



Alaric Compliance Services Webinar:
Everything You Want To Know About
Alternative Credit Funds
Tuesday, February 5, 2019

Table of Contents

- I. Introduction
- II. “Credit” as an Asset Class
- III. “Alternative Credit”
- IV. Private Fund Structuring
- V. Key Compliance Issues
- VI. Further Operational Compliance Issues
- VII. SEC Exam Readiness

I. Introduction

- Lately alternative credit has become a larger asset class with serious attention from institutional investors.
- Investors searching for enhanced yields and active management of interest rate risks have driven the demand for alternative credit focused funds.
- Investors reducing traditional credit exposure and replacing it with alternative credit.
- It includes liquid high-yield, bank loans, structured credit and emerging market debt-and also less liquid distressed debt, direct lending and specialty finance.
- Greater complexity, varying liquidity and risk profiles drive the need for detailed customized compliance programs.

II. “Credit” as an Asset Class

Private vs. Public Credit

- Variety of Instruments
- Differences from Public Debt
- Segments
 - Middle-market/Venture debt
 - Mezzanine/Senior-secured
 - Distressed
 - Asset-based
 - Structured credit (CLOs)
 - Niche exposure
 - Real estate/Infrastructure/High-yield corporate/”Rescue” financing

III. “Alternative Credit”

Strategies

- Segment exposure
- Correlation plays
- Market dislocations
- Opportunistic/Special situations

Market Participants

- Private funds—PE/Hedge
 - Reasons why equity focused PE fund managers have entered the alt credit space
 - Differences between PE funds and credit funds
- BDCs
- Other registered Closed-End Funds (“CEFs”)
- CLOs

III. “Alternative Credit” (con’t)

Sourcing/Investment Process

- Sponsored/Unsponsored
- Direct lending
- “Club”/Syndicated deals
 - Warehousing/”Season and sell”
- “Underwriting”—Due diligence/Credit analysis
- Portfolio Monitoring
- Distressed/Default work-out situations

IV. Private Fund Structuring

Models—PE/HF/Hybrid

- Capital accessing – Immediate/Deferred payments (“calls”)
- Investor liquidity – Lock-ups/”gates”; Private BDC term-end “split/spin-off” optionality

Tax Considerations

- Loan origination – *U.S. Trade or Business*
- Non-U.S. investors – *Effectively Connected Income (“ECI”)*
- U.S. tax-exempt investors – *Unrelated Business Taxable Income (“UBTI”)*
- PIK income

Additional Challenges for New Entrants

- New “Risk Profile”/Deal term & Investor negotiation issues
- New Conflicts

V. Key Compliance Issues

A. Staple Private Fund Risk Areas

1. Marketing

- 33 Act offering registration exemptions
 - Reg D – Manner of offering
 - Reg S – Tiers/“Flow-back” risk
- Risk factor disclosure
- Performance portrayals
 - Projections
 - Actual
 - IRR/ROI issues
 - Past performance/Related accounts
- BD status issues/Use of placement agents

V. Key Compliance Issues (con't)

A. Staple Private Fund Risk Areas

2. Investor Eligibility; Processing and Acceptance Protocols

- “Accredited Investor”
- “Qualified Purchaser”/“Knowledgeable Employee”
- “Qualified Client”
- ERISA “employee benefit plan” investors
- AML/OFAC; KYC
- FATCA

V. Key Compliance Issues (con't)

A. Staple Private Fund Risk Areas

3. Fees

- Customary fee arrangements
 - Base management fees
 - Incentive fees
 - Adviser Act restrictions
 - “Carried interest” tax treatment issues
 - Industry Norms
- Ancillary fee problem areas
 - Structuring/Formation fees – BD/“Underwriter” status issue
 - Transparency
 - Transaction fees
 - Monitoring fees

4. Expenses/Allocation Issues

V. Key Compliance Issues (con't)

B. Portfolio Management and Trading

1. Investment opportunity allocation

- Generally
 - Manager self-interest
 - Side-by-side management issues
- Particular to credit funds
 - Competing capital structure exposures
 - Distress scenarios
- How to address
 - Identify all material conflicts and applicable regulatory compliance provisions
 - Organizational and offering documents; features and disclosures
 - Adviser mitigation and detection controls

2. Best Execution

V. Key Compliance Issues (con't)

B. Portfolio Management and Trading

3. Insider trading controls

- Applicability to loan investment activity
- Scenarios
 - Credit monitoring process
 - Creditor committee participation
 - Covenant calculations
 - Vendors to publicly-held companies
 - Approaching liquidity events

V. Key Compliance Issues (con't)

B. Portfolio Management and Trading

3. Insider Trading Controls (continued)

- Controls – 2 types
 - Avoidance/Mitigation
 - NDAs
 - Data rooms – “Public”/”Private”
 - Use of expert consultant networks
 - Space sharing controls
 - Information/Conduct “walls” or “barriers”
 - Detection/Handling possession of MNPI
 - Advertent/Inadvertent scenarios
 - Restricted/Watch lists
 - Responses
- New hire orientation; Refresher training
 - Identifying/Recognizing MNPI
 - Responsive action

V. Key Compliance Issues (con't)

B. Portfolio Management and Trading

4. Transactions with Affiliates

- Cross-trades
- Principal capacity transactions

V. Key Compliance Issues (con't)

B. Portfolio Management and Trading

5. ERISA Issues

- Cross trades
- Syndication related transactions
 - Loan participations
 - “Season and sell” arrangements
- SPV subsidiaries
- Positions acquired in secondary market transactions
- Marketing constraints/DOL fiduciary rule
- VCOC compliance exemption availability

V. Key Compliance Issues (con't)

C. Valuation

- Fair valuation
- Methods
 - Going concerns -- Combination of methods
 - Comparable transactions
 - Income/Market yield approach; discounted cash flow
 - P-WERM
 - Distress/"Waterfall" scenarios – Probable liquidation value
 - Warrants/Other equity kickers – OID/OPM
- Process
 - Sequential/Rotational valuations
 - "Valuation event" triggers
 - Third-party valuation agents
 - Fair value estimates
 - "Range of Value" estimates

V. Key Compliance Issues (con't)

D. Custody

- Advisers Act custody rule requirements
- Compliance exceptions
 - “Privately issued securities”
 - Financial statement audits
- Audit Issues
 - SPVs
 - Consolidation
 - JVs/CLOs
 - Asset verification audits

VI. Further Operational Compliance Issues

A. Use of Leverage

- Financing sources
- Risk disclosures

B. Funding Capacity

- Unfunded loan commitments

C. Borrower KYC

D. Voting/Consent Solicitations

E. Recordkeeping

F. IT-centric Issues

- BC/DR
- Privacy/Information security/ID theft
- Cyber-security
- Form PF filings

VII. SEC Exam Readiness

- **Generally**
- **Matters of Note**
 - Conflicts of interest
 - Ancillary fees/Expenses
 - Investment opportunity allocation
 - Controls
 - LPA provisions/PPM disclosures
 - Matching RIA manual-level policies and procedures
 - Testing and monitoring of the controls

VII. SEC Exam Readiness (con't)

- Deal sourcing
- Valuation
- Marketing/Track record
- Personal/Proprietary trading
 - MNPI controls
 - Transacting in restricted securities via online trading venues
- Whistleblower protections/"impeding" issues

VIII. Questions and Answers
