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Alternative Mutual Funds

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

By Jennifer Banzaca

The continuing quest for new sources of capital as well as the heightened regulation of hedge fund managers and their funds has prompted managers to explore launching alternative mutual funds. Simultaneously, the desire for innovative investment strategies and uncorrelated returns has heightened retail investor demand for such products, according to a June 2012 report from McKinsey & Company (McKinsey Report). See "McKinsey Analyzes Trends in the Mainstreaming of Alternative Investments and Outlines Strategic Imperatives for Traditional Asset Managers," The Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012). However, the organization and operation of alternative mutual funds present numerous challenges and risks for hedge fund managers – in particular, challenges and risks different from those typically encountered in the hedge fund world. Retail is not necessarily simple, especially if you are starting with a non-retail orientation.

This two-part article series is designed to enable hedge fund managers to weigh the more salient pros and cons of launching alternative mutual funds. This first installment discusses 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. The second article will detail specific steps necessary to launch an alternative mutual fund; costs and fees associated with launching and operating an alternative mutual fund; how such funds are typically distributed; investment restrictions applicable to alternative mutual funds; and some common conflicts of interest hedge fund managers face when operating alternative mutual funds and traditional hedge funds side by side. For analysis of an analogous side-by-side management scenario that raises its own conflicts of interest, see "How Can Hedge Fund Managers Use Reinsurance Businesses to Raise and Retain Assets and Achieve Uncorrelated Returns? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 3 (Jan. 17, 2013) (in particular, the discussion under the heading "Compliance Policies and Procedures to Address Conflicts Raised by Side-By-Side Management").

What Are Alternative Mutual Funds?

Fund Structures

Generally, alternative mutual funds are similar to traditional mutual funds. To begin with, they are open-ended, publicly-offered investment vehicles that offer daily liquidity, enhanced transparency and access to retail investors, unlike traditional hedge funds, which restrict liquidity and transparency and impose investor qualification standards. Alternative mutual funds are typically established as trusts or corporations, as opposed to most domestic hedge funds, which are organized as limited partnerships or limited liability companies. Like traditional mutual funds, alternative mutual funds register as investment companies and are regulated as such pursuant to the Investment Company Act of 1940 (Investment Company Act), which means that they are subject to investment restrictions, fund governance requirements, periodic reporting requirements and numerous compliance obligations.

Aisha Hunt, a Partner at Dechert LLP, noted, "The legal structure of most alternative mutual funds does not differ from the legal structure of traditional mutual funds. Alternative mutual funds are typically structured like traditional mutual funds as Delaware statutory trusts that are registered with the SEC under the Investment Company Act of 1940 (Investment Company Act)."

Additionally, like traditional mutual funds, alternative mutual funds register their securities pursuant to the Securities Act of 1933 (Securities Act), thus allowing them to offer their securities to the public without restrictions as to investor qualifications and advertising. On the other hand, and while the JOBS Act may change this, most hedge funds still rely on the Rule 506 safe harbor, which requires that investors qualify as "accredited investors" and restricts general solicitation and advertising. See "Implications for Hedge Fund Managers of the Rule Amendments Recently Adopted by the SEC to Raise Accredited Investor Standards," The Hedge Fund Law Report, Vol. 5, No. 1 (Jan. 5, 2012). Furthermore, alternative mutual funds are subject to periodic reporting requirements imposed by the Investment Company Act, and managers of alternative mutual funds are required to be registered with the SEC as investment advisers pursuant to the Investment Advisers Act of 1940.

Hunt explained, "Many of the legal issues that apply to alternative mutual funds are classic legal issues that mutual funds have been dealing with for decades. New legal issues are emerging and rapidly evolving, including the impact of new CFTC rules and how mutual funds can use derivatives. Most hedge fund strategies can fit into the four corners of mutual fund regulations. Some hedge fund strategies are not a fit for a mutual fund. For example, illiquid strategies cannot be offered through a mutual fund because mutual funds are required to provide daily liquidity."

Investment Strategies

Alternative mutual funds differ from traditional mutual funds principally because of the investment strategies employed by the alternative versions. George Silfen, a Partner at Kramer Levin Naftalis & Frankel LLP, explained, "An alternative mutual fund is a mutual fund that employs strategies that are typically pursued in the hedge fund channel and therefore typically pursued by hedge fund managers. Additionally, there are single strategy funds and sub-advised funds, which try to replicate a fund of hedge funds strategy."

As James Dilworth, Founder and CEO of Simple Alternatives, explained, "There is no technical category of 'alternative mutual funds.'" What you have in a traditional product are stocks and bonds (or equities and fixed-income), but, within the alternative mutual fund category, you have anything and everything else, such as managed futures, long/short equity or any esoteric strategy that is outside the 'normal' stock or bond portfolio. For the most part, an alternative mutual fund is a fund that goes both long and short."

According to Frank Attalla, a Principal at Rothstein Kass, an alternative mutual fund "is almost anything that is not your standard long-only exchange-traded fund. It is mostly a hedge fund strategy."

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Hunt further explained, "When most people refer to an alternative mutual fund, they are referring to a mutual fund that employs some type of alternative strategy, including certain hedge fund strategies, such as a merger arbitrage strategy, a long/short strategy or a managed futures strategy that you would typically see employed by private funds."

Because alternative mutual funds must offer daily liquidity, certain investment strategies are typically better suited for such products than others. These strategies include traditional long/short equity, market-neutral, merger arbitrage and global macro strategies. For a discussion of a "moderate disconnect" between investor and manager expectations concerning fund liquidity, see "Aksia Survey Reveals Hedge Fund Managers' Perspectives on AUM Composition, Fees, Liquidity, Advertising Practices, Transparency, Reporting and High-Frequency Trading," The Hedge Fund Law Report, Vol. 6, No. 3 (Jan. 17, 2013).

According to Rothstein Kass' Attalla, "As long as you are not trading commodities, do not have a lot of illiquid assets and are not highly levered, pretty much any strategy can fit into a mutual fund model. Even if you have illiquid assets or trade derivatives, you can do a closed-end fund, which is a similar model."

Dan Sondhelm, Partner and Senior Vice President of SunStar Strategic, added, "The types of strategies offered in an alternative mutual fund could be anywhere from currency funds to long/short funds; from multi-asset funds to managed futures funds. They are all designed to zig when the market zags. They are all designed to have low correlation to the markets. That is why they have done so well and why investors have flocked to these types of mutual funds in recent years."

"We are also seeing some hedge fund managers launch more conservative versions of their traditional hedge fund strategy or more sophisticated versions of traditional strategies," Hunt said. "You may see a long-only fixed-income strategy that focuses on a non-agency residential mortgage-backed securities play. Such a strategy may involve very sophisticated risk management and certain analytics that you do not typically see traditional managers employ."

Why Would Hedge Fund Managers Want to Launch Alternative Mutual Funds?

There are at least six compelling reasons for hedge fund managers to launch alternative mutual funds.

First, alternative mutual funds offer hedge fund managers the opportunity to access new sources of capital. Among other things, the mutual fund structure is appealing and familiar to many retail investors and their advisers. In addition, because alternative mutual funds do not seek exemptive relief from the Investment Company Act or the Securities Act, investors are not subject to qualification standards and need not be "accredited investors" or "qualified purchasers" to invest in such funds. See "SEI Report Describes the Growth Opportunity for Hedge Fund Managers in Regulated Alternative Funds," The Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011).

Simple Alternatives' Dilworth explained the demand story as follows: "Increasingly, institutional investors, such as endowments and pensions, have allocated more assets to the alternative asset class, most of which has been hedge funds. However, there have been a lot of hedge fund managers who have had a hard time competing with large institutional managers for institutional capital. The majority of hedge funds are not able to participate in the asset growth from the institutional capital being deployed because they are simply too small. So, you have increased demand from the financial advisers and retail investors who want access to the strategies, but that cannot use the limited partnership structure, thus opening up a whole new marketplace. The way these two worlds are starting to collide is via the mutual fund structure, which is the structure of choice for retail advisers." For more on the evolving views of endowments with respect to hedge fund allocations, see "State Street Report Describes an Evolution in the 'Endowment Model' of Hedge Fund Investing," The Hedge Fund Law Report, Vol. 5, No. 48 (Dec. 20, 2012).

Hunt explained, "For hedge fund managers, launching an alternative mutual fund is an unprecedented opportunity to raise assets. As an alternative manager, you are not just competing with other alternative managers; you are competing for assets in traditional multi-trillion dollar asset classes. You can potentially raise substantially more assets through a mutual fund than a hedge fund because you can access retail distribution channels. The focus is shifting from the hedge fund as a legal structure to the hedge fund manager and the strategy. Managers are assessing how to optimize the distribution of their strategy."

Second, restrictions on the use of general solicitation and advertising to market hedge funds do not apply to alternative mutual funds. Even after passage of the JOBS Act, hedge funds are only permitted to market their hedge funds using general solicitation and advertising if they take reasonable steps to ensure that purchasers of fund securities are accredited investors. See "Annual Thompson Hine Hedge Fund Seminar Focuses on Implications for Hedge Fund Managers of the JOBS Act, Form PF and Form CPO-PQR," The Hedge Fund Law Report, Vol. 5, No. 42 (Nov. 9, 2012). Hedge fund managers that offer alternative mutual funds can publicize their business and investment strategies, which could indirectly benefit their hedge funds. See "JOBS Act: Proposed SEC Rules Would Dramatically Change Marketing Landscape for Hedge Funds," The Hedge Fund Law Report, Vol. 5, No. 34 (Sep. 6, 2012). Sondhelm explained, "They can talk about their strategy and performance, which gives managers a lot more flexibility to get the word out. Given the uncertainty in the JOBS Act, having a mutual fund at least allows you to tell your story no matter what, and you may get a drift-over effect to the rest of your business. Even if you are not promoting the business, if you are promoting a fund with a similar strategy and the same portfolio managers, that does give you some credibility and may cause some qualified investors to invest in your hedge fund or through a separate account." For a discussion of a study coming to a conclusion that supports Sondhelm's point, see "New Study Offers Surprising Findings on the Incentives Created by Concurrent Management of Hedge and Mutual Funds," The Hedge Fund Law Report, Vol. 2, No. 23 (Jun. 10, 2009).

Third, demand for retail alternative products is growing because of retail investors' desires for innovative investment strategies, diversification and uncorrelated returns. According to the McKinsey Report, alternatives are rapidly moving into the mainstream retail market. The McKinsey Report predicted that by 2015, "retail alternatives are expected to account for one-quarter of retail revenues and a majority of revenue growth, as retail investors, confronted with volatile financial markets and the underfunding of their own retirements, follow the path blazed by institutional investors. Fueling this trend is a shift in investment frameworks from

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relative to absolute return and a convergence of traditional and alternative asset classes, investment managers and products."

According to Hunt, "Brokerage firms are increasingly adding alternative mutual funds to their platforms, and in some cases, are asking hedge fund managers to launch alternative mutual funds for their platforms to meet the demand for more sophisticated investment management."

Fourth, alternative mutual funds offer hedge fund managers the opportunity to diversify their product offerings and investor base.

According to Dilworth, "One of the biggest benefits is having a wider distribution net or a larger pool of potential capital for their business. It allows managers to diversify their assets under management by going after a much larger target market than they are currently able to. That is very attractive to hedge fund firms that are interested in growing their businesses."

Sondhelm agreed, adding, "Operating a mutual fund opens up a different audience for hedge fund managers, including individuals and organizations that may not have been eligible to invest in hedge funds in the past. It diversifies your revenue stream. The markets continue to be volatile, which means that there is going to be demand for alternative retail products for a long time. If you have a good strategy, and you want to diversify your business, it makes a great deal of sense to consider a mutual fund."

"The advantage to the hedge fund manager of sponsoring or subadvising an alternative mutual fund is that it diversifies your product line," Silfen explained. "Instead of being subject to the whims of larger investors that may have different factors that impact their subscription or redemption decisions, the retail investors base may react to different factors. If you are able to raise assets from a different client base, you can have a more diversified business."

Fifth, the increased regulation of hedge funds and their managers has closed the gap between the regulation of hedge funds and mutual funds, which in turn has reduced the disincentive for hedge fund managers to offer alternative mutual fund products. See "Hedge Fund Managers Launching Mutual Funds in an Effort to Stay a Step Ahead of Regulatory Convergence," The Hedge Fund Law Report, Vol. 2, No. 15 (Apr. 16, 2009). As Attalla said, "For years, hedge fund managers have just stayed in the private space and stayed away from the regulated space. A lot of times they did not have to register as investment advisers, which is one requirement to launch a mutual fund. It was a little more lucrative in terms of the fees managers can charge on their hedge funds. That goes away in the mutual fund space. Post Dodd-Frank, many hedge fund managers have to, or already have registered with the SEC as investment advisers. So, one hurdle has already been eclipsed. In addition, the difficulty faced by hedge fund managers in raising capital has been a driving factor in why managers are looking now to the registered space." The growing popularity of retail products in Europe, such as UCITS funds, likely has also contributed to the increased willingness on the part of hedge fund managers to offer retail products in the United States. See "Are Alternative Investment Strategies Within the Spirit of UCITS?," The Hedge Fund Law Report, Vol. 5, No. 23 (Jun. 8, 2012).

Sixth, there are no limitations on the number of investors that can invest in alternative mutual funds, unlike some traditional hedge funds that rely on an exclusion from Investment

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Company Act registration contained in Section 3(c)(1). A big advantage of a mutual fund is there is no limit to the number of investors you can have. See "SEC Order Increasing the Dollar Threshold for 'Qualified Client' Status Further Chips Away at the Utility of the 3(c)(1) Fund Structure," The Hedge Fund Law Report, Vol. 4, No. 28 (Aug. 19, 2011).

What Are Some Disadvantages of Launching an Alternative Mutual Fund?

There are at least nine potential drawbacks for hedge fund managers in launching alternative mutual funds.

First, the fees for managing alternative mutual funds are typically fixed-asset-based fees and are lower than those for managing traditional hedge funds. As a result, hedge fund managers count on raising more assets to offset the lower fees earned on managing such assets.

According to Dechert's Hunt, "With a mutual fund, you can charge a fulcrum fee, which is a different type of performance fee, but it does not permit the traditional hedge fund fee structures. So, managers are sometimes reluctant to forego a performance fee. I think that you cannot assess the profitability of charging a performance fee versus a mutual fund management fee without taking into account the assets that could be raised through a hedge fund versus a mutual fund. Some hedge fund managers have converted their hedge funds (where they have had difficulty raising assets) into mutual funds, and it has been a more profitable endeavor because, although they are charging lower fees, it is on a larger pool of assets."

Second, alternative mutual funds typically offer investors daily liquidity, which could require a manager to maintain extra cash on hand to fund redemptions, which could, in turn, hinder a manager's ability to effectively deploy certain investment strategies. For a discussion on managing fund liquidity, see "Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012). According to Attalla, the daily liquidity of an alternative mutual fund is a concern for some hedge fund managers, who typically offer monthly, quarterly or annual liquidity. Additionally, hedge fund investors could be subject to lockups of a year or more, which alternative mutual fund investors do not face.

Third, regulations require alternative mutual funds to offer greater transparency into their operations and portfolios as compared with traditional hedge funds. For more insight on investor expectations concerning fund transparency, see "What Do Hedge Fund Investors Want in Terms of Liquidity and Transparency?," The Hedge Fund Law Report, Vol. 4, No. 39 (Nov. 3, 2011). To begin with, because alternative mutual funds are registered with the SEC pursuant to the Investment Company Act and Securities Act, they must file publicly-available registration statements that contain significantly more information about the mutual fund and its manager than the typical hedge fund private placement memorandum contains about the hedge fund and its manager. These registration statements must be periodically amended. Also, unlike traditional hedge funds, alternative mutual funds must file semi-annual shareholder reports pursuant to Securities Exchange Act of 1934.

Additionally, alternative mutual funds are required to report their portfolio holdings at least quarterly. Silfen commented, "You are more exposed in all your actions. You now have a

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retail public that will be aware of whatever issues you may have come up. Your portfolio has to be publicly filed four times a year. With the amount of transparency investors are demanding even on the hedge fund side, we are not seeing too much of a concern with that kind of public disclosure of the portfolio on a 60-day lag. With a multi-manager product, you only have to disclose aggregate positions. So you do not really know which subadviser is investing in a particular security."

Managers that provide heightened portfolio transparency with respect to their alternative mutual funds could also be giving more transparency into their hedge funds than they would like if such hedge funds employ similar investment strategies.

Fourth, the Investment Company Act imposes investment restrictions on alternative mutual funds. For instance, alternative mutual funds typically are not permitted to invest more than 15% of their assets in illiquid investments. In addition, as the second installment in this series will discuss, alternative mutual funds are subject to restrictions on their use of leverage pursuant to the Investment Company Act. Specifically, a fund's net assets must be at least three times aggregate borrowings immediately after any borrowing. Also, the Investment Company Act and Internal Revenue Code impose asset diversification standards that mutual funds (including the alternative kind) must satisfy quarterly.

Fifth, the costs of organizing and operating alternative mutual funds is typically greater than those for traditional hedge funds because of the significant resources and personnel required to operate and sell shares in a mutual fund. For more on the expected costs of operating a hedge fund, see "Citi Prime Finance Report Dissects the Expenses of Running a Hedge Fund Management Business, Identifying Components, Levels, Trends and Benchmarks," The Hedge Fund Law Report, Vol. 6, No. 1 (Jan. 3, 2013).

"It is very onerous to set up an alternative mutual fund," Dilworth commented. "Because you are trading in public markets and offering a product to the public, it is a much more regulated vehicle and requires much more oversight. Obviously, you need to deploy more resources to a mutual fund. First of all, selling a mutual fund is very different from selling interest in a hedge fund. It typically requires a sales force or a distribution team. It really takes a lot of commitment from the manager to go after the retail market. It is not just a simple as launching a new vehicle. It is operationally very intensive, and the margins are a lot lower than on the hedge fund side of the business."

Among other things, an alternative mutual fund is required to "fair value" its securities on a daily basis to permit the calculation of the fund's net asset value to permit investors to subscribe to or redeem from the fund.

Sixth, Sondhelm pointed out that another challenge of launching a mutual fund is attracting assets. "For the hedge fund manager that thinks, 'If you build it, they will come,' that is not the way it usually works. You really need to think of a distribution strategy, and you should really think of this strategy even before you launch the fund. Once you launch the fund, it is really too late."

Seventh, managers offering alternative mutual funds may be diverting business away from their traditional hedge funds because of the attractiveness of lower fees and greater liquidity and transparency offered through alternative mutual fund products. Hunt explained, "Some hedge fund managers worry about cannibalization. To the extent they are offering the same strategy through a mutual fund and a hedge fund, there is a concern that investors in the hedge fund might just move over to the mutual fund to avoid paying higher fees. What some managers are doing to combat that is to offer different versions of their strategies. Maybe they have a more aggressive strategy that tends to yield higher returns that they offer through a hedge fund, and then they offer a more conservative version of that strategy through a mutual fund."

Eighth, alternative mutual funds are subject to heightened fund governance requirements pursuant to the Investment Company Act, which requires, among other things, that their boards be comprised of a majority of independent directors. See "Davis Polk 'Hedge Funds in the Current Environment' Event Focuses on Establishing Registered Alternative Funds, Hedge Fund Manager M&A and SEC Examination Priorities," The Hedge Fund Law Report, Vol. 5, No. 24 (Jun. 14, 2012). Rothstein Kass' Attalla explained, "It may be that the general partner may be one member, but you have to have a majority of independent directors. A lot of general partners are used to calling the shots and do not want to give up that much control of their funds." Additionally, alternative mutual funds must hold quarterly board meetings where various information about the fund's activities, including trading and operational information, must be disclosed. Also, the CCO of an alternative mutual fund manager must report all compliance issues directly to the fund's board of directors as opposed to the manager. On CCO reporting lines in the hedge fund context, see "To Whom Should the Chief Compliance Officer of a Hedge Fund Manager Report?," The Hedge Fund Law Report, Vol. 4, No. 22 (Jul. 1, 2011).

Ninth, regulatory scrutiny of alternative mutual funds could increase in coming years. At a December 18, 2012 speech before the Regulatory Compliance Association in New York City, Bruce Karpati, the Chief of the SEC's Asset Management Unit of the Division of Enforcement, expressed the agency's concern that retail investors may not be sufficiently sophisticated to understand and invest in mutual funds offering hedge fund strategies. For more on Karpati's speech, see "OCIE Director Carlo di Florio and Asset Management Unit Chief Bruce Karpati Address Examination and Enforcement Priorities for Hedge Fund Managers at the RCA's Compliance, Risk & Enforcement 2012 Symposium," The Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013).

What Are the Different Ways Hedge Fund Managers Can Enter the Alternative Mutual Fund Business

There are several different ways hedge fund managers can enter the mutual fund business, Silfen explained. "The traditional way is to sponsor their own mutual funds, find distribution partners and hope the distribution garners assets. Another way is for the hedge fund manager to subadvise either an entire fund or a sleeve of a multi-strategy fund. Subadvising allows the hedge fund to manage the money and not have to worry about taking on the labor of some of the administrative, back office responsibilities. At the same time, it also presumes that there is a distribution partner and that the hedge fund manager just has to manage the money and someone else is taking care of distribution. Subadvising has been the typical approach that hedge fund managers have taken to date because it allows them to diversify their product line while at the same time allowing the manager to manage the retail money without having to get overly involved with all the regulatory and distribution burdens of sponsoring a mutual fund. On the other hand, sponsoring an alternative mutual fund gives the hedge fund manager greater control over the product. Sometimes it might help distribution to give that hedge fund manager greater control."