Current Issues Relating to Liquid Alt Funds

Financial Services Regulatory and Enforcement
Current Issues
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Topics to be covered

• Liquid alts and other current issues
• Derivatives and leverage
• Exchange-traded products
• Exchange-traded funds
• Exchange-traded notes
• Exchange-traded commodity pools
• Exchange-traded managed funds
• Issues and outlook
What is a “Liquid Alt Fund?”

• “Liquid Alternative Funds”
  • What is a liquid alt fund?
    • No clear definition, but generally understood to be a registered investment company whose primary investment strategy falls into one or more of three buckets
      • Non-traditional asset class (e.g., currencies)
      • Non-traditional strategies (e.g., long/short equity)
      • Illiquid assets (e.g., private debt)
  • Strategies
    • Generally seek to produce positive risk-adjusted returns (alphas) that are not closely correlated to traditional investments or benchmarks
    • Differ from those of traditional mutual funds that typically follow long-only strategies in traditional asset classes
What is a “Liquid Alt Fund?”

- Liquid alt funds are registered as investment companies and thus are available to retail investors
- SEC took note of rapid growth of liquid alt funds
  - As of May 2014, according to the SEC, liquid alt funds had $300 billion AUM (2.3% of all mutual fund AUM)
  - In 2013, inflows were 32.4% of inflows to all mutual funds
  - Investment Company Institute (ICI) measures liquid alt fund assets at $170 billion as of December 2014, up from $41 billion in 2007
- Reasons for rapid growth
  - Investor demands
    - Retail market seeks distinctive returns in specific sectors
    - Investors demand enhanced yield in low interest rate environment
    - Investors reacting to market volatility seek risk-adjusted returns
    - These strategies were previously available only to private fund investors
What is a “Liquid Alt Fund?”

• Reasons for rapid growth
  • Characteristics of liquid alt funds
    • Investment liquidity
    • Portfolio transparency
    • Lower advisory fees (not typical “2 and 20”)
    • Lower investment minimums
    • Absence of investor eligibility requirements
    • Daily pricing of shares
What is a “Liquid Alt Fund?”

• ICI measure of liquid alt fund growth

What is a “Liquid Alt Fund?”

• Regulatory concerns
  • Hedge fund advisers not familiar with registered fund limitations
    • Alt strategies present heightened risks in numerous compliance areas, e.g.,
      • Gifts and entertainment
      • Co-investments
      • Valuation
  • Fair valuation
    • SEC staff suggests that liquid alt managers address valuation concerns by ensuring that valuation policies include
      • The requirement that fund monitor situations giving rise to fair valuation
      • Methodologies for determining fair value
      • Price overrides
      • Controls
      • Prompt notification to, and review and approval by, persons not directly involved in portfolio management to mitigate conflicts of interest
What is a “Liquid Alt Fund?”

- Regulatory concerns
  - Liquidity
    - Some strategies may involve investment in illiquid securities that exceed accepted guidelines (e.g., 15% of assets)
      - Funds should establish policies for assessing liquidity to ensure compliance
  - Leverage
    - A primary goal of the 1940 Act is to protect mutual fund investors from excessive leverage
    - Some strategies may involve leverage through use of derivatives (discussed below)
  - Disclosure
    - Generic disclosures of risks are not sufficient
    - Disclosures should relate to risks taken as a whole
  - Oversight by fund board of directors
- Office of Compliance Inspections and Examinations (OCIE) 2014-2015 liquid alt sweep examinations
Derivatives and leverage

• What are derivatives?
  • “Derivatives” generally mean instruments or contracts whose value is based upon, or derived from, some other asset or metric (“reference asset”)
  • A common characteristic of most derivatives is that they involve leverage

• How do registered investment companies use derivatives?
  • Increase leverage to boost returns
  • Gain access to certain markets
  • Achieve greater transaction efficiency
  • Hedge interest rate, credit and other risks

• Types of derivatives
  • Currency derivatives (e.g., cross-currency hedge)
  • Interest rate derivatives (e.g., interest rate swaps)
  • Credit derivatives (e.g., credit default swap)
  • Equity derivatives (e.g., foreign index futures, stock index futures)
Derivatives and leverage

• “Senior securities”
  • Funds using derivatives must consider limits on leverage contained in Section 18 of the ICA
  • Section 18 generally bars an open-end mutual fund from using leverage in its capital structure
    • Mutual funds are precluded by Section 18(f) from issuing any senior securities
    • Section 18(g) defines “senior securities” to include (i) any instrument constituting a security and evidencing indebtedness or (ii) any stock with priority as to distribution of assets or payment of dividends
      • In other words, open-end mutual funds may issue only common stock
  • Section 18 does not restrict the ability to borrow from a bank as long as a fund maintains an asset coverage ratio of at least 300%
  • Section 18(g)(1) permits temporary (usually up to 60 days) borrowing of up to 5% of a fund’s total assets at the time of the loan from any source
    • Such temporary borrowing may not be renewed
  • Many funds have sought and obtained exemptive relief enabling inter fund lending between affiliated funds within the same fund complex
Derivatives and leverage

• Senior securities
  • In 1979, the SEC stated certain types of investments with embedded leverage are subject to the Section 18 prohibition on senior securities
    • Futures and options on futures
    • Reverse repurchase agreements
    • Forward commitment agreements
    • Stand-by commitment agreements
    • Short sales
    • When-issued securities
  • Other derivative instruments are viewed as creating senior securities
Derivatives and leverage

• Asset coverage test
  • The SEC will not consider a derivative instrument to be a senior security if the fund “covers” potential exposure by earmarking liquid assets that cannot be used for other purposes
    • Full notional value versus “delta” value
    • Segregated accounts should be marked to market daily
    • Additional assets should be segregated whenever the total value of the account falls below the amount required to be maintained
  • Alternative cover strategies
    • To cover a long position in a futures contract, a fund could purchase a put option on that futures contract with a strike price at least as high as the futures contract
    • A fund could cover a short position in a futures contract by purchasing the underlying instrument or a call option on the futures contract at a price no higher than the short position
Derivatives and leverage

- Other issues for funds that use derivatives
  - Portfolio diversification
  - Concentration
  - Investing in securities-related issuers
  - Valuation
  - Accounting and financial statement reporting
  - Disclosures
  - Fund names
  - Risk analysis
  - Board oversight
Exchange-traded products

- Exchange-traded products (ETPs) include:
  - Exchange-traded funds (ETFs)
  - Non-1940 Act pooled vehicles
  - Exchange-traded notes (ETNs)

- Growth Trends

Exchange-traded funds

• What is an ETF?
  • An ETF is a pooled investment vehicle whose shares are listed and traded on a stock exchange
    • Shares are traded intra-day
    • Shares trade at the market price, which may differ from the ETF’s net asset value (NAV)
    • Investors can buy and sell ETF shares through a broker, just like they would shares of any publicly traded company

• How are ETFs structured?
  • ETFs typically are structured as open-end investment companies or unit investment trusts
    • ETPs that invest primarily in futures contracts, currencies and commodities are not structured as investment companies, but rather as commodity pools
Exchange-traded funds

• Mutual Funds versus ETFs
  • Similarities between ETFs and mutual funds
    • Open-end investment companies (mutual funds) and ETFs are companies that invest in securities and other assets
      • Investors own a proportionate share of the pool of assets
      • Mutual funds and ETFs are subject to the investor protections of the Investment Company Act of 1940 (“1940 Act”)
  • Differences between ETFs and mutual funds
    • ETFs may be structured as open-end investment companies but operate differently
    • Mutual funds continuously offer and redeem shares to the public
      • At the end of each business day, mutual funds calculate their NAV
      • Investors buy and sell shares at the next-determined NAV (forward pricing)
    • ETFs sell “creation units” to “authorized participants” (APs) only, not investors
      • ETFs publish the contents of creation units daily
      • Investors buy and sell shares on exchanges at the market price, not at NAV
      • ETFs can be more fully invested since cash does not flow in and out of the portfolio on a daily basis
    • New exchange-traded managed fund (ETMF) – a hybrid
Exchange-traded funds

• Advantages of ETFs
  • ETFs offer several advantages over traditional investment companies
    • ETFs offer investors access to a wide range of sectors, geographies and strategies, including, for example, health care, leisure and entertainment, inflation-protected treasuries, sovereign debt, covered bonds and foreign currencies
    • Many ETFs have lower expenses than mutual funds, but brokerage commissions may offset these lower expenses
    • ETFs have lower tracking errors than mutual funds because they do not manage daily cash flow into and out of the portfolio
    • ETFs may be more tax efficient than mutual funds because they do not sell securities to raise cash to meet daily redemption requests
    • ETFs provide greater portfolio transparency
Exchange-traded funds

• What is the market for ETFs?
  • In more than 22 years of existence, ETFs have attracted more than $1.9 trillion of net assets*

Exchange-traded funds

• How ETFs trade
  • Market pricing versus NAV
    • Mutual funds and ETFs establish their NAV once a day, as of the close of business
    • Mutual fund share shareholders can trade shares once per day at NAV
    • ETF shares are traded on an exchange, and share prices fluctuate all day according to market demand
      • Investors may buy at a premium or discount to NAV
      • Investors selling or buying ETF shares throughout the day may receive different prices
  • ETFs have daily transparency
    • Imbalances in supply and demand can affect the market price of an ETF throughout a trading day
    • Transparency minimizes discrepancies between market value and NAV
      • Third parties continuously calculate the intraday indicative value (IIV) of the ETF’s portfolio securities, which is publicly available
Exchange-traded funds

- Types of ETFs
  - Index-based ETFs track the performance of a reference index
    - Index components are fully transparent
  - Actively managed ETFs pursue an investment objective (much like a mutual fund)
    - Portfolio managers select securities based on research
    - Portfolios must be transparent
      - Website identifies securities and weightings
      - Transparency raises other issues
  - Geared ETFs use derivatives to produce a return that is a multiple (positive or negative) of a reference index
Exchange-traded funds

• Moratorium on leveraged ETFs
  • In March 2010, the SEC staff announced a moratorium on ETFs that “make significant investments in derivatives”
  • In December 2012, the SEC staff partially lifted the moratorium
    • The staff announced that it will no longer defer consideration of exemptive requests relating to actively managed ETFs that make use of derivatives, provided
      • ETF directors review and approve use of derivatives and how the adviser manages risk
      • ETF disclosure is consistent with relevant SEC and staff guidance
    • The staff continues to oppose applications of highly leveraged (geared) ETFs
  • Financial Stability Oversight Council (FSOC) indicated that this might affect not only hedging activities of ETFs but also related disclosures
Exchange-traded notes

- Exchange-traded notes (ETNs) are senior unsecured debt obligations of an issuer (usually a bank) designed to track the return of an underlying index or other benchmark
  - According to SEC data, as of Year End 2014, there were 96 alternative ETNs representing approximately $6.3 billion in total market cap
- ETNs are not pooled investment vehicles and are not registered under the ICA, but ETNs must be registered under the Securities Act of 1933
- Like ETFs, ETNs trade on an exchange and can be bought and sold by individual investors during the trading day
  - ETNs are debt securities and do not trade at NAV
  - ETN prices are based solely on supply and demand in the market
- ETNs must have a repurchase feature that gives investors the ability to redeem notes of a specified minimum value or denomination on a minimum weekly (usually daily) basis at a predetermined price
- The creditworthiness of an ETN itself is not rated, but is based on the creditworthiness of the issuer
Exchange-traded commodity pools

- Exchange-traded commodity pools offer undivided interests in a pool that invests directly in underlying commodities
- Because the underlying assets are not securities, exchange-traded commodity pools do not have to register under the ICA
- Shares of exchange-traded commodity pools are registered under the Securities Act of 1933
- Exchange-traded commodity pools give investors exposure to commodities without taking physical delivery of a commodity
- Shares of exchange-traded commodity pools can be bought and sold on an exchange and held in an ordinary brokerage or custodial account
Exchange-traded commodity pools

- Exchange-traded commodity pools generally must comply with the requirements of Form S-1
  - Exchange-traded commodity pools do not meet the definition of an “investment company” and cannot register under the ICA
  - Form S-1 filings are subject to review by the Division of Corporate Finance
- Exchange-traded commodity pools are subject to regulation by CFTC
  - Investment advisers may have to register as commodity pool operators
  - Funds must comply with CFTC disclosure requirements
Exchange-traded managed funds

- November 2014 – SEC approves novel exchange-traded managed fund (ETMF) structure
  - ETMFs feature characteristics of ETFs and mutual funds
  - Like ETFs, ETMFs
    - List and trade shares on national securities exchanges
    - Directly issue and redeem shares only in creation units
    - Impose fees on creation units issued and redeemed
    - Primarily use in-kind transfers
  - Like mutual funds, ETMFs
    - Sell and redeem their shares at prices linked to ETMF’s next determined NAV
    - Maintain confidentiality of current portfolio holdings
  - As a policy matter, SEC believes daily transparency of portfolio holdings is not needed because ETMF shares trade on next-determined NAV
    - Market makers do not engage in arbitrage and assume no intraday risk
    - Thus, no need for market makers to hedge intraday, eliminating the need for up-to-the-minute portfolio holdings
SEC’s proposed liquidity rules

- September 22, 2015: SEC proposed rules that would require open-end funds, including ETFs (but not money market funds) to adopt liquidity risk management programs
- As proposed, fund’s board must approve the program, which must include:
  - Classification of the liquidity of fund portfolio assets and assessment of liquidity risk
    - A fund would classify each portfolio position, or portion of position, into one of six liquidity categories based on the amount of time required to convert the position to cash without market impact
  - Determination of three-day liquid asset minimum
    - A fund would determine a minimum amount of its portfolio to be held in cash and assets convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale
SEC’s proposed liquidity rules

- Board approval and review
  - A fund’s board would be required to approve its liquidity risk management program, including the three-day liquid asset
    - At least annually, the board would review a written report that discusses the adequacy of the fund’s liquidity risk management program and the effectiveness of its implementation
- The SEC proposed to codify current SEC guidelines stating that funds should invest no more than 15% of their assets in “illiquid assets”
- Proposed rules include new disclosure and reporting requirements regarding liquidity risks and risk management practices of a fund
SEC’s proposed liquidity rules

• Swing Pricing
  • The proposals would also permit funds, with the exception of money market funds and ETFs, to use “swing pricing” subject to board approval. Swing pricing refers to a mechanism that would adjust the net asset value of a fund’s shares to effectively pass on the costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder.
  • The comment period ends 90 days after publication in the Federal Register (January 13, 2016)
Issues and outlook

• CFTC Rule 4.5 may require advisers of some ETFs that use derivatives to register as commodity pool operators (CPOs)
  • CFTC recently narrowed exemption for investment companies
  • CPO status will increase compliance and disclosure costs
  • Revising investment strategies to avoid CPO status may increase trading costs
• SEC staff is not likely to lift the moratorium on new geared ETFs until the SEC or the staff resolves issues raised in the SEC’s August 31, 2011 Concept Release on fund use of derivatives
  • First step – proposed rules would require enhanced disclosure of derivatives and leverage
• Implications of the Volcker Rule
• FINRA voiced concerns about the proliferation of newly created exchange-traded index products
  • Questions whether retail investors fully understand these products
  • Regulatory and examination priority for 2015
Issues and outlook

• The plaintiff’s bar has taken notice of ETFs
  • In Q1 2013, a suit was filed by two pension funds against several ETFs, their adviser, an advisory affiliate that provided securities lending services and the trustees of the ETFs challenging the split between the securities lending revenue paid to the ETFs and that paid to the adviser and its affiliates under Section 36(b) of the ICA

• ETF and liquid alt fund assets are likely to continue to grow and increase market share

• October 2014 – SEC signals it will deny applications for non-transparent ETFs
  • Proposed ETFs would not disclose portfolio holdings on a daily basis
  • SEC emphasized transparency to ensure that ETFs trade at market prices close to their NAV

• June 2015 – SEC Division of Trading and Markets issued release seeking public input to evaluate listing and trading of ETPs in the marketplace, and the risks posed by ETPs
Issues and outlook

• December 2015: SEC guidance or proposed rules concerning investment company use of derivatives and leverage?
  • SEC has hinted that substantive regulation of use of derivatives and leverage is on the way
  • Proposals including substantive limits could dramatically affect operations of liquid alt funds