies

Conditions Precedent to Effective Time for Model Amendment

Other factors

Counterparty status for MiFID	▪ fair treatment ▪ suitability
Relationship to traded securities	▪ MAR/insider dealing
Liability for amendment costs	

Red Flags

Internal process points for Implementation Plan
Covenants and/or Conditions Subsequent
for Model Amendment

LIBOR Transition – what should clients be doing?

- Assess LIBOR exposure:
  - Portfolio level
  - Fund level
  - Funding arrangements, counterparty exposures and 3P consents
  - Internal systems, performance measures and accounting audit
- At **fund level**, review constitutional documents for LIBOR references
- **Funding strategy** to reduce LIBOR exposures:
  - Ensure new business contracts contain appropriate fallbacks / conversion mechanics / reduced amendment requirements
  - Consider preference for:
    - Fewer currencies
    - Shorter tenors / shorter roll dates to maximise liquidity
    - Bilateral based funding
    - Smaller creditor groups – avoid unanimity
    - “relationship” banking

LIBOR Transition – what should clients be doing?

- **IT Systems personnel** – check availability of software engineers qualified to work on your systems
- **From 2020**, expect to receive correspondence requesting fallbacks or a change in the interest basis
  - Where are the documents?
  - Track industry developments in all affected currencies and products
  - Identify (i) commercially linked trades (ii) any mismatches between the trade and the asset it hedges (eg a cash product hedged with a derivative)
  - Consider whether a change in rate triggers clearing/margining
- Decide **remediation strategy**:
  - Maximising effective use of technology for due diligence (no Magic Bullets!)
  - Wait & see or reach out to critical service providers / counterparties?
  - Piecemeal (contract by contract) or relationship wide?
  - Ensure availability of software engineers qualified to work on your systems

Q&A

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Latest U.S. Regulatory Developments – what you need to know

Speakers:

Gaven Cheong, Partner, Simmons & Simmons

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Debra Franzese, Partner, Seward & Kissel LLP

- Alliance formed October 2012
- Focus on Investment Funds and Asset Management
- Active client referrals
- Integrated US, UK and HK law offering

Service Offering for our Asian Managers

- Review of all fund documents for U.S. regulatory disclosures including ERISA, FINRA, CFTC, Adviser’s Act language
- U.S. tax disclosures in PPM and tax allocation powers in constitutional documents
- U.S. Regulatory filings including CFTC, ERA filing, Blue Sky & Form D

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Today's session

- U.S. Tax updates – Jim Cofer
- U.S. Regulatory Developments – Debra Franzese
- Q & A session – common issues faced by Asian managers

U.S. Tax Update

James C. Cofer, Partner, Seward & Kissel LLP

Agenda

- U.S. Tax Reform Summary
- Fund Structuring Post Tax-Reform
- Sales of Partnership Interests
- Partnership Audit Rules Update

U.S. Tax Reform Summary

The Alternative Investment Management Association Limited

Summary of Tax Reform

- Corporations
  - Modified territorial tax system
  - Lower tax rate (21%)
- Individuals
  - Flatter tax (fewer deductions)
  - Lower tax rate (37%)
- Some “loopholes” closed
  - Increased carried interest holding period

Fund Structuring Post-Tax Reform

The Alternative Investment Management Association Limited

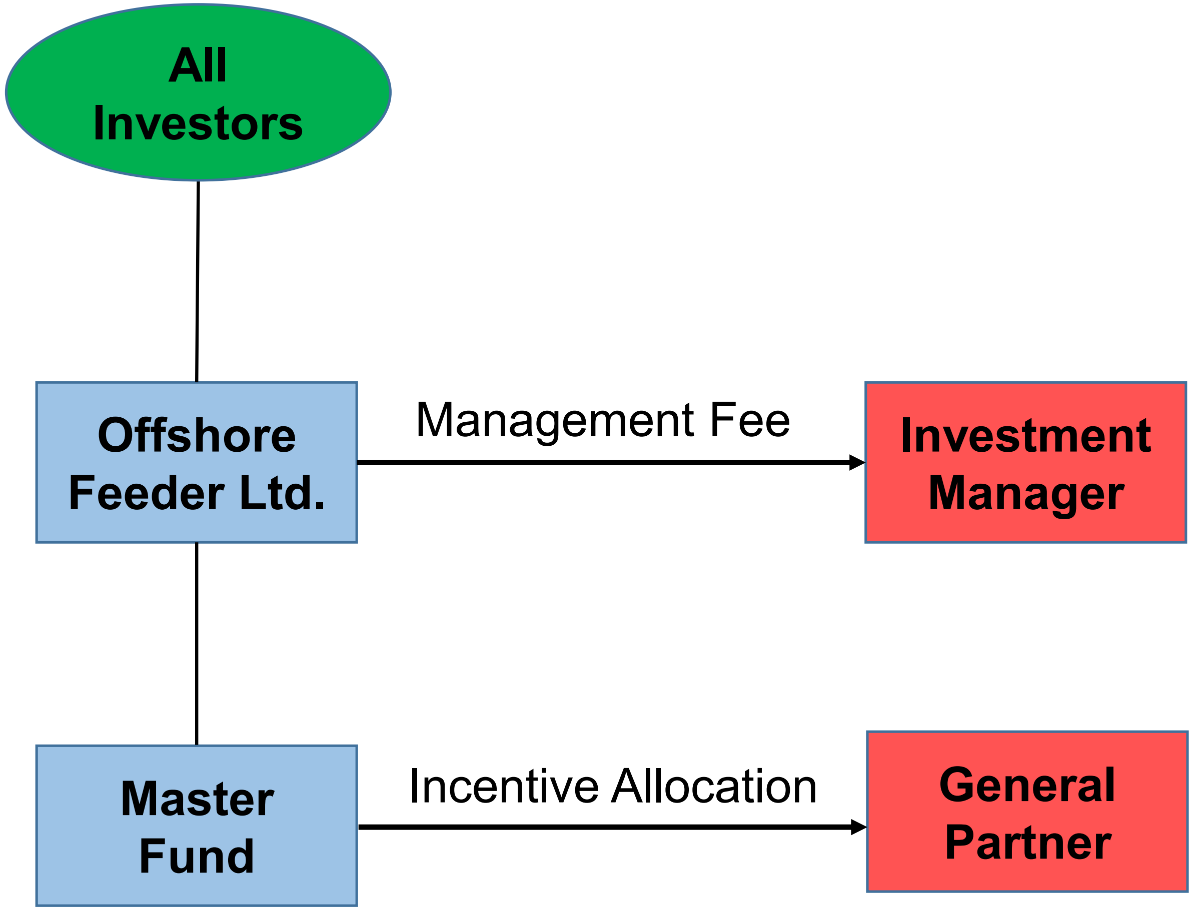
The New Environment

- New limitations on expenses
  - ➢ Expenses of “investor” funds are not deductible
  - ➢ Business interest expense is subject to new deduction limitations
  - ➢ Business losses are subject to limits on use against other income (such as salary)

Investor Fund Expenses

- Private investment funds are characterized as either “traders” or “investors” in securities
- U.S. investors could deduct expenses of “investor” funds subject to limitation
- Under the new law, U.S. investors cannot deduct the expenses of “investor” funds
- Certain structures may preserve deductibility

Preserving Deductibility – PFIC



Preserving Deductibility – PFIC

- Potential advantages
  - Management fee is deductible
  - Long-term capital gains flow through to U.S. investors (with QEF election)
- Potential disadvantages
  - Losses are “trapped”
  - Additional filing obligations for U.S. investors
  - Dividends and foreign taxes have unfavorable treatment

Business Interest Expense

- Deductions for “business interest” limited to 30% of EBITDA (EBIT after 2022)
- Interest is very broadly defined
- Limitation is determined at partnership level
- This rule may apply to “trader” funds
- Trader funds with significant amounts of “interest” expense may consider structuring alternatives

Business Loss Limitations

- Use of “business losses” against other income (e.g., salary) limited to $500,000 per year
- Any unused losses are added to an individual’s loss carryforward and are available for use next year (subject to annual limitations)
- Applies to a management company
- Application to a “trader” fund is unclear

Sales of U.S. Partnership Interests

Taxation of Sale of U.S. Partnership Interest

- Gain on the sale of a partnership interest by a non-U.S. person is subject to U.S. tax to the extent that the partnership's assets consist of U.S. business property
- To the extent there is U.S. real estate in the partnership, the change is limited in scope
- Must file a tax return to report the gain
- Applies to most investments in MLPs

New Withholding Tax

- New 10% withholding tax on the gross proceeds from the sale of such a partnership interest
- Withholding tax will apply to sales of PTP interests by non-U.S. funds (broker will generally withhold)
- Certain exceptions are available
  - ➢ U.S. seller (must obtain W-9)
  - ➢ De minimis ECI
  - ➢ No gain realized (limited to non-PTPs)
- If buyer doesn't withhold, then partnership must withhold going forward from ECI

Partnership Audit Rules Update

The Alternative Investment Management Association Limited

The New Audit Regime

- New audit regime for partnerships became effective for taxable years beginning on or after January 1, 2018
- Any additional tax assessed on an audit will be collected at the partnership level, rather than the partner level with appropriate adjustments
- “Push out election” under Section 6226 available for additional interest charge

Partnership Representative

- Under the new rules, the “tax matters partner” concept is replaced by a “partnership representative”
- A partnership representative represents the partnership in examinations before the IRS
- Final regulations released in August are largely taxpayer favorable and resolve many questions

Partnership Representative Regs

- Partnership representative need not be a partner
  - ➢ A partnership can be its own representative
  - ➢ A disregarded entity can be a representative
- The partnership representative must have a "substantial presence in the United States"
- If an entity is appointed partnership representative, an individual with a substantial presence in U.S. must also be appointed

Options for Non-U.S. Managers

- U.S. person in organization
- Third party service provider
- Non-U.S. Person has “substantial presence”
  - have a U.S. tax identification number (e.g., a social security number, EIN or an ITIN);
  - have a U.S. phone number (could be a VOIP number);
  - have a U.S. mailing address (could be registered office); and
  - Be available to meet IRS auditors at a time and place determined by the IRS

U.S. Regulatory Updates and their impact on non-U.S. managers

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Panel

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