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ALTERNATIVE FUNDS
IN THE REGISTERED FUND MARKETPLACE

Growing in popularity, alternative investment mutual funds raise a variety of issues under the Investment Company Act and the Investment Advisers Act. The authors provide an overview of such funds, the role of fund boards, and the constraints on investment imposed by the Investment Company Act. They then turn to a variety of other issues and close with a discussion of recent regulatory and industry initiatives reflecting new concerns about the marketing and risks of such funds.

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Registered investment companies, or “mutual funds,” that emphasize “alternative” investment assets and strategies (“Alt Funds”) raise a range of issues under the Investment Company Act of 1940.¹ With appropriate focus and attention to these issues, the investment adviser or sponsor to the Alt Fund will be able to anticipate and address these issues, to the extent possible, prior to establishing the fund. Nevertheless, navigating these issues can be challenging, especially for those investment advisers or sponsors new to the registered mutual fund marketplace. This article intends to serve, in part, as a roadmap for identifying and addressing these issues.

¹ This article focuses solely on matters involving Alt Funds that are organized as open-end investment companies that are not exchange-traded funds.

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Historically, alternative investment assets and strategies referred to those created by investment advisers and operated outside of the highly regulated world of mutual funds. In recent years, however, mutual funds that employ alternative investment assets and strategies (“Alts”) as part of their principal investment strategies have been introduced into the registered mutual fund marketplace.² While Alts may vary widely

² As of January 2014, there were a total of \$259 billion in assets invested in 481 Alt Funds according to remarks given by National Examination Program Assistant Director, Renee Esfandiary, at the Securities and Exchange Commission. *SEC Compliance Outreach Program National Seminar for Investment Adviser and Investment Company Senior Officers*, 30-31 (Jan. 30, 2014), available at <http://www.sec.gov/info/cco/ccons2014-presentation.pdf>. Net asset flows to Alt Funds had increased to \$40 billion in 2013 from \$ 13 billion in 2012.

IN THIS ISSUE

- **ALTERNATIVE FUNDS IN THE REGISTERED FUND MARKETPLACE**
- **CLE QUESTIONS, Page 193**

from each other, there are certain characteristics that are common among them. For example, Alts, to varying extents, may include characteristics such as novelty, complexity, illiquidity, leverage, lack of transparency, a high degree of reliance on active or quantitative management skill and sophistication, higher fees, and, generally, a sense of higher risk and higher potential rewards. While some Alt Funds may entail a more pronounced risk-and-return tradeoff, other Alt Funds may allow for diversification of returns as well as reduction of risk in an investor's portfolio. Nevertheless, in contrast to traditional equity or fixed-income mutual funds, it is common among Alt Funds to hold nontraditional investments (e.g., commodity and currency-related investments) or employ complex and unique investment strategies (e.g., long/short strategies).

Not surprisingly, the increased popularity of Alt Funds within the registered fund marketplace has also brought with it increased attention from the regulators. Over the course of the past year, there have been numerous regulatory-focused developments relating to Alt Funds. For example, the SEC staff has issued a Risk Alert, as well as announced its 2014 examination priorities, both of which include a discussion on Alt Funds. In addition, the SEC staff has made numerous public statements that all highlight the need for investment advisers to Alt Funds to consider the restrictions imposed by the 1940 Act.³ Further, in

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Morningstar Direct U.S. Open-End Asset Flows Update (Jan. 2014), available at <http://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsJan2014.pdf>.

³ *Bowden: Beware of Alternative Funds*, FUND INDUSTRY INTELLIGENCE, 5 (Mar. 17, 2014) (discussing comments made by the director of the SEC's Office of Compliance, Inspections, and Examinations that Alt Funds were "fraught with risk" and avoidance of reckless action was essential); Alan Katz, *Alternative Mutual Funds to Get SEC Test for Leverage, Liquidity*, BUSINESSWEEK (Apr. 23, 2014) (discussing comments made by Jane Jarcho, National Associate Director of the investment company examination program at the SEC, concerning SEC examination plans to shed light on how funds are trying to generate yield and how much risk Alt Funds are taking).

response to the registered fund marketplace shift to more Alt Funds, the Mutual Fund Directors Forum has released a white paper addressing board oversight of Alt Funds.

This article first provides an overview of Alt Funds, then reviews various risk considerations that are associated with Alts, followed by a discussion of board approval and oversight of Alt Funds. This article then considers certain issues that arise under the 1940 Act that may be applicable to an Alt Fund, as well as other regulatory considerations faced in operating such funds. Finally, this article examines the compliance program of an Alt Fund and reviews the most recent industry and regulatory developments concerning such funds.

OVERVIEW

Definition

While Alt Funds seek to accomplish their investment objectives through nontraditional investments and strategies, there is no standard definition of "alternative" either in the registered mutual fund marketplace or under the 1940 Act. Generally, the registered mutual fund marketplace has used the term "Alts" to refer to investments and strategies that (i) are outside of the traditional three major asset class categories of stocks, bonds, and cash; (ii) are expected to have low correlations with these three major asset classes; (iii) have been traditionally operated in an environment relatively free of regulatory constraints (i.e., not within the parameters of the 1940 Act); and (iv) traditionally unavailable to retail investors (e.g., only available through hedge funds). As the registered mutual fund marketplace has continued to evolve and expand, Alts have become more prevalent in the registered fund space.

Examples of Alts

The Alts universe is particularly diverse. Alts may include the following categories and descriptions:

- **Absolute Return.** Absolute return funds strive to achieve positive returns independent of the market condition by seeking to outperform a risk-free

benchmark and not following a traditional long-only benchmark.

- *Long/Short - 130/30.* A long/short (130/30) fund combines long and short security selection strategies with a net exposure of a 100% long position (e.g., 130% long and 30% short).
- *Commodities.* Commodity funds focus on investments designed to track prices of a single commodity or multiple commodities by investing in either the physical assets or derivatives, such as futures, options, and swaps.
- *Managed Futures.* Managed future funds primarily trade derivatives, such as futures, options, swaps, and listed and over-the-counter foreign exchange contracts through strategies, such as price-momentum or trend-following.
- *Market Neutral.* Market Neutral funds attempt to reduce systematic risk created by factors such as exposures to sectors, market-cap ranges, investment styles, currencies, or countries. They try to achieve this by matching short positions within each area against long positions in order to reduce systematic risk.
- *Alternative Allocation (multi-strategy).* Multi-strategy funds pursue their investment objective by using several different strategies within the same fund typically through multiple portfolio managers.
- *Currency.* Currency funds invest in either a single currency or multiple currencies typically by using short-term money market instruments.
- *Leverage.* Leveraged funds use debt to supplement the original investment, which often results in magnified gains or losses.
- *Natural Resources.* Natural resource investment strategies focus on commodity-based industries, such as energy, chemicals, and minerals.
- *Inverse and Inverse with Leverage.* Inverse funds and leverage funds seek to generate returns equal to a fixed multiple (or an inverse of a fixed multiple) of short-term returns of an equity or fixed-income index.
- *Arbitrage Strategies.* Arbitrage funds seek to profit from the discrepancies between related securities in a single asset class or multiple asset classes.

- *Hedge Fund Replication.* Hedge fund replication uses liquid securities, such as funds that track equity and fixed-income indexes, to track returns of an otherwise illiquid hedge fund or a pool of hedge funds.
- *Real Assets.* Real asset funds invest in vehicles in which the underlying assets involve nonfinancial assets, such as real estate, real estate investment trusts, and infrastructure.
- *Distressed Debt.* Strategies focusing on distressed debt involve purchasing debt obligations that trade at depressed levels.
- *Private Equity/Venture Capital.* Private equity and venture capital are used to fund new ventures using strategies including leveraged buyouts, mezzanine financing of leveraged buy-outs, or distressed debt.

RISK CONSIDERATIONS

There are various risk considerations commonly associated with Alts. Note that these considerations are typically the same considerations that exist with a mutual fund's investments in "traditional" securities, although in the case of Alt Funds, the risk considerations may be more difficult to measure or value.

The risks presented by Alts may include market risk and credit risk. Market risk is the risk that the market value of the investment will decrease due to, for example, changes in interest rates or other market conditions. Credit risk is the risk that the counterparty to a transaction will default on its obligations, or that legal impediments will interfere with the counterparty's ability to perform its obligations. Alts may also give rise to various legal risks. In some cases, investment advisers may need specialized legal assistance to review derivative instruments and other assets, particularly with respect to issues relating to the Commodity Exchange Act, the Bankruptcy Reform Act of 1978, domestic and foreign tax law, and state laws, with which investment advisers may be less familiar than with the requirements of the 1940 Act.

The risks associated with Alts underscore the need for investment advisers of Alt Funds to ensure that systems are in place to coordinate all regulatory facets of the investment program and that appropriate personnel have the requisite understanding of Alts.

BOARD APPROVAL AND OVERSIGHT

The board of directors or trustees of an Alt Fund have several significant responsibilities to the Alt Fund itself

and the Alt Fund’s shareholders. As a general matter, the board should exercise knowledgeable and meaningful oversight over the operations of the Alt Fund and its investment adviser. One of the most important areas of board responsibility is oversight of the management of the Alt Fund’s portfolios of securities.

Educational Training

A special educational training provided by the investment adviser to the board of the Alt Fund, as well as a discussion with the board of the risks associated with such investments, can provide the board with familiarity of the Alt Fund in order for the board to properly exercise its oversight function. The training session could include, for example, one or more presentations that provide an overview of (i) product features of the Alt Fund (including a discussion of the investment strategies and risks, the investment adviser’s compliance and operational capabilities, and pricing and fee caps); (ii) common regulatory issues (including a discussion of leverage, liquidity, and valuation); and (iii) the role of the board (including an evaluation of the investment adviser’s overall capabilities and fees).

Board Approval of Investment Advisers and Sub-Advisers

General Overview. Section 15(c) of the 1940 Act requires that a majority of the board of a mutual fund, including a majority of the independent trustees of the fund, approve the investment advisory contract between the fund and its investment adviser. Section 15(c) also provides that the board must request, and the investment adviser must provide, all information reasonably necessary to evaluate the contract. Separately, Section 36(b) of the 1940 Act imposes a fiduciary duty upon the investment adviser with respect to the receipt of fees and gives mutual fund shareholders a private right of action against the investment adviser for breach of this duty, subject to certain procedural limitations.⁴ Based on these sections of the 1940 Act, as well as general fiduciary obligations of a mutual fund board in connection with its oversight responsibilities, boards

typically request and evaluate a comprehensive set of materials in connection with both new and ongoing advisory agreements, which include information about the investment adviser’s experience and skill in performing its duties under the agreement and the appropriateness of the fees to be charged. This is commonly known as the “15(c) process.”⁵

The same process and disclosure rules also apply to investment advisory agreements involving sub-advisers, although the nature of the information is likely to differ given the often more limited role played by the sub-advisers. In this context, both the SEC and the private bar have recently focused attention on the portion of the fund advisory fee retained by the investment adviser and the services provided for that fee.

Section 15(c) Process for Alt Funds. When a proposed investment strategy is complex, novel, or otherwise unfamiliar to a board, which may include Alts, the investment advisory contract approval process should entail additional educational and informational components and sufficient time to address questions and concerns. In general, the board should review the investment objectives as well as the investment strategies and the types of assets of the Alt Fund. Skill and experience of the portfolio management team should be areas of focus, including a review of the performance record, if available. The board of an Alt Fund will want to satisfy itself, where relevant, that the fees are justified by various factors, such as the services provided. Compliance and disclosure may be important components of the process. If the investment adviser intends to retain a sub-adviser to manage the Alt Fund, the board will also want to be satisfied that the investment adviser can adequately supervise the sub-adviser and that the allocation of the advisory fee between the investment adviser and sub-adviser is appropriate based upon the relative duties and responsibilities involved.

Retention of Consultants. The strategy or strategies to be employed by the investment adviser to an Alt Fund may be so complex that the board may wish to retain independent consultants to assist it in the due diligence process. For example, strategies that rely on quantitative

⁴ Case law under § 36(b) requires deference to the board’s approval of the contract where the board has requested and reviewed the information in a conscientious manner and the fee approved is not so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining. *Jones v. Harris Associates*, 559 U.S. 335 (2010) (citing *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982)).

⁵ SEC disclosure rules also require mutual funds to disclose in their shareholder reports the factors the board considered in the Section 15(c) process and the conclusions reached, including, among others, the nature of the services provided. Form N-1A, Item 27(d)(6).

analysis may require the involvement of consultants with specialized expertise.⁶

Red Flags. Red flags that may arise during the investment advisory contract approval process include, with regard to the adviser, a lack of track record with these types of investments, performance issues, lack of operational capacity, a limited regulatory compliance history, or limited resources dedicated to its compliance program. The board should have an open discussion with the investment adviser to explore these issues prior to the approval of the investment advisory contract.

SPECIFIC CONSIDERATIONS UNDER THE 1940 ACT

Alt Funds are subject to numerous legal provisions under the 1940 Act, including the limitations and requirements with respect to leverage and asset segregation, liquidity, valuation, disclosure, portfolio investment management, and custody.

Leverage and Asset Segregation

Strategies that depend on borrowing and traditional leverage will need to conform to the basic leverage limitations found in the 1940 Act.⁷ Strategies that use derivatives will separately need to comply with the asset segregation and coverage requirements. Limitations on leverage, as well as the asset segregation and coverage requirements, can impose significant constraints on investment flexibility and assets available for pursuing some of the Alt Fund's investment objectives.

Section 18 of the 1940 Act has been applied by the SEC staff to derivatives that create indebtedness leverage, such as futures, forward contracts, and written options.⁸ In applying Section 18, the SEC staff has required funds to "cover" the contractual obligations these derivatives create by establishing and maintaining

segregated accounts consisting of cash, U.S. government securities, high-grade debt, or other liquid securities in amounts at least equal in value to the obligations. The SEC staff also has permitted funds to cover derivatives positions by engaging in offsetting transactions.

This "cover" framework was established by the SEC staff in 1979, and it originally applied to reverse repurchase agreements, when-issued securities, and short sales, all of which entail leverage.⁹ In 1987, the staff extended its position to address futures and forwards.¹⁰ Essentially, the Alt Fund either must hold an offsetting position or set aside high-grade debt or other liquid securities in an amount sufficient to cover its potential future obligation.¹¹ These requirements are intended to ensure that the Alt Fund will be able to meet its future obligations, as well as function as a practical limit on the amount of leverage it may undertake.¹²

It is important to note that Alt Funds that engage in significant derivatives activities will need to consider other provisions of the 1940 Act, including requirements relating to diversification, portfolio concentration, and exposure to certain securities-related issuers.¹³ For example, it may not be clear to the Alt Fund what entity should be treated as the "issuer" of certain derivatives instruments. In addition, fund subsidiaries that are controlled foreign corporations ("CFCs"), which are discussed below, must comply with any applicable asset segregation on a stand-alone basis.

⁶ *In re AXA Rosenberg Group LLC*, Inv. Act Co. Rel. No. IC-29574 (2011) (an enforcement proceeding arising from allegations of nondisclosure of an error in a quantitative investment model). As part of the settlement, respondents agreed to retain an independent compliance consultant with experience and expertise in quantitative investment techniques.

⁷ Section 18(f) of the 1940 Act restricts leveraged capital structures, generally prohibiting mutual funds from issuing any class of "senior security." Funds may, however, borrow from banks if they maintain 300% asset coverage for all such borrowings.

⁸ However, the SEC staff has not applied §18 to derivatives that create economic leverage, such as purchased stock call options.

⁹ *Securities Trading Practices of Registered Investment Companies*, Inv. Act Co. Rel. No. IC-10666 (Apr. 18, 1979).

¹⁰ *See, e.g., Dreyfus Strategic Investing & Dreyfus Strategic Income*, SEC No-Action Letter (June 22, 1987).

¹¹ *See, e.g., Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter (July 2, 1996) (permitting the use of equity securities and other liquid assets for asset segregation purposes).

¹² Frequently, questions arise concerning the amount of assets that should be segregated with respect to positions in certain types of derivatives, and whether a particular offsetting transaction qualifies under the SEC guidance. In addition, the guidance varies depending on the instrument as well as the position taken on the instrument (*i.e.*, whether the position could be characterized as long or short). This guidance can be found in numerous SEC staff no-action letters, which are posted on the SEC's website at <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

¹³ *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Inv. Co. Act Rel. No. IC-29776 (2011).

Liquidity

All registered funds, including an Alt Fund regardless of its strategy, must stand ready on a daily basis to redeem its securities at their proportional net asset value and may not delay payment for more than seven days, absent relief from the SEC.¹⁴ In addition, it may not invest more than 15% of its net assets in “illiquid assets.”¹⁵ The SEC staff defines an illiquid asset as any asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.¹⁶ Ordinarily, exchange-traded derivatives, such as certain futures and options on securities and futures, have readily available markets and, therefore, would not be subject to the 15% limitation. Many over-the-counter derivatives, such as currency forward contracts, also have deep and liquid markets. However, as with many OTC derivatives (such as those linked to illiquid instruments or illiquid markets), it can be difficult to exit the position promptly. In addition, Alt Funds may hold securities or real assets that are or may become illiquid (*e.g.*, distressed debt or commodities).

Valuation

Alt Funds must value their net assets daily. The 1940 Act provides, in general, that the value of securities for which market quotations are readily available is their market value, and that the value of other securities and assets is their fair value, as determined in good faith by the board of directors.¹⁷ As a practical matter, boards of Alt Funds must adopt policies specifying how securities and assets for which market quotations are not readily available will be valued. Boards then delegate responsibility to fund management for valuing the Alt Fund’s assets according to its stated policies.

Alt Funds should value derivative instruments at their market value, which is based on information supplied by an exchange, pricing service, or OTC dealer. In other situations, an Alt Fund must “fair value” certain of its

securities. These may include certain OTC derivatives, foreign securities (especially those in emerging or “frontier” markets), real assets, and distressed debt.

Mutual funds have generally been using derivatives for decades and have developed methodologies for valuing these instruments. However, newer asset classes pose challenges and may require substantial groundwork to determine a workable valuation methodology.

Disclosure

An Alt Fund’s policies and practices with respect to its assets and investments are subject to a number of disclosure requirements under the federal securities laws and regulations. Generally, the Alt Funds registration statement must provide disclosure concerning all significant fund investment practices and risks, including those relating to investments (or potential investments) in Alts.¹⁸ In addition, these investments must be consistent with the Alt Fund’s stated investment objectives and policies, name, and risk profile as set forth in the Alt Fund’s prospectus, sales materials, and other disclosure documents.

The investment adviser must ensure that the Alt Fund’s principal strategies and risks are disclosed in plain English and in summary form. Detailed descriptions of other related practices are also required, including those relating to valuation and asset segregation. Typically, the disclosure relating to Alt Funds tends to be lengthier than other mutual funds.

Portfolio Investment Management

The investment adviser’s compliance program should address potential issues involving the portfolio investment management process. The management and operation of an Alt Fund may raise potential conflicts of interest that should be reviewed in consideration of Section 17(d) of the 1940 Act, which is intended to prohibit abuses arising from conflicts of interest. For example, conflicts may arise where the investment adviser for the Alt Fund manages both the Alt Fund and other private or proprietary accounts, such as hedge funds (“side-by-side management”). Inherent in side-by-side management of Alt Funds and unregistered funds (or accounts) with varying fees is the possibility that the investment adviser will provide preferential treatment of those funds or accounts with higher compensation. The investment adviser has a fiduciary duty with respect to each account under its management

¹⁴ Sections 2(a)(32) and 22(e) of the 1940 Act.

¹⁵ *Revisions of Guidelines to Form N-1A*, Inv. Co. Act Rel. No. IC-18612 (1992).

¹⁶ *Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies*, Inv. Co. Act Rel. No. IC-14983 (1986). The determination of what assets of a fund are illiquid assets requires monitoring on the part of a fund’s compliance personnel and may change over time depending upon certain factors involving those assets.

¹⁷ Rule 2a-4 under Section 2(a)(41) of the 1940 Act.

¹⁸ Form N-1A.

and should take proper steps to address any potential conflicts of interest. In addition, transactions in the same security are typically aggregated and allocated across accounts. Procedures must be in place to ensure fair and equitable treatment to all accounts with respect to the aggregation and allocation of trades.

Custody

Alts may implicate the custody provisions of the 1940 Act. Under the 1940 Act, a mutual fund can place and maintain its assets only with qualified custodians as set forth in Section 17(f) of the 1940 Act and the rules thereunder.

Derivatives. Alts with leverage generally entail cash positions that move from one party to the next and the cash positions of an Alt Fund should be in the hands of a qualified custodian. The SEC adopted Rule 17f-6 to govern the maintenance of margin with a futures commission merchant (“FCM”). Specifically, mutual funds that enter into futures contracts or that write commodity options must deposit a specified amount of assets or cash as “initial margin” in connection with such transactions. Investors other than funds typically deposit initial margin directly with an FCM. If, however, the FCM is an affiliated person of a mutual fund’s investment adviser, Rule 17f-6 is not available. Such a fund must deposit the margin in special accounts in the name of an FCM with their custodian banks. Rule 17f-6 contains a number of requirements, including that any gains on a fund’s transactions, other than *de minimis* amounts, can be maintained by the FCM only until the next business day following receipt.

Swaps are generally positions in cash that flow back and forth from a fund to its counterparty. Funds that use OTC swaps may create tri-party accounts with their custodians to hold assets that may need to be posted to their counterparties under the terms of the swaps. Beginning in July of 2010, the SEC staff has provided relief under Section 17(f) to allow funds to engage in centrally cleared credit default swaps, interest rate swaps, cash-settled commodity index swaps, and foreign currency swaps, and post the required margin amounts with the appropriate market intermediary (*i.e.*, an FCM or a broker).¹⁹

Foreign Assets. Mutual funds typically use bank custodians to establish and maintain a global network

through which the fund’s assets are held abroad. This custodian is referred to as a “foreign custody manager” or a “global custodian.” The custodian’s services generally include safekeeping the fund’s assets, settling securities transactions, receiving dividends and interest, providing foreign exchange services, paying fund expenses, reporting failed trades, reporting cash transactions, monitoring corporate actions at portfolio companies, and tracing loaned securities. The custody provisions of the 1940 Act are designed to ensure the safekeeping of fund assets and protection from theft and other fraud.

With respect to custody in foreign countries, Rule 17f-5 under the 1940 Act allows Alt Funds to maintain their foreign securities in the custody of a “foreign custody manager” (generally, foreign banks or foreign subsidiaries of U.S. banks). Rule 17f-7 under the 1940 Act allows registered investment companies to maintain their foreign securities in the custody of “eligible foreign securities depositories,” provided the company or its investment adviser receives an appropriate analysis of the relevant risks on an ongoing basis. The securities clearance, settlement, and securities holding systems in frontier markets may not be as reliable as those in developed markets or even emerging markets. As a result, issues may arise that relate to the ability of a fund to place and maintain its assets with qualified fund custodians. In addition, the global custodian of a fund may be called upon to exercise more oversight concerning the local laws relating to the clearance, settlement, and holding systems in frontier markets, to help ensure that the fund is aware of custody risks in the jurisdiction.

OTHER REGULATORY CONSIDERATIONS

CFTC Compliance Issues

Investment advisers to Alt Funds that engage in significant “nonhedging” commodities activities, and investment advisers to CFCs engaging in such activities, must register as “commodity pool operators” (“CPOs”).²⁰ Ultimately, CPOs that are investment advisers to mutual funds must comply with the CEA and regulations promulgated by the CFTC, as well as the regulatory regime imposed on funds and investment advisers under the 1940 Act and the Investment Advisers Act of 1940.

¹⁹ See, e.g., *Chicago Mercantile Exchange*, SEC No-Action Letter (July 10, 2013) (relief for cash-settled commodity index swaps and foreign currency swaps).

²⁰ In February 2012, the CFTC amended Regulation 4.5 under the CEA to narrow the exclusion from regulation as a CPO that had previously been available with respect to mutual funds.

On August 22, 2013, the CFTC adopted final rules that harmonize certain compliance obligations for CPOs of SEC-registered mutual funds.²¹ These harmonization rules adopted a “substituted compliance” framework, meaning that the CFTC will accept the SEC’s disclosure, reporting, and recordkeeping regime as substituted compliance for substantially all of Part 4 of the CFTC’s regulations, as long as the CPO complies with applicable requirements under the SEC’s statutory and regulatory compliance regime. An Alt Fund with a registered CPO should carefully review its compliance program in light of the harmonization rules to ensure it is meeting all applicable requirements.

Compliance with IRS Regulations

To be qualified as a “regulated investment company” or “RIC” under Subchapter M of the Internal Revenue Code, an Alt Fund must derive at least 90% of its gross income from qualifying sources (often referred to as “good income”). Alt Funds that intend to engage in substantial activities relating to commodity-linked derivatives can give rise to various issues under the federal tax regime that allows RICs to provide pass-through taxation to their shareholders. For instance, when an Alt Fund uses derivatives to a significant degree, it may need to establish a CFC to hold the derivatives and produce “good income.” A CFC is typically a wholly owned and controlled subsidiary of the Alt Fund and organized under the laws of a non-U.S. jurisdiction, such as the Cayman Islands.

COMPLIANCE PROGRAM

Rule 38a-1 under the 1940 Act requires mutual funds to implement, and the boards thereof (including a majority of the independent trustees) to approve, compliance programs that are reasonably designed to prevent violations of the federal securities laws and that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund. Mutual funds must conduct an annual review of these compliance programs for adequacy and effectiveness, and they must designate a chief compliance officer with responsibility for administering the policies and procedures. Rule 206(4)-7 under the Advisers Act requires registered investment advisers to implement policies and procedures reasonably designed to prevent violations of the Advisers Act. In designing compliance policies and

procedures, funds and investment advisers must first identify conflicts and other compliance factors creating risk exposure for the investment adviser, the fund, and shareholders, with regard to the fund’s particular operations, and then design policies and procedures that address those risks.

Investment advisers and the board should review any new strategies for additional risks, including those associated with Alts. In addition, because Alt Funds may not have existing compliance programs that address all relevant aspects of the new investment asset or strategy, the board should approve additional policies and procedures, as needed. Certain types of strategies may call for specific types of procedures. For example, those strategies that rely on quantitative analysis (*e.g.*, sophisticated mathematical or computer modeling techniques to explain or predict the movements of a financial market) may require adoption of specialized compliance procedures to account for the risks in the use of specialized technology and calculations. Policies and procedures that should be reviewed and analyzed in consideration of Alts include, for example, leverage and asset segregation, liquidity, and valuation. Moreover, to the extent any personnel new to the registered mutual fund environment are tasked with any responsibilities concerning Alts, additional compliance training and supervision may be required.

INDUSTRY DEVELOPMENTS

SEC Risk Alert

On January 28, 2014, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) issued a Risk Alert on the due diligence processes that investment advisers use when they recommend or place clients’ assets in Alts, such as hedge funds, private equity funds, or funds of private funds.²² While the Risk Alert does not directly apply to the operational aspects of Alt Funds themselves, the observations and comments by the SEC staff may further assist investment advisers of Alt Funds.

The Alert notes that an investment adviser that exercises discretion to purchase Alts on behalf of its clients, or that relies on a manager to perform due diligence of Alts, must determine whether such

²¹ *Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 78 Fed. Reg. 52308 (Aug. 22, 2013).

²² *OCIE National Exam Program Risk Alert, Investment Adviser Due Diligence Processes For Selecting Alternative Investments And Their Respective Managers* (Jan. 28, 2014), available at <http://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf>.

investments (i) meet the clients' investment objectives and (ii) are consistent with the investment principles and strategies that were disclosed by the manager to the adviser. The Alert then describes current industry trends and practices in investment advisers' due diligence.

As compared to observations from prior periods, the SEC staff noted that investment advisers are:

- seeking more information and data directly from the managers of Alts, including information relating to position-level transparency. Further, investment advisers are increasingly recommending that their clients' assets be managed within a separate account, and not within a pooled investment vehicle, in order to gain full transparency and control.
- using third parties to supplement and validate information provided by managers of Alts, including using portfolio information aggregators that provide portfolio-level information aggregated from across various private funds. The investment adviser uses such information to assess the risk of a particular Alt.
- independently verifying relationships and assets with key third-party service providers and increasingly requiring an independent administrator, and the administrator-issued transparency reports, for a private alternative investment fund.
- performing additional quantitative analysis and risk assessments of Alts and their managers, which are intended to identify aberrations in investment returns and potential problems before those problems impact performance.

In addition, the SEC staff observed certain deficiencies in several of the advisory firms examined, which included:

- omitting alternative investment due diligence policies and procedures from their annual reviews, even though these investments comprised a large portion of investments on behalf of clients;
- providing potentially misleading information in marketing materials about the scope and depth of the due diligence conducted; and
- having due diligence practices that differed from those described in their disclosures to clients.

In addition to these deficiencies, the SEC staff also made the following observations:

- Detailed written policies and procedures that required adequate documentation would assist with the consistent application of the due diligence process.
- Advisers should conduct periodic review of their services providers to determine whether the services providers were abiding by the terms of their agreements.

OCIE National Examination Program: Priorities for 2014

OCIE published its 2014 examination priorities in order to communicate with investors and funds about areas that the SEC staff perceives to have heightened risk.²³ The focus area includes, among others, "policy topics." "Policy topics" are areas in which the SEC has an interest in gaining a better understanding of business practices or learning the practical application of previously adopted rules and guidance.

As a policy topic, OCIE indicated that the SEC staff will continue its assessment of funds offering "alternative" investment strategies, with a particular focus on: (i) leverage, liquidity, and valuation policies and practices; (ii) the staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors. The staff will review the representations and recommendations made regarding the suitability of such investments.

In addition, on March 18, 2014, at the Investment Company Institute Conference in Orlando, Florida, Jane Jarcho, the National Associate Director of OCIE, announced that it would begin a sweep examination program targeting 15-20 mutual fund complexes that offer Alt Funds. The announcement highlighted the areas of liquidity, leverage, and board oversight of Alt Funds, among other areas in the Alt Fund's operations, about which the SEC had concerns with respect to compliance with the 1940 Act.

Mutual Fund Directors Forum Report

On January 23, 2014, the Mutual Fund Directors Forum published a white paper entitled "Board

²³ *Examination Priorities for 2014* (Jan. 9, 2014), available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

Oversight of Alternative Investments” in response to the increasing number of boards that oversee mutual funds offering hedge-fund-like strategies.²⁴ The white paper notes that while a trustee’s duties do not change based on the type of fund a board oversees, boards may face unique challenges because of the strategies and investments used by Alt Funds.

The white paper also notes that one of its purposes is to help boards focus on questions for boards to consider when overseeing funds with investment strategies that are significantly different from more traditional, long-only equity and fixed-income funds. Specifically, the white paper discusses:

- questions that a board should consider if the investment adviser proposes adding an Alt Fund to the complex, such as whether the investment adviser and other service providers have the requisite expertise, knowledge, and resources to manage and operate an Alt Fund;
- areas that may need special attention if the investment adviser hires a sub-adviser to manage the Alt Fund, particularly if the sub-adviser lacks prior experience in managing a mutual fund; these areas include the due diligence initially conducted by the investment adviser on the sub-adviser and whether the investment adviser has the appropriate resources to oversee the sub-adviser’s management of the

Fund and the ongoing compliance obligations under the 1940 Act;

- considerations for boards as they seek to understand an Alt Fund’s investment strategy, such as whether the investment strategy is functioning as expected, and how to evaluate the Alt Fund’s performance through comparison with benchmarks and peer groups; and
- challenges in operational risk oversight, particularly with respect to restrictions under the 1940 Act that may complicate the investment adviser’s implementation of the Alt Fund’s strategy (*e.g.*, valuation, liquidity, and leverage).

CONCLUSION

The proliferation and popularity of Alt Funds during the past several years has presented challenges to the portfolio managers, investment advisers, and boards of Alt Funds, as well as to regulators overseeing Alt Funds. The many varieties of Alt Funds and the strategies and investments employed by them has created specific challenges for all parties involved with respect to compliance with the 1940 Act and other regulations. Recent attention paid to Alt Funds by regulators has helped focus Alt Fund boards, investment advisers, and compliance personnel on the importance of operating these funds within a sound compliance framework. ■

²⁴ See *Report of the Mutual Fund Directors Forum, Board Oversight of Alternative Investments* (Jan. 23, 2014), available at http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Alternative_Investments_-_January_2014.pdf.

CLE QUESTIONS on Gedrich/Zimmerman, *Alternative Funds in the Registered Fund Marketplace*. Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrp@att.net. The cost is \$40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. Alt Funds traditionally have been subject to the regulatory restraints of the Investment Company Act of 1940. **True False**
2. Section 15(c) of the Investment Company Act requires that a majority of the board of a mutual fund, including a majority of the independent trustees of the fund, approve the investment advisory contract between the fund and its investment adviser. **True False**
3. Registered Alt Funds using derivatives that create indebtedness leverage are required by the SEC staff to “cover” 50% of the contractual obligations these derivatives create by maintaining special segregated accounts. **True False**
4. Beginning in July 2010, the SEC staff provided relief under Section 17(f) to allow funds to engage in centrally cleared swaps of various kinds and post the required margin amounts with an appropriate market intermediary, such as an FCM or a broker. **True False**
5. In August 2013, the CFTC adopted final rules to “harmonize” the compliance obligations for commodity pool operators of SEC-registered mutual funds with the CFTC’s regulations. **True False**

A F F I R M A T I O N

_____, Esq., an attorney at law, affirms pursuant to CPLR
[Please Print]

2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

Dated: _____

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