Transitioning Alternative Investment Strategies into the Registered Fund Space

Legal and Regulatory Considerations

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2012 Mutual Funds and Investment Management Conference
March 19, 2012

I. Introduction

A. The Challenge

"Alternative" investment strategies are, almost by definition, strategies that have been created and have evolved with relative freedom from regulatory constraints, and certainly outside of the highly and multiply regulated world of mutual funds. While asset classes and strategies that may be referred to as "alternatives" vary widely from each other, there are certain characteristics that are commonly (although not always correctly) associated with alternatives. These include novelty, complexity, illiquidity, leverage, lack of transparency, a high degree of reliance on active or quantitative management skill and sophistication, high fees, and generally a sense of higher risk and higher potential rewards.

To a mutual fund lawyer asked to help transition an alternative strategy into the registered fund space, this list of characteristics raises a range of potential issues. These issues run from the product design phase—Can the strategy work within the liquidity and leverage limits of the Investment Company Act of 1940 (the "1940 Act" or "ICA") as well as the tax constraints of the Internal Revenue Code? Will the adviser have to register with the Commodity Futures Trading Commission ("CFTC") as a commodity pool operator?; through the organization, registration, and implementation phase—Will the board be comfortable with evaluating the skill of the manager and approving the level of fees? Can the strategy and risks be described in a plain English prospectus? Does the fund or adviser have an adequate compliance program for all elements of the strategy?; and on through the roll out phase—Will the registered representatives selling the fund be adequately trained to make suitability decisions and explain the product? Many of these issues, like navigating the contract approval process, are "classic," in that funds have been dealing with the basic regulatory framework for decades. Others, like the prospect of CFTC regulation for commodities funds, are "emerging"; even the regulators do not yet know what will be involved.

* The authors are grateful to John Baker, Alison Fuller, Peter Hong, Michael Mundt, and William Pilling for their assistance in preparing this outline.

B. Scope of the Outline

This outline is designed to identify the most common issues that arise for funds considering alternative strategies in each phase of the fund launch. Not all issues are raised for all alternative strategies, and there may be issues raised for particular strategies that we have not included. As a note of caution, this discussion addresses the legal requirements and their application to alternatives at a very generic level, and will not provide enough information for resolution of the issues in any particular case. Where possible, we refer you to more extensive materials for that purpose.

II. Choosing a Universe of "Alternatives"

A. Fluid Boundaries and Classifications

1. No Static Consensus

There is no standard definition of "alternative" in the investment world, or even a consensus as to what should be included in the "alternative" universe. Generally, the term is used 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 to the three major asset classes; (iii) traditionally operated in an environment relatively free of regulatory constraints; and (iv) not traditionally available to retail investors. However, the investments and strategies that may be characterized as alternatives vary widely among each other, and the universe of what is considered "alternative" changes over time, as once unconventional or "exotic" instruments and strategies become more familiar or "mainstream" and are absorbed into retail distribution channels.

2. Absence of Standard Industry Taxonomy

To illustrate the fluid nature of the "alternatives" universe, Morningstar has a separate fund class for "Alternatives," while Lipper does not. In the Alternatives class, Morningstar includes the categories Bear Market, Currency, Long/Short Equity, Market Neutral, Multi-Alternative, Equity Precious Metals, Managed Futures, and Volatility, as well as seven "Trading" categories (Leveraged Commodities, Inverse Commodities, Leveraged Debt, Inverse Debt, Leveraged Equity, Inverse Equity, and Miscellaneous). Morningstar has a separate class for Commodities (not included within the Alternatives class), although commodities are often considered to be part of the alternatives universe (see the Cerulli Associates list below). Morningstar does not have a category for "Absolute Return," which is currently one of the most talked about "alternative" product descriptions, while Lipper does have an Absolute Return category.

3. "Absolute Return" Example

Classification of strategies within the alternatives universe also varies. Absolute return is a good example. In a Morningstar paper about absolute return, a fund analyst (Ryan Leggio) provides the following working definition: "Any fund whose benchmark is tied to an index that is <u>almost always positive</u>, in either nominal or inflation-adjusted terms, over rolling five-year periods."

However, he notes that absolute return funds are very different from each other; they have different benchmarks, Morningstar categories, portfolio strategies, and asset class exposures; some are tactical while others are not; they have different investment time horizons, varying from one to ten years; and their holdings vary dramatically from fund to fund. He also notes that eleven Morningstar categories (including a number of bond categories, multi-alternative, mid blend and large value equity, and real estate) include at least one absolute return fund.

B. Working List of Alternatives

For purposes of this outline, we will use the list and nomenclature from the Cerulli Associates presentation included in the materials, which identify asset classes and strategies that are currently considered "alternatives" and are either currently used in registered funds or are being considered by funds. We will also use the term "alternatives" to refer to both asset classes and strategies. These alternatives are:

- Absolute return
- Commodities
- Global tactical asset allocation
- Frontier markets (equity and debt)
- Arbitrage strategies (e.g., convertible currency, merger/risk)
- Global infrastructure
- Hedge fund replication
- Multi-asset strategy
- Long/short extension strategies
- Distressed debt
- Managed futures
- Market neutral
- Alternative allocation
- Currency
- Inverse with leverage
- Leverage
- Natural resources
- Inverse or bear market
- 130/30
- Alternative energy

III. Legal and Regulatory Considerations

The purpose of this portion of the outline is to identify legal and regulatory issues that are commonly raised by transitioning an alternative strategy into the registered fund space. We have organized it by phase (Product Design, Implementation and Registration, and Roll Out) and, within those phases, by "classic" vs. "emerging" issues. As indicated above, "alternatives" vary greatly in terms of asset class, strategy, investment objective, complexity, and other characteristics, and thus raise very different legal issues. Thus for each issue, we provide a very high level discussion of the legal provision and a brief explanation of how it might apply to certain alternatives. However, because of the definitional issues discussed, we do not attempt to "map" the legal issues to all the alternatives to which they may apply.

A. Product Design Phase—Looking for Show Stoppers (or Show Delayers)

The first question in transitioning an alternative strategy into the highly regulated fund world is whether it can it work in the registered fund context. This requires mapping the strategy against the basic structural requirements of the 1940 Act and Subchapter M of the Internal Revenue Code and, for funds with substantial commodities activities, the requirements of the Commodity Exchange Act ("CEA") and CFTC regulation, to determine whether there are any insurmountable regulatory issues or issues likely to require exemptive relief or otherwise cause delay. The classic core issues in product design are whether the fund will be able to operate within the 1940 Act leverage restrictions and daily valuation and liquidity requirements. Funds with significant commodities activities will have to address requirements of Subchapter M of the Internal Revenue Code regarding "good" investment income and whether they are commodity pool operators and thus subject their advisers to CFTC regulation. Moreover, at any given time, there can be additional regulatory roadblocks, such as the Securities and Exchange Commission ("SEC" or "Commission") staff's current moratorium on granting exemptive relief for ETFs with significant investments in derivatives. There are also a number of other issues, such as affiliate transaction limitations, that can have both direct and collateral effects on advisers who may manage both private and registered funds, and that should be considered at this early stage in order to avoid unintended consequences.

An important follow up question is whether, once the strategy has been "domesticated" into the regulated context, it will retain the intended risk/return characteristics. This is essentially a business question, but requires education of the portfolio manager about the regulatory constraints and a dialogue between the product management and legal groups.

<u>Classic Issues</u>

1. Valuation

Open end funds must value their net assets daily. The 1940 Act defines value as (a) market value if market quotations are readily available (interpreted by SEC staff to include an implicit requirement that market quotations also be reliable) or (b) with respect to other securities and assets, fair value as determined in good faith by the board of directors. See Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder.

Boards are not required to determine the fair value of holdings directly, but rather approve written policies and procedures under which fair value is determined. The Commission has outlined four components that should be included in these procedures: (a) monitoring for circumstances that may necessitate the use of fair value pricing; (b) criteria for determining when market quotations are not reliable for a particular security; (c) adoption of a methodology or methodologies to determine the current fair value of securities or assets the fund will hold; and (d) regular review of the appropriateness and accuracy of the methods used in valuing securities. See Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, 81 SEC Docket 2775 (Dec. 17, 2003).

Application to Alternatives. Alternatives may involve securities and other assets for which market quotations are not readily available or reliable, and thus must be "fair valued" under a methodology approved by the board. These may include certain over the counter derivatives, foreign securities (especially those in emerging or "frontier" markets), real assets, and distressed debt. Funds have been using derivatives for decades and have developed methodologies for valuing these instruments. Newer asset classes, however, pose challenges and may require substantial groundwork to determine whether or not there is a workable methodology. If a particular strategy requires exemptive relief (for example, if there is an affiliate transaction issue), conditions relating to valuation methodology may be worked out in the exemptive process. At the "SEC Speaks" conference in February 2012, a representative from the SEC's Office of Inspections and Examinations ("OCIE") noted that funds with alternative strategies will be a priority for the inspection team, in part because of valuation and liquidity challenges.

2. Liquidity

An open end fund 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. See Sections 2(a)(32) and 22(e) of the 1940 Act. To ensure that funds can meet this obligation, SEC staff interpretations prohibit open end funds from investing more than fifteen percent (15%) of their net assets in "illiquid assets." See Revisions of Guidelines to Form N-1A, Securities Act Release No. 6927 (Mar. 12, 1992) (for money market funds the limit is 5% and additional liquidity requirements are imposed under Rule 2a-7). An illiquid asset is defined 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 fund has valued the investment on its books. If a fund goes over the 15% limit as a result of a change in value of its investments, it would not purchase further illiquid investments until it fell back within the limits.

The liquidity of any fund investment is a question of fact that must be addressed on a case-by-case basis. Among the factors to consider are restrictions on transferability, the availability of market bids from multiple sources (including sources independent of the counterparty or dealer), the feasibility of entering into offsetting transactions with the same or a different counterparty (in the case of derivatives), and any rights the fund may have to close out a position on a mark-to-market basis. It is important to remember that liquidity is separate from valuation. Many securities and assets that are fair valued are still liquid. Also, liquidity is not an issue for closed

end funds, and there are hybrid vehicles available, either through Rule 23c-3 under the 1940 Act or exemptive relief, that may be available to accommodate different levels of liquidity.

Application to Alternatives. Alternatives may involve securities (such as distressed debt) and assets (such as real assets) that are or may become illiquid. Unlike valuation, which can be addressed through appropriate procedures and methodology, liquidity requires an actual market and opportunity for disposition. That is, liquidity issues can be more resistant to satisfactory resolution. Note the comment under the discussion of "Valuation," above, regarding funds with alternative strategies as priorities in OCIE examinations and potential attention to liquidity issues.

3. Leverage

Section 18(f) of the 1940 Act prohibits open-end funds from issuing "senior securities" (e.g., most claims senior to common stock) and places explicit limitations on the borrowing activities of the fund. In practice, it allows open-end funds to borrow only from banks and requires a minimum of 300 percent asset coverage.

The SEC and its staff traditionally have applied the prohibitions of Section 18 of the 1940 Act to a fund's use of derivative instruments. The SEC's staff has taken the position that the use of certain derivative instruments may entail the issuance of prohibited senior securities. In this way, the SEC is equating a fund's obligation to make payment on the derivative instrument with a note written by, or an evidence of indebtedness of, the fund that has a payment priority senior to payment on the shares issued by the fund.

Rather than prohibiting funds from engaging in derivative transactions, the SEC staff has established an interpretive approach pursuant to which funds may enter into offsetting transactions or by segregating fund assets in amounts that would cover some amount of the fund's potential liabilities under the instruments. The SEC and staff's approach to "cover" is set forth in a series of SEC releases and staff no-action letters beginning in 1972.

On August 31, 2011, the SEC published a concept release entitled "Use of Derivatives by Investment Companies under the Investment Company Act of 1940." Release No. IC-29776 (the "Concept Release"). The Release states that the Commission is reviewing the use of derivatives by funds, including the potential implications of derivatives for fund leverage, and requested comments to assist it in determining whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds and if so, the nature of such initiatives or guidance. Comments were due by November 7, 2011, and the Commission has not yet taken further public action.

A select bibliography that focuses on SEC and staff guidance analyzing the application of Section 18 to senior securities can be found here: http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm. These issues are also discussed in the ABA's Report of the Task Force on Investment Company Use of Derivatives and Leverage.

Application to Alternatives. Strategies that depend on borrowing and traditional leverage will need to conform to the basic leverage limitations in the 1940 Act. Strategies that use derivatives will need to comply with the asset coverage requirements. Limitations on leverage and the asset segregation and coverage requirements can impose significant constraints on investment flexibility and assets available for pursuing the fund's strategy. Furthermore, because of the SEC's current reevaluation of its position on derivatives, the long term nature of these restrictions is uncertain.

It is also important to note that funds with 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, which are also addressed in the Concept Release and the ABA Report. In addition, fund subsidiaries that are controlled foreign corporations (see the Tax discussion below) must comply with any applicable asset segregation on a stand-alone basis.

4. Tax—Subchapter M "Good Income" Requirements

To be qualified as a "regulated investment company" or "RIC" under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"), a fund must derive at least 90% of its gross income from qualifying sources (often referred to as "good income"). In Rev. Rul. 2006-1, as modified and clarified by Rev. Rul. 2006-31, the IRS held that income and gains from derivative contracts (e.g., futures or swaps) that provide for a total-return exposure on a commodity index will not be considered good income.

Subsequent to the issuance of Rev. Rul. 2006-1, the Internal Revenue Service ("IRS") has issued more than 70 private letter rulings ("PLRs") to individual RICs, holding that a RIC's income from investment in commodities through use of (1) offshore blocker corporations classified as controlled foreign corporations ("CFCs") and (2) commodity-linked notes ("CLNs") is "good income." These PLRs recognize that mutual funds and other registered investment companies properly can gain indirect exposure to commodities by investing in CFCs and CLNs, under certain conditions. In addition, following the amendment of Subchapter M by the American Jobs Creation Act of 2004, a RIC's income from qualified publicly traded partnerships (typically known as master limited partnerships) that invest in commodities is "good income." RICs are also permitted to gain indirect commodity exposure by investment in stock of corporations (domestic or foreign) such as gold mining companies.

There are two limitations to investing in a CFC that is wholly-owned by a mutual fund. First, no more than 25% of the RIC's assets can be invested in the subsidiary under the RIC asset diversification test (quarterly test). Second, the IRS requires a representation that the subsidiary will satisfy the coverage requirements under Section 18(f) of the 1940 Act (notwithstanding that the subsidiary is not registered under the 1940 Act) which means the subsidiary needs to hold sufficient liquid assets to satisfy such requirements. The subsidiary must also comply with certain other requirements of the 1940 Act, including leverage, investment restrictions and affiliated transaction prohibitions.

The structured notes approved by the IRS typically provide, among other things, for a 3X return on a commodities index, a coupon and principal protection in the form of a "knock out" provision whereby the note automatically terminates on the following index trading day if the index falls below the knock-out level of between 12% to 15% depending upon the type of commodities index. At 3X leverage, this means the holder of the note generally can lose between 36% and 45% of the principal protected.

In July 2011, the IRS suspended the issuance of further commodity PLRs to allow it to reconsider the basis upon which it had issued such rulings. To date, the IRS has neither resumed issuing commodity PLRs nor issued any published guidance with respect to investment by RICs in commodities.

Application to Alternatives. Funds that intend to engage in substantial activities relating to commodity-linked derivatives, and that do not have a pre-existing PLR relating to use of a CFC or transactions in CLNs, will need to evaluate the impact of these activities and their ability to rely on existing authorities. Some practitioners believe there is more of a statutory basis for holding that income from a CFC, to the extent distributed, is good income assuming the corporate form of the CFC is respected.

5. Affiliate Transaction Prohibitions

The 1940 Act imposes strict limitations on transactions between a registered fund, on the one hand, and its affiliates and principal underwriter (first tier affiliates) and affiliates of its affiliates and principal underwriter (second tier affiliates, collectively, fund affiliates), on the other. Fund affiliates include the adviser and controlling persons of the adviser. Section 17(a) of the 1940 Act prohibits fund affiliates from knowingly selling or purchasing securities or property to or from the fund, other than fund shares. Section 17(e) prohibits fund affiliates from purchasing or selling property as agent of the fund, other than certain brokerage transactions. Exemptive relief is available for principal transactions under Section 17(b) of the 1940 Act, but is time consuming and typically granted under only limited circumstances.

Section 17(d) of the 1940 Act generally prohibits a fund affiliate, acting as principal, from effecting any transaction in which the registered investment company is a joint participant, in contravention of SEC rules adopted for the purpose of prohibiting the registered investment company from being a participant "on a basis different from and less advantageous than that of such other participant." Rule 17d-1 under the Act generally prohibits a first or second tier affiliate of a registered investment company, acting as principal, from participating in, or effecting any transaction in connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which a registered investment company is a participant, without having received an exemptive order from the SEC.

The SEC and the courts have stated that the purpose of Section 17(d) and Rule 17d-1 is to prevent overreaching by an investment company affiliate where the affiliate has a conflict of interest with the investment company. The SEC and the courts have thus acknowledged that these provisions do not reach every economic relationship between the fund and its affiliate.

The SEC staff has also stated that for an economic relationship between a fund and its affiliates to fall within the purview of Rule 17d-1, there must be some element of combination or profit motive. The staff further stated that the requisite element of combination or profit motive is present when the affiliate of a fund has both a "material pecuniary incentive" in the transaction or arrangement and "the ability to cause the investment company to participate" in the transaction. In such situations, the fund may cease to be a "free agent."

Application to Alternatives. While many alternatives do not pose affiliate transaction issues, all arrangements with affiliates should be reviewed in the product design stage to determine whether they are permitted, and if not, whether exemptive relief is necessary. The application of the affiliated transaction prohibitions of the Act will depend on the structure of the vehicle.

Circumstances that raise potential conflicts of interest should also be reviewed under Section 17(d). Often potential conflicts of interest can be addressed through procedures that, depending on the circumstances, are designed to eliminate or manage the conflict. For example, potential conflicts can arise where the adviser for the alternative strategy will be managing both the fund and private or proprietary accounts. In that case, the adviser typically adopts "side by side" procedures that address potential conflicts of interest in allocation of trades and investment opportunity.

6. Custody

Section 17(f) of the 1940 Act requires all funds to place and maintain their assets with only eligible fund custodians, as designated in the section of the Act and the SEC rules thereunder. 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 for 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 registered investment companies 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.

Application to Alternatives. For most purposes, custody will be an operational issue, dealt with in the implementation phase (for example, in connection with margin posted for short sales and centrally cleared swaps). However, where foreign custody in particular countries will be required, it should be addressed in advance. The securities clearance, settlement and securities holding systems in frontier markets may not be as reliable as those of developed markets or emerging markets. As a result, issues relating to the ability of a fund to place and maintain its

assets with eligible fund custodians may arise. The staff of the SEC in the past has shown some flexibility in addressing unique securities holding systems. See Templeton Russia Fund, Inc. (pub. avail. Apr. 18, 1995). 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.

Emerging Issues

1. ETF Moratorium

On March 25, 2010, the SEC announced that it was conducting a review to evaluate the use of derivatives by mutual funds, ETFs, and other investment companies. Pending completion of the review, the SEC staff determined to defer consideration of exemptive requests under the Act to permit ETFs that would make significant investments in derivatives. As a result, the staff is not reviewing applications to introduce new leveraged ETFs. With respect to actively managed ETFs, the Commission is only granting new relief to ETFs that agree not to invest in any futures, options, or swaps. New index-based ETF applications must clarify that the relevant indices would not include derivatives. Although the Commission issued its Concept Release on the use of derivatives by investment companies last year, there is still no indication of when the derivatives review will be complete, and when the ETF moratorium might be lifted or modified.

Application to Alternatives. Many ETFs offer exposure to traditional asset classes and strategies, but some ETFs also pursue alternative strategies, and some of those, in turn, would use derivatives to pursue these alternative strategies. The staff's decision affects new and pending exemptive requests from certain actively-managed and leveraged ETFs that particularly rely on swaps and other derivative instruments to achieve their investment objectives, and effectively prohibits the launch of these funds until the SEC completes its review.

2. Rule 4.5—CFTC Regulation of Commodity Pool Operators

On February 9, 2012, the CFTC adopted amendments that, among other things, narrowed the conditions under which registered investment companies ("funds") can claim exclusion from the definition of "commodity pool operator" ("CPO") under CFTC Rule 4.5 under the CEA. The CFTC also rescinded Rule 4.13(a)(4), which provided an exemption from registration for persons that operated private funds. Concurrently with the adoption of these amendments, the CFTC proposed amendments to part 4 of its regulations in an attempt to harmonize the compliance obligations for investment advisers of funds that will have to register as CPOs due to the amendments to Rule 4.5.

CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for funds that would otherwise fall within the definition. Current Rule 4.5 does not impose any trading or marketing restriction on funds that claim the exclusion.

Under the amended rule, a fund claiming the Rule 4.5 exclusion will be subject to both a trading threshold test and a marketing restriction test. Under the trading threshold test, the fund will

have to limit its trading in commodity interests that is not for bona fide hedging purposes so that the initial margin and premiums paid to establish positions in commodity interests will not exceed five percent of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses on such positions. In the alternative, a fund may claim the exclusion under Rule 4.5 if the aggregate net notional value of the fund's commodity interest positions (other than for bona fide hedging purposes), determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses on such positions. Under the marketing restriction test, a fund claiming the exclusion under Rule 4.5 would be prohibited from marketing the fund "as a vehicle for trading in commodity futures, commodity options, or swaps markets," for example, if it is explicitly offering a managed futures strategy.

The CFTC concluded that the investment adviser of a fund, rather than the fund itself, is the entity required to register as the CPO. As registered CPOs, advisers to affected funds will be required to comply with CFTC's reporting and disclosure regulations under the CEA. Because these regulations may conflict with requirements by the Investment Advisers Act of 1940, to which the adviser will also be subject, the CFTC has proposed a "harmonization" of the provisions of the two regulatory regimes. The proposed rule would provide relief from delivery and acknowledgment requirements, certain periodic financial reporting obligations, and the requirement that records be maintained at the CPO's main office. Additionally, the proposed rule addresses those areas where CFTC and SEC rules are in conflict with each other. For example, under the proposed CFTC rule, pools with less than three years of operations would have to present the performance of other pools operated by the adviser. The CFTC has acknowledged that this may conflict with SEC limits on the use of past performance and has sought comment on the requirement. Other conflicts relate to where in the disclosure document a particular disclosure is required to be.

The amendments to Rule 4.5 are effective as of April 24, 2012. Compliance with amendments to CFTC Rule 4.5 for purposes of registration only will occur on the later of either December 31, 2012 or within 60 days following the adoption of final rules defining the term "swap," and establishing margin requirements for such instruments. Investment advisers of funds required to register due to the amendments to Rule 4.5 will be subject to the CFTC's recordkeeping, reporting, and disclosure requirements set forth in part 4 of the CFTC rules within 60 days following the effectiveness of a final rule implementing the CFTC's proposed harmonization effort. The release accompanying adoption of the amendments did not distinguish between funds relying on Rule 4.5 before the effective date of the amendments and funds that are launched after the effective date but prior to the compliance date; however, we understand that the CFTC staff takes the position that these new funds may not be able to rely on the December 31 compliance date for registration, although they may await the final swap definition if that definition is required to determine whether they meet the thresholds.

Application to Alternatives. Advisers to funds with significant "non-hedging" commodities activities, and advisers to controlled foreign corporations with such activities, will be required to register as CPOs and ultimately to comply with CFTC reporting, disclosure and other requirements as well as regulation imposed on fund advisers under the 1940 Act and the Investment Advisers Act of 1940. Because the harmonization rules are still in the proposed

stage, there is no certainty as to the scope and impact of those rules. However, based on the proposal, there is industry concern that CFTC regulation of CPOs in the fund context could impose both duplicative and inconsistent burdens. The rule amendments also remove an important exemption from commodity trading advisor ("CTA") status, so advisers required to register as CPOs may also have to register as CTAs.

B. Implementation and Registration Phase

Classic Issues

1. Board Approval of Advisory and Other Agreements

Under Section 15(c) of the 1940 Act, in order for a person to serve as the investment adviser of a registered fund, the investment advisory contract between the fund and the adviser must be approved by a majority of the board, including a majority of the independent trustees of the fund. Section 15(c) also provides that the board must request and the adviser must provide all information reasonably necessary to evaluate the contract. Section 36(b) of the Act imposes a fiduciary duty upon the adviser with respect to the receipt of fees and gives fund shareholders a private right of action against the adviser for breach of this fiduciary duty, subject to certain procedural limitations. Case law under Section 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. See Jones v. Harris Associates, 130 S. Ct. 1418 (2010), citing Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982). Based on a combination of Section 15(c) and Section 36(b), as well as general fiduciary obligations of the 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 adviser's experience and skill in performing its duties under the agreement and the appropriateness of the fees to be charged. The process whereby the independent trustees review and consider information about the advisory relationship is commonly known as the 15(c) process.

SEC disclosure rules require funds to disclose in their shareholder reports the factors the board considered in the 15(c) process and the conclusions reached, including, among others, the nature of the services provided.

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

Application to Alternatives. Where a proposed investment strategy is complex, novel, or otherwise unfamiliar to a fund board, the 15(c) process may entail additional educational and informational components and extra time to answer questions that may need to be built into the process. Skill and experience of the portfolio management team are likely to be areas of focus,

including provision of track record information, if available. Boards will want to satisfy themselves, where relevant, that comparatively higher fees are justified by the services provided and other factors. Compliance and disclosure, which are discussed below, may be important components of the process. If the fund will be retaining a sub-adviser, the Board will want to be satisfied that the adviser can adequately supervise the sub-adviser, and that the allocation of the advisory fee between the adviser and sub-adviser is appropriate.

2. Compliance Programs

Rule 38a-1 under the 1940 Act requires 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. Boards are also called upon to approve the compliance policies and procedures of the adviser, principal underwriter, administrator, and transfer agent. Funds must conduct an annual review of these compliance programs for adequacy and effectiveness, and 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, including the advisers to registered funds, to implement policies and procedures reasonably designed to prevent violations of the Advisers Act.

In designing compliance policies and procedures, funds and advisers must first identify conflicts and other compliance factors creating risk exposure for the adviser, the fund, and shareholders, in light of the fund's particular operations, and then design policies and procedures that address those risks. The SEC has suggested that adviser compliance programs, at a minimum, address specific matters, including:

- The portfolio management process, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons; and
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.

The SEC has stated that fund compliance programs should, at a minimum, cover certain critical areas of fund operations, including: (i) the pricing of portfolio securities and fund shares, including with respect to fair valuation; (ii) the identification of affiliated persons; (iii) the protection of nonpublic information; (iv) market timing; and (v) disclosure of portfolio holdings.

Application to Alternatives. Funds adopting alternative strategies may not have existing compliance programs that address all relevant aspects of the new strategy. Management and boards typically review the new strategies for additional risks and adopt additional policies and procedures were appropriate. Certain types of strategies, for example those that rely on quantitative analysis (sophisticated mathematical or computer modeling techniques to explain or predict the movements of a financial market) may suggest specialized compliance procedures. See In re AXA Rosenberg Group LLC, Securities Act Release No. 9181 (Feb. 3, 2011) (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). It may also be appropriate to amend existing policies, such as valuation, liquidity monitoring, and trading allocation procedures, to take into consideration the alternative strategy. Moreover, to the extent the alternative strategy will involve personnel that are new to the registered environment, additional compliance training and supervision may be appropriate.

3. Prospectus Disclosure and the Registration Process

Under the SEC's summary prospectus rules, a fund must set forth in plain English the fund's principal investment objectives, strategies and risks. The longer "statutory" prospectus and Statement of Additional Information ("SAI") provide more detailed information for investors seeking such additional information. See Form N-1A, Registration Form Used by Open-End Management Investment Companies.

Registration statements for new funds are typically filed with the SEC with a 75-day waiting period during which the SEC staff reviews the disclosure and provides comments.

Application to Alternatives. For complex strategies, it can be challenging to describe the fund's principal strategies and risks in a plain English, summary form. It is not uncommon to receive substantial questions and comments from the SEC staff with respect to both the strategy and the disclosure. Detailed description in the statutory prospectus and SAI can also lead to questions about the various practices described, including questions concerning valuation and asset segregation policies for derivatives.

Certain areas that may be the focus of staff attention are:

Disclosure of derivatives. In a July 30, 2010 letter from the SEC staff to the Investment Company Institute, the SEC staff stated that all funds that use or intend to use derivative instruments should assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner using plain English. Any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance. The disclosure concerning the principal risks of the fund should similarly be tailored to the types of derivatives used by the fund, the extent of their use, and the purpose for using derivative transactions. Finally, a fund should assess the completeness and

accuracy of the derivatives-related disclosures in its registration statement in light of its actual operations.

Fund names. Section 35(d) of the 1940 Act prohibits a fund from adopting as part of its name any word or words that the Commission finds are materially deceptive or misleading. Rule 35d-1, adopted under this provision, prohibits a name suggesting that the fund focuses its investments in a particular type of investment, a particular industry or group of industries, or a particular country or geographic region unless the fund has a policy to invest, under normal circumstances at least 80% of the value of its assets in the particular type of investments, the particular industry or industries, or investments tied economically to the particular country or geographical region suggested by the fund's name. Historically, the rule has been applied fairly narrowly to apply to types of investments (such as stocks or bonds) rather than style of investments (such as growth or value) or particular strategies. In general, though, any type of name could be viewed as misleading if it represents the fund in a manner that does not reflect its actual practices. We understand that the SEC staff from time to time raises comments relating to the names of funds using alternative strategies.

Adoption of Predecessor Performance. The SEC staff has provided no-action relief permitting funds to include the performance of predecessor separate accounts in the fund performance presented in the funds' prospectus, statement of additional information, advertisements, and sales literature. See MassMutual Institutional Funds, SEC No-Action Letter (pub. avail. Sept. 28, 1995). In this case, the predecessor separate investment accounts, which were reorganized into the funds, were not registered entities, but they were managed in a manner equivalent to the management of the funds. Also, the funds were created for purposes entirely unrelated to the establishment of a performance record. Funds using alternative strategies may consider relying on the MassMutual letter to include prior performance of a predecessor private fund using the same strategy when the conditions are met.

Use of Related Performance. Generally, in appropriate circumstances, funds may include related party performance from another fund or account in the management section of the prospectus, although not in the performance section in the risk/return summary. The standards for inclusion of such performance are set forth in a no-action letter provided to Nicholas Applegate Mutual Funds, SEC No-Action Letter (pub. avail. Aug. 6, 1996). In addition, under certain limited circumstances, the performance of a portfolio manager may be viewed as "portable." See Bramwell Growth Fund, SEC No-Action Letter (pub. avail. June 30, 1996). The same individuals must be responsible for the management of both funds, and the performance information must not be presented in a misleading manner and must not obscure or impede understanding of information that is required to be in the fund's prospectus. In practice, these conditions may be difficult to meet with respect to a strategy previously conducted outside of the fund's regulatory constraints. Note that FINRA does not permit related party performance in advertising materials. Note also that the CFTC's proposed rules on harmonization of regulation for CPOs would require presentation of past performance in certain situations that may conflict with SEC requirements. See "Rule 4.5 – CFTC Regulation of Commodity Pool Operators," above.

4. Custody

See the discussion under "Custody" above.

C. Roll Out Phase

Classic Issues

The Financial Institutions Regulatory Authority ("FINRA") imposes various obligations on its members and their associated persons in connection with the practices in marketing funds. In particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended, sales materials related to funds must be fair and accurate, and members must have adequate supervisory procedures in place to ensure that these obligations are met.

1. Suitability

NASD Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, a firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made. This analysis has two components. The first is determining whether the product is suitable for any customer, an analysis that requires members and associated persons to fully understand the products and transactions they recommend. The second component involves addressing suitability with respect to the circumstances of the particular customer. Customer specific suitability analysis requires that members make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and such other information used or considered to be reasonable by the member or registered representative in making recommendations to the customer.

A new consolidated FINRA suitability rule will become effective on July 9, 2012. New FINRA Rule 2111 retains most of the core features of the suitability obligations in former NASD Rule 2310. Similar to the NASD rule, the new FINRA rule will require a FINRA member to have "a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer …" The most significant change is the expansion of a member's suitability obligation to apply to recommendations of investment strategies, including recommendations to "hold" securities, in addition to recommendations for the "purchase, sale or exchange of any security." The new Rule requires members to think more broadly about what "strategy" has been recommended to the customer and whether it is suitable, and they must understand that their suitability obligations may not begin and end with a specific order.

2. Communications

Members' communications with the public must also comply with NASD Conduct Rule 2210 and Interpretive Materials under NASD Conduct Rule 2210. Communications with the public, which include advertisements, sales literatures, and correspondence, must meet certain content standards, including prohibition on false, exaggerated, unwarranted or misleading statements or

claims. In addition, fund advertisements and sales literature must be filed within 10 days of first use or publication.

3. Supervision

FINRA Rule 3010 details supervision requirements. Members are required to maintain a supervisory system for their registered representatives. Written procedures must be created to ensure oversight of the representatives' activities in handling customer accounts. In addition to establishing written procedures, members must document the steps they have taken to ensure adherence to these procedures.

4. Training

FINRA Rule 1250 also sets forth the minimum standards for training programs, which must cover investment features and risks, suitability, and regulatory requirements, for securities products, services, and strategies offered by a member.

Application to Alternatives. With respect to funds with alternative strategies that are novel or complex, all aspects of the distribution process may require additional time and attention in order to ensure that the sales force has an understanding of the product sufficient to make an appropriate suitability determination and that marketing materials communicate the strategies, and their attendant risks, fairly and effectively. This may involve a broader educational effort using a multi-disciplinary approach, including participation by the portfolio managers who are most familiar with the product.

With respect to leveraged and inverse exchange-traded funds, FINRA has provided specific views. Regulatory Notice 09-31 reminds firms of sales practice obligations relating to these funds. In the Notice, FINRA took the view that "[w]hile such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis…. Therefore, inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets." Accordingly, FINRA stated that these products raised issues with respect to communications with the public, suitability, supervision and training. After the Investment Company Institute, among others, expressed concern that FINRA should not be suggesting that any product is per se unsuitable, FINRA clarified its position in the following "FAQ" relating to Non-Traditional ETFs: "Q. Can leveraged and inverse ETFs be suitable for a retail investor? A. While it is not FINRA's position that all leveraged and inverse ETFs are unsuitable for all retail customers, firms that recommend them must carefully consider their suitability for each customer." Non-Traditional ETFs FAQ, FINRA, at http://www.finra.org/Industry/Regulation/Guidance/P119781.

5. Performance Advertising

See the discussion under "Prospectus Disclosure and the Registration Process" above.

Emerging Issues

In January 2012, FINRA released Regulatory Notice 12-03 regarding heightened supervision of "complex products." The Notice expressly states that it does not define the term complex products, but indicates that the term may include a security or investment strategy with novel, complicated or intricate derivatives-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities. The Notice provides guidance to firms about the supervision of these products, whose features may make it difficult for a retail investor to understand the essential characteristics of the product and its risks.

The Notice reminds members of the importance of supervision and training for complex products and provides examples of heightened supervisory and compliance procedures that may be appropriate. The Notice states that the decision to recommend complex products to retail investors is one that a member should make only after the member has implemented heightened compliance and supervisory procedures. These heightened compliance and supervisory procedures may include procedures to ensure that members' registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted and procedures to monitor how the products performed after the member approved them. In addition, the Notice recommended training of registered representatives who recommend complex products to ensure they understand the features and risks associated with those products.

The Notice does not expressly mention alternative strategies or registered funds, other than leveraged exchange-traded funds, although it does refer to hedge funds. For products determined to be complex products within the meaning of the Notice, member firms will be subject to significantly increased supervision and training requirements.

IV. Conclusion – The Importance of Education

Reviewing alternative strategies for transitioning into the registered fund space may seem at times like taking—or teaching—a course in Mutual Funds 101. And in fact, legal education of all involved in the three phases of the fund's launch is a significant component of the process. Nonetheless, as is clear from the materials presented showing fund launches of more and different alternative strategies, the process is doable. Because of the nature of alternatives, where they come from, and the potential for "culture shock" for those encountering fund regulation for the first time, perhaps the main lessons learned are: to review all potential issues—even those we have assigned to the roll out phase—as early in the process as possible, in order to assess and communicate their consequences; to involve a multi-disciplinary team and an open dialogue among all constituents; and to build enough time and resources into the process to allow for education of all concerned, including the regulators.