

# Registered Alternative Investment Funds

## IDC Webinar

Review of Compliance and Board Considerations

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Bob Leveille, Chief Compliance Officer, Putnam Funds and Putnam Investments

Elizabeth Reza, Partner, Ropes & Gray LLP

Ralph Verni, Chair, Eaton Vance Funds

Annette Capretta, Deputy Managing Director, IDC, *Moderator*

# Trends – alternative fund launches

Alternative Classification	New Launches 01/01/12-12/31/12	Total Number of Funds as of 12/31/12	Percentage Increase vs YAG
Absolute Return	80	217	58%
Long Short Equity	49	142	53%
Commodities General	33	92	56%
Managed Futures	25	34	278%
Specialty Fixed Income	8	56	17%
Equity Leveraged	7	157	5%
Dedicated Short Bias	7	137	5%
Equity Market Neutral	6	74	9%
Currency	4	46	10%
Extended US Large Cap Core	1	47	2%
Totals	220	1,002	28%

Source: Lipper

# Trends – increasing interest

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- Registered “alternative” investment products are appealing to sponsors and investors
- Reasons
  - Interest by retail investors in hedge funds and other alternative strategies
  - Interest by institutions in transparency and liquidity
  - Focus on absolute returns/uncorrelated returns
  - Regulatory developments

## Trends – increasing interest (cont.)

- Regulators are also expressing increased interest
  - OCIE Examination Priorities for 2013 (pub. February 21, 2013)
    - “Alternative” investment companies – do leverage, liquidity, and valuation policies/practices comply with regulations; are boards, compliance personnel, and back offices staffed, funded, and empowered to handle new strategies; are funds being marketed to investors in compliance with regulations?
  - SEC concept release – Use of Derivatives by Investment Companies (pub. August 31, 2011)
  - SEC staff saying registered alternative products give shareholders increased exposure to derivatives, options, and other riskier assets compared to traditional mutual funds

# What are alternative products?

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- No universal definition
- Challenging for Lipper/Morningstar to classify
- Typical examples:
  - Long/short funds
  - Absolute return funds
  - Commodity funds
  - Managed futures funds
  - Fund of hedge funds

# General regulatory restrictions

- Investment Company Act of 1940
  - Leverage limitations
    - Coverage requirements related to use of derivatives – regulatory uncertainty
  - Diversification requirements
    - Derivatives use
  - Restrictions on investments in companies in the securities business
  - Restrictions on transactions with affiliates (Section 17)
  - Custody requirements
    - Alternative managers are often used to using prime brokerage arrangements
  - Limited performance fees

# General regulatory restrictions (cont.)

- 1933 Act
  - SEC review and annual updates
  - Additional offering limitations if not 1933 Act registered
- Advisers Act
  - Registration of adviser
- Accounting
  - Will investments and techniques increase accounting/financial statement complexity and/or cost and/or increase the possibility of NAV errors?
- Internal Revenue Code
  - Compliance with RIC and Subchapter M requirements
  - If not a RIC, how will it be taxed?

# General regulatory restrictions (cont.)

- Miscellaneous
  - Blue Sky laws
  - NYSE listing standards for funds of hedge funds
- Open-end funds have particular regulatory obligations relating to liquidity
  - 15% limit on illiquid investments
  - Must strike NAV daily and meet redemption request within 7 days
    - Valuation issues



# Compliance considerations

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- Policies/procedures should be reviewed and enhanced for funds that utilize alternative investment strategies
  - Policies/procedures designed for traditional strategies may not be suited for new and different practices
- CCO goes through a very similar “questioning” process as the Board

# Board considerations

- Understanding strategy and the fund's role
  - How will the fund behave on its own and in tandem with other portfolio holdings and/or products?
  - What types of instruments/techniques will be used to implement the strategy?
    - Are these new instruments/techniques for the adviser/PM?
    - If derivatives, what types and to what extent? What process is undertaken by adviser before it begins to use new derivative instruments for investment purposes? What controls are in place to deal with counterparty exposure, margin, segregation of assets, etc.? Do compliance procedures/practices fall within the range of practices described in SEC concept release?
    - Will instruments result in increased leverage?

## Board considerations (cont.)

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- Understanding strategy and the fund's role (cont.)
  - Is borrowing (non-derivative) permitted?
  - Will techniques used (swaps, commodities, Cayman subsidiary) give rise to CFTC registration/reporting?

## Board considerations (cont.)

- Does the adviser possess the necessary expertise?
  - Portfolio management expertise
    - Lack of track record may make evaluation difficult
    - Track record may have been developed in a non-1940 Act product
    - Will investment staff be increased to accommodate new product?
  - Operational/compliance expertise
    - Is there adequate staffing/expertise to handle special operational, accounting, valuation, tax, compliance, and other system requirements?
    - Will accounting and financial statement reporting become more difficult?

## Board considerations (cont.)

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- Does the adviser possess the necessary expertise?
  - Does adviser have adequate expertise to oversee sub-adviser (if sub-adviser is engaged)?
  - Does the adviser have plans to introduce other alternative products in the near term?

## Board considerations (cont.)

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- How should the board measure success?
  - Understand the aim/goal of the alternative product
  - Define how success should be measured
    - Prior to launch, if possible
    - Complexity may make peer analysis and benchmark comparison “best available”

## Board considerations (cont.)

- How should the board measure success (cont.)?
  - Performance benchmarking
  - Expense benchmarking
    - Multiple techniques cause expenses to vary
    - Benchmark against cost to manage traditional assets
    - Look for peer groups comprised of funds with similar investment techniques and weightings, if possible
    - Be wary of “outliers” within peer group

## Board considerations (cont.)

- Understanding the sales process/shareholder communications
  - Has the prospectus disclosure been reviewed by counsel? How does it compare with disclosure for similar products?
  - Will shareholder report disclosures be tailored to meet guidance issued by the SEC staff to describe use of derivatives and their effects on returns?



## Board considerations (cont.)

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- Risk Management
  - Does management have a process for identifying and managing risk?
  - Has strategy been tested in times of market stress?
  - What risk metrics will be used: Sharpe ratio, VAR, standard deviation, tail risk scenario simulations?

## Board considerations (cont.)

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- Conflicts issues
  - If side-by-side management with a performance fee product, does the compensation structure create possible conflicts?
  - If side-by-side management of long and short products, how are potential conflicts being handled?
- What should the Board expect to hear from the CCO and counsel?

# Practical tips for Board review process

- Consider independent director pre-meetings or pre-meeting between committee chairs and management to discuss alternative product proposals
- Consider 2-step process – conceptual proposal then specific approvals
- Ask management to give independent directors special training on derivatives, new investment techniques, valuation challenges, etc.

# Practical tips for Board review process

- Consider providing a template with specific questions the Board wants answered in connection with new fund launches
- Consider forming a special committee to oversee alternative products
  - *ad hoc* or permanent