Integrating Regulated Funds onto Your Platform

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MANAGED FUNDS ASSOCIATION

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I. Background

A. Industry Trends and Developments

1. In recent years, mutual fund advisers and financial intermediaries (including broker-dealers, banks, financial advisers and insurance companies) have begun to add alternative investments to their product menus and recommended client portfolio allocations.

2. Some firms have built their own infrastructures to deliver alternative investment products. Others have partnered with managers of private investment funds, formed joint ventures to offer these products or acquired private fund managers.

3. One reason for these developments is the increased focus of traditional advisory firms and financial intermediaries on high-net-worth investors and the "mass affluent" market. In addition, to reduce volatility and provide a source of non-correlated returns, a growing number of financial intermediaries are recommending allocation of clients' assets to alternative asset classes and alternative strategies that seek "absolute returns."

4. Alternative investment products offer a way for traditional asset managers and fund distributors to: enhance revenues (from performance-based compensation structures), diversify sources of revenues, offer new opportunities to portfolio managers and retain key talent, and satisfy the growing demand for alternative investment strategies.

5. A growing number of private fund managers are seeking to grow their assets under management by accessing retail investors and distribution channels (including the 401K market) and are seeking to diversify their product offerings and revenue streams. Building asset-based revenues is attractive to private fund managers because, in valuing a private fund manager, the multiples assigned to asset-based fees (which are relatively predictable) are generally higher than those assigned to performance-based revenues (which are not predictable). Other developments may also increase private fund manager interest in retail distribution opportunities:

   (a) The investment adviser of an investment company registered under the Investment Company Act of 1940 (the "1940 Act") must be a registered investment adviser. The Dodd-Frank Act required the registration of many advisers to hedge funds and other private investment funds. This expanded the universe of private advisers eligible to sponsor and manage registered funds.

   (b) The approval by the Securities and Exchange Commission (the "SEC") of final rules implementing the JOBS Act removes the ban of Regulation D on the use of general solicitations and advertising in connection with private offerings. This gives private fund managers the option of "branding" their businesses and may encourage some private fund managers to capitalize on the value of their brands by offering retail products.

6. A 1997 amendment of Subchapter M of the Internal Revenue Code of 1986 (the "Code") (which governs the taxation of mutual funds) facilitated the ability of registered investment companies to make greater use of certain investment techniques associated with alternative investment strategies (such as short sales of securities) consistent with applicable qualification requirements.

B. Growth of Alternative Registered Funds

1. In February 2015, McKinsey & Company issued a report titled "The $64 Trillion Question: Convergence in Asset Management" that projects growth of the retail segment of the market will be

a primary force behind the growth of alternative investments (particularly in the United States). The report estimates that by 2020, alternatives will comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues.

2. According to a recent *Bloomberg Business* article, liquid alternative funds had approximately $715 billion of total assets under management in 2015.[1] As of June 2015, there were approximately 652 alternative mutual funds in the U.S. market, according to a recent *Hedgeweek* special report.[2]

3. According to a 2015 report by PwC titled *Alternative Investments: It's Time to Pay Attention*, liquid alternative funds registered under the 1940 Act are expected to grow at a compounded annual growth rate of 18 percent from now until 2020. Another PwC report titled *Alternative Asset Management 2020: Fast Forward to Centre Stage* estimates the demand for liquid alternative mutual funds to increase from $260 billion at the end of 2013 to around $664 billion by 2020.

II. Benefits of 1940 Act Registration

A. Broader Flexibility in Offerings

1. Private investment funds relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act for an exclusion from the 1940 Act definition of the term "investment company" are not required to register under the 1940 Act.

    (a) Section 3(c)(1) requires that a fund be sold in a private offering and limits the number of beneficial owners of interests in the fund to not more than 100 persons.

    (b) Section 3(c)(7) requires that a fund be sold in a private offering and that investors be limited to persons who are "qualified purchasers" as defined by Section 2(a)(51) of the 1940 Act (generally, individuals who own "investments" of $5 million or more and entities that own "investments" of $25 million or more).

    (c) The private offering requirements of Section 3(c)(1) and Section 3(c)(7) essentially require that offerings be made only to "accredited investors," as defined by Rule 501 of Regulation D under the Securities Act of 1933 (the "1933 Act") (generally, individuals having a net worth of more than $1 million or annual income in excess of $200,000).

2. Registration of a fund under the 1940 Act allows a fund to have more than 100 investors, without the need to sell interests in the fund only to qualified purchasers. This makes registered funds better suited to broad offerings by brokerage firms and financial advisory firms that have large numbers of clients, many of whom are not qualified purchasers. Also, the elimination of the 100-investor limit enables product sponsors to set lower minimum initial investment requirements without adversely affecting the amount of assets that can be raised.

3. A registered fund can make a public offering by registering its shares under the 1933 Act. A publicly offered fund need not limit its investors to persons who are "accredited investors," may use advertising and may offer its securities to persons with whom it does not have a pre-existing substantive relationship.

4. Like registered funds, business development companies ("BDCs") are not subject to various constraints applicable to private investment funds.

[1] "Hedge Fund Copycats Draw Record Money as Clients Seek Safety" (Dec. 11, 2015).

[2] "The Ascent of Liquid Alternatives" (November 2015).

(a) A BDC may sell its shares in a public offering.

(b) There are no limitations that restrict the persons to whom shares of a BDC may be sold.

(c) BDCs do not register under the 1940 Act. However, they are regulated in substantially the same way as registered funds, with certain exceptions.

5. Registered funds and BDCs may seek to qualify as "regulated investment companies" ("RICs") under Subchapter M of the Code. This enables the funds, under certain circumstances, to avoid entity-level taxation and to provide simplified tax reporting to investors on Form 1099.

6. Attachment A (Comparison of U.S. Alternative Fund Structures) provides a comparison of the structure and features of private investment funds to those of registered funds and BDCs.

B. Other Benefits of 1940 Act Registration

1. Generally, a private fund's assets will be deemed "plan assets" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") if 25 percent or more of the value of interests in the fund are owned by ERISA plans. Section 401(b)(1) of ERISA, however, explicitly provides that the assets of a fund registered under the 1940 Act are not plan assets. Thus, regardless of the extent of ownership by employee benefit plans, a registered fund's assets will not be plan assets and ERISA constraints will not apply to the management and investment of those assets.

2. The adviser of a fund (whether a private fund or registered fund) that makes use of commodity futures and other commodity interests may be eligible for an exemption from registration as a commodity pool operator ("CPO") and registration as a commodity trading advisor if the fund trades a de minimis level of commodity interests. However, advisers of registered funds have a somewhat greater ability than private fund managers to avail themselves of exemptions from registration and avoid various regulatory requirements imposed by the Commodity Futures Trading Commission.

   (a) Rule 4.13(a)(3) under the Commodity Exchange Act of 1974 (the "CEA") provides an exemption from registration as a CPO to the manager of a private investment fund if the fund's use of commodity interests is limited so as to meet one of two de minimis tests and the fund is not marketed as a commodity pool or as a vehicle for trading in commodities.

   (b) The adviser of a registered fund may also avail itself of an exemption from CPO registration (pursuant to Rule 4.5 under the CEA) if similar requirements are met. However, in determining compliance by a registered fund with the de minimis tests, commodity interests used for "bona fide hedging" purposes need not be considered.

3. FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) prohibits broker-dealers from allocating to specified "restricted persons" shares being sold in public offerings of "new issues" of equity securities that trade at a premium in the secondary market. As a practical matter, the rule requires that private funds create a "carve out" so that profits from new issues are allocated only to persons who are not restricted. The prohibitions of Rule 5130 do not apply to sales of new issues to registered funds.

III. Types of 1940 Act Registered Alternative Funds

A. Types of Funds

1. Registered funds are being used to deliver various types of alternative investment programs. Registered alternative funds include: single manager/strategy funds (e.g., long/short, market neutral, hedged equity); multi-manager alternative funds; private equity funds; funds of hedge funds and funds of private equity funds; and real asset/commodities funds.

2. Generally, registered alternative funds are organized either as closed-end funds or open-end funds (including open-end funds that operate as exchange-traded funds). The choice between these two structures is typically driven by the nature of a fund's investment program, the nature of its portfolio and consideration of other factors, including the fund characteristics/features desired by distribution channels.

   (a) Open-end funds, by definition, are registered management investment companies that issue redeemable securities (i.e., shares that are redeemable at the option of the investor).

   (b) A closed-end fund is a registered management investment company that does not issue redeemable securities.

   (c) The provisions of Rule 22c-1 under the 1940 Act require that shares of open-end funds be redeemable on a daily basis. A closed-end structure avoids this requirement and thus enables greater control over the timing of cash flows to/from a fund. This structure may be required for funds that invest in illiquid securities but may also be appropriate for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance.

   (d) Under SEC interpretations of Section 22(e) of the 1940 Act, an open-end fund may not invest more than 15 percent of its assets in illiquid securities. Thus, an open-end structure is not feasible for registered alternative funds that invest a significant portion of their assets in securities that are illiquid (e.g., registered funds of hedge funds, registered private equity funds and certain distressed funds).

   (e) Although a closed-end investment company issues interests that are not redeemable, investors in a closed-end fund can be provided with liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can provide liquidity similar to the liquidity of an investment in a private equity fund by providing liquidity (by making distributions to investors) only as the fund's investments are sold or become liquid.

   (f) Alternatively, as described in more detail below in III. C., shares of a registered closed-end fund can be listed for trading on a securities exchange, which provides daily liquidity to investors without impacting fund cash flows.

B. Non-Publicly Traded Closed-End Funds

1. A registered closed-end fund that is not traded on an exchange can be structured to have features similar to a private investment fund. Such a fund can be privately offered, impose a performance fee or incentive allocation, be taxed as a partnership and provide periodic liquidity to investors through repurchase offers. A privately offered fund needs to comply with Regulation D under the 1933 Act

and limit its investors to "accredited investors." In order to pay performance-based compensation, investors need to be "qualified clients." See III. D. below.

2. Non-publicly traded closed-end funds typically provide liquidity to investors by making offers to repurchase interests. Repurchase offers may be made in reliance on Rule 13e-4 (the issuer repurchase rule) under the Securities Exchange Act of 1934 Act (the "1934 Act") or in reliance on Rule 23c-3 under the 1940 Act (the "interval fund" rule). In both cases, interests in a fund are repurchased based on the net asset value of the interests, determined as of a specified valuation date.

   (a) Funds that do not rely on Rule 23c-3 cannot promise to make repurchase offers at specified periodic intervals. They can make discretionary repurchase offers on a recurring basis, but each such offer must be approved by the fund's board.

   (b) A fund that relies on Rule 23c-3 is required to make offers to repurchase at a specified interval (either quarterly, semi-annually or annually) and in each offer must offer to purchase a specified amount of interests equal to at least 5 percent, but not more than 25 percent of outstanding interests. Various other conditions are imposed by Rule 23c-3.

   (c) The conditions of Rule 23c-3 governing the timing and pricing of repurchase offers make it difficult for registered funds of hedge funds to rely on the rule. Such funds typically make repurchase offers in reliance on Rule 13e-4 under the 1934 Act.

   (d) A registered fund that elects to be taxed as a partnership must limit the frequency of its repurchase offers (and restrict transfers of interests) to avoid becoming a publicly traded partnership taxable as a corporation. Interests in the fund must not be redeemable or readily tradable. Semi-annual offers, and quarterly offers with a notice requirement of 65 days, are typically viewed as acceptable in this regard.

3. Depending on the combination of features that a non-publicly traded registered closed-end fund has, it can have the look and feel of a private investment fund or the look and feel of a mutual fund. The nature of the investor and the intended distribution channel generally play an important role in product design. For example, a large brokerage firm with retail distribution will generally prefer a more "investor friendly" product design, such as a publicly offered fund (which avoids the need to comply with rules applicable to private placements) that relies on Rule 23c-3 to make quarterly repurchase offers, does not pay performance-based compensation and is taxed as a "regulated investment company" under Subchapter M of the Code.

4. Public offerings by non-traded closed-end funds are subject only to notice filings under state "blue sky" laws.

C. Publicly Traded Closed-End Funds

1. From an adviser's perspective, a publicly traded closed-end fund is a "permanent capital" vehicle (i.e., assets under management are not subject to decrease as a result of redemptions of shares or withdrawals of capital).

2. Generally, these funds have very few 1940 Act limitations on the nature and type of their investments. As a result of their greater investment flexibility, publicly traded closed-end funds are often used by asset managers in lieu of a "BDC" structure (which is further described in IV. below) to allow offshore or other investments that would be considered "bad" assets for a BDC.

3. As a practical matter, incentive fees on realized capital gains for publicly traded registered funds are not feasible. However, BDCs may pay performance fees based on net realized capital gains and both registered funds and BDCs may pay fees computed as a percentage of their income.)

D. Open-End Funds

1. Lately, there has been a growing number of registered open-end investment companies (mutual funds) that pursue alternative investment strategies, including multi-manager alternative funds that are sub-advised by private fund advisers that are each responsible for managing a “sleeve” of a single fund investment portfolio.

2. Rule 22c-1 under the 1940 Act requires that mutual funds determine the net asset value of their shares and honor requests for redemptions of shares on a daily basis. Under Section 22(e) of the 1940 Act, mutual funds must make payment of redemption proceeds within seven days absent certain specified extraordinary circumstances (such as when the New York Stock Exchange is closed other than for customary closings). Because of these requirements, the SEC and its staff take the position that mutual funds may not invest more than 15 percent of their assets in illiquid securities (10 percent in the case of money market funds).

3. Generally, mutual funds are publicly offered on a continuous basis, and investors can purchase shares on a daily basis. For this reason, mutual funds must periodically update their prospectuses and other disclosure documents by filing post-effective amendments to their registration statements with the SEC.

4. Generally, mutual funds need to qualify as RICs to avoid entity-level taxation (because the publicly traded partnership rules would preclude partnership taxation of a 1940 Act registered fund that provides daily liquidity).

5. Exchange-traded funds (“ETFs”) are typically structured as open-end funds. Unlike a mutual fund, however, the shares of an ETF trade on a stock exchange at prices determined by the market.

    (a) Unique to an ETF is the process by which shares of an ETF are created. Large institutional investors and market makers have the ability to provide baskets of securities to an ETF in exchange for blocks of shares called “creation units” which shares can then be sold on an exchange. Similarly, shares of ETFs can be redeemed in creation units on an “in-kind” basis. It is this mechanism that, in large part, enables the prices at which ETF shares trade to closely reflect the net asset value of the shares.

    (b) ETFs can be index-based or actively managed.

E. Performance-Based Fees/Allocations

1. A registered fund that pays performance-based compensation (other than a fulcrum fee) cannot be listed for trading on a securities exchange because there presently are no mechanisms that would enable the fund to restrict ownership of its shares to investors who are qualified clients.

2. A registered fund can have a fee structure that is similar to that of private investment funds (e.g., an asset-based management fee and a performance-based incentive allocation or incentive fee that is a specified percentage of net profits) if interests in the fund are sold only to “qualified clients.”

    (a) Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”) provides an exemption from the general Advisers Act prohibition on performance fees where a fund is sold

only to persons who are "qualified clients" (generally, a person with a net worth of more than $2 million, excluding the value of their principal residence, or who has at least $1 million under the management of the fund's adviser and its affiliates).

(b) Under the provisions of Rule 205-3, interests in a registered fund of hedge funds that does not impose a performance-based fee (or allocation) must also be sold only to qualified clients if the registered fund invests in any domestic hedge fund that: (i) has a performance-based compensation arrangement; (ii) relies on Section 3(c)(1) of the 1940 Act; and (ii) is managed by a registered adviser. (This results from a "look through" to the investors in the registered fund that is required by Rule 205-3 when determining whether investors in the underlying hedge fund are qualified clients.)

3. Section 205(b)(2) of the Advisers Act permits the adviser of a registered fund to receive compensation based on the net asset value of the fund averaged over a specified period and increasing and decreasing proportionately based on the investment performance of the fund measured over a specified period relative to the investment performance of an appropriate securities index. Such fees (called "fulcrum fees") must be computed in accordance with Rule 205-1 and Rule 205-2 under the Advisers Act.

IV. Business Development Companies

A. Characteristics of BDCs

1. A BDC is a closed-end management investment company that elects to be regulated under the BDC-related provisions of the 1940 Act in lieu of registering as an investment company under the 1940 Act. In many respects, a BDC is regulated under the 1940 Act in the same way as a registered closed-end fund.

2. Subject to certain requirements discussed below, BDCs may invest in equity securities or debt securities. A BDC that invests primarily in loans and other types of debt securities is essentially a hybrid between a public finance company and a registered investment company from a regulatory perspective and provides access to public capital markets.

3. Shares of a BDC may be offered publicly (and such shares may be listed for trading on a securities exchange) or may be offered in a private placement.

4. Privately offered BDCs may only be sold to accredited investors. Private BDCs are typically sponsored by private equity firms. In many cases, shares are offered through a private placement to the sponsor's existing investor base, rather than via a continuous public offering. BDCs following this model typically draw down capital via capital calls, similar to a private equity fund structure. A private BDC will generally target a future initial public offering and exchange listing.

5. BDCs are permitted by Section 205 of the Advisers Act to charge management fees and incentive fees similar to traditional private fund structures without any limitation as to whether its shareholders are qualified clients.

6. In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets. Such "good" or eligible assets are U.S.-organized, privately held (or "micro-cap" public) operating companies (non-3(c)(1) or -3(c)(7) entities). For these purposes, "micro-cap" companies are those with less than $250 million in public market capitalization.

7. A BDC must have at least a 200 percent asset coverage ratio (total assets to debt) at the time of any new borrowings. These asset coverage requirements are less stringent than those applicable to registered funds. See IX. A. below.

8. BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional public operating companies.

9. BDCs can elect to be taxed as RICs. The same qualification requirements under the Code that apply to registered funds apply to BDCs that seek to be taxed as RICs. Where a BDC is taxed as a RIC, tax-exempt investors may invest directly in the BDC, rather than through an offshore blocker. See VI. below.

B. Benefits of BDC Status

1. Unlike a private investment fund, a BDC is not required to limit the number of its investors or to sell its shares only to qualified purchasers.

2. Also, because a BDC (unlike a private investment fund) can make a public offering, it may advertise and sell its shares to investors who are not accredited investors.

3. A BDC can charge a performance fee without limiting its investors to qualified clients.

4. If a BDC elects to be taxed as a RIC, it may avoid entity-level taxation and provide tax reporting to investors on Form 1099, which is preferred by investors.

5. In certain respects, BDCs have somewhat greater flexibility under the provisions of the 1940 Act regulating transactions with affiliates.

C. BDC Management

1. The investment adviser of a BDC may be paid a performance fee that does not exceed 20 percent of the BDC's net realized capital gains. In addition, the adviser may earn an asset-based fee as well as a fee based on a percentage of the BDC's income.

2. Some BDCs are internally managed by employees of the BDC. Under these circumstances, employees can be compensated by the BDC through salaries and pursuant to a "profit-sharing plan" that pays out annually no more than 20 percent of the BDC's net income.

3. A BDC must "make available" to its investee companies "managerial assistance" (e.g., offer to serve on the company's board or to provide strategic consulting). A BDC may be compensated for providing these services.

D. Other Regulatory Considerations

1. BDCs must make regular public disclosures of their financial condition (financial statements, including a schedule showing each of their investments) on a quarterly basis (i.e., on Forms 10-Q and 10-K).

    (a) Following the last quarter of a fiscal year, the publicly disclosed financials statements (on Form 10-K) must be audited.

    (b) Quarterly and annual financial statements are subject to Sarbanes-Oxley certifications.

2. BDCs have ongoing 8-K reporting obligations and must disclose certain material corporate events promptly on Form 8-K.

3. A BDC may be restricted in its ability to co-invest with other funds and accounts managed by the investment adviser of the BDC. See V. B. below.

V. Key Implications of 1940 Act Regulation

A. Applicability of 1940 Act Investment Restrictions

1. Registered funds and BDCs are subject to various investment-related restrictions and limitations imposed by the 1940 Act. Among other things, these include restrictions on investments in the securities of securities-related issuers (Section 12(d)(3) of the 1940 Act) and limitations on the use of leverage (Section 18 of the 1940 Act), which imposes asset coverage requirements applicable to the issuance of "senior securities".[3]

2. The use of registered funds is feasible for delivering alternative investment strategies to investors only where the investment programs fit within the 1940 Act regulatory scheme. However, most hedge fund investment programs, including those involving short sales of securities, can be implemented consistent with requirements of the 1940 Act, except for certain highly leveraged strategies.

B. Prohibitions on Transactions with Affiliates

1. The 1940 Act and the rules thereunder contain various provisions (e.g., Section 17(a) and Rule 17d-1 for registered funds and Section 57 for BDCs) that generally prohibit affiliated persons of a registered fund or BDC, and affiliated persons of such persons, from engaging in any principal transaction, or any joint enterprise or other joint arrangement, with the registered fund or BDC.

2. The provisions of Rule 17d-1 (and Section 57(a)(4) with respect to BDCs) prohibiting joint enterprises need to be considered in connection with the purchase or sale of privately offered securities where both a registered fund and any of its affiliated persons (including other funds) are purchasing or selling the same securities.[4]

3. BDCs frequently obtain SEC exemptive orders permitting co-investments with affiliated funds that would otherwise be prohibited pursuant to Section 57(a)(4).[5]

4. The prohibition of Section 17(a) on affiliated transactions must also be considered when managing a registered fund of hedge funds. Generally, a private fund in which a registered fund of hedge funds proposes to invest may be an affiliated person of the registered fund if: (i) the adviser of the registered fund of funds serves as or is affiliated with the general partner/adviser of the private fund; (ii) the registered fund of funds owns five percent or more of the outstanding voting securities of the private fund; or (iii) funds and other accounts managed by the adviser of the registered fund of funds own, in the aggregate, five percent or more of the outstanding voting securities of the private fund (Section 2(a)(3) of the 1940 Act). For this reason, registered funds of hedge funds (and their affiliates) typically purchase a class of non-voting securities of the underlying fund or contractually waive their voting rights when investing in private funds.

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[3] *See* VIII. A., *infra*.

[4] *See* VIII. D. 1., *infra*.

[5] *See also* IX. C., *infra*.

5. Although Section 17(a) generally prohibits a registered fund from purchasing securities from or selling securities to an affiliated person of its investment adviser (including private investment funds managed by the registered fund's investment adviser), such transactions are permitted by Rule 17a-7 under the 1940 Act in the case of securities for which market quotations are readily available if the registered fund is affiliated with the other party to the transaction solely by reason of having the same investment adviser (or an affiliated adviser), common directors and/or common officers. Rule 17a-7 may not be available to permit cross-trades between a registered fund and a private fund where the funds are affiliated as a result of the adviser of the funds serving as general partner or owning 5 percent or more of the interests in the private fund.

6. Section 17(e)(2) of the 1940 Act and Rule 17e-1 thereunder generally permit the use of a broker-dealer affiliated with the registered fund's adviser to effect securities transactions on an agency basis, subject to a condition that the commissions paid to the affiliated broker not exceed the "usual and customary" broker's commission.

C. "Corporate Governance" Requirements

1. The 1940 Act imposes certain governance requirements under which registered funds and BDCs are required to have "independent directors" and requires that various matters be approved by these directors (and, in some cases, also approved by fund shareholders).

2. Among other requirements, investment advisory agreements and distribution agreements of registered funds and BDCs must be approved by a majority of the independent directors. These agreements may have initial terms of two years and can continue in effect thereafter only if approved annually by a majority of the independent directors. In addition, the agreements must provide for automatic termination in the event of an "assignment" and for termination by the registered fund or BDC on not more than 60 days' notice.[6]

3. In recent enforcement proceedings against investment advisers in connection with the advisory agreement renewal process under Section 15(c) of the 1940 Act, the SEC has found that boards of directors were furnished with incomplete information (and in one case, that the board also failed to request sufficient information) and that shareholder reports misrepresented material information pertinent to the renewal process.[7]

D. Record-Keeping Rules and SEC Examinations

1. Rule 31a-1 under the 1940 Act requires that registered funds and BDCs maintain certain specified books and records.

2. Section 31(b) of the 1940 Act provides that these books and records are subject to reasonable periodic, special and other examinations by the SEC and its staff.

E. Public Reports

1. Registered funds must send audited annual reports and unaudited semi-annual reports to their investors within 60 days after the end of the applicable fiscal period. These reports, which are filed with the SEC and publicly available, contain financial statements, including statements of investments that identify all investments held by the funds. In addition, registered funds must file

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[6] *See* Section 15 of the 1940 Act.

[7] *In the Matter of Kornitzer Capital Management, Inc. and Barry E. Koster*; *In the Matter of Commonwealth Capital Management, LLC, et al.*; *In the Matter of Northern Lights Compliance Services LLC, et al.)*

reports with the SEC showing their investment holdings as of the end of their first and third fiscal quarters.

(a) Sarbanes-Oxley certification requirements are applicable to these filings and require that a registered fund's principal executive officer and principal financial officer certify the accuracy of the information contained in a registered fund's reports.[8] In addition, a registered fund must maintain disclosure controls and procedures and internal control over financial reporting as required by Rule 30a-3 under the 1940 Act.

(b) The SEC has recently proposed the adoption of new reporting requirements for registered funds that would expand the disclosure and reporting obligations of registered funds and require investment information to be filed with the SEC on a more frequent basis.[9]

2. BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional operating companies.[10]

3. Pursuant to Section 32(a) of the 1940 Act and related rules, the independent registered public accounting firm of a registered fund and a BDC must be selected by the vote of a majority of the independent directors at an in-person meeting.

F. Fund Administration and Compliance

1. Operating registered funds and BDCs requires implementation of systems to assure compliance with the 1940 Act and other laws.

(a) Rule 38a-1 under the 1940 Act requires that registered funds and BDCs adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. A registered fund must also appoint a chief compliance officer ("CCO"). A fund's compliance program and its CCO must be approved by the independent directors of the fund, and the independent directors must also approve the CCO's compensation.

(b) On an annual basis, the CCO must review the adequacy of the compliance program and provide a report to the fund board regarding that review.

(c) There is no prohibition on the CCO of a fund also serving as CCO of the fund's adviser.

2. Registered funds and BDCs require various administration, fund accounting and transfer agent services in connection with their operations. An outside administrator and transfer agent can be retained by a fund to supply these services. Frequently, the services provided by an administrator will include supervision of regulatory and tax compliance.

VI. Taxation of Registered Funds and BDCs

A. Taxation Options

1. Most registered funds and BDCs seek to qualify as RICs under Subchapter M of the Code. This enables the funds to avoid entity-level taxation if certain required distributions are made to investors and also enables the funds to provide simplified tax reporting to investors on Form 1099.

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[8] Rule 30a-2 under the 1940 Act.

[9] *Investment Company Reporting Modernization*, ICA Rel. No. IC-31610 (May 20, 2015).

[10] *See* IV. D, *supra*.

2. Registered closed-end funds can also opt to be taxed as partnerships, in which case tax reporting to investors is provided on Schedule K-1. If a registered fund is taxed as a partnership, it does not have to meet the requirements of the Code applicable to RICs.

3. There is a strong preference in retail distribution channels for tax reporting on Form 1099. However, when it is anticipated that concentration of a fund's investment positions or the sources of its income will preclude RIC qualification, a registered closed-end fund taxable as a partnership may be the only viable option.

4. Registered funds and BDCs that qualify as RICs are treated as corporations for tax purposes. Thus, there is no flow through to U.S. tax-exempt investors in such funds of unrelated business taxable income (UBTI).

5. Funds taxed as partnerships are typically organized as limited liability companies or limited partnerships. Funds taxed under Subchapter M are typically organized as business (or statutory) trusts or as corporations.

B. RIC Qualification

1. To qualify as a RIC, a registered fund or BDC must meet a quarterly diversification test as well as an annual test relating to the sources of its income.

   (a) Under the diversification test, as of the end of each taxable quarter, at least 50 percent of a RIC's assets must be represented by: cash; U.S. government securities; securities of other RICs and other securities as to which the RIC's investment is limited in respect to any issuer to an amount not greater than five percent of the value of the RIC's total assets and not greater than 10 percent of the outstanding voting securities of such issuer. In addition, a RIC generally may not invest more than 25 percent of its assets in the securities (other than U.S. government securities and securities of other RICs) of any one issuer or in the securities of one or more qualified publicly traded partnerships.

   (b) Under the source of income test, at least 90 percent of a RIC's gross income during its taxable year must be derived from: dividends; interest; payments with respect to securities loans; gains from the sale or other disposition of stock; securities or foreign currency; certain other income (including, but not limited to, gains from options, futures and forward contracts) derived with respect to its business of investing in stock, securities or currencies; or from net income derived from an interest in a qualified publicly traded partnership. For purposes of this test, non-qualifying (or "bad") income would include income derived from: non-financial commodities; direct ownership of real estate and rents from real property; certain unincorporated entities; and intangibles, such as trademarks, patents and royalties.

2. RICs sometimes use "blocker" entities taxable as corporations for U.S. tax purposes to hold investments that would generate bad income if held directly by a RIC in order to facilitate their investment programs.

VII. Multi-Manager Alternative Funds

A. Fund Features

1. Over the past few years, many mutual fund groups and fund of hedge funds managers have launched multi-manager mutual funds that pursue alternative investment strategies and hire private

fund managers as sub-advisers. Each sub-adviser has responsibility for managing a designated portion of the fund's portfolio allocated to it by the fund's adviser.

2. Sub-advisory agreements are entered into by the advisers (rather than by the funds) and the fees payable to the sub-advisers are typically paid by the advisers.

3. The funds obtain exemptive orders from the SEC pursuant to which sub-advisory agreements entered into with sub-advisers need not be approved by fund shareholders. The orders also provide exemptions under which the fee paid to each sub-adviser need not be publicly disclosed (although disclosure of aggregate fees paid to all sub-advisers is required).

B. Sub-Advisory Agreements

1. Sub-advisory agreements require the sub-advisers to manage the funds' assets consistent with fund investment policies and restrictions, applicable law and the requirements of Subchapter M. In most cases, the agreement requires the sub-adviser to manage its designated portion of the fund's assets as though it constitutes all of the fund's assets (which facilitates compliance by the fund with applicable investment-related restrictions) measured as a percentage of the fund's assets.

2. The agreements sometimes specify investment parameters that the sub-adviser will be expected to follow in managing the fund's assets (which are intended to control risk exposures and achieve desired risk/return characteristics). These parameters may be more restrictive than what is required under a fund's policies or by the 1940 Act.

3. In many cases, the sub-advisory agreement (or a separate agreement between the adviser and sub-adviser) may include additional terms relating to the sub-advisory relationship, such as: exclusivity provisions; a requirement that the sub-adviser charge a fee that is the lowest it charges to similarly-situated clients (i.e., a "most favored nation" or "MFN" provision); or an agreement relating to "capacity" (i.e., that the sub-adviser will agree to accept additional assets from the fund allocated to it by the adviser up to a specified amount). Careful consideration should be given to the nature of these supplemental provisions to assure that they do not involve arrangements intended to benefit the adviser or sub-adviser (and not the fund).

C. Supervision of Sub-Advisers

1. The adviser of a multi-manager mutual fund has a responsibility to supervise the services provided by each sub-adviser and to monitor those services for compliance with applicable investment policies and restrictions and applicable law.

2. Because private fund managers of registered funds often have little or no experience managing the assets of registered funds, it is important that advisers of multi-manager mutual funds conduct appropriate due diligence to assure themselves that prospective sub-advisers have implemented procedures and controls needed to assure investment-related compliance.

    (a) The due diligence process for sub-adviser selection should include consideration of whether a prospective sub-adviser has effective procedures that address compliance with 1940 Act requirements and Subchapter M.

    (b) Areas of focus should include: policies regarding trade allocations; trade error policies; procedures to comply with 1940 Act leverage limits; policies regarding the use of "soft dollars"; and expense allocation practices. Certain sub-adviser policies and practices used in

connection with managing private funds may not be permissible or acceptable when managing the assets of registered funds.

(c) Advisers of multi-manager mutual funds need effective systems to monitor compliance with investment-related restrictions and regulatory requirements that are based on ownership of specified percentages of an issuer's outstanding securities that cannot fully be controlled by the individual sub-advisers (e.g., beneficial ownership reporting under the 1934 Act and Subchapter M diversification requirements).

(d) Generally, sub-advisers should be required to adhere to fund adopted policies governing various matters, such as policies relating to the use of affiliated brokers (Rule 17e-1 procedures), cross-trades (Rule 17a-7 procedures); and purchases of securities in underwritten offerings in which an affiliated broker is a participant (Rule 10f-3 procedures).

(e) In the absence of definitive SEC guidance, there have been varying practices, regarding how to comply with asset segregation requirements applicable to certain types of derivatives. For this reason, advisers and sub-advisers should agree on the asset segregation procedures that will be used for various types of derivatives. However, the SEC has recently proposed a new rule regulating the use of derivatives by registered funds and BDCs that will, if adopted, impose specified asset segregation requirements.[11]

D. Board Oversight

1. The board of a multi-manager alternative mutual fund has important oversight responsibilities in connection with the operations of the fund.

2. Among other things, boards need to evaluate: the adviser's capabilities and experience in selecting sub-advisers; the controls in place to monitor services provided by sub-advisers and overall fund compliance with applicable investment-related restrictions; and whether sub-advisers have adequate procedures and controls to assure compliance with the 1940 Act and other legal requirements.

VIII. Registered Funds of Hedge Funds

A. Fund Characteristics

1. Registered funds of hedge funds are structured as closed-end funds.

2. Interests in registered funds of hedge funds have been offered in both private and public offerings.

3. The form of organization has typically been a limited liability company or limited partnership, except for funds that have elected to be taxed as RICs, which have typically been organized as trusts.

4. Interests in registered funds of hedge funds have not been publicly traded. These funds have provided liquidity to investors by means of repurchase offers, which are generally made pursuant to Rule 13e-4 under the 1934 Act.

[11] *See* IX. A . 6, *infra*.

B. Application of 1940 Act Provisions

1. The "fund of funds" restrictions of Section 12(d)(1) of the 1940 Act were amended in 1996 and no longer restrict the ability of a registered fund to invest in hedge funds or other types of private investment funds.

2. Investment in any one underlying hedge fund should not exceed 40 percent of a registered fund's assets. An investment in excess of this amount could result in the registered fund being deemed to be "formed for the purpose" of investing in the hedge fund, which would require the hedge fund to "look through" to the investors in the registered fund in determining its eligibility to rely on the exclusions made available by Section 3(c)(1) and Section 3(c)(7) of the 1940 Act. This "look through" requirement would likely result in the hedge fund being unable to rely on either of those exclusions because the registered fund will probably have more than 100 investors and have investors who are not qualified purchasers.

3. A hedge fund relying on Section 3(c)(1) of the 1940 Act needs to prohibit any registered fund from purchasing 10 percent or more of its outstanding interests. The purchase by a registered fund of an interest exceeding this limit would require the hedge fund to count investors in the registered fund as its beneficial owners for purposes of the Section 3(c)(1) requirement limiting beneficial owners to not more than 100 persons.

4. Assuming a registered fund does not "control" the hedge funds in which it invests, the hedge funds will generally not be subject to any of the provisions of the 1940 Act. (Under Section 2(a)(9) of the 1940 Act, control is presumed when a company owns more than 25 percent of the outstanding voting securities of another company).

5. However, the affiliated transaction prohibitions of the 1940 Act can become applicable to a hedge fund that accepts an investment from a registered fund.

   (a) Under Section 2(a)(3) of the 1940 Act, ownership by a registered fund of 5 percent or more of the outstanding "voting securities" of a hedge fund would cause the registered fund and the hedge fund to be affiliated persons of one another. Affiliation could also arise in other ways. For example, if the adviser of a registered fund manages funds (whether or not registered) and other accounts that, in the aggregate, own more than 5 percent of the voting securities of a hedge fund, the hedge fund would be an affiliated person of an affiliated person of the registered fund.

   (b) If the hedge fund is an affiliated person of a registered fund (or an affiliated person of such a person), Section 17(a) of the 1940 Act would generally prohibit the hedge fund from selling interests in such fund to the registered fund and prohibit the hedge fund from repurchasing such interests from the registered fund.

   (c) The term "voting security" is defined by Section 2(a)(42) of the 1940 Act to mean any security presently entitling the owner to vote for the election of directors of a company. However, the circumstances under which interests in a hedge fund should be considered voting securities are unclear. For this reason, registered funds of hedge funds, and other funds and accounts managed by the same investment adviser, typically purchase a class of non-voting securities of a hedge fund, or enter into irrevocable contractual waivers of their voting rights, to assure that their interests in the hedge funds are not voting securities. This practice enables registered funds of hedge funds and their affiliated persons to own, in the aggregate, 5 percent or more of the outstanding interests in a hedge fund. The SEC staff has not provided

any written guidance relating to this practice, but has not objected to use of these arrangements.

(d) Even in circumstances where voting rights have been waived or where a non-voting share class of a hedge fund is owned, significant ownership of the outstanding interests in a hedge fund may possibly cause the interests owned by a registered fund, and by funds and accounts managed by the registered fund's adviser, to be de facto voting securities.[12]

IX. Other Regulatory Considerations

A. Leverage and Use of Derivatives

1. Many registered alternative funds use short sales and derivatives in connection with their investment programs. These practices may be deemed to result in the issuance of "senior securities" subject to the limitations of Section 18 of the 1940 Act.

2. Generally, Section 18 of the 1940 Act imposes a 300-percent asset coverage requirement on closed-end investment companies with respect to the issuance of senior securities constituting indebtedness (which means that a fund needs $3 in total assets to cover $1 of borrowings). In the case of open-end investment companies, Section 18(f) of the 1940 Act generally prohibits the issuance of senior securities, but permits borrowings from a bank subject to maintaining 300-percent asset coverage.

3. BDCs are subject, under Section 61 of the 1940 Act, to a 200-percent asset coverage limitation.

4. Under interpretations issued by the SEC and its staff, an investment position of a fund will constitute a senior security for 1940 Act purposes if it creates a potential future payment or delivery obligation on the part of the fund. Transactions that are viewed as creating senior securities include: short sales, writing options, futures transactions, swaps, forwards, reverse repurchase agreements and when-issued commitments. However, generally, these transactions will not be deemed senior securities if a fund segregates on its books (or on the books of its custodian bank) liquid assets having a value (marked-to-market daily) at least equal to the amount of its potential obligations.[13]

5. Some registered alternative funds may use derivatives to facilitate implementation of investment exposures that they might not otherwise be able to achieve consistent with 1940 Act investment-related restrictions.

6. On Dec. 11, 2015, the SEC issued a release proposing to adopt new Rule 18f-4 under the 1940 Act.[14] The proposed rule, if adopted, will regulate the use of derivatives by registered funds and BDCs and will also regulate other trading practices of such funds that are deemed to involve the issuance of "senior securities," including short sales of securities.

(a) The proposed rule represents the SEC's efforts to provide a clearer regulatory framework applicable to the use of derivatives by regulated funds. As explained in the SEC release, Rule 18f-4 is "designed to address the investor protection purposes and concerns underlying

[12] *See Wells Fargo Alternative Asset Management, LLC* (pub. avail. Jan. 26, 2005).

[13] *See, e.g.*, *Securities Trading Practices of Registered Investment Companies*, ICA Rel. No. 10666 (April 18, 1979); *Dreyfus Strategic Income* (pub. avail. June 22, 1987); *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995); and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 1, 1996).

[14] *Use of Derivatives by Registered Investment Companies and Business Development Companies,* ICA Rel. No. 31933 (Dec. 11, 2015).

section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions."

(b) The proposed rule would, subject to various conditions, provide regulated funds with an exemption from Section 18's restrictions on the issuance of "senior securities" in connection with effecting derivatives and financial commitment transactions. If adopted, the provisions of the rule will supersede prior guidance of the SEC and its staff relating to these matters.

B. Trade Allocations

1. Investment advisers have a fiduciary duty to treat all clients fairly. Thus, advisory firms that manage both traditional mutual funds (or other "long only" accounts) as well as funds or other accounts that pursue alternative investment strategies need to assure that their policies on trade allocations appropriately address conflicts that may exist as a result of differing trading strategies or as a result of the fact that the firm receives greater compensation for managing funds and accounts that use alternative investment strategies (possibly including performance-based fees or allocations). The conflict is particularly acute in circumstances where the same portfolio managers have responsibility for both types of accounts and where investment personnel have a direct participation in revenues derived from accounts that they manage.

2. One way to mitigate these conflicts is to establish information barriers between personnel involved in managing hedge funds (or other alternative strategy accounts) and other investment personnel within the firm. However, this is not always feasible or practicable.

3. If information barriers are not established, trade allocation procedures must be implemented to assure that no client accounts are disadvantaged where there are non-pro rata allocations (e.g., the firm's hedge funds purchase or sell a security that is not also purchased or sold by the firm's registered funds) and to deal with conflicts arising from the fact that short sales effected for certain accounts may adversely affect other accounts (e.g., the firm's hedge funds selling short a security held long by the firm's registered funds) and other trading practices that might be viewed as unfair to any client (e.g., the hedge funds purchase thinly traded securities shortly after significant sales of the same securities by the registered funds).

(a) Procedures should require either: (i) independent approval of specified types of transactions (i.e., approval by someone other than the portfolio manager); or (ii) the preparation by the portfolio manager of a contemporaneous memorandum of the trading decision which sets forth the rationale for the trade and the differing decisions made for different clients.

(b) Back-end monitoring of trading patterns should be used to identify potentially abusive practices.

4. A firm's trade allocation policies should be disclosed in its Form ADV, and appropriate disclosure should also be included in a fund's offering documents.

C. Co-Investments

1. Rule 17d-1 generally prohibits an affiliated person of a registered fund or a BDC (or an affiliated person of such a person) from entering into any "joint enterprise or other joint arrangement" in which the registered fund or the BDC is also a participant absent an exemptive order issued by the SEC.

2. The SEC staff has taken the position that co-investments in privately placed securities made by a registered fund and other accounts managed by the fund's adviser may be prohibited by Rule 17d-1 unless various conditions are met.[15] The staff took a no-action position in *MassMutual*, allowing co-investments in privately placed securities, subject to certain conditions. One of those conditions is a requirement that no terms of the transaction are negotiated other than "price."

3. Because BDCs generally invest in privately negotiated transactions and are often part of a complex of other private or registered funds managed by the same adviser (i.e., affiliated persons of the BDC) that seek to participate in the same investment transactions, BDCs must be cognizant of the joint transaction prohibitions of Section 57(a)(4) of the 1940 Act and Rule 17d-1. For this reason, many BDCs have applied for and obtained SEC orders pursuant to Section 57(a)(4) and Rule 17d-1 permitting co-investments, subject to various conditions.

D. Use of Side Letters

Investors in hedge funds and other private investment funds sometimes enter into "side letters" with the managers of these funds to obtain various rights that are not given to all investors (e.g., more favorable withdrawal rights, reduced fees, transparency and indemnification rights). When the adviser of a registered fund of hedge funds also manages one or more unregistered funds of hedge funds, the use of side letters may raise an issue under Rule 17d-1 under the 1940 Act because of the SEC's position in *MassMutual*. Registered funds of hedge funds should implement procedures to address this potential issue.

E. Valuation Issues

1. Some alternative investment strategies may involve the purchase of investments that are illiquid or otherwise hard to value. These may include investments in privately placed (or restricted) securities, thinly traded securities, interests in private investment funds or complex derivatives.

2. Valuation of investments and related internal controls is an area of SEC regulatory focus and has been the subject of SEC enforcement actions.[16]

3. Interests in hedge funds and other private investments are illiquid and market quotations for these securities are not available. Section 2(a)(41) of the 1940 Act requires that these interests be valued at their "fair value," as determined in good faith by the board of directors of a registered fund. A registered fund investing in hedge funds will generally have to rely on valuation information supplied by the managers of the underlying private funds in which the registered fund invests. Because transparency to the underlying hedge fund portfolios is not always available, the adviser of a registered fund may have no means of verifying the valuations provided by the hedge fund managers.

   (a) In its September 2003 report, *Implications of the Growth of Hedge Funds* (the "Hedge Fund Report"), the SEC staff recommended that the SEC adopt a rule under the 1940 Act prohibiting registered funds from investing in hedge funds unless their boards of directors adopt procedures designed to ensure that interests in hedge funds are valued consistently with the requirements of the 1940 Act.

   (b) The SEC has not proposed the adoption of such a rule. However, comments of the SEC staff given in connection with its reviews of registration statements filed by registered funds of

[15] *Massachusetts Mutual Insurance Company* (pub. avail. June 7, 2000) ("*MassMutual*").

[16] *See, e.g.*, *In the Matter of Morgan Asset Management, Inc., et al.*, ICA Rel. No. 29704 (June 22, 2011).

hedge funds have essentially required the adoption of procedures addressing the valuation of interests in hedge funds.

4. Registered funds and BDCs must adopt procedures governing the valuation of securities for which market quotations are not readily available. These procedures should identify the factors and methodologies that will be used to value the specific types of investments that are held.

X. Regulatory Focus on Alternative Registered Funds

A. Distribution and Sales Practices

1. In the Hedge Fund Report, the SEC staff stated that it did not find evidence of significant numbers of retail investors investing directly in hedge funds.

   (a) The staff recognized, however, that investments in registered funds of hedge funds expose retail investors to hedge fund-related risks and urged the SEC and the NASD, now the Financial Industry Regulatory Authority ("FINRA"), examination staffs to be "vigilant" in identifying violations by broker-dealers of their suitability obligations to customers.

   (b) SEC staff concerns related primarily to the "downstreaming" of hedge fund risks to retail investors through registered funds of hedge funds (because the hedge funds in which the registered funds invest are not subject to regulation under the 1940 Act).

2. Notice to Members 03-07 (*NASD Reminds Members of Obligations When Selling Hedge Funds*) summarized the obligations of broker-dealers selling hedge funds, including registered funds of hedge funds, to their customers as follows:

   (a) Sales Materials: Hedge fund-related sales materials must be fair and balanced and must fully disclose risks. (NASD Conduct Rule 2210 — *Communications with the Public* — is applicable to advertising and sales literature relating to registered hedge funds. Among other things, it requires that the content of such materials meet the standards and requirements of Rule 2210 and that the materials be filed with FINRA).

   (b) Suitability: FINRA members selling interests in hedge funds must have a reasonable basis for recommending a particular strategy or investment to a customer. Members must make a "reasonable basis" suitability determination regarding each hedge fund they offer to customers based on product-specific due diligence. Members must also make a "customer specific" suitability determination before recommending a particular hedge fund to a customer (as required by NASD Conduct Rule 2310) based on the customer's financial and tax status, the customer's investment objectives and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. A customer's specific level of assets does not, by itself, satisfy a member's obligation to determine customer suitability.

   (c) Internal Controls: Members must have internal controls, including supervisory and compliance procedures, to ensure that sales of hedge funds comply with all relevant FINRA and SEC rules, and they must be able to demonstrate compliance with those procedures.

   (d) Training: Members must train associated persons about the characteristics of, and risks associated with, hedge funds before they allow their associated persons to recommend hedge funds to customers.

3. FINRA issued an Investor Alert to inform investors of matters, including risks, that they should consider when making decisions to invest in registered alternative funds.[17]

4. FINRA has conducted examinations of hedge fund sales literature used by broker-dealers and brought a number of enforcement actions against firms based on their use of sales literature that violated the standards of Rule 2210. FINRA has also conducted examinations of certain broker-dealers to determine if hedge funds (including registered hedge funds) are being sold to smaller retail investors for whom such investments may not be suitable.

5. In July 2015, the Massachusetts Securities Division launched an examination into the sales by state registered investment advisers of a number of alternative mutual funds in order to determine whether the firms properly recommended the alternative mutual funds to retail clients in the state. The inquiry resulted in an alert issued by the Massachusetts Securities Division in which it addressed a number of its concerns relating to the offer and sale of various investment products to retail investors.[18]

6. FINRA's 2016 Regulatory and Examination Priorities Letter (Jan. 5, 2016) identifies practices relating to sales of alternative products, including alternative mutual funds, as an area of focus.

   (a) In this letter, FINRA notes that these products require additional scrutiny by broker-dealers in arriving at suitable recommendations for their customers. It also notes the importance of adequate due diligence with respect to alternative products, the need for appropriate review of these products by new product review committees, and the training of registered representatives to assure their understanding of products recommended to customers.

   (b) FINRA cautions that broker-dealers should monitor for excess concentration of risky products in customer accounts.

B. OCIE Examination Priorities

1. The SEC's Office of Compliance Inspections and Examinations ("OCIE") indicated that "alternative investment companies" would be an area of focus in connection with its examinations in 2015.[19]

2. OCIE indicated that it will continue its assessment of funds offering alternative strategies and that it will focus on: (i) leverage, liquidity and valuation policies and practices; (ii) staffing, funding and empowerment of boards, compliance personnel and back-offices; and (iii) the manner in which these funds are marketed to investors.

C. Due Diligence in Selecting Alternative Investments and Their Managers

1. In a National Exam Program Risk Alert (the "Risk Alert"),[20] OCIE set forth its observations regarding trends in due diligence processes used by investment advisers in selecting alternative investment funds for their clients. The observations, which were based on examinations of advisers to pension

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[17] FINRA, Investor Alert: Alternative Funds Are Not Your Typical Mutual Fund (June 12, 2013), *available at* www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds.

[18] *See* Guidance in Connection with the Retail Sales of Structured Products by Massachusetts Registrants (Oct. 26, 2015), *available at* www.sec.state.ma.us/sct/ sctguidance/guidance.pdf.

[19] National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), *available at* www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[20] Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers (Jan. 28, 2014), *available at* www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf.

funds and private funds of funds conducted by OCIE, are also relevant to the procedures used by the advisers of multi-manager mutual funds in selecting and monitoring sub-advisers.

2. Among other things, OCIE noted in the Risk Alert that:

   (a) Advisers are seeking more information and data from managers of alternative investments (e.g., position-level transparency) and requesting that assets of their clients be managed as separate accounts to enhance transparency, controls and the monitoring of liquidity and valuation, and to reduce the risk of misappropriation of assets or the charging of unauthorized fees or expenses.

   (b) Advisers are using third parties to supplement analyses and validate information. Practices in this area include: (i) the use of portfolio information aggregators (risk aggregators) to obtain a better understanding of portfolio level risk; (ii) third-party verification of service provider relationships and assets being held or serviced by the service provider; (iii) investing in funds that have independent administrators or provide transparency reports from administrators; (iv) use of third parties to perform background checks on managers and their key personnel; and (v) regulatory history review (e.g., use of FINRA BrokerCheck and review of regulatory filings such as Form ADV).

   (c) Advisers are enhancing and expanding their processes by focusing on operational due diligence matters (such as a review of managers' valuation policies and procedures), reviewing legal documents, assessing fund liquidity terms and portfolio liquidity, conducting onsite visits, and conducting more detailed reviews of audited financial statements.

3. The Risk Alert also enumerates matters identified in the due diligence process that advisers view as warning indicators of risks relating to investments, operations and risk management. In addition, the Risk Alert discusses certain deficiencies that OCIE identified in its examinations: (i) failure to include review of due diligence procedures as part of the annual compliance review required by Rule 206(4)-7 under the Advisers Act; (ii) deviation of actual due diligence practices from disclosures and failure to review disclosures for consistency with fiduciary principles; and (iii) potentially misleading or unsubstantiated claims relating to the due diligence process in marketing materials.

Attachment A: Comparison of U.S. Alternative Fund Structures

	Domestic Hedge Fund	**Domestic Private Equity Fund**	**Closed-End Fund/Non-Publicly Traded**	**Closed-End Fund/Publicly Traded**	**Publicly Traded Business Development Company**	**Mutual Fund**
Typical Investments	Primarily liquid investments	Primarily illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	Primarily illiquid equity or debt of private companies (and securities of micro-cap companies)	Primarily liquid investments
Key Restrictions on Investments	None	None	Leverage limitation (300% asset coverage on debt)	Leverage limitation (300% asset coverage on debt)	Leverage limitation (200% asset coverage)	Leverage limitation (300% limitation on debt; only "senior securities" may be bank borrowings)
Form of Entity	Partnership or LLC	Partnership or LLC	Corporation, trust, partnership or LLC	Corporation or trust	Corporation or trust	Corporation or trust
Governance	General partner or managing member	General partner or managing member	General partner, managing member, directors or trustees	Directors or trustees	Directors or trustees	Directors or trustees
Tax Status	Partnership	Partnership	Partnership or Subchapter M	Subchapter M	Subchapter M	Subchapter M
1940 Act Status	Excluded by Section 3(c)(1) or 3(c)(7)	Excluded by Section 3(c)(1) or 3(c)(7)	Registered	Registered	Subject to BDC provisions of the 1940 Act	Registered
Manner of Offering	Private offering	Private offering	Public or private offering	Public offering	Public offering	Public offering
Investor Qualification Requirements	Accredited investors, qualified purchasers	Accredited investors, qualified purchasers	Accredited investors (if privately offered)	No restrictions	No restrictions	No restrictions
Performance-Based Allocation or Fee	Yes	Yes	Yes (if investors are limited to "qualified clients")	No	Yes (without requirement that investors be "qualified clients")	No

	Domestic Hedge Fund	**Domestic Private Equity Fund**	**Closed-End Fund/Non-Publicly Traded**	**Closed-End Fund/Publicly Traded**	**Publicly Traded Business Development Company**	**Mutual Fund**
Liquidity	Periodic (quarterly, semi-annually or annually, potentially with lock-ups and/or gates)	None; fund typically has 7- to 10-year term	Periodic repurchase offers (not more frequently than quarterly)	Exchange-traded	Exchange-traded	Daily liquidity at current NAV

About the Speakers

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Jaime is a partner in EY's Financial Services Office. She has more than 17 years of experience in the asset management industry, including serving asset management clients such as mutual funds, SEC-registered and non-registered hedge funds, private equity funds, business development companies, investment advisers and general partners.

Prior to rejoining EY in 2014, Jaime was the Chief Accountant for the SEC's Division of Investment Management for three and a half years, where her responsibilities included directing the financial reporting, accounting and auditing practices of investment companies in compliance with the federal securities laws and discussing significant investment company accounting and auditing standard-setting matters with the FASB and PCAOB. While at the SEC for nearly seven years, Jaime also worked closely with other Divisions and Offices within the SEC, including the Division of Enforcement, the Office of Compliance Inspections and Examinations (OCIE) and the SEC's Office of the Chief Accountant.

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Jennifer is a Managing Director, Chief Compliance Officer and Deputy Chief Operating Officer of TSSP. Prior to joining TSSP, Jennifer spent 10 years at Goldman Sachs & Co., where, most recently, she was a Managing Director co-heading Americas Securities Division Compliance, and was a member of the Securities Division Risk Committee, the Securities Division Client and Business Standards Committee and the Global Special Situations Group Investment Committee.

Jennifer was previously an associate at the law firm of White & Case LLP.

Jennifer earned her J.D. from Fordham University School of Law and her B.A. in International Relations from the University of Michigan.

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John is a partner at Schulte Roth & Zabel, where he primarily represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade of experience, John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities

and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, DC Super Lawyers* "Rising Star." He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics that include SEC regulations and capital-raising, executive compensation disclosure and implications of Rule 144 revisions, and SPACs and M&A issues.

John holds a J.D. from Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

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Prior to joining BKCC in 2008, Larry served as Senior Vice President, General Counsel and Corporate Secretary for Porter Novelli, Inc., an Omnicom Group Inc. agency and a global public relations firm. Before joining Porter Novelli, Inc., Larry was with the law firms of Spitzer & Feldman P.C. and Beckman, Millman & Sanders LLP, where he practiced corporate, securities and investment management law.

Larry is admitted to the Bars of the States of New York, Connecticut and the United States District Court for the District of New Jersey. He currently serves on the Board of Directors for Girl Be Heard, a New York-based non-profit theatre group that uses theatrical performances to bring global issues affecting girls to audiences worldwide. Larry has also served on the Board of Directors of the Darien Youth Hockey Association, and as a Trustee of the Rye Country Day School, as well as President of the Rye Country Day School Alumni Executive Board.

Larry received a J.D. from the Benjamin N. Cardozo School of Law and a B.A. (Economics) from Hobart College.

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Shlomo is a partner and co-head of the Tax Group at Schulte Roth & Zabel. He focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund

managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various Schulte Roth & Zabel alerts.

Shlomo earned his J.D. from Hofstra University School of Law.

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