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Regulatory brief

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SEC sweep: Liquid alternative funds

Overview

Alternative mutual funds ("liquid alts") have experienced explosive growth in recent years[1] as investors continue to seek higher returns in the current low yield environment, while maintaining some protection against downside risk. The Securities and Exchange Commission's ("SEC") examination staff has taken notice, and recently announced a coordinated review (or "sweep") of various liquid alts managers and funds.

Several factors contribute to the SEC's interest in liquid alts. First, assets under management in liquid alts have surged in recent years, approaching $200 billion as of year-end 2013. Second, liquid alts are a relatively new product for retail investors, so their potential risks may not be well understood. Third, many alternative fund managers who manage liquid alts have limited experience with the regulatory requirements of the Investment Company Act of 1940 (the "1940 Act"), which are applicable to mutual funds including liquid alts. Similarly, many investment advisors with experience in managing mutual funds under the 1940 Act have limited experience with the alternative assets managed in liquid alts.

The SEC is keen to shift from reactionary regulation (for which the agency was criticized after the 2008 crisis) to proactive oversight. Therefore, we believe the SEC will scrutinize liquid alts and their managers closely in the upcoming sweep, likely focusing on the following requirements that commonly challenge liquid alts managers: liquidity, leverage, investment allocation, governance, and sub-advisor oversight.

Liquid alts are increasingly moving into the mainstream. Successful firms will prepare not only for the upcoming SEC examination sweep, but also for long-term operations under closer SEC supervision.[2] To that end, implementing a robust compliance program that addresses common liquid alts management challenges is essential.

This **Regulatory Brief** (a) provides background on liquid alts, (b) describes the SEC's concerns, (c) suggests areas of future exam focus, and (d) offers suggestions on what industry participants can do now to prepare.

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[1] In 2013, liquid alts experienced a 44% growth rate, compared to just 3% for all mutual funds.

[2] See PwC's *Regulatory Brief, Asset manager SIFI designation: Enter SEC* (June 2014).

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Background

Alternative strategies in 1940 Act clothes

Liquid alts are alternative investment vehicles structured as mutual funds and registered under the 1940 Act. They feature the traditional retail-oriented mutual fund characteristics of daily pricing and liquidity, transparency, and low minimum investments. At the same time, liquid alts are designed to mimic the risk-return and correlation profiles that alternative investment strategies provide through exposure to certain asset classes, complex trading techniques, and leverage.

Alternative investment strategies (including long-short equity, currency, global macro, private equity, real estate, and commodities) have historically only been available to accredited investors through private fund structures, and are generally more suitable for investors with longer investment time horizons and low liquidity needs. Alternative investments, due to their high risk-adjusted returns and portfolio diversification benefits, have grown in popularity over the past 20 years and comprise a significant and increasing percentage of sophisticated institutional investor portfolios (e.g., sovereign wealth funds, pension funds, and endowments). Recently, however, many investment managers have opened up this arena of the investment world to retail investors through liquid alts.

Launching a liquid alts fund

The liquid alts market remains very much in nascent stages, and launching liquid alts products requires considerable upfront costs and infrastructure investment. Alternative investment firms can access the market either by directly sponsoring a fund, or as a partner (e.g., a sub-advisor or through a turnkey administrative platform) with another asset management entity that has existing 1940 Act distribution and compliance capabilities.

Direct sponsors have significant obligations associated with creating a fund, including establishment of a board of directors, development of written compliance policies and procedures, regulatory reporting, and ongoing 1940 Act compliance. Accordingly, direct sponsorship is normally best suited for managers that have an existing mutual fund offering and compliance infrastructure.

Strategies flow from 1940 Act constraints

Launching liquid alts is not as simple as repackaging existing private fund strategies into a mutual fund. The 1940 Act requires portfolio managers to provide daily liquidity (to meet redemption requests) and calculate a daily net asset value ("NAV"), while also restricting the use of leverage and short-selling. As a result, certain alternative strategies and asset classes that are commonly utilized in private alternative funds are not feasible within the structure of a mutual fund. Not surprisingly, the primary strategies currently employed in liquid alts tend to be global macro, long-short equity, and managed futures, while private equity, venture capital, timberland, infrastructure, and merger arbitrage are not viable options.

SEC concerns

Senior officials in the SEC's Office of Compliance Inspections and Examinations ("OCIE") recently announced plans to conduct a nationwide sweep of liquid alts and their sponsors. According to OCIE officials, the first phase of the sweep will start this summer, continue for about six months, and target 25 complexes that manage one or more liquid alts. Aside from examining funds for legal compliance, the sweep will likely identify areas in which liquid alts managers would benefit from SEC guidance.

OCIE believes liquid alts managers need strong discipline to manage less liquid or hard-to-value securities within open-end vehicles that must provide daily liquidity and valuation. As noted by OCIE director Andrew Bowden, "alternative funds are the bright, shiny object . . . but they are a sharp object."

Potential risks of liquid alts could be further amplified in the current economic environment. The Federal Reserve's ongoing effort to stimulate the economy through its quantitative easing campaign has driven interest rates to historically low levels, significantly reducing the returns of traditional low-risk investment options such as CDs, money market funds, treasuries, and short-duration bond funds. As a result, many retail investors who previously relied on such investments to generate steady income streams may be seeking unfamiliar and riskier products, including liquid alts, in an effort to generate sufficient returns.

Against this low-yield backdrop is an asset management industry in transition. On one side of the industry, many mutual fund companies are struggling as they continue to lose market share to low-cost ETFs, and are therefore considering (or have already launched) liquid alts products. On the other side of the industry are dedicated alternative investment firms looking to tap into the lucrative retail investor market to boost their revenues.

It is our view that the SEC is keenly aware of these dynamics and is moving quickly to develop a thorough understanding of overall practices, risks, and controls in the evolving liquid alts space. By doing so, the SEC seeks to avoid the criticism that it received following the 2008 financial crisis for failing to proactively address the risk of "bright, shiny objects" of the mid 2000s (e.g., subprime mortgage-backed securities, collateralized debt obligations, credit default swaps, and other complex and highly-leveraged products). Depending on the sweep findings, the SEC may decide that liquid alts warrant more regular monitoring as part of its routine investment company examination program.

In the long-term, the SEC will likely adopt a more robust version of Form N-SAR (the current semi-annual report for registered investment companies). Currently, Form N-SAR requires registered investment companies to report, among other things, information about portfolio turnover and investment practices. As part of a broader action plan to improve 1940 Act risk monitoring, the SEC is weighing the possibility of expanding Form N-SAR to require more detailed holdings, exposure, and risk management information, reportable on a monthly basis. While these changes may in part motivated by the SEC's intent to re-assert oversight over the asset management industry vis-à-vis the Financial Stability Oversight Council,[3] the modified Form N-SAR will also produce more timely and relevant data to assist in monitoring the liquid alts market.

What will be the areas of SEC exam focus?

Based on market risk factors, recent SEC enforcement actions, and recent officials' remarks, firms should expect the OCIE examination sweep to focus on five major substantive areas: liquidity, leverage, investor allocations, governance, and sub-advisor oversight.

Liquidity

Arguably the most difficult regulatory constraint in managing an alternatives strategy within a mutual fund framework is complying with the strict liquidity requirements of the 1940 Act. Unlike private funds that typically have quarterly redemption periods and can impose redemption gates in times of market stress, open ended mutual funds must: (1) limit illiquid securities to no more than 15% of the fund's net assets, (2) meet daily redemption requests, and (3) calculate daily NAV.

As a result, some of diversification benefits available in traditional alternative investments (that are inherently illiquid) are lost in liquid alts. Our view is that while liquid alts will offer investors some diversification benefits, mandated liquidity constraints will ultimately lead them to be significantly watered down versions of true alternative funds. This, however, may not always be accurately communicated to investors, resulting in some liquid alts over-promising and under-delivering on their low correlations to market returns and their ability to weather market storms.

Managing daily liquidity (including daily NAV calculations) would also be challenging to managers who lack experience measuring and monitoring liquidity of assets with such precision and frequency. These assets include instruments (such as leveraged loans) that do not settle on a normal T+3 cycle (i.e., within three days after a trade), or do not have a deep trading market.

In addition, creating effective liquidity stress tests based on various market environments and potential redemption scenarios is complicated by a lack of historic observations. Because most liquid alts were created after the 2008 crisis, liquid alts products have a limited history of being held by retail investors, and many liquid alts have not yet endured periods of market stress.

Since the SEC examiners will be well aware of these challenges, in order to prepare for the upcoming sweep, firms should be ready to demonstrate a thorough understanding of the 1940 Act liquidity requirements, and the appropriate compliance procedures and risk controls to manage the fund in a range of market conditions.

Leverage

Excessive use of financial leverage is one of the risky practices that the 1940 Act attempts to prevent. Accordingly, SEC regulations have traditionally limited a fund's exposure to certain transactions and derivative contracts which, for minimum initial margin, can contractually obligate the fund to pay much larger future amounts.

While the 1940 Act prohibits direct borrowing for investment purposes, the SEC has employed a more flexible approach to limiting indirect borrowing through leveraged investments such as futures, written options, and short sales. Although this approach allows leveraged investments, it requires the funds to segregate assets or to enter offsetting transactions sufficient to cover potential liabilities associated with these investments, thus putting a practical limit on the amount of leverage and derivatives exposure that a mutual fund can achieve. Since December 2005, the SEC staff has been further relaxing this approach by informally permitting funds (but only for cash-settled derivatives) to segregate only daily mark-to-market margins, instead of full notional amount of derivatives positions. This has allowed funds to segregate fewer assets and invest more in derivatives.

[3] See note 2.

While mutual fund advisors are well accustomed to leverage limits and controls and disclosures that are necessary to comply with them, these requirements are likely to be unchartered territory for private fund managers launching liquid alts. Although private fund managers have been pressured to manage leverage more conservatively following the demise of Long Term Capital Management, private fund organizing documents typically do not limit the use of leverage as an investment tool, which remains a common practice in these funds.

Compounding these risks, processes for monitoring leverage limits and segregating or covering liabilities are challenging to automate. Most mutual fund advisors monitor compliance by way of manual spreadsheets and calculations instead of automated portfolio compliance systems. This increases the probability of error in the process, especially for private fund managers that are new to leverage requirements.

Finally, alternative fund advisors may not be accustomed to common governance tools (e.g., new product diligence committees, risk disclosure reviews, and board reporting) that have largely succeeded in mitigating leverage risks in mutual funds.

Given these challenges, in the upcoming sweep the SEC will likely be watching for new liquid alts managers who have not implemented robust controls and training around leverage limits. In addition, examiners will be curious to see if liquid alts investors are fully informed of the fund managers' use of indirect leverage to the extent that it is allowed (through outsized investments in banks, lenders, loan portfolios, and structured vehicles such as collateralized loan and debt obligations). Use of these strategies, without informing investors, was a major cause of enforcement actions against mutual funds following the 2008 financial crisis.

To prepare for the upcoming sweep, managers should focus on their policies and compliance testing and monitoring related to leverage. They should also consider preparing a formal presentation to fund directors to explain leverage compliance methods in the context of liquid alts, laying out clearly for the board the policies, procedures, responsibilities, and monitoring associated with the use of leverage.

Investment allocation

Investment allocation policies and procedures are of particular concern because investment advisors have a fiduciary obligation to treat all clients equitably. The SEC has long recognized the inherent conflicts of a single advisor managing hedge funds (which pay performance fees) side-by-side with mutual funds that have similar investment objectives (but pay only management fees). Due to this complexity, chief compliance officers and fund counsels often state that allocation policies and procedures are some of the most difficult to draft and administer.

Advisors running private funds and liquid alts under the same strategy face a difficult balancing act between (a) allocating investment opportunities between a traditional private fund and a related liquid alts fund so that risk and performance dispersion between the two funds can be explained almost entirely by 1940 Act constraints and fund prospectus restrictions, and (b) convincing existing private fund investors that their investment is sufficiently unique to justify the high performance fees paid under the private fund structure.

Well aware of these conflicts, the SEC in the upcoming sweep will likely scrutinize situations in which it appears that a liquid alts fund underperformed relative to a related private fund because of unfair investment allocation practices. Accordingly, advisors should expect a close review of their investment allocations, associated policies and procedures, and performance dispersions by the SEC.

Governance

Board oversight, including the directors' fiduciary responsibility to disclose and mitigate conflicts of interest, is a core attribute of the mutual fund industry. In contrast, private fund managers commonly believe that their funds align management and client interests (through incentive fees, general partner investments in the fund, and use of third-party fund administrators) without the need for board oversight. Many private fund boards therefore exist merely to meet minimum requirements in fund agreements and offshore regulations.

Alternative managers new to the mutual fund environment should expect to face a more demanding board than they were accustomed to in their private funds, especially as directors gain exposure to liquid alts strategies. These managers should also be aware of the connections between issues that come before the registered fund board, the private fund board, and any limited partner advisory committee. For example, potential conflicts of interest between funds involving investment allocations should be communicated to the relevant fund boards and committees well in advance of a transaction.

On the other hand, traditional mutual fund boards may need additional education and expertise to understand liquid alts trading strategies, including short exposures. 1940 Act compliance officers will have to extend their knowledge base to effectively manage risks associated with liquid alts strategies and to ensure compliance with regulatory requirements.

The SEC has made it clear that competent and informed board governance in the liquid alts space is important. Board materials and minutes should reflect coherent communication and understanding of the alternative investment risks and control framework, as well as the conveyance of sufficient information to permit directors to make informed decisions.

Sub-advisor oversight

Investment advisors have for a while claimed that they are increasingly using quantitative and factor analysis to conduct due diligence on alternative strategy sub-advisors (to, e.g., prevent performance manipulation). Earlier this year, OCIE released a Risk Alert Bulletin assessing investment advisors' due diligence activities, and observed that some advisors had overlooked their own due diligence policies and procedures when conducting annual compliance program reviews, while others exaggerated the extent of their due diligence in marketing materials. Investment managers using sub-advisors must have not only robust due diligence programs, but also have infrastructure in place to confirm the liquid alts fund, in the aggregate, is compliant with the 1940 Act.

What should liquid alts managers be doing now?

To prepare for the SEC's planned sweep examination, firms should at a minimum:

- Have appropriate liquidity compliance controls in place, and develop sound risk management practices that ensure adequate liquidity in distressed market conditions.
- Have controls, limits, systems, and disclosures that are sufficient to manage leverage risk.
- Consider reviewing and updating investment allocation policies, procedures and disclosures, and monitor liquid alts performance with respect to related private funds.
- Ensure the board materials and minutes thoroughly evidence board's review and deep understanding of the unique risks inherent to alternative investment strategies.
- Create robust due diligence programs for multi-manager sub-advisor oversight, and develop controls to ensure the fund as a whole is compliant with the 1940 Act.

Alternative investments are moving into the mainstream and will, with few exceptions, be regulated in some form or another. Firms should be preparing not only for the upcoming SEC examination sweep, but also for a future regulatory environment, in which alternatives may no longer be considered an "alternative" approach.[4] Implementing a robust compliance program geared towards the most pressing areas of SEC concern will enable firms to streamline the launch of new products, manage the products efficiently, and minimize the cost of compliance in the future.

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[4] Alternative assets are expected to continue to increase, growing by an average 9% a year and reaching $13 trillion in 2020. See PwC's *Asset Management 2020: A Brave New World* (December 2013).

Additional information

For additional information about this Regulatory Brief or PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

David Sapin
Partner, Financial Services Regulatory Advisory
646 471 8481
david.sapin@us.pwc.com

Shyam Venkat
Partner, Financial Services Risk Advisory
646 471 8296
shyam.venkat@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Scott Weisman, Kent Knudson, Todd Humphrey, and Lauren Leipold.

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