COMPLIANCE CORNER

Considerations for Private Fund Managers in Sub-Advising Alternative Mutual Funds

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Introduction

In recent years, an increasing number of investment companies registered under the Investment Company Act of 1940 (the "1940 Act") have been formed that pursue alternative investment strategies. Among these products are multi-manager alternative funds structured as open-end funds (*i.e.,* mutual funds) that provide daily liquidity to investors and retain private fund managers as sub-advisers, with each sub-adviser assigned responsibility for managing a designated portion of the fund's portfolio (the "allocated portion"). Sub-advising a mutual fund may be an attractive option for private fund managers seeking to diversify their revenue stream without bearing the costs of forming and distributing a fund. However, private fund managers should understand the regulatory regime of the 1940 Act as it applies to sub-advising an alternative mutual fund. This article discusses these regulatory and compliance considerations.

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Compliance Program

Although the principal investment adviser of a multi-manager alternative fund (the "Adviser") is responsible for supervising the services provided by each sub-adviser and monitoring those services for compliance with the fund's investment policies and restrictions and applicable law, managers serving as sub-advisers of such funds must implement effective controls and procedures that address compliance with the requirements of the 1940 Act and the fund's investment policies and restrictions. As registered investment advisers, the compliance programs of sub-advisers must comply with the Investment Advisers Act of 1940 (the "Advisers Act"). However, Rule 38a-1 under the 1940 Act requires that mutual funds adopt policies and procedures reasonably designed to prevent violations of the federal securities laws (as opposed to the Advisers Act only) and provide for the oversight of compliance by certain of the fund's service providers (including sub-advisers). As a result, the compliance policies and procedures of the sub-adviser must be (i) approved by the fund's independent trustees at the time the sub-adviser is initially approved by the independent trustees to serve as sub-adviser and (ii) deemed reasonably designed to prevent violations of the 1940 Act in the sub-adviser's management of its "allocated portion." Additionally, on an annual basis, the chief compliance officer of the mutual fund must review the adequacy of the fund's compliance program (which includes the compliance program of the sub-adviser) and provide a report to the fund's board of trustees regarding that review. During such annual review, the sub-adviser must demonstrate its continued compliance with applicable restrictions of the federal securities laws in managing the allocated portion.

Regulatory Perspective

The Securities and Exchange Commission (the "SEC") has recently focused on the risks associated with alternative mutual funds. In February 2017, the SEC's Office of Investor Education and Advocacy issued an Investor Bulletin on alternative mutual funds which

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cautioned investors that an investment in an alternative mutual fund may be a risky investment and may not always be appropriate for retail investors. Additionally, the SEC's Office of Compliance Inspections and Examinations announced in January 2014 that one of its exam priorities would be alternative mutual funds. The Financial Industry Regulatory Authority has also weighed in and issued an investor alert in June 2013 pointing out the unique characteristics and risks of alternative mutual funds. (See SEC Investor Bulletin: *Alternative Mutual Funds* (Feb. 3, 2017), available at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_altmutualfunds.html; SEC OCIE *Examination Priorities for 2014* (Jan. 9, 2014), available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf; and FINRA *Alternative Funds Are Not Your Typical Mutual Funds* (June 11, 2013), available at http://www.finra.org/newsroom/2013/finra-issues-new-investor-alert-alternative-funds-are-not-your-typical-mutual-funds, respectively.)

Investment Restrictions under the 1940 Act

Although most investment restrictions under the 1940 Act are applicable to the fund as a whole and not specifically to the allocated portion, the sub-advisory agreement between the sub-adviser and the Adviser could require that the sub-adviser manage the allocated portion in accordance with the requirements of the 1940 Act. The investment and tax restrictions applicable to the sub-adviser also depend on the compliance structure of the fund itself. For example, compliance with many of the fund-level position limits discussed below can be passed through to all sub-advisers of the fund or could be simply prohibited altogether at the sub-adviser level without prior consent from the Adviser. Sub-advisers should understand the compliance approach for each of the fund's investment restrictions.

"With enhanced SEC scrutiny of alternative mutual fund products, a private fund manager should carefully assess the legal and compliance implications associated with serving as a sub-adviser of an alternative mutual fund."

Illiquid Investments

The SEC has recently adopted new Rule 22e-4 under the 1940 Act pertaining to mutual fund liquidity. Pursuant to Rule 22e-4 under the 1940 Act, mutual funds must establish a formal liquidity risk management program designed to ensure that they are able to meet redemption requests without materially affecting remaining investors' interests in the fund. A sub-adviser should understand its role within the liquidity risk management program implemented by the mutual fund.

A mutual fund may not purchase an illiquid investment if, as a result, more than 15 percent of the net assets of the mutual fund would be invested in illiquid investments. Rule 22e-4(a)(8) defines an illiquid investment as any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.

Industry Concentration

A registered fund must declare a policy on concentration of investments within any industry group. Although a fund may choose to not concentrate in an industry, if it does intend to invest more than 25 percent of the value of its assets in the securities of issuers engaged in any one industry, it must at all times concentrate its investments in that industry, except under specifically defined circumstances. Such concentration is measured by the particular industry classification methodology used by the registered fund.

Diversification

A registered fund must also declare itself to be "diversified" or "non-diversified." Generally, a diversified registered fund is required to invest at least 75 percent of the value of its total assets in cash and cash items (including receivables), government securities, securities of other registered funds and other securities that are limited in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of the acquiring fund or 10 percent of the outstanding voting securities of the issuer.

Leverage Limitations

In addition, Section 18 of the 1940 Act limits the use of leverage by imposing a 300 percent asset coverage requirement applicable to borrowings from banks and the issuance of senior securities, which can include any transaction that has a future payment or delivery obligation (including derivative transactions). However, derivative transactions are not subject to the asset coverage requirement if the fund segregates cash and liquid securities with a value at least equal to the amount of the potential payment or settlement obligation. Although most hedge fund investment programs, other than certain highly leveraged strategies, can operate in compliance with 1940 Act leverage limits, a sub-adviser should be cognizant of the leverage and asset coverage limitations applicable to its allocated portion. (The SEC has proposed the adoption of Rule 18f-4 under the Investment Company Act. See *Use of Derivatives by Registered Investment Companies and Business Development Companies,* Investment Company Act Release No. 31933 (Dec. 11, 2015), which, if adopted, will impose new requirements on the use of leverage by registered funds that is obtained through borrowings, derivatives, short sales and certain other transactions.)

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Tax Restrictions

A sub-adviser must also be aware of restrictions relating to the mutual fund's qualification as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986 (the "Code"). Although these Subchapter M restrictions are viewed at a fund level, the sub-advisory agreement or other policies applicable to the sub-adviser may require that a sub-adviser manage the allocated portion in accordance with the restrictions of the Code.

Other Investment Restrictions

Investment limitations arising under the 1940 Act include Section 12(d), which restricts investments in other registered funds, in securities of issuers engaged in securities-related businesses and in securities of insurance companies. More specifically, under Section 12(d)(1)(A) of the 1940 Act, a registered fund cannot generally: (1) acquire more than three percent of another registered fund's voting shares; (2) invest more than five percent of its total assets in any one registered fund; or (3) invest more than 10 percent of its total assets in registered funds. In addition, under Section 12(d)(3) of the 1940 Act, a registered fund cannot, with certain exceptions, acquire more than five percent of the equity securities or more than 10 percent of the debt securities of issuers that engage in securities-related businesses. Such issuers include brokers, dealers, underwriters and registered investment advisers.

Each registered fund is required to adopt fundamental investment restrictions, which may not be changed without shareholder vote. Managers sub-advising alternative mutual funds should be aware of these fundamental investment restrictions, which are set forth in the fund's prospectus and statement of additional information.

Prohibitions on Transactions with Affiliates

The 1940 Act and the rules thereunder contain various provisions (*e.g.*, Section 17(a) and Rule 17d-1) that generally prohibit any affiliated person of a registered fund, which includes a sub-adviser, and any affiliated person of such a person from engaging in any principal transaction or participating in any joint enterprise or other joint arrangement (or acting in concert) with the registered fund. This prohibition includes, with certain exceptions, cross-trades between a registered fund and any affiliates, aggregation of orders with affiliates in privately offered securities, including co-investments where both a registered fund and an affiliate jointly participate, purchases of securities being underwritten by an affiliate and the use of affiliated broker-dealers for portfolio transactions. Cross-trades and co-investments, however, are permitted under limited circumstances where the subject security has an active trading market, subject to compliance with applicable 1940 Act rules and SEC staff interpretations. Accordingly, private fund managers should consider whether their own compliance policies and procedures are appropriately designed to identify any potential affiliated transactions prior to a trade being consummated. In addition, private fund managers should be aware that trading of assets comprising the allocated portion can have affiliated transaction implications for the entire registered fund.

Sub-Adviser's Code of Ethics

As a registered investment adviser, a sub-adviser's code of ethics must comply with Rule 204A-1 under the Advisers Act. However, as a sub-adviser to a mutual fund, the sub-adviser's code of ethics must also comply with Rule 17j-1 under the 1940 Act, which contains requirements in addition to those found in Rule 204A-1 under the Advisers Act. These include the requirements that the code of ethics be approved by the fund's board of trustees on an annual basis and that any material change to the code of ethics be approved by the fund's board of trustees within six months of the adoption of such change. In addition, pursuant to Rule 17j-1, a sub-adviser's code of ethics must prohibit employees from engaging in any conduct prohibited by Rule 17j-1(b), which covers fraud, untrue statements and manipulative practices.

Recordkeeping

A sub-adviser is required to maintain and preserve certain books and records relating to its management of the allocated portion that will be subject to reasonable periodic, special and other examinations by the SEC staff. (Rule 30e-1 under the 1940 Act.) In order to clarify exactly which records the sub-adviser is required to keep, the sub-advisory agreement should clearly state which provisions of the 1940 Act's recordkeeping rules (*i.e.,* Rules 31a-1 and 31a-2) will be applicable to the sub-adviser.

Conclusion

With enhanced SEC scrutiny of alternative mutual fund products, a private fund manager should carefully assess the legal and compliance implications associated with serving as a sub-adviser of an alternative mutual fund. A manager's compliance program should be properly designed, with the input of expert counsel, to ensure the manager's compliance with the 1940 Act and other requirements applicable to its service as a sub-adviser.

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