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Alternative Mutual Funds

How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital? (Part Two of Two)

By Jennifer Banzaca

Alternative mutual funds present opportunities for hedge fund managers to diversify their product offerings and to attract retail investors. At the same time, retail investors are clamoring for opportunities to invest with the most talented investment professionals, many of which are attracted to working with hedge fund firms. However, hedge fund managers that launch alternative mutual funds face significant business challenges and regulatory concerns unique to the registered fund world.

This two-part article series is designed to familiarize hedge fund managers with alternative mutual funds and to help them determine whether it is advisable to launch such funds. This second article details specific steps necessary to launch an alternative mutual fund; costs and fees associated with launching and operating an alternative mutual fund; distribution of alternative mutual funds; investment restrictions applicable to alternative mutual funds; and a key conflict of interest hedge fund managers face when operating alternative mutual funds and traditional hedge funds side-by-side. The first installment discussed the structure of alternative mutual funds; the investment strategies typically employed by alternative mutual funds; why hedge fund managers consider launching alternative mutual funds; some drawbacks of launching alternative mutual funds; and the various ways in which hedge fund managers can participate in the alternative mutual fund business. See "How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital? (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 5 (Feb. 1, 2013).

What Steps Must a Hedge Fund Manager Take to Launch an Alternative Mutual Fund?

Fund Organization and Structuring

Once a hedge fund manager makes the threshold determination to launch an alternative mutual fund – the first article in this series outlined some of the decision points on the way to such a determination – the next step is to consider choice of entity, structuring and similar items. One of the first such items that a fund sponsor (which typically is the manager) should consider is the form of organization for an alternative mutual fund. Typically, managers organize their alternative mutual funds as Delaware statutory trusts, Massachusetts business trusts or, in some cases, Maryland corporations. This contrasts with hedge funds, which are typically organized (on the domestic side) as limited partnerships or limited liability companies. However, like limited partnerships and limited liability companies, trusts can be structured to qualify for pass-through tax treatment for investors.

The fund's operations are typically overseen by a board of trustees, which hires the manager, who in turn hires the other service providers for the fund.

Once the manager chooses the form of organization for the alternative mutual fund, the manager should tackle structuring decisions. A fund manager can organize an alternative mutual fund as a stand-alone fund with a single pool of investments and investors. Alternatively, the manager can establish an alternative mutual fund using a master-feeder structure, with each feeder fund having its own investment strategy, branding strategy and group of investors. Managers can also structure their funds as series trusts with each series having its own investment objectives, investors and investment portfolios, as described below in more detail. Aisha Hunt, a Partner at Dechert LLP, explained, an alternative mutual fund "is usually structured as a Delaware statutory trust with multiple series. Each individual series really constitutes a fund." For an analogous structure in the hedge fund context, see "Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012).

Managers that choose not to organize their own stand-alone funds can participate in the alternative mutual fund business by managing one or more series in an existing series trust in which multiple managers participate. Such series trusts are referred to as "shared trusts." Hunt said, "Shared trusts are typically sponsored by a mutual fund administrator. These administrators have pre-established relationships with each service provider and a board. So, they are creating one-stop shops, a turn-key solution for a hedge fund manager to launch a mutual fund by launching a new series in an existing trust. This way, the service provider agreements are in place; the board is in place; and the trust has an existing distributor. You cut through the red tape, and you can focus on your distribution plan." In many ways, shared trusts are similar to managed account platforms for hedge fund managers. For a discussion of managed account platforms, see "Considerations for Hedge Fund Managers Looking to Join Managed Account Platforms (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012).

Operational and Other Issues

Among other things, the fund sponsor will need to recruit board members for the fund. The Investment Company Act of 1940 (Investment Company Act) requires that at least 40% of the fund's board members be "independent" (i.e., those persons that do not have a significant business relationship with a fund's manager or underwriter) although in practice, the percentage of independent board members for such funds is typically much higher. The fund manager will typically provide the affiliated board members and recruit unaffiliated persons to serve as independent board members.

Additionally, the sponsor will need to retain service providers for the fund, which typically include the manager (if the sponsor is other than the manager) as well as a custodian, prime broker, transfer agent, fund accountant, independent auditor, administrator, financial printer and distributors. The board is responsible for approving the service providers for the fund. With respect to the manager, the board is not only responsible for initially approving the manager, but also annually approving the manager and its advisory contract with the fund pursuant to Section 15(c) of the Investment Company Act. The board is also responsible for overseeing the activities of the fund's service providers.

These tasks can take significant time to accomplish. Hunt explained, "Launching a stand-alone fund requires negotiating individual service provider agreements, as well as identifying and vetting potential board members. The process of launching a stand-alone fund family can take upwards of six months but is a compelling option for larger managers who want greater control over service provider relationships and the fund launch process."

Hedge fund managers may opt to use some of the same service providers for their alternative mutual funds as those used for their hedge funds, but the efficiencies they expect to realize through this approach may not materialize. Hunt explained that some of the key services provided to mutual funds are very different from those provided to hedge funds. James Dilworth, Founder and CEO of Simple Alternatives, commented that the actual representatives and teams that work with hedge funds are likely to be different from those that work with alternative mutual funds. As such, depending on the circumstances, it may make more sense for managers to use a different set of service providers for their alternative mutual funds.

Additionally, funds are required to draft compliance policies and procedures reasonably designed to detect and prevent violations of the federal securities laws pursuant to Rule 38a-1 under the Investment Company Act. Rule 38a-1 also requires the fund board (by a vote of a majority of disinterested board members) to approve the fund's compliance policies and procedures as well as those of each manager, principal underwriter, transfer agent and administrator, and to annually review the compliance policies of the fund and each of these service providers. The fund's compliance program should be distinguished from that of its manager, which must also establish and maintain its own compliance program pursuant to Rule 206(4)-7 under the Investment Advisers Act of 1940 (Investment Advisers Act). See "How Hedge Fund Managers Should Approach Preparing For, Conducting and Documenting the Annual Compliance Review (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 13 (Mar. 29, 2012). Rule 38a-1 also requires the board to designate a chief compliance officer of the fund and to set the compensation of the chief compliance officer by a vote of a majority of disinterested board members. See "Who Should Newly Registered Hedge Fund Managers Designate as the Chief Compliance Officer and How Much Are Chief Compliance Officers Paid?," The Hedge Fund Law Report, Vol. 4, No. 7 (Feb. 25, 2011).

For managers concerned about the onerous tasks of operating an alternative mutual fund, a shared trust may provide an attractive solution. The trust handles operating, governance, servicing and administrative tasks, which allows the manager to focus on managing the portfolio. This cost-effective approach can be particularly appealing for earlier-stage managers with limited budgets.

Registration Issues

Prior to selling securities and operating the fund, the sponsor will need to register the fund as an investment company pursuant to the Investment Company Act and its securities pursuant to the Securities Act of 1933 (Securities Act). To begin with, the fund must file a form of notification of registration on Form 8-A with the SEC, which is a fairly short form. Then, the fund generally must file a registration statement on Form N-1A (which includes a statutory prospectus) via the SEC's electronic data gathering and retrieval (EDGAR) system within three months of filing its Form 8-A. Frank Attalla, a Principal at Rothstein Kass, said that managers will need to work with an attorney to prepare and file a Form N-1A registration statement, which provides information about the fund strategy, fund expenses, risks of investing, the manager, service providers and more. The registration statement is subject to SEC review, and, typically after amendments are made, the SEC can allow the registration statement to become effective or declare it effective. Pursuant to Section 24(f)(1) of the Investment

Company Act, upon the effective date of the registration statement, the fund will be deemed to have registered an indefinite amount of its securities.

Prior to the effective date of a registration statement, the fund can deliver a preliminary prospectus as long as it contains substantially all of the information contained in the final prospectus. However, fund sponsors should be careful about discussing the fund and its pending registration statement prior to the effectiveness of the registration statement, a practice known as gun jumping.

Once the fund's securities are registered, the fund must update its registration statement each year within four months of the end of its fiscal year. In addition, the fund is subject to periodic reporting requirements pursuant to the Investment Company Act, including the need to file Form N-Q after its first and third quarter, disclosing the complete schedule of the fund's portfolio holdings and Form N-PX on an annual basis describing how the fund voted on specific proxy issues. These disclosures are typically not disclosed on an unsolicited basis by hedge funds.

In addition to registering the fund and its securities, the manager of the fund must register as an investment adviser with the SEC. This is accomplished through the filing of Form ADV via the Investment Adviser Registration Depository (IARD). A manager of an alternative mutual fund must register with the SEC as an investment adviser regardless of its total assets under management. Because managers become subject to the substantive provisions of the Investment Advisers Act upon registering with the SEC as well as potential SEC examination, it is imperative that investment advisers establish their Rule 206(4)-7 compliance policies and procedures prior to registering with the SEC. See "When and How Can Hedge Fund Managers Permissibly Disguise the Identities of Their Hedge Funds in Form ADV and Form PF?," The Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).

Distribution of Alternative Mutual Funds

Unlike most hedge funds, alternative mutual funds are not distributed principally by the manager. Typically, they are distributed by registered broker-dealers, much like traditional mutual funds. As Dan Sondhelm, Partner and Senior Vice President of SunStar Strategic, explained, "In the distribution process, the first step is to develop your product, to know who your customers are going to be and where you are going to get demand from and develop a product in terms of the expenses and the loads. Managers need to develop a product that is sellable and then decide whether to sell through one of the mutual fund supermarkets, like Schwab, Fidelity or Ameritrade, or a larger firm like Raymond James. It is a challenge just to get on one of these platforms. Once you get on a platform, the issue is then getting in front of the customers on those platforms. Do you hire a salesperson? Do you work with the media? Do you leverage technology or advertising? What role does the portfolio manager want to play in the marketing of the fund? So there is a lot to think about before you even start a mutual fund."

"Distribution is the biggest challenge in launching a mutual fund because it is a different type of distribution," Hunt said. "Most mutual funds are distributed through broker-dealers, registered investment advisers and mutual fund supermarkets. The mutual fund distribution process is very different from the hedge fund asset raising process." Because of the way a mutual fund is structured, a mutual fund must have a statutory underwriter or a principal distributor, which must be a registered broker-dealer. George Silfen, a partner at Kramer Levin Naftalis & Frankel LLP, further explains that "mutual funds are distributed in a variety of ways. They can be distributed on a load basis through paid brokers. The brokers sell the funds in exchange for a commission, which is usually about 40 basis points on assets that come in through the platform."

Fund Fees and Expenses

Organizational Expenses

Sources who spoke with The Hedge Fund Law Report agreed that it is generally expensive to launch an alternative mutual fund. According to Sondhelm, "I think the biggest expense, at least initially, will be legal fees."

Fees Paid to Managers

Like hedge funds, alternative mutual funds pay their managers a management fee based on a percentage of assets under management, although the percentage paid by alternative mutual funds is typically smaller than that paid by hedge funds. For a discussion of trends in hedge fund fees, see "Preqin Study Reveals Institutional Investors' Latest Views and Expectations on Hedge Fund Terms," The Hedge Fund Law Report, Vol. 5, No. 36 (Sep. 20, 2012). Sondhelm explained, "For a mutual fund manager, the management fee could be 75 basis points to 125 basis points."

Unlike hedge funds, mutual funds typically do not pay their managers performance-based compensation, with the exception of "fulcrum fee" arrangements. Silfen explained that generally, the presence of retail investors in alternative mutual funds prevents the manager from being able to receive performance-based compensation because the Investment Advisers Act generally limits advisers to receiving performance-based compensation from only qualified clients. See "SEC Adopts Final Rules Governing the Payment of Performance Fees to Registered Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 9 (Mar. 1, 2012). Unlike hedge funds, managers are not permitted to provide different fee schedules to different investors within the same alternative mutual fund. Managers of alternative mutual funds hope that the assets they accrue will allow them to offset the lower management fee rate and the lack of performance-based compensation. They hope to charge lower fees on more assets and higher fees on fewer assets.

The compensation to be paid by the alternative mutual fund to the investment adviser must also be approved annually by the fund's board, including a majority of independent trustees, as part of the Section 15(c) process described above.

Operating Expenses

In addition to management compensation, alternative mutual funds also pay their managers fees to cover certain operating, administrative or marketing expenses. Sondhelm said, "There is an operations fee, which covers a lot of the administrative costs of running the fund. In some cases there is a 12b-1 fee, which is a marketing fee that mutual funds use to offset those distribution costs."

As Dilworth explained, "The big disconnect between hedge funds and mutual funds are the fees. In the traditional long-only world, fees are one of the first things that investors will look for. Within mutual funds themselves, there are a variety of different fees but for the most part, traditional long-only mutual funds tend to be about 1%. The alternative mutual fund fees tend to be double the fees that you will see in a traditional mutual fund, somewhere between 1.5% and 3%."

Sondhelm noted on this point, "In the ongoing operation of the fund, you will have platform fees if you distribute your fund through a platform. Generally, you might charge 1.5% for your fund, but these platform companies might charge you 40 basis points if money comes in through that channel. There are also ongoing operation costs that really add up. A mutual fund could cost between $100,000 and $200,000 up front, but there could be some pretty serious annual fees, depending on what your assets are. So, running a fund is not cheap."

Because of the initial challenge in raising assets for alternative mutual funds, Sondhelm explained that some hedge fund managers launching alternative mutual funds may need to subsidize the costs of launching and operating the fund until sufficient assets are raised. This makes fund distribution an even more pressing task for such managers.

Investment Restrictions

The Investment Company Act and the Internal Revenue Code (IRC) imposes various restrictions on the investment activities of alternative mutual funds.

First, the Investment Company Act requires that most investments made by an alternative mutual fund constitute "liquid" investments. As Dechert's Hunt noted, "A mutual fund is an open-end management company, which requires the fund to provide daily liquidity. Because of the liquidity requirements, the Investment Company Act requires that a mutual fund invest no more than 15% of its assets in 'illiquid securities' as defined in the Investment Company Act. In order to comply with the Investment Company Act, if the strategy does not entail investing more than 15% in illiquid securities, there could still be other restrictions that could be show stoppers or make a managing a strategy through a mutual fund challenging."

Because of these investment restrictions, Sondhelm noted that "you do not have 100% flexibility in cloning your hedge fund strategy. There are certain things you cannot do in a mutual fund that you can do in a hedge fund. Also, you may have an extensive track record as a hedge fund manager, but you cannot use that track record when marketing your alternative mutual fund because the strategy might not be exactly the same." See "Portability and Protection of Hedge Fund Investment Track Records," The Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011).

Second, the Investment Company Act imposes various restrictions on an alternative mutual fund's use of leverage. Section 18(f)(1) of the Investment Company Act prohibits an alternative mutual fund from issuing any class of "senior securities" or selling any class of senior securities for which it is the issuer. An alternative mutual fund may borrow money from a bank, provided that immediately after such borrowings, there is asset coverage of at least 300% for all of its borrowings. Hunt explained, "If you have a portfolio with $100, you can borrow up to $50, which would give you the asset coverage of $150 to cover the $50 borrowed." Or as Silfen put it, "direct leverage is limited. For every dollar you borrow from a bank, you need two dollars of equity in the fund to cover it. Hedge funds do not have these limitations on leverage. So, it is a challenge."

Alternative mutual funds may face restrictions on their short selling or derivatives transactions because short sales, reverse repurchase agreements, firm commitment agreements, standby commitment agreements, futures, forwards, written options and certain other derivatives transactions may involve the issuance of a senior security subject to the prohibitions and asset coverage requirements of Sections 18(a)(1) and 18(f)(1) of the Investment Company Act. "The SEC and the staff have indicated, however, that they will not object to a mutual fund engaging in these transactions without complying with the asset coverage and other requirements of Sections 18(a)(1) and 18(f)(1), provided that the mutual fund segregates assets, or otherwise 'covers' its obligations under the instruments, consistent with SEC and staff guidance," Hunt said.

Third, the Internal Revenue Code requires an alternative mutual fund to pass certain asset diversification tests to qualify as a regulated investment company for federal income tax purposes.

Issues Hedge Fund Managers Must Consider in Simultaneously Managing Alternative Mutual Funds and Hedge Funds Employing the Same Investment Strategy

One of the biggest conflicts of interest for hedge fund managers managing an alternative mutual fund and a hedge fund employing the same investment strategy side-by-side is the allocation of investment opportunities among the funds. There is some concern that where a manager manages both types of funds simultaneously, it has an incentive to allocate a disproportionate amount of more attractive investments to hedge funds and to allocate a disproportionate amount of less attractive investments to the mutual fund because of the performance fees earned from the hedge fund.

As Attalla noted, "A manager has to be conscious that he is not favoring the hedge fund over the alternative mutual fund just because of fees."

As a result, managers should adopt policies addressing the allocation of investment opportunities among their various funds. Dilworth explained, "If a manager is running an alternative mutual fund and a hedge fund with the same strategy, it has to have specific policies regarding order allocation." These allocation policies should include an allocation methodology that ensures that an alternative mutual fund is not systematically disfavored in the allocation of investment opportunities and that all funds are afforded fair and equitable treatment over time. Generally, most allocation policies use pro rata allocation (based on assets under management) as a default allocation methodology and then cite factors that could alter the default allocations. Managers should typically avoid deviating from their allocation methodology after trades have been executed unless they memorialize why the deviation is justifiable. (In the course of an examination, SEC staff members are likely to scrutinize any memoranda justifying a departure from a manager's allocation policies and procedures.) For an action involving improper allocation of investment opportunities, see "SEC Charges Hedge Fund Manager and Its Founder with Securities and Investment Adviser Fraud Based on 'Cherry Picking' of Trades," The Hedge Fund Law Report, Vol. 6, No. 1 (Jan. 3, 2013). A manager's compliance staff should periodically spot check allocations to ensure that the policies and procedures are being followed.

Hedge fund managers should disclose this conflict of interest and the substance of their order allocation policies and procedures in their hedge fund offering memoranda

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and alternative mutual fund prospectuses. Additionally, the offering memorandum or prospectus should include a disclaimer that not every investment opportunity will be available to every fund managed by the firm. In other words, the hedge fund and alternative mutual fund may follow substantially similar strategies, but the hedge fund may follow that strategy with incrementally more risk, for example, by employing more leverage than is permitted by the Investment Company Act. In such a situation, the hedge fund may experience greater returns (or greater losses) by purchasing the same number and type of securities with more leverage. Generally, this would be a justifiable deviation in performance between a hedge fund and mutual fund otherwise following the same strategy. But the manager can preempt complaints by investors in the mutual fund by disclosing the possibility of such deviations, and the rationale for them. See "How Should Hedge Fund Managers Handle and Document Investor Complaints?," The Hedge Fund Law Report, Vol. 5, No. 36 (Sep. 20, 2012).