Use of Sub-Advisers and Liquid Alternative Funds

Key Considerations and Legal Issues

Jack W. Murphy
Philip T. Hinkle*

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*Dechert associates Joseph McClain and Matthew Virag provided substantial input on this paper.

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I. Introduction

In recent years, many investment managers that traditionally manage private funds have been opening retail funds or establishing investment advisory relationships with investment advisers to retail fund products. These managers generally use the same or a similar investment strategy for retail funds that they use to manage private funds. These investment strategies may include, among others, "long/short," "managed futures," funds of hedge funds (or hedge fund-linked investments) and quantitative strategies. Retail funds that are managed using alternative or non-traditional strategies are generally referred to as "liquid alts funds."

There are numerous alternative approaches available to private fund managers looking to develop retail fund business lines, including launching a proprietary retail fund complex, opening a fund on a shared trust platform or serving as a sub-adviser to a fund managed under a "manager of managers" structure. Depending on the targeted investors, liquid alts funds can be U.S. registered funds ("registered funds"), such as open-end funds, closed-end funds, exchange traded commodity pools or business development companies, or UCITS (retail funds offered to investors within the European Union), among other structures. For a summary comparison of features across these categories of retail funds, see **Appendix A**.

Private fund managers' investment strategies must be modified to some extent to comply with relevant requirements under the Investment Company Act of 1940 ("1940 Act") relating to liquidity and leverage, among others. This outline focuses on U.S. registered open-end funds operating alternative strategies under a manager of managers structure. The outline reviews key requirements that may impact alternative investment strategies and manager of managers relationships and provides an overview of recent developments relevant to these funds.

II. Recent Market Developments and Key Drivers

Liquid alts funds have increased exponentially in popularity in the last five years. According to a recent report, liquid alts funds have been growing 38% annually since 2008 while the entire U.S. mutual fund industry has grown 9% annually over the same time period.[1] The growth is likely to continue; retail investors are expected to add $49 billion to liquid alts funds over the next year, up from $34 billion over 2013.[2] Currently, liquid alts funds account for approximately 3% of the entire mutual fund market and are on track to account for a much larger portion of that market in the future.[3]

Multiple factors have contributed to the increased use of liquid alts funds:

- Hedge fund managers use liquid alts funds to access new sources of capital through new retail distribution channels.
  - Liquid alts funds allow private fund managers to diversify and broaden their client base and their products managed. Mutual fund clients differ from hedge fund investors in their investment behavior and tend to withdraw assets from under-performing funds more slowly.
  - Creating retail products allows private fund firms to attract a larger number of investors, decreasing vulnerability to redemptions by individual clients.
  - Liquid alts funds permit an unlimited number of investors to invest in the fund.
- Liquid alts funds may be marketed publicly while private funds historically could not engage in general solicitation.[4]
- Retail investors have increasingly been demanding innovative investment strategies.
- In the wake of the Dodd-Frank Act, the SEC and CFTC have subjected hedge fund managers to more strict regulations, eliminating certain perceived benefits of managing private funds over registered funds.

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1 *From Alternatives to Mainstream Part Two*, Deutsche Bank Survey (Sept. 2014); s*ee also* Joe Morris, "The Future of Liquid Alts: More Money, (Way) More Products," *Ignites* (Sept. 9, 2014).

2 *Id.*

3 *Id.*

4 The marketing gap may be narrowing though, as the Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") have each recently adopted rule amendments to allow private fund managers to engage in certain general solicitations.

III. Key Requirements for Liquid Alts Funds

A. SEC Registration

Like any registered fund, a liquid alts fund must be registered under the 1940 Act and must register its shares under the Securities Act of 1933 ("1933 Act"). Furthermore, it must maintain a current prospectus in order to make a continuous offering of its securities.

Unlike advisers to private funds, which may not be required to register as investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), an investment adviser or sub-adviser to a registered fund must register with the SEC as an investment adviser via Form ADV. Upon registration, managers become subject to the substantive requirements of the Advisers Act. An adviser's Form ADV must be amended annually and whenever there have been material changes to the information therein.

B. Advisory Fee Structures

Prohibition on Performance Fees: Unlike advisers to private funds, investment advisers to registered funds are generally prohibited under Section 205(a)(1) of the Advisers Act from charging performance fees (compensation based on a percentage of the capital gains or capital appreciation) to the fund. As a result, registered fund investment advisers typically receive an investment advisory fee based on a percentage of the fund's assets under management by the adviser in accordance with Section 205(b)(1). In addition, in contrast to hedge fund advisers, mutual fund advisers are prohibited from establishing different fee schedules for different investors within the same mutual fund.

Exemption for Fulcrum Fee Arrangements: Sections 205(b)(2) and (c) of the Advisers Act, as implemented by Rules 205-2 and 205-3 thereunder, provide an exception from this prohibition for "fulcrum fee" arrangements.

- An investment adviser to a registered fund may charge an investment advisory fee "based on the asset value of the [fund] under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the [fund] over a specified period in relation to the investment record of an appropriate index . . . ."
- If a fund performs equal to its specified index over the specified period, the adviser receives an advisory fee based on the "fulcrum" or base fee rate. The fulcrum rate is adjusted incrementally upwards for outperformance and downwards for underperformance over the applicable period.

The fulcrum fee structure is viewed as a way to attract investment advisers who have previously only managed private funds to manage liquid alts funds. Investment advisers and sub-advisers that choose to implement performance-based advisory fees should solicit the input of legal counsel and audit firms to be sure they are structured properly and avoid pitfalls.[5]

[5] For further detail on the applicable laws and regulations and guidance from the SEC and its staff and the American Institute of Certified Public Accountants ("AICPA"), *see* Sander M. Bieber and Lisa R. Price, "Fulcrum Fees: Registered Funds' Alternative Fee Structure," *The Investment Lawyer* (Sept. 2014) and Jack W. Murphy and Julien Bourgeois, "Mutual Fund Performance Fees: Discussions and Observations," *The Investment Lawyer* (Nov. 2006).

C. Fund and Adviser Compliance Policies and Procedures

As discussed in more detail below, sub-advisers to registered funds must establish an appropriate compliance program with specifically tailored written policies and procedures. For investment advisers new to the management of registered funds, this process can require one of the most significant expenditures of time and resources in opening the initial registered funds. However, once incurred, this will not be a recurring expenditure as the adviser takes on additional registered fund sub-advisory mandates or opens proprietary mutual funds.

1. Overview of Rule 38a-1 and Fund Compliance Programs

Rule 38a-1 under the 1940 Act requires each registered fund to: (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance of each investment adviser, principal underwriter, administrator and transfer agent of the fund; and (ii) review, at least annually, the adequacy of such policies and procedures and the effectiveness of their implementation. Rule 38a-1 also requires a fund's board to review and approve the policies and procedures of the fund's investment adviser(s) (including sub-advisers), principal underwriter, administrator and transfer agent. For a list of common fund and adviser compliance policies and procedures, please see **Appendix B**.

A majority of the directors or trustees that are not "interested persons" of the fund as defined in the 1940 Act ("Independent Board Members") must approve these policies and procedures. The approval must be based on a finding that the policies and procedures are reasonably designed to prevent violations of the federal securities laws by the fund and by each investment advisor, principal underwriter, administrator and transfer agent of the fund.

The board must also review the adequacy of the policies and procedures of the fund and each of the fund's investment adviser, sub-adviser(s), principal underwriter, transfer agent and administrator on an annual basis. The board must also review the effectiveness of the implementation of these policies and procedures.

A majority of the fund's Independent Board Members must designate a chief compliance officer ("CCO") of the fund, approve his or her compensation and be empowered to remove the CCO at any time. The role of the fund's CCO and compliance department is vitally important to establishing and managing the relationship between the fund's board, primary investment adviser and sub-advisers.

In conducting the review of a potential sub-adviser's compliance policies and procedures, a fund's CCO and compliance department should take into consideration whether the sub-adviser has previously served as a sub-adviser or adviser to a registered investment company.

2. Key Policies and Procedures

Sub-Adviser Oversight Procedures. The primary investment adviser in a manager of managers structure generally establishes policies and procedures governing its oversight of sub-advisers. These procedures describe the primary investment adviser's responsibilities to: (i) review and conduct due diligence on prospective sub-advisers; (ii) inform new and current sub-advisers of the restrictions applicable to the particular fund they manage; (iii) review and assess each sub-adviser's legal, compliance and operational infrastructure (including, where relevant, specialized trading documentation) on an ongoing basis; (iv) monitor the sub-adviser's investment performance over time; and (v) monitor the overall structure of each fund in light of the fund's investment objectives and strategies. A key part of this role is communicating to the sub-adviser

which components of the funds' compliance program must be reflected in the sub-adviser's own compliance program.

Key Sub-Adviser Procedures to Review. Sub-adviser policies and procedures that must be considered include, among others, policies and procedures relating to: (i) compliance with investment restrictions; (ii) placing and executing fund transactions (e.g., best execution, conflicts of interest and side-by-side management, trade allocation and aggregation, transactions with affiliated persons (Rule 17a-7), affiliated brokerage (Rule 17e-1) and soft dollars); and (iii) procedures ensuring compliance with substantive restrictions under the 1940 Act (e.g., procedures relating to liquidity, diversification, leverage through derivatives and/or bank borrowing, concentration and diversification). More information on substantive restrictions under the 1940 Act is set forth below in the section entitled "Key 1940 Act Restrictions on Registered Fund Portfolio Investments" below.

Side-by-Side Management of Registered Funds and Hedge Funds. Advisers and sub-advisors to alternative registered funds frequently manage liquid alts funds and hedge funds that use the same (or very similar) investment strategies. This raises potential conflicts of interest regarding the allocation of investment opportunities between the funds. For example, the adviser may have an incentive to allocate more attractive opportunities to the hedge fund because of the performance-based fees that hedge funds are permitted to charge.

These investment advisers and the fund boards engaging them should carefully consider the investment adviser's policies and procedures that address the allocation of investment opportunities across different funds. These policies and procedures should ensure that the liquid alts fund is not systematically disfavored with respect to investment opportunities. Most such policies and procedures allocate opportunities on a pro rata basis based on assets under management and may provide a list of factors that can permit the adviser to deviate from this default allocation. Compliance staff should run periodic checks to ensure that the policies and procedures are being observed.[6]

Advisers should carefully document the justification of any deviation from their allocation policies and procedures because SEC staff members are likely to scrutinize these records during an examination.

3. Sub-Adviser Code of Ethics

In addition, Rule 17j-1 under the 1940 Act requires that a fund obtain board approval of the code of ethics of each of its investment advisers (including sub-advisers) and primary underwriters, based on a finding that the code of ethics contains provisions reasonably necessary to prevent "access persons" from engaging in any conduct prohibited by Rule 17j-1(b).

4. Sub-Adviser Proxy Voting Policies and Procedures

Among its fiduciary responsibilities, a fund's board is obligated to vote proxies relating to the fund's portfolio securities. The board may retain this authority or delegate it to a fund's registered investment adviser (including a sub-adviser) or a third party service provider.[7] Rule 206(4)-6 under the Advisers Act requires that any registered investment adviser (including a sub-adviser)

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[6] Advisers should disclose this potential conflict of interest in the hedge fund's offering memorandum, the mutual fund's prospectus and the adviser's Form ADV.

[7] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release No. IC-25922 (Jan. 31, 2003).

adopt and implement policies and procedures governing the voting of proxies relating to clients' securities. Form N-1A requires a description of each applicable policy and procedure to appear in the fund's registration statement.

If a fund's board delegates proxy voting authority to a sub-adviser, it must oversee the proxy voting process and ensure that proxies are voted consistently with the best interests of the fund's shareholders. In order to fulfill its obligation under Rule 38a-1 to oversee a sub-adviser's voting of proxies, the board of a fund must review the proxy voting policies and procedures of any sub-adviser that has delegated authority and make the required findings as discussed above.

D. Key 1940 Act Restrictions Applicable to Registered Fund Portfolio Investments

1. Daily Liquidity, NAV Requirements and Illiquid Securities

- *Daily Liquidity:* Section 22(e) of the 1940 Act requires that registered funds provide proceeds to shareholders within 7 days of redemption. Registered funds are not permitted to impose gates or otherwise suspend shareholder redemption rights.

- *Calculating a Daily NAV:* Section 22(c) of the 1940 Act and Rule 22c-1 thereunder require a registered fund to calculate its net asset value ("NAV") per share each day the markets are open and to offer and redeem its shares at a price based on the fund's current NAV next computed after the receipt of a purchase or redemption order.

  - Under Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder, a fund's NAV must be based on the current market value of the fund's holdings, if available, and on the fair value as determined by the fund's board otherwise.

  - Boards typically approve fair valuation policies and procedures of the fund, delegate the responsibility of day-to-day valuation activities to the adviser and monitor the adviser's valuation process on a periodic basis.

- *15% Restriction on Illiquid Securities:* The SEC takes the position that registered funds may not invest more than 15% of net assets in illiquid securities (5% for money market funds). An illiquid security is defined as one that cannot be disposed of within 7 days at approximately the same value at which the fund valued the instrument.

  - *OTC Derivatives and Liquidity Determinations:* Over-the-counter ("OTC") derivative instruments, such as swaps, are generally considered to be illiquid. However, many investment managers that use OTC derivatives negotiate termination provisions in trading agreements in order to treat those instruments as liquid. Generally, these provisions must allow the fund to terminate the contract and receive final payment within 7 days.

- Many primary advisers utilizing a manager of managers structure require sub-advisers to provide input and assistance in the valuation and liquidity determinations in accordance with board-approved valuation and liquidity policies and procedures. It is important that both the investment adviser and investment sub-adviser conduct sufficient due diligence to understand each others' processes and be prepared to work together to satisfy their obligations to the fund in these areas.

- Valuation and liquidity have been an area of SEC examinations and enforcement action focus in recent years.

2. Names Rule

- Section 35(d) of the 1940 Act and Rule 35d-1 thereunder mandate that registered funds may not adopt a misleading name.

- *80% Test:* Rule 35d-1 imposes two different "80% policy" tests:

  - Under Rule 35d-1, a fund's name will be deemed to be materially deceptive and misleading if the name suggests an investment in a particular type of investment or industry or industries unless: (i) the fund adopts a policy to invest, under normal circumstances, at least 80% of its assets in the particular type or category suggested by the fund's name; and (ii) either the policy is a fundamental policy under Section 8(b)(3) of the 1940 Act (i.e., cannot be changed without shareholder approval) or the fund has adopted a policy to provide the fund's shareholders with at least 60 days' prior notice of any change in the 80% policy.

  - In addition, Rule 35d-1 provides that a fund's name indicating an investment emphasis in a certain country or geographic region will be materially deceptive and misleading unless: (i) the fund adopts a policy to invest, under normal circumstances, at least 80% of its assets in investments that are tied economically to the particular country or geographic region suggested by the fund's name; (ii) the fund discloses in its prospectus the specific criteria used by the fund to select investments that are consistent with this policy; and (iii) either the policy is a fundamental policy or the fund has adopted a 60-day shareholder notice policy.

- *Exceptions:* The SEC has recognized that certain terminology merely suggests an investment strategy (as opposed to an industry or type of investments) and therefore generally is not deemed to be subject to a required 80% test (e.g., "focused" or "managed futures").

3. Custody Requirements

- Section 17(f) of the 1940 Act requires a registered fund to custody its securities with banks (as defined under the 1940 Act) or, subject to certain SEC rules, with broker-dealers or the registered fund itself. Generally, registered funds maintain their assets with a U.S. bank custodian.

- *Exemptions:* The SEC has adopted rules to allow registered funds to utilize certain other custody arrangements. These exemptions permit the fund to custody certain assets with U.S. securities depositories such as SEC-registered clearing corporations (Rule 17f-4), non-U.S. sub-custodians (Rule 17f-5), futures commission merchants ("FCMs") (Rule 17f-6) and non-U.S. securities depositories (Rule 17f-7).

- *FCM Exemption:* Under Section Rule 17f-6, registered funds are permitted to use FCMs as a custodian for posting collateral or margin necessary for executing futures contracts, commodity options contracts and cleared swaps.

  - In order for a fund to maintain margin in the custody of an FCM, the FCM must be registered with the CFTC and not be a first or second tier affiliated person of

the fund. The fund may only maintain a de minimis amount of gains (i.e., variation margin paid to the fund) with the FCM for more than one day.

- Rule 17f-6 requires that the written contract between a fund and its FCM provides that:
    - the FCM will comply with the applicable segregation and secured amount requirements of the Commodity Exchange Act ("CEA") and the CFTC;
    - the FCM may place initial margin, as appropriate, with another FCM, a clearinghouse (including a clearinghouse for a foreign exchange) or a U.S. or foreign bank, provided, in doing so, the FCM obtains an acknowledgement from that other entity that the margin is held on the fund's behalf in accordance with the provisions of the CEA; and
    - the FCM will promptly furnish copies or extracts of records or other information regarding the fund's assets as the SEC may request.
- Primary investment advisers often review their sub-advisers' futures account agreements and excess margin practices to ensure that they comply with these requirements.

4. Restrictions on Leverage Transactions

- *Senior Securities:* Section 18(f) of the 1940 Act limits the ability of a registered fund to borrow or engage in "senior securities" transactions that leverage its portfolio. While a "senior security" is defined as "any bond, debenture, note, or similar obligation or investment constituting a security and evidencing indebtedness" as well as "any stock of a class having priority over any other class as to the distribution of assets and payments of dividends," the SEC has broadly interpreted Section 18(f) to apply to any transaction that exposes a fund's shareholders to "leverage," such as short sales, reverse repurchase agreements and derivative transactions (e.g., swaps, futures and written security and commodity options).
- *Covering Exposure:* The SEC and its staff have provided guidance that a fund can avoid the issuance of senior securities when engaging in transactions involving leverage by (i) segregating on the books of its custodian or designating on the fund's records certain amounts of liquid assets or (ii) entering into an offsetting transaction. The "cover" amount must at all times be sufficient to meet the fund's potential obligations under the transaction (i.e., by "covering" the leverage exposure created by the transaction). This practice is meant to ensure that the fund always has liquid assets sufficient to meet its future obligations as well as to place a practical limit on the ability to leverage fund assets. Alternatively, a fund may treat the leveraged transaction as a borrowing and cover the transaction as discussed below. The amount of cover required will depend on the particular derivative instrument used.

5. Restrictions on Leverage through Bank Borrowing

- While a fund cannot issue senior securities, Section 18(f) provides that a fund may borrow from a bank provided that there is asset coverage of at least 300% for all borrowing of the fund (200% for a closed-end fund). If the asset coverage falls below the

applicable threshold, the fund is required to reduce the amount of its borrowing within three days so as to reestablish the 300% asset coverage amount. This effectively allows an open-end fund to borrow up to 33 1/3% of its total assets, including loan proceeds.

- Section 18(g) of the 1940 Act allows a fund to enter into a temporary loan that does not exceed 5% of the registered fund's total assets as of the time it was made. A loan is presumed temporary if it is repaid within 60 days and is not extended or renewed and otherwise is presumed not to be temporary.

6. *Industry Concentration*

- *Industry Concentration Policies:* Under Section 8(b) of the 1940 Act, a registered fund must disclose its policy with respect to concentration (i.e., an investment of more than 25% of a fund's assets in an industry or group of industries). A fund's concentration policy cannot be changed without shareholder approval. A fund may concentrate its investments in one industry and still be diversified (as discussed below).
    - A fund that does not have a concentration policy may not purchase securities of any issuer if, after the purchase, it would be concentrated in an industry.
- *Defining the Industry:* While a registered fund has some discretion in defining the relevant industry, the SEC has taken positions regarding certain industry classifications (e.g., privately issued mortgaged-backed securities).

7. *Diversification*

- *Diversified/Non-Diversified Election:* Section 5 of the 1940 Act classifies a fund as diversified or non-diversified. A fund must disclose its status under this section in its prospectus and identify related implications and risks.
    - *Diversified Fund:* A diversified fund must, with respect to at least 75% of its total assets, limit its investment in securities of any one issuer (excluding cash items, U.S. government securities or securities of other investment companies) to (i) an amount not greater in value than 5% of the value of the total assets of such management company and (ii) not more than 10% of the outstanding voting securities of such issuer.
    - *Non-Diversified Fund:* A non-diversified fund is any fund other than a diversified fund. Although a non-diversified fund does not have to comply with the 1940 Act diversification requirements set forth above, both diversified and non-diversified funds must comply with the diversification requirements under the Internal Revenue Code ("IRC"), as discussed below. Shareholder approval is not required for a fund to change from non-diversified to diversified. Although a non-diversified fund that operates as a diversified fund for three years will be deemed to be a diversified fund, Rule 13a-1 provides that a non-diversified fund that operates as a diversified fund for a period of less than three years may return to operating as a non-diversified fund so long as it did not hold itself out as proposing to become a diversified fund during that time.
- Careful monitoring of portfolio holdings to ensure compliance with a fund's diversification status is important and may be challenging for a primary investment adviser to a multi-managed sub-advised fund.

- Identifying the "issuer" of fund holdings of derivatives and certain other instruments, such as repurchase agreements (in accordance with Rule 5b-3), presents another potential challenge.

8. Investments in Securities-Related Issuers

- Section 12(d)(3) of the 1940 Act limits a fund's ability to invest in a security or other interest in a broker-dealer, underwriter or investment adviser (each a "securities-related issuer").
- *15% Test:* Under Rule 12d3-1, a fund may invest in an unaffiliated securities-related issuer without limitations if the securities-related issuer received less than 15% of its gross revenues from securities related activities, unless the fund would control the issuer after the investment (subject to certain conditions).
- If a securities-related issuer is unaffiliated, but does not meet the 15% test, the fund may still invest subject to limits, including that, immediately after investment: (i) the fund cannot own more than 5% of the securities-related issuer's outstanding equity (or the relevant class of securities); (ii) the fund cannot own more than 10% of the securities-related issuer's outstanding debt securities; and (iii) the fund cannot invest more than 5% of the fund's assets in the securities of that issuer.
- Identifying the issuer and valuing positions in derivatives is a potential challenge.

9. Limitations on Investments in Other Investment Companies

- A registered fund's investment in other investment companies (whether registered or not) and sale of fund shares to other investment companies (whether registered or not) is limited by Section 12(d)(1)(A) and (B) of the 1940 Act. Section 12(d)(1) was intended to protect registered fund shareholders against the layering of sales charges, advisory fees and administrative costs resulting from the acquisition of securities of other investment companies.
  - Section 12(d)(1)(A)'s limitation on fund investments in other funds mandates that: (i) a fund may not own more than 3% of another investment company's voting shares; (ii) a fund may not invest more than 5% of its own assets in the securities of any single investment company; and (iii) a fund may not invest more than 10% of its cumulative assets in the securities of other investment companies.
  - Section 12(d)(1)(B)'s limitation on a registered fund's sale of its shares includes that, immediately after the sale: (i) the acquiring fund and any companies controlled by it may not own more than 3% of the registered fund's shares; or (ii) the acquiring fund and any investment companies controlled by it may not own more than 10% of the registered fund's shares.

10. Registration Statement and Reporting Requirements

- *Registration Statements:* Section 8(b) of the 1940 Act requires that a registered fund file a registration statement with the SEC to register under the 1940 Act and to register its shares with the SEC under the 1933 Act. The SEC has adopted Form N-8A as the initial registration notice under the 1940 Act for all registered funds and various forms on which different types of registered funds must file their registration statement (within the three

months after filing Form N-8A). Form N-1A is the registration statement form used by open-end funds and Form N-2 is the registration statement form used by closed-end funds.

- *Semi-Annual and Annual Reports to Shareholders:* Additionally, registered funds are subject to periodic reporting requirements. Under Section 30(e) of the 1940 Act and Rule 30e-1 thereunder, a registered fund must transmit a report to each shareholder of record on at least a semi-annual basis, including information about portfolio holdings and fund performance.

- *Semi-Annual Reporting to the SEC:* Rule 30b2-1 requires that, for each semi-annual and annual period, a registered fund must file a report on Form N-CSR that contains information with respect to the fund's code of ethics, certain controls and procedures, audit committee financial expert, auditor fees and the reports to shareholders, including certain certifications of fund officers relating to the fund's "disclosure controls and procedures" and "internal control over financial reporting." Section 30(a) and Rules 30a-1 and 30b1-1 thereunder also require registered funds to file a report containing certain data on Form N-SAR on a semi-annual basis.

- *Quarterly Holdings Reports:* Rule 30b1-5 requires a registered fund to file a complete schedule of its portfolio holdings with the SEC for the first and third fiscal quarters of each fiscal year on form N-Q. These reports also must be certified by fund officers.

- *Certifications:* Fund officers may obtain support for making the certifications required in the various reports to the SEC and shareholders by requesting sub-certifications and/or sign-offs from certain responsible parties within the fund's investment adviser. The primary investment adviser in a manager of managers structure may in turn require back-to-back certifications from its sub-advisers with respect to certain matters. It is important for investment advisers to communicate their expectations on these matters at the outset of a sub-advisory relationship in order for the sub-advisers to develop an appropriate comfort level with any requested sub-certifications.

E. Internal Revenue Code Limitations

1. 90% Good Income Test

- In order to qualify for favorable tax treatment as a Regulated Investment Company ("RIC"), Section 851 of the IRC requires that a registered fund derive at least 90% of its gross income from certain qualifying sources of "good income." "Good income" must be derived from dividends, interest, securities loans, gains from the sale or disposition of stock or securities, or other income derived with respect to the business of investing in stocks, securities and currencies (e.g., gains from options, futures or forwards contracts on these instruments).

- Examples of income that do not meet this "good income" qualification include direct investment in commodities and commodity-linked investments (e.g., swaps and futures on commodities). However, many funds invest in these instruments indirectly through "controlled foreign corporations" ("CFCs"), shares of which, subject to certain conditions, are deemed to generate good income under the IRC. These structures are particularly important to registered funds or sleeves of registered funds that employ a managed futures strategy.

2. *RIC Diversification Requirements*

- To qualify as a RIC under the IRC, a registered fund must also satisfy certain diversification requirements under the IRC at the end of each fiscal quarter of the taxable year. Under this requirement, among other things, a registered fund may not invest more than 25% of its assets in any single issuer, including a CFC. A registered fund must be careful to establish policies and procedures that ensure that the level of the fund's trading through a CFC does not require the fund to invest more than the 25% of its assets in the CFC or violate any other tax diversification requirements.

F. Use of CFCs

As noted above, many investment advisers utilizing an alternative strategy to manage a registered fund seek substantial commodity exposure. A registered fund may establish a wholly-owned subsidiary (i.e., a CFC) to permit the fund to gain greater exposure to the commodities markets while maintaining its tax status as a RIC. Income earned from the CFC is considered a dividend to the fund and is treated as qualifying income. As noted above, the fund may invest up to 25% of its assets in the CFC and continue to comply with tax diversification requirements.

A registered fund's board will typically approve the establishment of a CFC and oversee the CFC's investments and compliance procedures because the CFC is implementing part of the fund's investment program. As a result, the use of a CFC by a sub-adviser is an important threshold issue that must be discussed in establishing a new sub-advisory relationship for an alternative fund.

Although CFCs are not registered under the 1940 Act and generally are not required to comply separately with the provisions of the 1940 Act, the Internal Revenue Service ("IRS") private letter rulings relating to CFCs have nonetheless required CFCs to comply with Section 18(f) of the 1940 Act (among other conditions). As a result, compliance with respect to Section 18(f) and related SEC guidance must generally be met at both the fund and the CFC level.

Funds generally look through the CFC for many purposes. A registered fund typically looks through a CFC and aggregates the CFC's individual holdings together with direct holdings of the fund for purposes of testing compliance with the fund's requirements under the 1940 Act. Registered funds also generally consolidate the financial statements of the CFC into the registered fund's financial statements for financial reporting purposes, which results in the financial statements disclosing the CFC's investments as if the registered fund held them directly.

Section 7(d) of the 1940 Act prohibits an investment company organized outside of the United States from directly or indirectly offering its securities in the United States. A number of registered funds have set up offshore subsidiaries to receive favorable tax treatment when investing in foreign countries. Funds investing in CFCs generally rely on prior no-action relief from the SEC staff with respect to these provisions of the 1940 Act.[8]

A registered fund is prohibited from doing indirectly anything that it cannot do directly under Section 48(a) of the 1940 Act. As a result, a registered fund cannot cause a CFC to do anything that would cause the fund to violate the 1940 Act if done directly.

As noted above, Section 17(f) of the 1940 Act requires registered fund assets to be maintained with a qualified custodian and Rule 17f-5 sets forth the requirements for custody of assets held

[8] *See, e.g.*, Alternative Investment Partners Absolute Return (SEC No-Action Letter July 10, 2006).

outside the United States. Assets held by a fund's CFC that are maintained offshore are generally held by the fund's custodian, through its existing foreign custody network, consistent with the requirements of Rule 17f-5.

It is possible to hold contracts and investments that produce good income at the CFC level. However, as noted above, a registered fund is limited under the IRC to investing 25% of its assets in a CFC.

IV. Manager of Managers Arrangements

A. Exemptive Relief to Operate a Manager of Managers Structure

1. Role of Primary Investment Adviser

Many investment advisers to mutual funds have obtained an exemptive order from the SEC, or SEC staff, on a delegated basis, to permit them to enter into and materially amend investment sub-advisory contracts with respect to the funds they manage without seeking or receiving shareholder approval of those contracts. Funds utilizing these arrangements are generally referred to as using the manager of managers investment advisory structure.

The role of the primary investment adviser in a manager of managers structure is to oversee the investment operations of the fund complex, administer the affairs of the funds and make recommendations for each fund regarding its investment strategies and policies. The investment adviser selects and retains investment sub-advisers that exercise investment discretion with respect to portfolio investments of the fund assets allocated to it by the primary investment adviser.

The investment adviser evaluates, allocates and reallocates assets to and oversees the sub-advisers. The investment adviser also makes recommendations about the sub-advisers' hiring, termination and replacement to the fund complex's board of directors or trustees.[9]

2. Shareholder Voting and Disclosure Requirements

Section 15(a) of the 1940 Act requires that an investment advisory or sub-advisory agreement with a fund, and any amendments thereto, be approved by the holders of a majority of the outstanding voting securities of that fund. Rule 18f-2 under the 1940 Act states that any matter that is required to be submitted to the shareholders of a fund under the 1940 Act needs to be approved by the holders of a majority of the outstanding voting securities of that fund.

The 1940 Act, and the rules promulgated thereunder, require every registered fund to provide in its disclosure documents, including its registration statement, proxy statements and shareholder reports, information related to the compensation of investment advisers.[10] In the case of sub-advised funds, these provisions have generally been interpreted to require separate disclosure of the sub-advisory fee paid to each sub-adviser of a fund.

3. Exemptive Relief

A primary investment adviser that wishes to operate under the manager of managers structure will apply for and receive exemptive relief ("Manager of Managers Relief") from the SEC from certain provisions of the 1940 Act and from certain SEC rules. The Manager of Managers Relief:

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9 The primary investment adviser may be held liable for the actions and omissions of the sub-adviser. *See, e.g., Western Asset Management Co. and Legg Mason Fund Adviser, Inc.,* Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (where each of the primary investment adviser and sub-adviser settled with the SEC for $50,000 for the failure to reasonably supervise a portfolio manager employed by the sub-adviser who committed fraud).

10 *See, e.g.*, Item 19(a)(3) of Form N-1A; Items 22(c)(1)(ii), 22(c)(8) and 22(c)(9) of Schedule 14A; Item 48 of Form N-SAR; and Sections 6-07(2)(a), (b) and (c) of Regulation S-X.

- permits the primary investment adviser to enter into and materially modify sub-advisory agreements without obtaining shareholder approval; and

- exempts the fund from certain advisory fee disclosure requirements, granting the ability to disclose only the (i) aggregate fees paid to the adviser and any wholly-owned subsidiaries of the investment adviser; (ii) aggregate fees paid to unaffiliated sub-advisers; and (iii) fees paid to each affiliated sub-adviser (other than a wholly-owned sub-adviser).[11]

Until recently, the SEC has granted Manager of Managers Relief only for funds advised by unaffiliated sub-advisers. Recently, the SEC expanded Manager of Managers Relief to include funds advised by wholly-owned sub-advisers, subject to certain additional conditions. These additional conditions are designed to mitigate any conflict of interest or opportunity for self-dealing with respect to hiring wholly-owned sub-advisers by: (i) requiring the fund's board to monitor any conflicts of interest and (ii) providing the fund's board with sufficient independence, resources and information to monitor and address any such conflict of interest or opportunity for self-dealing. This relief currently does not cover affiliated sub-advisers that are not wholly owned by the primary investment adviser.

4. Conditions of Exemptive Orders

Many recent exemptive orders are subject to the conditions summarized below:

1. approval by each fund of the manager of managers structure by (i) a majority of the outstanding voting securities or (ii) the initial shareholder for new funds;

2. disclosure in the fund's prospectus of the existence and substance of the order and that the investment adviser has the ultimate responsibility to oversee and recommend hiring, termination and replacement of sub-advisers;

3. within 90 days of hiring a sub-adviser, the fund will distribute to shareholders all information about the new sub-adviser that is required to be disclosed in a proxy statement;

4. at all times, at least a majority of the board will be Independent Board Members, and the nomination and selection of new or additional Independent Board Members will be placed within the discretion of the then-existing Independent Board Members;

5. independent legal counsel will be engaged to represent the Independent Board Members and the selection of such counsel will be within the discretion of the then-existing Independent Board Members;

6. whenever a sub-adviser change is proposed for a sub-advised fund with an affiliated sub-adviser (including a wholly-owned sub-adviser), the board, including a majority of the Independent Board Members, will make a separate

[11] The rationale for the "aggregated fee disclosure" relief includes: (i) requiring disclosure of fees paid to individual sub-advisers does not serve a meaningful purpose as funds pay their investment adviser to monitor, evaluate and compensate each sub-adviser; and (ii) requiring sub-advised funds to disclose individual sub-advisory fees may put the investment adviser (and, thus, the fund) at a competitive disadvantage when negotiating the fees paid to sub-advisers on a fund's behalf.

finding, reflected in the board meeting minutes, that such change is in the best interests of the sub-advised fund and its shareholders and does not involve a conflict of interest from which the primary investment adviser or the affiliated sub-adviser derives an inappropriate advantage;

7. the primary investment adviser must provide profitability information to the board in connection with a sub-adviser change, including the expected impact on the investment adviser's profitability, and provide quarterly profitability information to the board on a per fund basis;

8. the primary investment adviser will continue to provide management services to each fund, including overall supervisory responsibility for the general management and investment of each fund's assets;

9. limitations on the ownership of interests in sub-advisers by trustees and officers of the fund and the primary investment adviser;

10. disclosure in the fund's registration statement regarding the aggregate fees paid to (i) the primary investment adviser and (ii) the sub-adviser(s);

11. expiration of the order in the event the SEC adopts a rule providing substantially similar relief; and

12. for each fund that pays fees to a sub-adviser directly from fund assets, any changes to a sub-advisory agreement that would result in an increase in the total management and advisory fees payable by the fund will be required to be approved by the shareholders of the fund.

B. Process for Board Approval of Sub-Advisers

1. Board Approval Under Section 15(c)

Under Section 15 of the 1940 Act, investment advisory contracts must be approved by a majority of the fund's Independent Board Members at an in-person meeting. The board must approve the terms of the proposed sub-advisory agreement and conclude the proposed sub-advisory fee is fair and reasonable. The board should generally consider the personnel, operations, financial condition, investment advisory capabilities and past performance.

The requirement that the contract be approved at an in-person meeting presents an opportunity for the prospective sub-adviser to meet with the board and discuss its background, investment philosophy and investment strategy as well as answer questions from the board. The investment adviser should also explain to the board the reasons for recommending the sub-adviser and how the sub-adviser's strategy fits with the fund as a whole. The adviser will typically provide the board with a memorandum discussing the business rationale in advance of the meeting.

2. Key Points of the Sub-Advisory Agreement

Among other things, Section 15(a) requires that a registered fund's advisory contract must precisely describe all compensation to be paid by the fund. The investment adviser, subject to board approval, generally negotiates the sub-advisory agreement with a prospective sub-adviser. The investment adviser should demonstrate to a fund's board that it negotiated the lowest sub-advisory fee possible. As discussed, the "aggregate fee" exemptive relief is based, at least in part,

on the notion that the investment adviser would be at a competitive disadvantage if the prospective sub-adviser knew what the other sub-advisers charged the fund.

Section 15 of the 1940 Act requires that an investment advisory contract be terminable at any time, without penalty, by the fund's board or a majority vote of its shareholders. Contracts with advisers must also automatically terminate in the event of any assignment.

A number of other terms may be included in the sub-advisory agreement, including:

- reports, notifications and certifications required to be provided to the primary investment adviser;
- limitations on liability, including limiting the sub-adviser's liability for (i) willful misfeasance, bad faith, negligence or a reckless disregard of its obligations under the agreement and (ii) its allocated portion of fund assets;
- indemnifications between the primary investment adviser and sub-adviser;
- restrictions on sub-adviser communications with other sub-advisers of the fund other than for limited purposes to satisfy certain exemptive rules (e.g., Rule 17a-10);
- payment by the sub-adviser of expenses incurred in connection with management of the fund; and
- confidentiality and use of names.

3. Disclosure Requirements

Once the sub-adviser is approved by a registered fund's board, the investment adviser must file a supplement to the fund's registration statement with the SEC disclosing the change. The supplement will generally describe the following information:

- the sub-adviser's investment strategy;
- additional risk factors, if appropriate;
- names and descriptions of portfolio managers;
- the sub-adviser's address, assets under management and description of ownership;
- a summary of the sub-adviser's proxy voting policies and procedures and potential conflicts of interest policies; and
- other accounts managed by the portfolio managers, ownership of fund securities and compensation policies respecting the portfolio managers.

The fund is also required to inform all shareholders, within 90 days of hiring any new sub-adviser, of the hiring by providing a notice of internet availability of the information statement (along with the information statement, if it chooses). The information statement and notice is also filed with the SEC and generally contains all information that would be required to be included in a proxy statement. The considerations taken into account by the board when approving the sub-advisory agreement must also be included in the information statement.

4. Registration Statement Updates

In connection with the annual update to a registered fund's prospectus and statement of additional information, the primary adviser will need to coordinate with each sub-adviser to ensure that the disclosure relating to the sub-adviser continues to be accurate. Each sub-adviser should review the fund's registration statement in connection with this process. The sub-adviser also has an obligation to inform the investment adviser of any changes that would affect the registration statement (e.g., the composition of the investment team). The sub-adviser should also confirm on a regular basis that the investment strategy and types of instruments invested in are accurately stated in the registration statement.

V. Recent Litigation and Regulatory Developments

A. SEC Sweep Examination on Alternative Strategy Funds

In connection with the rapid increase in assets being invested in liquid alts funds, these registered funds have also been the subject of heightened regulatory scrutiny.

The SEC staff has stated that it will be assessing liquid alts funds in connection with its investment adviser and investment company examination program in its annual announcements of examination priorities since 2013. The staff has stated that it would review these funds with a "particular focus" on: (i) leverage, liquidity and valuation policies and practices; (ii) the staffing, funding and empowerment of boards, compliance personnel and back-offices; (iii) the manner in which such funds are marketed to investors; and (iv) representations and recommendations made regarding the suitability of such investments.[12]

In addition, as reported in the Wall Street Journal, in August 2014 the SEC began a "sweep" examination that reviewed liquid alts funds.[13] In connection with the launch of the sweep exam, the SEC staff member leading the SEC's investment adviser and investment company exam program stated that the exam staff would initially review around 30 firms by April 2015 and may cover more firms thereafter, if deemed necessary. The same staff member had previously stated that the staff would focus on funds utilizing the "most common strategies attracting the most assets: nontraditional bond funds, long/short equity funds, multi-alternative funds and market-neutral funds."[14] It has been reported that, in addition to covering established mutual fund companies, the sweep covered a number of investment advisers that until recently had not offered mutual funds as part of their lineup, and that the SEC staff members have delivered request letters asking to speak with members of the boards of certain mutual funds.

In addition to covering the previously-announced focus areas, it is our understanding that the SEC staff has requested information relating to sub-advisers and the funds' board governance structures and oversight processes. The SEC staff is also reviewing sub-adviser compliance policies and procedures, with a focus on cover of senior securities and derivatives investment monitoring and risk management (in addition to the previously-announced focus areas noted above). In addition, it is our understanding that the SEC staff has requested that funds provide the staff copies of all trade documentation, including ISDAs and confirmations.

B. Manager of Managers Fee Litigation

Section 36(b): Section 36(b) of the 1940 Act imposes a fiduciary duty on investment advisers and sub-advisers with respect to the receipt of compensation paid by a registered fund. This fiduciary duty is undefined under the 1940 Act, but litigation under Section 36(b) has provided some guidance as to the information and factors that are relevant to courts in considering whether an investment adviser has breached this fiduciary duty.

Under the principal judicial decisions in this area, the central question to be considered is whether the fee to be charged under an investment advisory agreement is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of

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[12] "Examination Priorities for 2014," National Exam Program, Office of Compliance Inspections and Examinations, SEC (Jan. 9, 2014).

[13] "SEC Launches Examination of Alternative Mutual Funds," WALL ST. J., Aug. 12, 2014.

[14] "Alternative Mutual Funds Draw Concerns," WALL ST. J., May 1, 2014.

arm's-length bargaining. A U.S. Supreme Court case from 2010 articulated that judicial deference should be given to decisions made by an informed board.[15] The court stated that factors that should be considered by the board in approving fund fees include:

- nature and quality of services provided to the fund and its shareholders;
- profitability;
- indirect benefits that the adviser accrues on account of its relationship with the fund;
- economies of scale; and
- independence, expertise, care and conscientiousness of the board in evaluating the adviser's compensation.

Excessive Fee Lawsuits: Since 2010, there has been a wave of shareholder lawsuits challenging advisory fees charged by the primary adviser under the manager of managers structure. In these lawsuits, shareholders have alleged that the advisory fees retained by the investment adviser are excessive because the adviser delegates nearly all of the work to sub-advisers. Shareholders have alleged that certain investment advisers do not share economies of scale. Shareholders have also alleged that independent directors were not conscientious in approving investment advisory agreements and that investment advisers charge their own funds more than they charge to sub-advise similar, unaffiliated funds.

The first round of cases was brought against investment advisers that retained a large portion of the advisory fees. These cases included investment advisers that retained approximately 70-80% of overall fees (with the sub-advisers receiving only 20-30% of advisory fees charged). More recent shareholder complaints have followed similar models, but have been brought against advisers that retain close to half, or less than half, of advisory fees such as where the primary investment adviser/sub-adviser split with respect to fees was approximately 35% / 65%.

Many of the complaints are still pending. Plaintiffs have generally survived or avoided motions to dismiss and are now engaged in discovery. One case recently settled on the eve of trial. In another recent case, the court granted a motion to dismiss on statute of limitation grounds as the plaintiff failed to plead anything about fees during the 12 months prior to filing the complaint. Additionally, the court stated: "Regardless of their timeliness, I have serious doubts about the sufficiency of the allegations in the Complaint as compared to the standard for a violation of Section 36(b) . . . ."[16]

C. New CFTC Registration and Substituted Compliance Requirements

1. New CPO/CTA Registration Requirement

Historically, commodity pool operators ("CPOs") and commodity trading advisers ("CTAs") to registered funds were excluded/exempted from registration with the CFTC. In 2012, the CFTC

[15] *See Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418, 1426 (2010).

[16] *Curd v. SEI Investments Management Corp.*, No. 13-cv-7219 (E.D. Pa. Aug. 28, 2014), at 1 n.1.

modified the CFTC registration exclusion and exemptions available to registered funds and related CFCs that trade in commodity interests.[17]

Beginning in 2013, registered fund investments in "commodity interests" (which are very broadly defined to include commodity futures, options on futures, commodity options, swaps, forwards and options) implicate CPO and CTA registration with the CFTC. Unless an exemption from registration is available (e.g., funds with de minimis use of commodity interests), each CPO and CTA to a fund that invests in "commodity interests" must register as such with the CFTC and apply for membership with the National Futures Association ("NFA"), the self-regulatory organization that administers the CFTC's registration program.

The CFTC has stated that the investment adviser of a registered fund that cannot satisfy an exemption is the appropriate entity to register and function as the CPO, not the registered fund itself or its directors or trustees. The entity providing commodity interest trading advice to the fund (whether adviser or sub-adviser) is deemed to be the CTA of the fund.

As a result of these changes, advisers to alternative funds became subject to an entirely new regulatory regime under the CEA, CFTC Regulations and NFA rules.

2. *Registered CPO Substituted Compliance*

A primary investment adviser that is a registered CPO with respect to a registered fund may elect to be deemed compliant with CFTC disclosure, investor reporting and recordkeeping requirements with respect to the registered fund under CFTC Regulation 4.12(c) through compliance with the existing SEC regime applicable to the fund. To rely on Regulation 4.12(c) substituted compliance, the CPO and fund must comply with the following conditions:

1. the CPO must file a notice with the NFA of the CPO's intent to use the substituted compliance regime with regard to the CFTC's disclosure and reporting rules;

2. the CPO must file a notice with the NFA if the CPO uses or intends to use third-party service providers for recordkeeping purposes;

3. the CPO must file with the NFA the applicable registered fund's annual report (including audited financial statements) prepared pursuant to SEC requirements (rather than needing to meet the CFTC annual report requirements in CFTC Regulation 4.22);

4. the fund must add specified (but very limited) CFTC-related disclosure to the front page legend of the registered fund's current prospectus;

5. for a registered fund with less than three years of operating history, the registered fund prospectus must include the performance of all of the CPO's other pools (i.e., funds) and separately managed accounts that the CPO manages that are "substantially similar" in investment objectives, policies and strategies to those of the offered registered fund; and

6. to avoid preparing and providing monthly account statements to investors under CFTC Regulation 4.22, the fund must make the registered fund's daily NAV

[17] The CFTC rescinded exemptions applicable to CPOs and CTAs to private funds at the same time.

publicly available to investors and disclose how the information may be accessed and otherwise provide the SEC-mandated semi-annual and annual reports to investors and file them with the SEC.

3. CTA Registration Requirement Applicable to Sub-Advisers

As a CTA to a commodity pool implicating CPO registration, sub-advisers that utilize commodity interests as part of their strategy for a registered fund are not eligible for an exemption from registration as CTA under 4.14(a)(8).

NFA By-law 1101 requires that a primary investment adviser that is a registered CPO with respect to a registered fund must identify whether any prospective sub-adviser that will trade commodity interests is appropriately registered with the CFTC as a CTA. The investment adviser should also confirm that the proposed sub-adviser has in place a compliance program to ensure that it will comply with applicable requirements under the CTA registration regime.

4. Sub-Adviser CTA Recordkeeping Requirements

Historically, CFTC rules generally mandated that registered CPOs maintain required CPO and commodity pool records at the CPO's main business address. The substituted compliance rules discussed above permitted all registered CPOs to keep records with certain alternative entities, including a commodity pool's administrator, distributor, custodian, bank or registered broker or dealer acting in a similar capacity with respect to the pool. The list did not cover all types of entities which investment advisers routinely utilize in fund operations and which make and keep records in connection with their activities, including sub-advisers. In September 2014, the CFTC's Division of Swap Dealer and Intermediary Oversight issued exemptive relief that allows any person to be an alternative third-party recordkeeper for a CPO so long as:

- the CPO can produce the commodity pool records for inspection within 48 hours (if the records are held in the United States) and 72 hours (if the records are held outside of the United States) from the time the NFA, CFTC or Department of Justice makes a request for such records; and
- the CPO makes the required notice filing with the NFA, which includes an identification of each recordkeeper, contact information for the recordkeeper and representations made by both the CPO and the recordkeeper regarding the custody of the records (i.e., the sub-adviser).[18]

[18] *See* Exemptive Relief to Use Additional Third-party Recordkeepers in Commission Regulations 4.7(b)(4) and 4.23(c), CFTC Letter No. 14-114 (Sept. 8, 2014).

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Appendix A

Comparison of Publicly Offered Fund Structures

Open-End Fund		Exchange-Traded Closed-End Fund		Continuously Offered Unlisted Closed-End Fund	
Pros	**Cons**	**Pros**	**Cons**	**Pros**	**Cons**
• Continuously offered • Can engage in derivatives and short selling but must segregate liquid assets to cover the position • 1099s to investors	• Daily redemptions • Must calculate the fund's NAV on a daily basis • Limited to 15% in illiquid securities • No performance fee • Fund of funds structure does not work unless the underlying fund interests are liquid, such as a fund of mutual funds or ETFs	• Utilize underwriting syndicate to engage in an IPO to raise permanent capital • Exchange-listed • No redemptions • No limit on illiquid securities • Typically calculates NAV weekly • Can engage in derivatives and short selling but must segregate liquid assets to cover the position • 1099s to investors • Can have a finite term	• Typically performance fee, but can charge a performance on income only • NYSE rules require annual shareholders meeting • May trade at a discount to NAV, resulting in arbitrageurs attacking the fund • Arbitrageurs may engage in a proxy fight to: (i) elect their slate of directors, (ii) seek to replace the investment adviser, (iii) recommend one or more tender offers or (iv) seek to open-end the fund or convert the fund to an interval fund	• Continuously offered monthly closings • No requirement for annual shareholders meeting • No discount to NAV issues • No limit on illiquid securities • Typically calculates NAV monthly • Can engage in derivatives and short selling but must segregate liquid assets to cover the position • Can charge a performance fee on income only • Can have a finite term • Can utilize a master/feeder structure to offer the fund through different distribution networks (i.e., RIAs vs. broker/dealers) with different compensation structures	• Engage in periodic tender offers to provide investors with some liquidity • Fund of hedge funds or private equity funds can be offered to accredited investors only

Exchange-Traded Commodity Pool		Business Development Company		UCITS Fund	
Pros	Cons	Pros	Cons	Pros	Cons
• Can charge performance fee to retail investors • No leverage limitations • Can engage in derivatives and short selling • No diversification or concentration requirements • No restrictions on affiliate transactions • May be continuously offered or underwritten	• K-1 to investors • S-1 registration statement • Related pool performance disclosure requirements • Break-even table disclosure • Requires the operator and adviser to be registered as a CPO and CTA	• Utilize underwriting syndicate to engage in an IPO to raise permanent capital • Exchange-listed or continuously offered • No redemptions • No limit on illiquid securities • Can engage in derivatives and short selling but must segregate liquid assets to cover the position • 1099s to investors • Can charge a performance fee to retail investors on both income and capital gains	• Must invest at least 70% of its assets in “eligible portfolio companies” (U.S. private or small public operating companies; underlying funds are not eligible portfolio companies) • Requires SEC exemptive relief to co-invest with private funds in originated transactions	• Can engage in derivatives and synthetic short selling (must use cash settled Contracts for Difference (CFD), swaps or other derivatives) • Offers transparency, liquidity and potential for increased distribution (versus private or closed-end fund) • Performance fees possible • Very transparent, liquid and regulated from investors’ perspective	• Redemptions at least every 14 days • UCITS may not invest in gold, commodities or directly in real estate • No physical shorting of securities • No “side pockets” for illiquid securities

Appendix B

Common Compliance Policies and Procedures for Advisers/Sub-Advisers to Registered Funds

1. Anti-Money Laundering Policy and Procedures
2. Best Execution and Brokerage Allocation Policy and Procedures
3. Books and Records Policy and Procedures
4. Business Continuity Plan
5. Code of Ethics
6. Compliance with Fund Investment Restrictions Procedures
7. Conflicts of Interest Procedures
8. Counterparty Risk Procedures
9. Derivatives Use and Collateral Management Procedures
10. Diversification Requirements Procedures
11. FCM and Derivatives Clearing Organization Policies and Procedures
12. Form N-PX (Annual Report of Proxy Voting Record) Policy and Procedures
13. Form N-Q Reporting Policy and Procedures
14. Gifts, Gratuities and Entertainment Policy and Procedures
15. Industry Concentration Policy and Procedures
16. Insider Trading Policy
17. Investment in Other Funds Policy and Procedures
18. IRC Diversification (IRC Sec. 851), 90% Good Income (IRC Sec. 851) and 10% Annual Distribution (IRC Sec. 852)
19. Market Timing and Redemption Policy
20. Political Contributions and Activities (Pay-to-Play) Policy and Procedures
21. Portfolio Holdings Disclosure Policy and Procedures
22. Privacy Policy (Reg. S-P and other requirements) Policy and Procedures
23. Proxy Voting Policies and Procedures
24. Repurchase Agreement Policy and Procedures
25. Rule 10f-3 Acquisition of Securities from an Underwriting Syndicate Policy and Procedures
26. Rule 12b-1 Policy and Procedures
27. Rule 12d3-1 Acquisition of Securities Issued by Persons Engaged in Securities Related Businesses Policy and Procedures
28. Rule 17a-7 Affiliated Transactions Policy and Procedures
29. Rule 17e-1 Affiliated Brokerage Transactions Policy and Procedures

30. Rule 144A Securities Trading Policy and Procedures
31. Schedules 13G and 13D Filing Policy and Procedures
32. Section 18(f) Leverage and Borrowing Policy and Procedures
33. Section 22(e), Section 4(2) and Rule 144A Policy and Procedures
34. Securities Lending Policy and Procedures
35. Senior Securities "Cover" and Bank Loan Policy and Procedures
36. Service Provider Oversight Policy and Procedures
37. Side-by-Side Management Policy and Procedures
38. Soft Dollars Policy and Procedures
39. Sub-Adviser Oversight Policy and Procedures
40. Trade Allocation and Aggregation Policy and Procedures
41. Trade Error Correction Policies and Policy and Procedures
42. Valuation and Liquidity Determination Policy and Procedures

Thank You

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