

# Katten

Katten Muchin Rosenman LLP

## Liquid Alts for Fund Managers

### October 8, 2014

5:30–6:00 p.m. Registration

6:00–7:00 p.m. Panel Discussion

7:00–8:00 p.m. Cocktail Reception

### Katten Muchin Rosenman LLP

575 Madison Avenue

New York

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### Discussion Topics

- Opportunities for Private Fund Managers
- Accessing the Retail Market
- Structures and Strategies
- Legal and Compliance Issues

# Liquid Alts for Fund Managers

October 8, 2014

Katten Muchin Rosenman LLP  
New York



David L. Fogel

President, CFO and Co-Founder  
IndexIQ

Jack P. Governale

Partner, Financial Services  
Katten Muchin Rosenman LLP

Kathleen H. Moriarty

Partner, Financial Services  
Katten Muchin Rosenman LLP

Ryan Ross

Partner, Financial Services  
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## DAVID L. FOGEL

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David Fogel is President, CFO and Co-Founder of IndexIQ, a leading alternative asset ETF manager with over \$1.5 billion in AUM.

The company now has 11 ETFs, 1 mutual fund, and numerous separate accounts in the marketplace. IndexIQ has been a pioneer in the area of liquid alternative strategies, having launched a family of hedge fund replication indexes in March 2007 and the first alternative beta ETF, Ticker QAI, in March 2009.

David began his career as a corporate attorney at Sullivan & Cromwell LLP, where he advised clients on merger and acquisition transactions, corporate securities matters, banking transactions, and hedge fund creation.

In 1999, he co-founded SmartPortfolio.com, Inc., which became one of the leading stock research and financial information companies on the Web with over 250,000 subscribers prior to its sale to TheStreet.com in 2000. After the closing of the SmartPortfolio sale, David joined TheStreet.com as Vice President of New Product Development.

In 2003, David helped launch Circle Peak Capital LLC, a private equity firm focused on investments in small-cap consumer product and financial services companies. In 2005, he left to serve as Vice President at Groton Partners, a boutique merchant bank specializing in mergers and acquisitions and sophisticated private investments. At Groton, his work focused on pursuing acquisitions of both traditional and alternative asset management companies and launching an investment management business.

David received a BS, *summa cum laude* and Phi Beta Kappa, from the Georgetown University, School of Foreign Service, a JD, *magna cum laude* and Order of the Coif, from Georgetown Law Center, and an MBA (concentration in finance) from the McDonough School of Business, Georgetown University.



## JACK P. GOVERNALE

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### Practices

FOCUS: Financial Services  
Futures and Derivatives  
Private Equity  
Financial Services Regulatory and Compliance  
Private Funds and Investment Management

### Industries

Financial Institutions

### Recognition

*Legal 500*, 2014

### Education

JD, Brooklyn Law School  
BS, New York University

### Bar Admissions

New York  
New Jersey

### Court Admissions

US District Court, Eastern District of New York  
US Tax Court  
US District Court, Southern District of New York

Jack P. Governale is the head of Katten's New York Financial Services practice. Jack is a Registered Foreign Lawyer and a non-practicing partner in Katten Muchin Rosenman UK LLP.

He concentrates his practice in the area of investment management, representing domestic and offshore private investment funds and their managers, as well as investment advisers, commodity pool operators, and commodity trading advisors. Jack structures and organizes domestic and offshore hedge funds, funds-of-funds, venture capital funds and private equity funds and advises funds in negotiating prime brokerage agreements, marketing and placement agent agreements, administration agreements, credit and leverage facilities, and ISDA master agreements. He also has a background in tax law, international law and cross-border transactions.

Jack advises his fund and investment manager clients on a broad range of securities and futures regulatory matters arising under the Securities Act, the Securities Exchange Act, the Investment Company Act, the Investment Advisers Act, the Commodity Exchange Act, and the Dodd-Frank Wall Street Reform and Consumer Protection Act. He also assists investment advisers, commodity pool operators, and commodity trading advisors in registering with the Securities and Exchange Commission and Commodity Futures Trading Commission and advises them on their ongoing compliance and reporting obligations.

Jack's broad base of private fund clients with multiple focuses enables him to provide clients with practical, market sensitive advice in an increasingly complex global regulatory environment.

Jack is a frequent speaker at hedge fund seminars and conferences.





## KATHLEEN H. MORIARTY

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### Practices

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Public Funds  
Financial Services  
Regulatory and Compliance  
Entrepreneurial Ventures  
Advertising, Marketing and Promotions  
Intellectual Property  
Licensing  
Intellectual Property  
Structured Products

### Industries

Financial Institutions

### Recognition

ETP Icon of the Industry, 2012, 2013  
*Super Lawyers*, 2006–2007  
Capital Link Annual Close-End Fund and ETF IR Awards, Honorable Mention for Contribution to the Exchange Traded Funds Sector  
ETF Hall of Fame, Inaugural Member  
*Financial Times*, US Innovative Lawyers 2013  
ETF.com Lifetime Achievement Award, 2014

Kathleen H. Moriarty has extensive experience representing investment companies with the creation, structuring and development of new exchange-traded products.

Kathleen was actively involved in the development of Standard & Poor's Depository Receipts (SPDRs) and has since advised on the creation of many more exchange-traded funds (ETFs), including iShares, Vanguard Exchange-Traded Funds (VIPERS), ProShares, WisdomTree and IndexIQ.

Domestically, Kathleen represents a wide variety of market participants in connection with commodity-backed derivative securities and non-investment company exchange traded vehicles (ETVs), such as the SPDR Gold Trust and the US ETFs precious metals trusts. She counsels broker-dealers in connection with trading issues relating to the purchase and sale of ETF and ETV shares and also represents ETF managers in connection with the licensing of financial indexes as well as index providers licensing their financial products to ETFs. In addition, she works with a number of hedge fund and other pooled operators to bring their products to wider retail and individual markets, bringing her Investment Company Act of 1940 ('40 Act) and Jumpstart Our Business Startups Act (JOBS Act) insights to her clients to assist them in navigating the new regulatory landscape.

Kathleen counsels ETF projects globally, including assisting the Stock Exchange of Hong Kong with the structure and creation of the Hong Kong Tracker Fund and representing the American Stock Exchange and NYSE Arca in connection with the cross-listing of DIAMONDS Trust (DIA) on the Singapore Exchange and Euronext N.V. She regularly advises foreign entities and delegations from both public and private sectors with respect to the regulation and operation of US ETFs and ETVs. For her long-term contributions in this arena, Kathleen was nominated for the 2014 IndexUniverse ETF Lifetime Achievement Award.

Kathleen also assists her clients in Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) regulatory matters associated with the Dodd-Frank Act. She advises clients on how to register with the CFTC or how to structure their exchange-traded products to comply with rules regarding swaps and commodity pools.

### Education

JD, University of Notre Dame Law School  
AB, Smith College

### Bar Admissions

New York



## RYAN ROSS

Partner | Ernst & Young LLP

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Ryan Ross is a partner in EY's Tax practice and has more than 16 years of experience serving public and nonpublic clients in the asset management industry.

Ryan has spent the last 12 years in EY's Financial Services Office focusing both domestically and internationally on mutual fund, hedge fund, fund of hedge funds, and private equity clients.

He has experience with various corporate, partnership and fund of funds structures. He has extensive experience with the taxation of securities, including complex fixed income instruments, swaps, foreign securities and other derivatives.

Ryan earned a BS in accounting from Drexel University and is a Certified Public Accountant.

Ryan leads campus recruiting for the Chicago FSO tax practice as well numerous training and education sessions.



## PETER J. SHEA

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### Practices

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Public Funds  
Private Funds and  
Investment Management  
Financial Services  
Regulatory and Compliance  
Securities  
Broker-Dealers  
Futures and Derivatives  
Corporate  
Corporate Governance  
Entrepreneurial Ventures  
Private Equity  
Structured Products  
Securities Litigation and  
Enforcement

### Industries

Financial Institutions

### Education

JD, University of  
Pennsylvania Law School  
BA, The College of William  
& Mary

### Bar Admissions

North Carolina  
New York

Peter J. Shea is a partner in Katten's Financial Services practice. His clients range from NYSE-listed exchange traded funds to small private businesses as well as registered investment companies, hedge funds, investment advisors, broker-dealers and other financial institutions.

Peter has served as counsel in the following types of matters:

- Formation, registration and compliance for exchange traded funds, mutual funds, closed-end funds and business development companies;
- Creation and operations of hedge funds, distressed asset funds and other private investment vehicles;
- Formation, registration and ongoing compliance requirements of broker-dealers and investment advisers;
- Counsel to independent directors;
- Obtaining SEC no-action and other exemptive relief;
- Formation and financing of start-up companies;
- Public and private equity and debt offerings, including initial public offerings, and public debt and equity exchanges; and
- Ongoing regulatory compliance, SEC reporting and proxy solicitation requirements for public entities.

Peter has extensive experience as company counsel and fund counsel and has represented businesses in all phases of their development.

Peter is a former SEC Division of Enforcement Staff Attorney and a member of the ABA Business Law Section (Committee on Federal Regulation of Securities) and the Association of Securities and Exchange Commission Alumni.

# Katten

Katten Muchin Rosenman LLP

## OUR CLIENTS SAY...

"I've worked with Katten for over 10 years. By far, Katten and the partners that I work with ... bring a sharp, business approach to everyday issues, as well as complex problems and legal structures."

*U.S. News – Best Lawyers® "Best Law Firms" 2014  
(Private Funds/Hedge Funds Law)*

## FINANCIAL SERVICES

### Our Clients

Katten's Financial Services team effectively represents a broad range of financial market participants, including some of the world's most elite financial institutions and alternative investment managers, in regulatory, product structuring and transactional, tax, compliance, cybersecurity and other matters.

Our attorneys are actively engaged in advising commercial and investment banks, broker-dealers, futures commission merchants, investment advisers, alternative investment managers, finance companies, futures and securities exchanges, commodity trading advisors, commodity pool operators, proprietary trading firms, pension funds, family offices, sovereign wealth funds, and insurance companies. We also represent all manner of registered and alternative investment vehicles, including mutual funds, closed-end funds, exchange-traded vehicles and business development companies, liquid alternative funds, and hedge funds, funds of funds, venture capital funds, private equity funds, commodity pools, securitization vehicles, and bank collective investment funds.

### Our Services

Katten's comprehensive financial services representation draws on the unparalleled depth of knowledge and practical, real-world experience of its attorneys in securities, futures, banking and alternative investment management. Several of our attorneys previously held senior positions with regulatory agencies, including the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC),

## OUR HONORS

- Acquisition International Hedge Fund Awards 2013
  - US Law Firm of the Year
- *Chambers USA*
  - Capital Markets: Derivatives (Nationwide) 2014
  - Investment Funds: Hedge Funds (Nationwide) 2013
- *The Legal 500 United Kingdom* 2013
  - Corporate and Commercial – Financial Services (Non-Contentious/Regulatory)
  - Finance – Derivatives and Structured Products
- *The Legal 500 United States*
  - Investment Fund Formation and Management – Alternative/Hedge Funds – 2014, 2013
- *U.S. News – Best Lawyers® "Best Law Firms"* 2014, 2013
  - Derivatives and Futures Law (National, Chicago)
  - Private Funds/Hedge Funds Law (National, Chicago)



the Commodity Futures Trading Commission (CFTC), the Chicago Board Options Exchange (CBOE), the Chicago Mercantile Exchange (CME) and the Department of Justice (DOJ), or served as in-house counsel at financial services firms. With this breadth of experience, we are often able to recognize and resolve issues that other firms cannot, providing value to our clients during each stage of the process.

We assist in structuring, negotiating and documenting loans and traditional financial products as well as structured investments and the full range of exchange-traded and over-the-counter (OTC) derivatives transactions. Our attorneys guide clients through all aspects of regulatory compliance and provide comprehensive representation in investigations and enforcement actions brought by the SEC, DOJ, CFTC, FINRA, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, state regulators, and securities and futures exchanges. In addition, we counsel both first-time and well-established sponsors in the formation of funds in a variety of sectors of the fund industry, including hedge funds, venture funds, private equity funds, liquid alternative funds, leveraged buyout (LBO) funds, mezzanine funds, real estate funds, commodity and futures funds, industry-specific funds, and funds-of-funds. We also work closely with our clients' legal, operational and technical teams on the whole range of information technology projects, software-as-service and cloud hosting relationships, privacy and data security planning, and data breach responses. Due to the unique combination of regulatory and transactional experience Katten offers, our attorneys are often seen as outside general counsel for their clients, providing advice on a wide variety of legal matters.

We service our financial services clients from an international platform, offering seamless global coverage. Katten's London office works closely with our US offices to provide advice to a broad spectrum of domestic and international financial institutions, fund managers, trading advisors, banks, brokerages and proprietary trading firms in all aspects of exchange-traded and OTC commodities, securities and derivatives transactions, and EU regulatory matters.

We provide creative, strategic representation while being responsive to our clients' practical and economic needs. Our approach ensures that clients receive the full benefit of our regulatory, product, transaction, tax, employee benefits and litigation experience and our partnership service model yields long-term relationships.

## Our Experience

- Representation of a privately held alternative investment management firm based in the United States in consolidating with an unaffiliated global investment management firm with offices in Paris, New York, London, Zurich and Geneva.
- Representation of two affiliated investment advisers in forming a renowned international asset management firm.
- Representation of an independent asset manager in setting up a hedge fund structure dealing in bank loans for the use of a Japanese institutional investor who required daily liquidity and net asset value (NAV) transparency.
- Representation of a hedge fund manager—with more than \$6 billion of assets under management in the United States and globally—in a myriad of transactions designed to maximize its potential to pursue opportunities in the broadest investment universe in a tax-efficient manner.
- Representation of one of the largest and most successful hedge fund managers in the United States and otherwise in the creation of a family of funds designed to permit our client's related retirement plan investors to invest exclusively in our client's investment products on a "fee-free" basis pursuant to a Prohibited Transaction Exemption issued by the US Department of Labor (DOL).
- Representation of a leading global private equity firm and investment management company—with offices in, among other locations, New York, London, Dubai, Asia, Italy and Spain—and related investment funds with respect to the structuring of its "funds-of-one" (Global Market Strategies Feeder Funds) as part of its new hedge fund investment management business, including the ongoing representation of our client and the Global Market Strategies Feeder Funds.
- Representation of an independent asset manager's hedge fund complex and global investment management business in connection with existing funds and structuring and forming new products.
- Ongoing representation of a global investment management company.
- Representation of a global investment management company—with offices in London, New York and the Cayman Islands—with respect to structuring its international investment management business, including the ongoing establishment of a group of complex hedge funds.



- Representation of a hedge fund manager with more than \$300 million in assets under management in the United States and globally, in establishing a “fund-of-one” investment vehicle for the exclusive investment by a large fund-of-funds platform for its ERISA investors.
- Representation of a privately held financial institution in connection with structuring and forming new hedge fund products as well as representing existing hedge funds.
- Representation of an SEC-registered investment adviser in a two-step reorganization.

## LIQUID ALTERNATIVES

### Our Clients

Katten advises clients in all matters relating to liquid alternative investments and liquid alternative investment products, including the formation and operation of publicly offered and Investment Company Act of 1940-registered open-end mutual funds, exchange-traded funds and exchange-listed and over-the-counter closed-end funds pursuing alternative investment strategies.

We act as fund counsel and as counsel to independent directors, board committees, investment advisers and sub-advisers of registered funds and broker-dealers serving as fund distributors and underwriters. Our fund clients also include business development companies, variable life insurance and annuity products, and their providers.

### Our Services

Our attorneys assisting clients with liquid alternative investments have extensive experience in the private fund and alternative space and the more heavily regulated operating environment of investment companies registered under the 1940 Act. By bridging both the private fund and registered fund worlds, Katten is uniquely positioned to assist alternative investment managers who are interested in implementing their liquid alternative strategies in a registered fund vehicle in order to gain access to the retail marketplace.

Katten assists clients in determining if their liquid alternative investment strategies are appropriate for private fund vehicles, registered fund vehicles, or both.

This determination involves:

- assessing the feasibility of implementing liquid alternative investment strategies in a private fund and retail fund context;
- determining if liquid alternative investment portfolios can be managed under applicable registered fund limits (e.g., the 1940 Act leverage restrictions);
- determining the most appropriate structure for funds in the private (e.g., onshore or offshore; 3(c)(1) or 3(c)(7)) and registered (e.g., mutual fund, exchange traded fund, closed-end fund or business development company) context; and
- weighing whether to utilize existing umbrella fund platforms or create new fund entities.

Our approach emphasizes enhancing a registered fund’s public reputation through the provision of timely and sophisticated legal advice without impeding the fund’s ability to achieve its performance goals. In relation to liquid alternative investments, our services include the areas below.

- Designing fund products, including arranging and attending new retail product meetings with the Securities and Exchange Commission (SEC) in advance of registration
- Forming fund entities and obtaining SEC and state registrations
- Negotiating and drafting all required contracts, including adviser, distributor/underwriter and service provider agreements and other contracts, such as financial index licenses
- Advising on fund tax compliance, including Subchapter M tax issues, state tax issues, tax-exempt bond fund considerations, hub and spoke and master-feeder structures and preferential dividend issues
- Handling board, committee and shareholder meetings
- Drafting codes of ethics and compliance policies and procedures
- Making periodic reports to shareholders and SEC filings
- Reviewing advertising and marketing materials for Financial Industry Regulatory Authority compliance
- Advising on portfolio investment pricing/valuation, allocation and trading issues
- Advising on conflict-of-interest transactions, including side-by-side management conflicts between liquid alternative and private funds as well as changes in adviser compensation, fund mergers and acquisitions, and conversion of closed-end funds to open-end funds

- Preparing requests for SEC no-action, interpretive and exemptive relief
- Participating in client meetings with the staff of the SEC
- Advising about communications made before and during an offering
- Facilitating introductions to exchanges, market makers and other market participants
- Assisting in preparing for and responding to SEC examinations and inspections

We assist clients with their regulatory requirements pertaining to governance, liquidity and leverage, allocating investment opportunities, due diligence programs, and regulatory filings. We help them create robust compliance programs with an emphasis on liquidity, valuation and leverage practices, board governance, and due diligence programs.

In addition, we have extensive experience in a full range of litigation matters that arise in connection with investment management and financial services, including civil actions in court and arbitration proceedings, SEC, Commodity Futures Trading Commission, Department of Labor and self-regulatory organization investigations, administrative and injunctive proceedings, and state and federal criminal proceedings.

Liquid alternative investment products are at the intersection of Katten's strengths—our long history of providing counsel to registered public funds regulated by the 1940 Act and our sophisticated experience advising on the organization and management of private, alternative investment vehicles and their use of derivatives. With comprehensive financial services industry experience and in-depth product knowledge, Katten is able to provide counsel on the latest offerings, delivering pragmatic solutions that enable efficient operations and allow for future growth.



## Katten Attorney Kathleen Moriarty Honored With Lifetime Achievement Award for Pioneering Work With Exchange-Traded Funds

Firm News | March 21, 2014

(NEW YORK) Katten Muchin Rosenman LLP announced today that Financial Services partner Kathleen Moriarty received a Lifetime Achievement Award from ETF.com, an honor that is bestowed annually to one individual for outstanding long-term contributions to exchange-traded funds (ETF) investor outcomes. Moriarty, a 25-year ETF industry veteran, played a leading role in the development of the SPDR S&P 500 ETF (ticker symbol: SPY), the world's first ETF, and also drafted the prospectus for SPY, now the largest ETF in the country with \$160 billion in assets under management.

"Kathleen is truly a pioneer in this space. This award is one that is well-deserved and speaks to the exceptional and innovative contributions she has brought to the industry," said Vincent A.F. Sergi, Katten Chairman. "By playing a significant role in the creation, structuring and development of these funds early on, Kathleen's knowledge and experience in the ETF industry is unmatched."

Since Moriarty's involvement in the SPDR development, which earned her the nickname "SPDR Woman," she has helped guide the creation of other ETFs including iShares, Vanguard Exchange-Traded Funds (VIPERS), ProShares, WisdomTree and IndexIQ. She also advises individuals and entities regarding the registration and structuring of exchange-traded products based on current Securities and Exchange Commission and Commodity Futures Trading Commission regulations. Most recently, Moriarty has been working to launch the first-ever publicly traded ETF for the digital currency Bitcoin.

Additionally, Moriarty counsels ETF projects globally, including assisting the Stock Exchange of Hong Kong with the structure and creation of the Tracker Fund of Hong Kong and representing the American Stock Exchange and NYSE Arca in connection with the cross-listing of DIAMONDS Trust (DIA) on the Singapore Exchange and Euronext N.V. She regularly advises foreign entities and delegations from both public and private sectors with respect to the regulation and operation of US ETFs and exchange-traded vehicles (ETVs).

Moriarty was presented with the Lifetime Achievement Award at the ETF.com Awards on March 19, 2014, at Chelsea Piers in New York. ETF.com is a 14-year-old news, views and financial data company focused exclusively on exchange-traded funds. The awards distinguish the funds, firms and individuals that are improving investor outcomes by delivering innovative products to the market.



The Katten logo, featuring the word "Katten" in a white, serif font on a dark red rectangular background.

Katten Muchin Rosenman LLP



## Katten Partner Kathleen Moriarty Marks SPDR Anniversary by Ringing NYSE Opening Bell

Firm News | January 31, 2013

Kathleen Moriarty, a partner in the firm's Financial Services Practice, commemorated the 20th anniversary of SPDR S&P 500 ETF (NYSEArca:SPY), the first US-listed exchange-traded fund, by ringing the New York Stock Exchange opening bell on January 29. Ms. Moriarty, who earned the nickname "SPDR Woman" for her part in drafting the regulatory paperwork for SPY, also discussed the evolution of the exchange-traded industry with IndexUniverse.

July 14, 2014

## SEC Focuses on Burgeoning Liquid Alternative Funds Market

Registered investment companies that pursue alternative investment strategies (also referred to as “liquid alts”) are a relatively new form of offering for investment managers accustomed to operating private investment funds. Unlike a private fund, which invests without restrictions, the Investment Company Act of 1940 (the 1940 Act) extensively regulates the governance and operations of a liquid alt and imposes restrictions and limitations on its investment activities. In addition, because liquid alts are a relatively new product, retail investors may not fully understand the nature and potential risks of an investment in liquid alts. Nonetheless, liquid alts have experienced significant growth since their introduction. *The Wall Street Journal* reported that liquid alts have burgeoned from about \$38 billion in assets in 172 funds in 2008 to \$160 billion in assets in 429 funds in 2014.<sup>1</sup> However, the Securities and Exchange Commission (SEC) has estimated the assets in liquid alts to be in excess of \$300 billion as of May 2014.<sup>2</sup> In any respect, liquid alts are the fastest growing sub-category of mutual funds, receiving \$40.7 billion in investor funds in 2013.<sup>3</sup> This growth has occurred amidst a net reduction in assets for actively managed domestic equity mutual funds, which lost \$575 billion from 2007 to 2013.<sup>4</sup>

This rapid growth has engendered growing regulatory focus. In its Examination Priorities for 2014, the Office of Compliance Inspections and Examinations (OCIE) of the SEC announced that its National Exam Program will include, among other things, a concentrated review of liquid alts focusing on: (i) their leverage, liquidity and valuation policies and practices; (ii) the staffing, funding and empowerment of their boards, compliance personnel and back offices; and (iii) their marketing to investors, including the representations and recommendations made to investors concerning the suitability of the investment.<sup>5</sup> In January, OCIE also announced its intention to conduct a coordinated review, or sweep, of liquid alts and their investment advisers. OCIE’s initial review, which Division of Investment Management Director Norm Champ recently said is likely to begin this summer or fall, is expected to cover up to 25 alternative investment companies, or approximately 14 percent of the 185 liquid alt fund families currently in operation.<sup>6</sup> Based on the results of its initial review, OCIE

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<sup>1</sup> Daisy Maxey, *Alternative Mutual Funds Draw Concerns*, THE WALL STREET JOURNAL, May 1, 2014, citing Morningstar.

<sup>2</sup> Norm Champ, Director, Division of Investment Management, Remarks to the Practising Law Institute, Private Equity Forum, June 30, 2014, citing the Risk Analysis and Surveillance Team of the SEC’s Division of Enforcement.

<sup>3</sup> Trevor Hunnicutt, *Popular “Liquid Alts” Funds Face Regulatory Scrutiny*, INVESTMENT NEWS, June 24, 2014.

<sup>4</sup> *Id.*

<sup>5</sup> National Exam Program: Examination Priorities for 2014, Office of Compliance Inspections and Examinations, January 9, 2014.

<sup>6</sup> *Id.*; see also footnote 2.

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will decide whether to conduct a second sweep. One commentator has noted that this sweep on liquid alts reflects how “keen” the SEC is “to shift from reactionary regulation (for which the agency was criticized after the 2008 crisis) to proactive oversight.”<sup>7</sup>

OCIE's attention to liquid alts reflects regulatory concern that liquid alts present risks to investors who do not fully understand the nature of liquid alts and their strategies. Indeed, in March 2014, OCIE Director Andrew Bowden characterized liquid alts as “bright, shiny object[s]” but noted that “they are . . . sharp object[s].”<sup>8</sup> The Financial Industry Regulatory Authority, Inc. (FINRA) also has expressed concern about the retail marketplace's understanding of liquid alts; in a June 2013 investor alert, FINRA emphasized the need for investors to recognize the distinctions between liquid alts and both traditional mutual funds and the alternative private funds on whose strategies liquid alts are based.<sup>9</sup>

Liquid alts and their investment advisers can prepare for the sweep and future regulatory action by creating a robust compliance program, with an emphasis on liquidity, valuation and leverage practices, board governance and due diligence programs. Such a program would consider the risks noted by Director Champ in a June 30th address discussing the key points of emphasis the SEC considers in its review of liquid alts.<sup>10</sup> These risks, which include portfolio liquidity, use of leverage, disclosure of strategies and governance are discussed in further depth below.

Any adviser that operates in, or is seeking to enter, the liquid alts space should retain counsel that has extensive experience with the 1940 Act, the SEC and its examinations staff and the types of alternative investments used in liquid alts' strategies.

## Introduction to Liquid Alts

Liquid alts are publicly offered funds registered under the 1940 Act. While liquid alts have some of the same characteristics as traditional mutual funds, including daily pricing and liquidity, transparency, and low minimum investments, they seek to employ the risk return methods of alternative investment vehicles, including exposure to specific asset classes and the use of leverage and complex trading strategies. Alternative investment strategies (e.g., global macro, long-short equity and managed futures) are generally distinct from, and seek to produce positive risk-adjusted returns that are not closely correlated to, the traditional equity and debt strategies offered by most mutual funds and exchange-traded fund products.

Only certain qualified investors have access to alternative investment strategies through private funds. Recognizing that the popularity of alternative investments has been growing, investment advisers to private funds have seized an opportunity to expand their investor base and assets under management by providing retail investors access to alternative investments through liquid alts.

Alternative investment advisers can bring liquid alts to market by sponsoring independent alternative investment funds or by partnering with an asset manager that already has a fund structure in place, including 1940 Act distribution and compliance capabilities (e.g., an umbrella trust). The decision to independently sponsor a liquid alt or operate a fund out of an umbrella trust will largely depend on factors such as: (i) time and cost sensitivity; (ii) the complexity of underlying strategies and portfolios; and (iii) the desire for establishing a bespoke liquid alt infrastructure.

Independently sponsoring a liquid alt requires, among other things, establishing a board of directors and developing written compliance policies and procedures, regulatory reporting and compliance with the 1940 Act. Under an umbrella trust, much of these operations are in place in a turn-key environment, though not all umbrella trusts are structured in a manner that permits or is suitable for complex liquid alt strategies. In light of the OCIE Examination Priorities (and FINRA's 2013 investor alert), alternative investment advisers operating or preparing to operate liquid alts should consider their operations, the adequacy of their compliance regime and level of reporting to their boards, and the monitoring of portfolio activity in the 1940 Act context. As liquid alt advisers must be registered investment advisers under the Investment Advisers Act of 1940, as amended (Advisers Act), advisers also should consult with counsel regarding their obligations thereunder.

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<sup>7</sup> *SEC Sweep: Liquid Alternative Funds*, PricewaterhouseCoopers (June 2014).

<sup>8</sup> Andrew Bowden, Director, Office of Compliance Inspections and Examinations, People Handling Other People's Money at the Investment Adviser Association Compliance Conference (Mar. 6, 2014).

<sup>9</sup> *Alternative Funds Are Not Your Typical Mutual Funds*, Financial Industry Regulatory Authority, Inc., June 11, 2013.

<sup>10</sup> See footnote 2.



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## Regulatory Requirements

The 1940 Act imposes certain regulatory requirements on all investment companies, including liquid alts, and their investment advisers and sub-advisers. These requirements mandate, among other things, that liquid alts manage daily liquidity to meet redemption requests and calculate net asset value on a daily basis. The 1940 Act also restricts short-selling and the use of leverage.

Furthermore, under the 1940 Act, a liquid alt adviser must keep the liquid alt's board of directors fully informed about the investments the liquid alt makes and the liquid alt's operations and adherence to its principal strategies and investment restrictions. They also must implement robust due diligence policies and procedures to ensure compliance with the 1940 Act and provide appropriate regulatory documentation to the SEC. Liquid alt advisers that manage a private fund concurrently with a liquid alt also must ensure that investment opportunities are allocated fairly among the vehicles. Experienced counsel can provide guidance to liquid alt advisers on the relevant 1940 Act and Advisers Act requirements, compliance policies and procedures, board governance, due diligence and regulatory documentation.

### *Governance*

The board of directors of a liquid alt oversees its operations and monitors the activities of its service providers (including its investment adviser and any sub-adviser). At least half of the members of the board must be independent (i.e., without any material ties to the investment adviser, distributor or any sub-adviser).

The board has a fiduciary obligation to the shareholders of the liquid alt and must approve advisory agreements and the compliance regime that governs the liquid alt. Liquid alts are subject to board oversight regarding general operations, compliance, new products and service provider performance, as well as on matters such as disclosing and mitigating conflicts of interests. A liquid alt's board must be well-informed and understand complex liquid alt strategies to ensure that they are capable of performing their fiduciary duties to shareholders.

With respect to board operations, the SEC requires that board minutes reflect clear communication and understanding of the structure and risks of alternative investments and thereby indicate that the board was capable of making informed decisions with respect to such investments. Advisers and sub-advisers typically are required to report to, and to comply with all reasonable information requests from, the board on an ongoing basis and, particularly, at quarterly board meetings.

### *Liquidity and Leverage*

Liquid alts are subject to specific 1940 Act requirements that are intended to protect investors. Among other things, the 1940 Act mandates that liquid alts provide daily liquidity and limit their use of leverage.

The 1940 Act limits a liquid alt from investing in excess of 15 percent of its assets in illiquid investments. Furthermore, a liquid alt adviser must have policies and procedures in place to monitor and value such illiquid investments to comply with the daily net asset value publication requirements under the 1940 Act. In particular, liquid alt advisers must have adequate policies and procedures in place to address portfolio management in periods of heightened market movement or high levels of redemptions. A liquid alt adviser that has limited experience with the 1940 Act should work closely with its liquid alt's compliance officers, fund administrators and board of directors' valuation committee to ensure the adequacy of internal reporting, operations and stress testing relating to portfolio management, valuation and illiquid investments. In particular, Director Champ called for the implementation of robust, written policies and procedures to both assess the liquidity of investments and to address fair valuation of illiquid assets.<sup>11</sup>

In addition, the 1940 Act imposes limits and controls on, and disclosure requirements regarding, the use of leverage. While the 1940 Act prohibits direct borrowing for investment purposes, the SEC has allowed borrowing through certain leveraged investments (e.g., futures, written options and short sales). Liquid alt advisers are required to mitigate the risks of leverage either by segregating assets or entering into offsetting transactions to cover possible liabilities. They must also limit the overall amount of leverage and derivatives exposure and should establish a risk management framework to assess the impact of various market conditions on financial instrument positions of the liquid alt.

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<sup>11</sup> See footnote 2.

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Given the substantial risks involved with leverage and the fact that leverage is a common strategy among private alternative investment funds, liquid alt advisers' compliance with the 1940 Act's leverage requirements will likely be a key focus of OCIE examinations. Liquid alt advisers should consider employing common governance tools to mitigate the risks of leverage, such as new product diligence committees, risk disclosure reviews and board reporting. Additionally, disclosure regarding leverage and the derivatives used by a liquid alt to obtain such leverage is likely to remain a point of emphasis for the Division of Investment Management.

#### *Allocating Investment Opportunities*

Each liquid alt adviser has a fiduciary obligation to allocate investment opportunities fairly among its clients. A liquid alt adviser that manages a private fund side-by-side with a liquid alt that has similar objectives could face a conflict of interest due to the private fund's payment of performance fees, which could incentivize the adviser to allocate more investment opportunities to the private fund than the liquid alt (liquid alts charge a standard advisory fee but generally are not permitted to impose the higher performance-based fees often charged by private funds). Liquid alt advisers should ensure they comply with the requirements of the 1940 Act and the Advisers Act, as well as each fund's respective investment guidelines and restrictions when allocating investment opportunities among client accounts. In particular, liquid alt advisers must develop and implement consistent policies and procedures addressing trade allocation between liquid alts and private funds with the same or similar investment strategies.

#### *Due Diligence Program*

For fund structures that involve the use of sub-advisers (e.g., multi-manager liquid alts), liquid alt advisers are required to have robust due diligence policies and procedures to review sub-adviser activities and to ensure compliance with 1940 Act requirements. Earlier this year, OCIE issued a Risk Alert reviewing the due diligence programs of alternative investment advisers.<sup>12</sup> Among other things, OCIE found that alternative investment advisers are increasingly using quantitative and factor analysis to conduct due diligence and that advisers were more likely to consistently apply their due diligence processes when they adopt detailed written policies and procedures that require adequate documentation. OCIE also found deficiencies in alternative investment advisers' annual reviews of their policies and procedures and in their due diligence of marketing materials. In developing their due diligence programs, liquid alt advisers should address the deficiencies highlighted in the OCIE Risk Alert.

#### *Regulatory Filings*

Liquid alts and their investment advisers are subject to various regulatory filings. As discussed below, liquid alt advisers may disclose certain nonpublic regulatory filings to investors upon request or as permitted by law; other regulatory filings are made available to the public by the SEC. For some liquid alts' investment advisers, these regulatory filings are more than legal requirements under the securities laws: investment advisers to liquid alts that invest in underlying liquid alts should request and review the regulatory filings and other information of the underlying liquid alts as part of their investment due diligence policies and procedures.

As registered investment advisers, liquid alt advisers must file Form ADV Part 1 and Part 2A, which are made publicly available on the SEC's Investment Adviser Public Disclosure (IAPD) website.<sup>13</sup> Form ADV Part 1 discloses the adviser's business, ownership, clients, employees and disciplinary events for the adviser's employees. Form ADV Part 2A, commonly known as an adviser's "brochure," contains the adviser's free-form disclosures regarding fees, compensation, conflicts of interests and disciplinary history. In addition, other regulatory information about advisers are made available to the public, including enforcement action notices that reflect settlements, filed cases and decisions.

Certain of a liquid alt adviser's regulatory filings and information are not publicly available but may be provided to investors upon request or as required by law. These documents include Form ADV Part 2B, Form PF (if the adviser also manages at least one private fund), SEC findings, comment or deficiency letters, document requests and subpoenas. Form ADV Part 2B contains biographies of supervised persons of the adviser. Form PF, which the SEC uses to discern sources of systemic risk, contains in depth information on the adviser's leverage, risk profile, exposures and liquidity. SEC letters, document requests and subpoenas are nonpublic documents

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<sup>12</sup> National Exam Program Risk Alert: Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers, Office of Compliance Inspections and Examinations, January 28, 2014.

<sup>13</sup> The IAPD website is available here: <http://www.sec.gov/answers/iapd.htm>.

from SEC investigations or examinations. A liquid alt adviser may opt to release the foregoing regulatory filings and other documents in total, redact portions thereof or have investors review the filings and/or documents at the adviser's place of business. Liquid alt advisers should develop policies and procedures to govern such release of nonpublic regulatory filings and information.

As registered investment companies, the liquid alts themselves file a registration statement on Form N-1A, including a statutory prospectus and statement of additional information, with the SEC to register their securities in a public offering. Form N-1A provides required disclosures and basic financial information and sets forth certain investment policies and restrictions to which the liquid alt's investment adviser may be bound. Advisers and their counsel should periodically review disclosure to ensure that it adequately describes in plain English the risks of investment in, as well as the principal strategies and the operations of, the liquid alt. A liquid alt also will be required to file periodic reports on Form N-CSR (annual shareholder report), Form N-SAR (semi-annual report), Form N-PX (proxy voting report) and Form N-Q (quarterly portfolio holding report).

## Preparing for SEC Examinations

To prepare for SEC examinations and future regulatory oversight of liquid alts, liquid alt advisers should examine their compliance and portfolio management policies and procedures to ensure that their liquid alts operate in a manner consistent with liquidity requirements, leverage limits and portfolio monitoring systems. Liquid alt advisers also should work with the liquid alts' chief compliance officers and their boards of directors to update investment allocation and due diligence policies and procedures and to ensure that all relevant parties are fully informed of, and understand the substance of, the alternative investment strategies employed by the liquid alt.

Due to the heavily regulated nature of liquid alts, liquid alt advisers should seek experienced counsel that is intimately familiar with the 1940 Act, the SEC and its examinations staff and alternative investments.

*Katten Muchin Rosenman LLP will host a forthcoming seminar addressing issues relating to the formation of liquid alts and the OCIE examination priorities.*

# Katten

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7/10/14

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# Form of SEC Liquid Alts Examination Request

## General Information

1. Adviser's and Sub-Adviser's organization chart with ownership percentages showing the adviser, control persons, and all affiliates.
2. List of current employees, partners, officers and/or directors and their respective titles.
3. A list of all committees including a description of each committee's responsibilities, meeting frequency, and a list of the members of each committee. State whether the committees keep written minutes.
4. Any correspondence with the staff of the Commission or other regulatory agencies and any no-action letters or exemptive orders relied upon by the Alternative Mutual Funds.
5. A chart listing all funds in the complex with the following information as of **June 30, 2014**:
  - a. fund/portfolio name;
  - b. share class;
  - c. registration number;
  - d. investment objective;
  - e. portfolio turnover rate for last 2 years;
  - f. commencement date of operations; and
  - g. whether the Fund was classified as an alternative mutual fund, aggressive capital appreciation, balanced, capital appreciation, growth and income, foreign issuer, growth, income, long term debt (taxable), long term debt (tax-free), money market (taxable), money market (tax-free), precious metals, index, or other.
6. A trade blotter (*i.e.*, purchases and sales journal) that lists transactions (including all trade errors, cancellations, re-bills, and reallocations) in securities and other financial instruments (including privately offered funds) for the Alternative Mutual Funds. The preferred format for this information is in Excel as indicated in Exhibit 1.
7. For the Alternative Mutual Funds, provide the following holdings information as of the last day of each month for the Examination Period:
  - a. security name;
  - b. CUSIP (or other identifier);
  - c. fund name;
  - d. fund account number;
  - e. quantity or principal/notional amount owned by each fund;
  - f. cost basis;
  - g. the hierarchy level as defined by Topic 820; and
  - h. whether the position was deemed liquid or illiquid.

The preferred format for this information is in Excel.

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## Corporate Governance

8. For the Alternative Mutual Funds, please provide minutes of Directors/Trustees (“Board”), independent directors/trustees, and Board committee meetings for the 24-month period ended **June 30, 2014**. Please also provide all Board materials including ad hoc presentations. A draft of the minutes for the most recent Board meeting also should be provided.
9. Please describe any additional risks or heightened risks you have identified relating to the Alternative Mutual Funds and describe the controls in place to mitigate these risks.
10. Compliance and operational policies and procedures in effect during the Examination Period for the Adviser, Sub-Adviser(s), Funds, and their affiliates. Please be sure to include any policies and procedures concerning liquidity of investments, fair valuation, Section 18 (segregation/earmarking of fund assets), derivatives investment and monitoring, and risk management (including of economic leverage).
11. Any written interim or annual compliance reviews, internal control analyses, and forensic or transactional tests performed for the alternative mutual funds. Include a description of any significant findings of non-compliance with compliance policies and procedures.
12. For the Alternative Mutual Funds, please provide the rules inputted into any pre-trade or post-trade compliance system as well as any end-of-day testing output for: **December 31, 2013, June 2, 2014, and June 30, 2014**.
13. All compliance testing reports and analyses relating to compliance with the investment restrictions set forth in the Alternative Mutual Funds’ prospectus for **January 1, 2014 to June 30, 2014**.
14. A list of all risk management, performance attribution, or position reports utilized to monitor or quantify risk and exposure in the Alternative Mutual Funds’ portfolio from **January 1, 2014 through June 30, 2014**.
15. List of all investment instruments and all investment strategies utilized or expected to be utilized by the Alternative Mutual Funds’ portfolio manager. For each, please indicate which instruments or strategies have not been used in the past three years by the adviser in its management of other mutual funds or private funds or separately managed accounts.
16. Please describe the following:
  - a. How the following investment strategies and products are monitored for compliance: short sales; futures; options; and other derivatives including swaps; borrowings; and other forms of leverage; and
  - b. Systems, processes, and procedure used in identifying and managing risks.



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## Liquidity

17. All Board minutes and reports presented to the Board from **June 1, 2013 through June 30, 2014** concerning:

- a. The risk exposures and liquidity positions of the Alternative Mutual Funds, and the funds' ability to manage through changing conditions and potentially increased volatility;
- b. The review of the current valuation process and procedures relating specifically to the Alternative Mutual Fund holdings; and
- c. A review and discussion of current liquidity oversight and metrics used to measure liquidity of the Alternative Mutual Funds.

If it is easier, please just reference the meeting dates.

- 18. Documents supporting the Adviser's assessment of overall Alternative Mutual Funds liquidity and the funds' ability to meet potential redemptions over a number of periods. The assessments may include, for example, needs and sources of fund liquidity over 1 day, 5 days, 30 days, and potentially longer periods.
  - 19. Documentation supporting the nature and results of stress tests including assessment of sources of liquidity (such as cash holdings and other assets that would not require selling into declining or dislocated markets if volatility or market stress increases).
  - 20. Any internal reports created and maintained that reflect the amount of exposure to illiquid assets.
  - 21. Names of the individuals who are primarily responsible for monitoring the liquidity of the holdings in the Alternative Mutual Funds.
  - 22. Names of all pricing services, quotation services, valuation appraisers, and externally-acquired portfolio accounting systems used in the valuation process of the Alternative Mutual Funds' holdings. Also, please provide engagement agreements executed with these providers.
  - 23. A list of securities for which the price provided by a pricing service was overridden by the Adviser, Sub-Adviser(s), or Board of Directors and the date of the override.
  - 24. Documentation of forensic tests performed to determine the appropriateness of prior valuations for the Alternative Mutual Funds, such as look-back tests (comparing the price of a security that was previously fair valued with a subsequent market price), and acid tests/disposition analysis (comparing the sales price of a security to the prior day's fair valued price). Detail the frequency of back-testing by the fund.
  - 25. Term margin agreements with prime brokers and presentations of the firm to prime brokers covering risk management.
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26. Details of any lending facilities to which the Alternative Mutual Funds would have access in light of unexpected redemptions:

- a. Detail analysis supporting sizing of the facility;
- b. Detail allotment of facility to Alternative Mutual Funds;
- c. Detail lender(s);
- d. Detail term of facility;
- e. Detail dollar limit of facility;
- f. Detail when this facility has been used in the past and by which fund including terms and dollar amounts over the last 3 years; and
- g. Detail facility covenants and other relevant terms and conditions including whether it is a committed line.

27. Please describe the following:

- a. The valuation process used for the Alternative Mutual Funds during the Examination Period by security type (e.g., RMBS, CMBS, etc.) in terms of the data and models used, analysis performed, and output of the analysis. If indicative bid pricing is used, please indicate how indicative bids are obtained;
- b. Any fair value process employed including any testing and results, and all fair value reports prepared or reviewed by a valuation committee;
- c. The stale price policy and escalation process;
- d. Risk limits including liquidity related risk limits, formal policy around categorization, and monitoring thereof;
- e. Stress tests and scenario analyses including but not limited to the following: interest rate hikes, widening spreads, price shocks to equity, fixed income and other financial products, increased volatility, and reduced liquidity;
- f. Any Alternative Mutual Funds' positions held in side pockets or special situation accounts together with their valuation;
- g. The services provided by the pricing services and documentation of any cross-checks performed (i.e., comparing the prices used to the prices obtained from the pricing source) and quotes obtained from third parties; and
- h. Any reviews of pricing services regarding methodology, inputs, and assumptions.

### **Senior Securities/Leverage**

28. All Board minutes and reports presented to the Board from **June 1, 2013 through June 30, 2014** concerning:

- a. The use of derivatives and alternative investments;
- b. Risk management; and
- c. The review and discussion of policies and procedures implemented by the adviser/fund to monitor the Alternative Mutual Funds' leverage (both indebtedness leverage and economic leverage).

If it is easier, please just reference the meeting dates.

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29. Please provide any internal reports created and maintained as of **June 30, 2014** that reflect the amount of borrowing and leverage (indebtedness and economic leverage) exposure by holding (i.e., short sales, futures, credit default swaps, total return swaps, etc), by fund. In addition, please provide a report that demonstrates the securities that were segregated or earmarked on the fund's books to cover, for purposes of Section 18, any potential exposures created.
  30. Names of the individuals who are primarily responsible for monitoring indebtedness and economic leverage created by the holdings in the Alternative Mutual Funds.
  31. Please describe any limits on the amount of economic leverage to which the Alternative Mutual Funds may be exposed.
  32. For each derivative transaction employed by the Alternative Mutual Funds from **January 1, 2013 to June 30, 2014**, please provide all term sheets, ISDA agreements, and confirmations, as well as purchase and sale dates and the gain/loss for the transactions.



# EXHIBIT I

## Layout for Securities Trading Blotter/Purchase and Sales Journal

In conjunction with the scheduled examination, the staff requests records for all purchases and sales of securities for portfolios of advisory clients and proprietary accounts being advised. Please provide this record in Excel. This record should include the fields of information listed below in a similar format.

Please provide separate worksheets for: (i) equities (Note: ETF trades should be included with equities); (ii) fixed income; (iii) cash or cash equivalents, maturities, calls, pay-downs, expirations, or reinvestments of mutual fund dividends or capital gains distributions; (iv) mutual funds; and (v) options, futures, swaps and other derivatives.

Examples:

### I. Sample Trading Blotter for Equity Securities

Client Name/#	Trade Date	Settle Date	Buy/Sell	CUSIP	Security Symbol	Security Description	Quantity	Unit Price	Principal/Proceeds/Notional Value	Total Commission	Fees	Net Amount	Broker
155	1/1/00	1/3/00	B	1234567	MSFT	Microsoft Corp	100	\$100.00	\$10,000	\$10.00		\$10,010.00	ABC
123	1/2/00	1/5/00	S	89101112	IBM	IBM Corp.	500	\$100.00	\$50,000	\$50.00	\$1.67	\$49,948.33	DEF

### II. Sample Trading Blotter for Fixed-Income Securities

Client Name/#	Trade Date	Settle Date	Buy/Sell	CUSIP	Security Description 1 (Issuer)	Security Description 2 (Coupon Maturity, etc)	Quantity	Unit Price	Accrued Interest	Principal Value / Proceeds	Total Commission	Net Amount	Broker
155	4/2/98	4/6/98	B	802586AG2	SANTA ROSA CA PKG FACS DIST	4.60% 07-02-2004	50,000	100	\$95.83	\$50,000	\$0	\$50,095.83	GHI

### III. Sample Trading Blotter for Derivative Securities

Client Name	Trade Date	Settle Date	Buy/Sell	CUSIP	Security Description 1	Security Description 2	Quantity	Unit	Principal Value /	Total	Net	Security Broker	Economic Position Long or Short
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Name/ #	Date	Date	Sell	(Issuer)	(Coupon Maturity, etc)	Price	Payments	Proceeds	Commission	Proceeds	Type	Short Position
178	4/1/05	4/3/05	B	Deutsche Bank AG, Microsoft Corp., Credit Default Swap	6 Months 10-01-2005	100,000	\$95.83	\$100,000	\$0	\$100,095.83	Credit Default Swap	Buying Protection
182	2/1/07	2/3/07	S	Morgan Stanley, PD. If credit spreads as represented by the Barclays Capital U.S. CMBS AAA 8.5+ Index widen, pays the spread change minus 50 basis points*; RD If credit spreads as represented by the Barclays Capital U.S. CMBS AAA 8.5+ Index narrow, receives the spread change*, (TWSP)	9 Months 11-01-2007	150,000	\$0	\$150,000	\$0	\$150,000	Total Return Swap	Economic Long

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