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Chapter 45

Liquid Alternative Funds

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Registered investment companies, or “mutual funds,” that emphasize “alternative” investment assets and strategies (“Alt Funds”) have become increasingly common in the mutual fund landscape in recent years.¹ Historically, “alternative” investment assets and strategies refer to those created by investment advisers and operated outside of the highly regulated world of mutual funds. In recent years, however, mutual funds that use principal investment strategies focusing on alternative investment assets and strategies (“Alts”) to pursue the fund’s investment objectives have been introduced into the registered mutual fund marketplace.² While the various types of Alts may vary widely 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 trade-off, other Alt Funds may allow for diversification of returns as well as reduction of risk in an investor’s portfolio. Nevertheless, in contrast

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

2. As of December 31, 2013, in the aggregate, there was approximately \$132 billion in assets in Alt Funds with estimated net flows of approximately \$40 billion for the one-year period. Morningstar, Morningstar Direct U.S. Open-End Asset Flows Update (Jan. 2014), <http://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsJan2014.pdf>. As of June 30, 2015, the total amount invested in Alt Funds was approximately \$207 billion. However, as of November 2015, Morningstar reported that fund flows into its alternative strategies category have decreased by nearly \$17 billion in 2015. Fund Action, Investor Interest in Alts Funds on the Wane (Nov. 2015), www.fundaction.com/news/investor-interest-in-alts-funds-on-the-wane.

to traditional equity or fixed-income mutual funds, it is common among Alt Funds to hold nontraditional investments (for example, commodity and currency-related investments), or employ complex and unique investment strategies (for example, long/short strategies).

This chapter 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. The chapter then reviews Investment Company Act of 1940 (the “Investment Company Act”) considerations that may be applicable to an Alt Fund, as well as other regulatory considerations faced in operating such funds. Finally, the chapter examines the compliance program of an Alt Fund and reviews the most recent industry and regulatory developments concerning such funds.³

§ 45:2 Overview

§ 45:2.1 Definition

While Alt Funds seek to accomplish their investment objectives through non-traditional investments and strategies, there is no standard definition of “alternative” either in the registered mutual fund marketplace or under the Investment Company Act. Generally, the registered mutual fund marketplace has used the term “Alts” to refer to investments and strategies that are (i) outside of the traditional three major asset class categories of stocks, bonds, and cash; (ii) expected to have low correlations with these three major asset classes; (iii) traditionally operated in an environment relatively free of regulatory constraints (that is, not within the parameters of the Investment Company Act); and (iv) traditionally unavailable to retail investors (for example, 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. “Liquid Alts” refers to Alt Funds that, by their nature as registered funds, provide daily liquidity to shareholders.

§ 45:2.2 Examples

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

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3. In authoring this chapter, we will not intend to restate the various regulatory, compliance and operational aspects of forming and operating a non-Alts mutual fund discussed elsewhere in this treatise, but rather, emphasize and highlight those regulatory, compliance and operational aspects that are most critical in forming and operating an Alt Fund.

- (1) *Absolute Return*. Absolute return funds strive to achieve positive returns independent of market conditions by seeking to outperform a risk-free benchmark and not following a traditional long-only benchmark.
- (2) *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 (for example, 130% long and 30% short).
- (3) *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.
- (4) *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.
- (5) *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. Market-neutral funds seek to achieve this by matching short positions within each area against long positions in order to reduce systematic risk.
- (6) *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.
- (7) *Currency*. Currency funds invest in either a single currency or multiple currencies typically by using short-term money market instruments.
- (8) *Leverage*. Leveraged funds use debt to supplement the original investment, which often results in magnified gains or losses.
- (9) *Natural Resources*. Natural resource investment strategies focus on commodity-based industries, such as energy, chemicals, and minerals.
- (10) *Inverse and 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.
- (11) *Arbitrage Strategies*. Arbitrage funds seek to profit from the discrepancies between related securities in a single asset class or multiple asset classes.

- (12) *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.
- (13) *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.
- (14) *Distressed Debt*. Strategies focusing on distressed debt involve purchasing debt obligations that trade at depressed levels.
- (15) *Private Equity/Venture Capital*. Private equity and venture capital are used to fund new ventures using strategies, including leveraged buyouts, mezzanine financing of leveraged buyouts, or distressed debt.
- (16) *Bear Market*. Bear market strategies involve providing hedging or short exposure to market conditions.

§ 45:3 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, certain of these risks are greater and these 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 (CEA), 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 Investment Company 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.