



MUTUAL FUND DIRECTORS FORUM

*The FORUM for FUND INDEPENDENT DIRECTORS*

Report of the  
Mutual Fund Directors Forum

**Board Oversight of  
Alternative Investments**

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## EXECUTIVE SUMMARY

In recent years, driven in part by an increasing desire of retail investors for investment strategies that are not correlated with major market indices, there has been a convergence of private equity, hedge funds and mutual funds. Many strategies and products previously available only to sophisticated investors within private funds are being offered to retail investors through mutual funds.

The shift to more alternative funds poses an obvious question for the director community: Is the role of a director who oversees an alternative strategy fund different from that of a director who oversees a more traditional fund? The answer, most certainly, is “no.” Despite the fact that many of these funds pursue complex investment strategies and/or investments, the fundamental role of an independent fund director has not changed. Directors’ duties do not arise from the particular investment strategy or instrument employed by the fund, but rather from the legal and fiduciary duties they have to the fund and its shareholders.

Although their duties do not change depending on the type of fund they oversee, particular aspects of alternative funds may present unique challenges to independent directors. This paper will focus on some questions for boards to consider when overseeing funds with investment strategies that are significantly different from more traditional long-only equity and fixed income funds. As always, boards should oversee their funds based on the specific circumstances that are applicable to their fund complexes. The discussion that follows, however, will address some common issues including:

- Questions that the board can consider if the adviser proposes adding an alternative fund to the complex.
- Areas that may need special attention if the adviser hires a sub-adviser to manage the alternative fund, particularly if the sub-adviser lacks experience with registered funds.
- Considerations for directors as they seek to understand an alternative fund’s investment strategy and how to evaluate the fund’s performance.
- Challenges in operational risk oversight, particularly with respect to Investment Company Act of 1940 (“1940 Act”) restrictions that may make the manager’s implementation of the fund’s strategy difficult.

Effective oversight of these concepts requires a broad understanding of the alternative strategies and complex financial instruments used by a fund. Directors will undoubtedly need to continue to educate themselves to keep up to date with rapidly changing securities markets.

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## I. Introduction

Historically, the investment strategies of most mutual funds were fairly simple – funds either made long investments in equities or fixed income securities. Even as the fund industry evolved, “new” investment programs were usually just variations on these traditional themes. Innovation involved narrowing the scope of a fund’s investments, by focusing on a particular geographic market or asset type, or broadening a fund’s investment range by combining various investment strategies into a single fund.

Pressure from market forces on traditional asset classes coupled with increased interest from investors seeking to further diversify their investment portfolios have prompted the mutual fund industry to broaden the types of funds it offers. Retail investors and their advisers have shown increased interest in mutual funds offering complex investment approaches traditionally offered to more sophisticated investors through hedge funds. At the same time, institutional investors have been drawn to funds offering alternative strategies by the transparency and liquidity of mutual funds, as well as fee structures that are typically far lower than hedge funds. Mutual funds also have proven attractive to asset managers – private fund managers, especially after having registered as advisers with the SEC, are discovering that they can greatly broaden their investor base by offering hedge fund-like strategies to both retail and institutional investors through mutual funds. Faced with this convergence, traditional managers have been adding these increasingly popular funds to their product line-ups.

There has been extraordinary growth in both the number of funds offering investors “alternative strategies,” and inflows into these funds. In 2011, alternative mutual funds saw inflows of \$23.2 billion, while U.S. equity mutual funds experienced outflows of \$84.7 billion, according to *Morningstar & Barron’s 2011 Alternative Investment Survey of U.S. Institutions and Financial Advisors*. According to Morningstar, investors added \$59 billion to alternative funds in the first seven months of 2013. A study by McKinsey & Co., published in 2012, projected that by 2015, retail alternatives would account for one-quarter of retail revenues.<sup>1</sup>

The SEC has also taken an interest in the space. One of the 2013 examination priorities is alternative investment companies:

“The [Investment Adviser-Investment Company] Program is focusing on the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (“ETFs”), and variable annuity structures. More specifically, the staff will assess whether: (i) leverage, liquidity and valuation policies and practices comply with regulations; (ii) boards, compliance personnel, and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.”<sup>2</sup>

Given the substantial increase in the varieties of available alternative funds coupled with the increased interest by regulators, more directors are seeking to gain confidence that they are appropriately identifying the key oversight issues involved in alternative funds. This paper will focus on some questions directors can consider when overseeing these funds.<sup>3</sup>

## II. What Is An Alternative Fund?

The term “alternative fund”<sup>4</sup> is frequently employed, yet has no single definition. In the popular media, the term is often used as a short-hand method of identifying a fund that invests in “alternative” assets – e.g., not merely stocks, bonds, and cash. Industry sources generally define the term “alternative” broadly. For example, Lipper’s definition is: “portfolios that generate correlation benefits to traditional, long-only-constructed funds, as well as portfolios that implement a hedge fund–like strategy often incorporating one or a combination of the following: leverage, derivatives, short positions and/or multiple asset classes.”<sup>5</sup> Strategic Insight focuses on open end funds and ETFs that use hedge fund strategies.

Because there can be a variety of definitions, this paper will use the term “alternative fund” to describe any fund that uses non-traditional assets or strategies to a significant degree.<sup>6</sup> On the product side, alternative funds can be funds that invest in non-traditional assets – such as derivatives, structured securities, metals, hedge funds or commodities. On the strategy side, an alternative fund may include funds with alternative strategies – such as a managed volatility fund, risk parity, absolute return, long-short fund, hedged debt, market-neutral and managed futures.

## III. Managing the Fund

As the SEC’s staff noted in its August 2013 “IM Guidance Update,” “[e]ffective implementation of a fund’s investment objectives and policies requires effective management of the risks associated with those objectives and policies.”<sup>7</sup> That Guidance went on to note that “the fund’s board generally oversees the adviser’s risk management activities as part of the board’s oversight of the adviser’s management of the fund.”<sup>8</sup>

In general, a board’s risk oversight obligations for alternative funds are the same as traditional funds. For more information, see the Forum’s paper *Risk Principles for Fund Directors* published in April 2010.<sup>9</sup> The discussion below highlights some of the most prevalent issues with respect to oversight of funds with alternative investments and strategies.

### ***Does the adviser have the expertise, knowledge, and resources necessary to carry out the intended strategy?***

Prior to any fund launch, directors typically discuss whether the adviser has the expertise, knowledge, and resources to carry out the intended strategy of the new fund. However, boards may have a more difficult time assessing the adviser’s ability with respect to an alternative strategy. For example, because the number and kind of alternative fund strategies are rapidly increasing, the board may find that the adviser has a limited track record with the investments and/or strategy employed by the new fund. In such circumstances, the board will want to inquire about the portfolio manager’s experience with the type of investments and strategy the fund will employ. That experience may have come exclusively in the private fund context, making it more difficult for the fund

board to assess how that experience may translate to a registered fund. If the adviser's experience has come about exclusively in a private fund or separate account context, the board will also want to understand the limitations, if any, that may apply when the strategy is introduced in a registered fund. As discussed below, certain legal limitations that apply to registered funds may in some cases impact the adviser's ability to replicate the performance obtained in the private fund context.

The adviser may gain experience it otherwise lacks with respect to the alternative investments or strategies to be pursued by the fund, by hiring a portfolio manager with experience in this area or hiring a sub-adviser to provide day-to-day management of the fund. In such situations, an adviser's history with respect to past new products may help a board evaluate the adviser's abilities in the alternative fund context, particularly if the adviser does not have specific experience with the alternative strategy that will be used by the fund. For example, if the adviser has demonstrated that it only offers products after developing the in-house investment knowledge for other types of funds, the board may gain comfort that the adviser also has made the necessary investment in capacity to successfully offer an alternative fund as well.

In addition to the investment knowledge required to run an alternative fund, the adviser also needs sufficient back-office resources to support a new alternative fund – an assessment that also may be difficult for a fund board. The adviser needs the capability to make, confirm, and record trades of investments that may be new to the fund complex. Further, new products may not fit into existing fund record-keeping systems and therefore require manual data entry, which can raise issues of data accuracy. While an adviser to a registered fund always has to monitor portfolio holdings to comply with statutory and regulatory requirements, new investment vehicles and strategies may introduce additional complexities to these calculations. Working with its CCO, a board should ask how the adviser plans to incorporate the new fund into its operational systems to gain comfort that the adviser is capable of accommodating the new challenges presented by an alternative fund.

An alternative fund may introduce additional complexities to fund accounting as well. The accounting conventions that govern mutual funds, such as how and when to recognize income, can be very different from those that govern private funds. Particularly if the fund is hiring a sub-adviser to manage the new alternative fund, the board will want to consider discussing with the fund treasurer and/or the outside accounting firm whether they are comfortable that the accounting in connection with the new fund will be appropriate under the rules applicable to mutual funds.

***Do the service providers have sufficient expertise and resources to service the new alternative fund?***

In addition to looking at the expertise and resources within the adviser, boards will want to inquire whether the anticipated service providers for the fund, such as auditors, fund administrators, fund accountants, and attorneys have the appropriate expertise and resources necessary to adequately provide needed services to the alternative fund. In some cases this will involve teams within existing service providers; in some cases different service providers may need to be engaged.

***Has the adviser considered how the fund's strategies and/or portfolio holdings will fit within the regulatory requirements of an open end mutual fund?***

Some alternative fund strategies and products can be difficult to fit within the unique regulatory requirements that govern open-end funds. For example, the 1940 Act requires daily calculation of a fund's net asset value ("NAV"), practically restricts the illiquid securities in open-end funds, limits leverage, requires asset diversification, and places limits on concentration in particular issuers.

While traditional 1940 Act asset managers are familiar with these requirements, advisers with experience in private funds may not be. Further, even complexes with traditional funds may be challenged to adhere to regulatory requirements while investing in new asset classes or pursuing alternative investment strategies. In all cases, directors will want to work with the adviser and fund CCO to develop policies and procedures consistent not only with the regulatory constraints applicable to registered funds, but also with a fund's disclosed investment strategies and objectives.

Below are some of the more common regulatory issues which directors of alternative funds will want to consider.

**Valuation:** Open-end funds are required to calculate a fund's NAV daily.<sup>10</sup> Alternative funds may present unique challenges if the portfolio includes a wide range of complex investments, particularly if these securities are not held in other fund portfolios within the complex. Although fund independent directors generally do not play a day-to-day role in valuing a fund's individual investments, directors are ultimately responsible for fair valuing securities.

Prior to investing in derivatives or other complex investments, a board should understand how the adviser will value the particular securities and whether those securities fit into the fund's current valuation policies and procedures. Boards also will need to determine how best to monitor the implementation of the valuation policies and procedures on an ongoing basis. The Forum's June 2012 publication, *Practical Guidance for Fund Directors on Valuation Oversight* contains a more thorough discussion of a board's valuation responsibilities.<sup>11</sup>

**Liquidity:** Some alternative strategies involve heavy use of illiquid securities. However, the 1940 Act requires registered open-end funds to provide shareholders with redemption proceeds within seven days of the request to redeem. As a result, mutual funds must have liquid securities to meet redemption requests. SEC policy limits a fund's illiquid securities to no more than 15 percent of the fund's net assets.<sup>12</sup> The SEC has defined an illiquid asset as one that cannot be sold for the approximate value it is given by the fund within seven days.<sup>13</sup>

Complex investment products and securities that are not exchange traded may have an increased likelihood of being deemed "illiquid." Consequently, the strategies and investment vehicles used by alternative funds may make oversight of liquidity determinations more important to fund boards. While boards have the ultimate responsibility for making liquidity determinations, the SEC has stated that "the board may delegate the day-to-day function of determining the liquidity of securities to the fund's investment adviser, provided that

the board retains sufficient oversight.”<sup>14</sup> In order to provide sufficient oversight of an alternative fund’s liquidity, directors will want to ask how the manager will monitor a fund’s liquidity both at the time that a new, illiquid instrument is added to the portfolio and as circumstances change in the future.

**Leverage:** Mutual funds are subject to leverage limitations. Leverage in a fund may be explicit, through borrowing, or implicit, through use of some financial instruments and trading practices. For example, implicit leverage results from use of short sales, options, and some financial derivatives such as futures, swaps, and structured notes. Strategies that involve leverage require registered funds to “cover” the leveraged transaction by either entering into an economically offsetting position or by segregating sufficient liquid assets to meet its future obligations.<sup>15</sup> These regulatory restrictions on leverage can limit the types of investment strategies that may be offered in a registered fund. Covering the transaction is intended to reduce the risk of loss experienced by the fund; however, it could potentially affect the success of an alternative strategy to be employed by a fund.

If an alternative fund heavily relies on securities and strategies that create embedded leverage, boards may need to focus more attention on overseeing leverage issues in the fund. Directors will want to inquire how the adviser monitors a fund’s investments for leverage issues. Depending on the extent to which a fund’s investments create potential leverage issues, boards may ask for specific reporting on alternative investments including how these instruments contribute to the fund’s performance.

**Diversification:** Registered funds that are “diversified” investment companies must meet the 1940 Act’s requirements.<sup>16</sup> A diversified investment company is one in which 75 percent of the fund’s total assets consist of cash (and cash items), government securities, securities of other investment companies, and other securities. Securities of a single issuer that represent more than 5 percent of the fund’s total assets or that represent more than 10 percent of the issuer’s voting securities are not included in the 75 percent calculation.<sup>17</sup>

While the test appears to be a straightforward one, defining “issuer” may be difficult with respect to certain derivatives purchased by alternative funds. Current law leaves questions in this area, including whether a particular derivative should be considered a security for purposes of the diversification test and, if so, whether a fund should look to the counterparty to the derivative transaction or the reference asset underlying the derivative to determine diversification.<sup>18</sup> Because shareholder approval is required when a fund changes status from diversified to non-diversified (though is not required to go from non-diversified to diversified), the board will want to have confidence that there are processes and procedures in place to monitor a fund’s compliance with the diversification requirement.

**Concentration:** The 1940 Act requires that funds disclose their policy with respect to concentration in a particular industry or group of industries.<sup>19</sup> Concentration for this purpose is an investment of more than 25 percent of a fund’s assets in a particular industry.<sup>20</sup> Because changes in concentration policy generally require shareholder approval, there should be processes and procedures for monitoring a fund’s investments to determine when a security acquisition threatens to approach the 25 percent level for a

non-concentrated fund. For concentrated funds, boards will similarly want to understand that the adviser has policies and procedures in place to monitor for transactions that would potentially cause the fund to go below that level.

**Fair Allocation of Trades:** Section 17 of the 1940 Act requires fair and equitable allocation of investment opportunities and trades among mutual funds and other accounts. Fair allocation can be of particular concern when the adviser or sub-adviser manages other funds with a similar investment strategies – especially where the fees to the other funds may be higher than the fee paid by the mutual funds. Consequently, boards should discuss with the adviser what controls are in place to monitor fair allocation on an ongoing basis.

**Tax Issues:** Compliance with Subchapter M of the Internal Revenue Code allows mutual funds to pass along the taxes on capital gains, dividends, or interest earned to investors and avoid having to pay taxes at the investment company level.<sup>21</sup> Subchapter M requires funds to comply with two tests that may be more challenging with alternative funds holding complex investments. One test involves qualified income and the second, diversification.<sup>22</sup> The qualifying income test requires that at least 90% of the fund's income come from investments in the form of capital gains, dividends, and interest. Some complex financial investments may not generate sufficient qualifying income to count as “income” for tax purposes. For example, commodity futures may not generate “qualifying income” for purposes of this requirement. To ensure that funds adhere to the diversification requirements of the tax code, the funds must insure that they have a sufficient number of counterparties.<sup>23</sup> Fund boards will want to discuss these tax issues with fund counsel and fund auditors.

## **IV. Special Issues with Sub-Advisers**

When a fund engages a sub-adviser, the fund board must approve the agreement using a process that parallels that for approval of the primary advisory contract. A board is also required to approve the compliance policies and procedures of all sub-advisers, including their codes of ethics, and conclude that they are reasonably designed to prevent violation of the federal securities laws.<sup>24</sup> These requirements are the same whether a sub-adviser manages an alternative or a traditional fund. The Forum's 2009 publication, *Practical Guidance for Fund Directors on the Oversight of Sub-Advisers* contains more detailed information on board oversight of sub-advisers.<sup>25</sup> However, due to the unique investments and strategies pursued by alternative funds, coupled with the fact that many sub-advisers lack background in 1940 Act requirements, boards may have to focus on different issues than may typically be the case in overseeing a sub-advisory relationship for a traditional mutual fund.

### ***Has the sub-adviser managed registered mutual funds in the past, or is its past experience confined to the private fund arena?***

A traditional fund manager may wish to gain the expertise necessary to offer an alternative fund by engaging a sub-adviser rather than developing the talent within the adviser's organization. Many of these sub-advisers have significant experience investing

in alternative securities or pursuing investment strategies not typically available in traditional funds. However, particularly if the prior experience came about in the private fund context, these sub-advisers may have little familiarity with the legal requirements of registered funds. Accordingly, the board will want to ask about how much experience, if any, the sub-adviser has had with registered funds. As noted above, the 1940 Act and its regulations differ in some important ways from regulations governing private funds, including calculation of a daily NAV, restrictions on illiquid securities, leverage limits, asset diversification, and concentration limits. Exploring how much experience the proposed sub-adviser has with registered funds can help the board focus its approval inquiry and subsequent oversight efforts on areas of the most significant risk.

***What due diligence did the primary adviser undertake regarding the proposed sub-adviser's resources and compliance infrastructure?***

Boards will want to be aware of the level and nature of the primary adviser's due-diligence assessment of the proposed sub-adviser. In particular, the board should be comfortable with the resources and infrastructure available to manage registered funds and to adhere to the compliance requirements of a registered fund. The board will also want to be aware of the adviser's capabilities to monitor the sub-adviser's compliance. The inquiry is ongoing – directors will want to have confidence in the resource and compliance environment surrounding any sub-adviser at the time of the initial engagement, and on an ongoing basis, particularly after any changes to the structure or personnel at the sub-adviser.

The fund's CCO can be of great assistance to the board in this area, reporting on the due diligence process and the sub-adviser's ongoing compliance. The CCO's inquiries can be greatly assisted if the sub-adviser has an effective CCO of its own, and in particular, if the sub-adviser's CCO understands the regulatory requirements applicable to investment companies. "CCO to CCO" conversations can be a much more efficient way of gaining information helpful to the board's assessment of the sub-adviser's compliance program.

In addition to relying on the fund's primary adviser and CCO, some boards may determine to have an initial face-to-face meeting with the proposed sub-adviser. The board also may consider re-assessing that decision in the event of changes in the personnel or resources of the sub-adviser, or if performance deviates from what had been expected.

***Does the adviser have adequate resources to appropriately oversee the sub-adviser?***

Particularly if the adviser lacks extensive experience in the strategies and/or investments the sub-adviser is being hired to provide, the board will want to understand the resources that the adviser has put in place to oversee the sub-adviser. Boards may consider asking, for example, whether there will be, or whether there will need to be, any changes in the staffing levels at the adviser to ensure appropriate levels of oversight. The board will want to be comfortable that the adviser understands the new strategies and investments, how they are anticipated to perform in various markets, and how the adviser will oversee compliance with the regulatory requirements applicable to registered funds.

Oversight of the sub-advisory relationship by the adviser may be more complex where the adviser engages more than one sub-adviser to manage a single fund. In such cases, the

adviser will need to determine the percentage of the fund's assets that are allocated to each sub-adviser, and particularly if the fund has a multi-manager order, determine when to change sub-advisers for the fund. In addition to evaluating the performance of each sub-adviser and the adviser as a whole, the board may wish to pay special attention to how the adviser is managing the allocations among sub-advisers to a fund.

***Are there organizational and cultural differences between traditional asset managers and managers of alternative funds that may impact the registered fund?***

There are several differences between asset managers of registered products and those of private funds that boards may find useful to review in connection with overseeing an alternative fund. The discussion below is not exhaustive, but is meant to demonstrate some of the primary differences between registered funds and private funds on which boards and advisers may wish to focus in the due diligence and oversight of sub-advisers.

One difference concerns compensation practices. In private funds, performance fees are commonly used to reward out-sized fund performance. In the registered fund context, performance fees are rare because the fee is generally required to increase and decrease proportionately with the performance of the fund (a so-called "fulcrum fee"). Managers who are receiving typical private fund performance fees from managing hedge funds will be prohibited from receiving the same fees for managing registered funds. Boards will want to understand how that compensation differs, and how the potential conflict of interest may impact the time and attention the manager will be willing to devote to the mutual fund.

Another difference is that board oversight of trading policies is uncommon in the private fund context. Managers of hedge funds may be unused to a requirement to obtain board approval of trading policies; therefore, boards will want to inquire as to whether a sub-adviser understands the critical importance of board approval of certain trading policies, and in particular, any necessary pre-approval of changes in those policies.

Soft dollars may be another area of difference with advisers that primarily manage private funds. Section 28(e) of the Securities Exchange Act of 1934 provides a safe harbor for use of soft dollars – fund assets in the form of brokerage commissions – that are used to purchase brokerage and research services. Some arguably research-related expenses, such as computer terminals and trading software, explicitly fall outside of the Section 28(e) safe harbor and mutual fund assets may not be used to pay for these items. On the other hand, managers of private funds typically merely disclose the use of soft dollars for items falling outside the scope of the safe harbor. Because mutual funds must remain within the safe harbor, boards should be comfortable that a sub-adviser understands this regulatory difference.

The process required to begin using a new investment vehicle may be another area of difference. In a private fund, a portfolio manager may have the discretion to add a new type of investment to a fund's portfolio at any time. However, depending on the characteristics of the new investment and the established procedures followed by a particular fund complex or fund board, the board may be required to approve use of the new type of investment prior to its introduction into the portfolio. In cases that require pre-approval, the portfolio manager will generally need to explain how the new type of

investment will be used, how its use might change the fund's strategy, how it might impact the fund's performance, and how use of the new investment will be monitored. The board therefore may wish to discuss the adviser's processes and procedures for using a new type of investment prior to approval of the sub-adviser, to ensure that expectations in this area are clear.

***How are responsibilities divided between the primary adviser and sub-adviser, and how will the adviser oversee the sub-adviser?***

In approving a sub-advisory arrangement, the board should understand how duties and responsibilities are allocated between the adviser and the sub-adviser. Understanding the allocation of duties will help the board more effectively oversee the advisory relationships for the fund and will shed light on the allocation of the advisory fee between the adviser and sub-adviser. The board may wish to consider how the fee allocation between the adviser and sub-adviser compares with other sub-advised funds in the complex, taking into account the entrepreneurial risks the adviser may be assuming in launching the alternative fund, and what additional tasks the adviser may be required to do to appropriately supervise the sub-adviser to an alternative fund. If the sub-adviser has little experience with registered funds, for example, the adviser may need to have a far more resource-intensive approach than with a more traditional sub-advisory relationship. The regulatory issues discussed elsewhere in this paper, including the calculation of daily NAV, liquidity requirements, leverage restrictions, diversification requirements, and concentration limits are of primary concern but other issues may require attention as well.

For example, a sub-adviser who primarily manages funds for private clients may be reluctant to share information in certain areas, such as the level of fees charged to its other clients or even the sub-adviser's investment process. The board and adviser, on the other hand, need sufficient information to approve the sub-advisory contract as well as perform the ongoing monitoring required by the 1940 Act. Accordingly, the board and the adviser will likely wish to reach an agreement with the potential sub-adviser prior to approval of the relationship, to ensure that necessary levels of information will be shared on key issues. Typically, this is a matter of educating private fund advisers about the specific requirements for serving as a sub-adviser to a registered fund. The board, adviser, and sub-adviser should then work together to communicate the relevant information in a manner that is useful to the board as it goes about evaluating the sub-advisory relationship.

In addition, the board will need to evaluate the adviser's and CCO's capability to monitor and assess the sub-adviser's compliance policies in areas where the adviser has little in-house experience. For example, a sub-adviser with more experience in alternative investments may have the most information regarding the valuation of certain securities. To discharge its valuation responsibilities, the board should understand the extent to which the sub-adviser will participate in the valuation process and what resources the adviser has to oversee whether these securities are being valued in accordance with the fund's valuation policies. More generally, the board should understand how the adviser and fund CCO evaluate the sub-adviser's compliance program as a whole. Further, they should consider what types of reports will be furnished to the board in connection with the compliance program.

## V. Evaluating Performance

Performance assessment is an important responsibility of fund directors. Alternative funds may present a number of unique challenges as a result of their complex investment strategies, difficulties in determining an appropriate benchmark and peer group, and lack of a track record during which to evaluate performance.

### ***How is a fund's investment strategy intended to work, and is that strategy functioning as expected?***

In order to properly evaluate the performance of a fund, the board must first be familiar with the fund's investment strategy, how that strategy is intended to function in different market environments, and in some cases, the intended role of the fund in an investment portfolio. The investment strategies may be quite complex and may have multiple objectives. Directors should work with the adviser and legal counsel to understand what the fund's strategy is and establish an appropriate review process for fund disclosure.

Evaluation of whether the fund's strategy is working as expected may be more difficult with some alternative funds. Because of the relatively short performance track records of many alternative funds, the fund may not have experienced the market cycle in which it would be most effective. It may be difficult to evaluate the significance of over or under-performance that occurs within a particular period of review.

In addition, an investment strategy with multiple goals can complicate the task of evaluating performance. For example, a fund may seek to replicate the returns of a specified index, but with lower volatility. Each component of the strategy may need to be evaluated and measured separately in order to ascertain whether the fund is performing as anticipated. Accordingly, the board may wish to work with the adviser to develop new metrics to assist the board in assessing how well the alternative fund's investment strategy is working. While the board will want to have an initial understanding at the time the fund is launched of how the adviser intends to evaluate performance and whether the strategic objectives are being achieved, the board and adviser will likely wish to periodically revisit the topic to ensure that meaningful metrics continue to be applied.

In order to receive meaningful, helpful reports and metrics, the board may consider asking the adviser what measures that organization finds most helpful to evaluate how well the fund is achieving its performance goals. Armed with this information, the board can consider whether those same metrics and reports may be useful to the board in its evaluation of the fund's performance and effectiveness in achieving its strategic goals.

Despite the challenges in understanding these funds and how they are intended to function, the board should receive enough information to understand the goals, objectives, risks and strategies of the fund. In addition to specific information about the fund, more general education about changing markets and the proliferation of new investments can aid boards in their oversight of alternative funds. The board can consider asking the adviser to present educational sessions on specific products or strategies used in their funds, as well as how to evaluate expected performance over a range of market conditions. Directors also can take advantage of industry conferences and other educational sessions that cover board

oversight of complex investments. Boards that oversee particularly complex investment strategies may want to consider whether it would be helpful to add new directors with specific expertise in the types of strategies and investments being used. Boards may also consider establishing a committee to focus on the alternative funds' strategies and investments.

### ***Has the adviser identified a performance benchmark for the fund?***

An alternative fund may not have an obvious index or other benchmark that accurately corresponds to the strategy that the fund is pursuing, making selection of an appropriate benchmark more difficult than for a traditional fund. When the fund's anticipated performance cannot be accurately evaluated based on a single benchmark, some managers use custom benchmarks. Custom benchmarks may rely on several indices with different weights (e.g., the custom benchmark may consist of 40% of one broad based index, and 60% of a second, different index). If a fund's strategy includes elements not reflected in any index or available benchmark (as, for example, a fund seeking returns corresponding to those of a well-known index but with lower volatility), the board will want to understand the limitations of the performance benchmark as an indicia of performance, and may need to develop alternative measures to supplement the benchmark comparison.

Boards should discuss the choice of benchmark index with the adviser and understand both the reasoning that led to its adoption and any limitations to its use. There is often no obvious "right" benchmark, particularly if the fund is pursuing a novel strategy, and the benchmark selected may not be entirely reflective of whether the fund is performing as anticipated. The board should be comfortable with the adviser's reasoning and seek information from the adviser should the adviser seek to change the benchmark.

### ***How meaningful is the fund's peer group?***

Alternative fund strategies are evolving rapidly, and slight differences can result in marked differences in intended outcomes. The major providers of comparative performance and fee information to boards are all increasing their focus on alternative strategies, in an effort to bring some comparability to the area. Yet advisers and boards alike may find that the universe of funds with similar strategies is small, and therefore traditional peer group comparisons may be of limited value. Even funds that pursue similar strategies may do so relying on entirely different investments, making peer group comparisons more challenging. For example, two "market neutral" funds may have very different investment portfolios.

There may be no one "right" peer group for a given alternative strategy. Therefore, boards should work with management to understand the appropriate value – and limitations of – peer comparisons in the context of a particular alternative fund. Boards and management may also wish to work with the providers of peer group information to better define the fund's peer group based on its actual strategy and investment performance goals. In addition to the peer group information supplied by outside fund service providers, boards may find it helpful to ask which funds management sees as the main competitors to the fund, in an effort to more accurately compare the fund's performance and expenses with that of its true peers.

***Should the board consider asking for more frequent information about recently launched alternative funds in order to more closely monitor the fund’s growth and performance?***

As noted above, boards may find it challenging to assess how the fund is performing and whether it is meeting its performance goals. At least initially after launch, the board may find it helpful to receive more frequent reports on an alternative fund. While these reports might include information on asset levels as well as performance metrics, the precise information contained in the reports depends on the strategy employed by the alternative fund.

In the case of an initial launch of a fund, the 1940 Act specifies that the initial advisory agreement may continue to be in effect for two years, after which the board must annually approve the agreement.<sup>26</sup> Although the board may not be asked to review the contract for two years after initial approval, it may find it helpful in the interim to receive information regarding the services provided, potential conflicts of interest, and other issues often discussed during the contract renewal process.

## **VI. Disclosure Issues**

The SEC has indicated that funds must disclose principal investment strategies tailored specifically to how a fund expects to be managed. The SEC has also noted that the risk disclosure in the prospectus should provide “a complete risk profile of the fund’s investments taken as a whole.”<sup>27</sup> Because fund directors sign the fund’s registration statements the board, working with counsel, and the adviser should establish procedures to review disclosure on a complex wide basis.

***What systems are in place to evaluate whether the fund’s disclosure documents accurately describe the fund’s strategies and risks?***

The prospectus disclosure for alternative funds may be more difficult than with traditional, long-only equity or fixed income funds, as a result of the complex nature of the strategies that many alternative funds pursue. Portfolio managers who have an understanding of the securities, strategies, and risks of the fund can be an excellent resource when drafting fund disclosure. In addition, counsel may ask to see the schedule of investments, to monitor whether the disclosure matches the fund’s portfolio on an ongoing basis.

## **VII. Conclusion**

While registered funds historically have been relatively straightforward, primarily making long only investments in equities or fixed income securities, the industry has seen a significant increase in the types of funds available to investors. Retail and institutional shareholders as well as private fund managers have all recognized value in offering hedge fund-like strategies in the registered fund context. While fund directors overseeing alternative funds do not have special responsibilities, these funds can present unique challenges to fund boards. The questions discussed above can serve as a starting place for the increasing number of directors who are overseeing these products.

## Notes

- 1 See *The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management*, July 2012.
- 2 National Exam Program of the Office of Compliance Inspections and Examinations, *Examination Priorities for 2013*, February 21, 2013, <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>.
- 3 This publication has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member group serves on the Forum's Steering Committee. The Forum's current membership includes over 775 independent directors, representing 105 independent director groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.
- 4 The term "liquid alternatives" also has become more frequently used. The term refers to alternative funds that offer daily liquidity.
- 5 Available at <http://lipperinsight.thomsonreuters.com/2012/12/an-alternatives-universe/>.
- 6 This paper focuses on funds that are structured as open-end funds, though many alternative funds are structured as closed-end funds. Though the issues presented by any registered fund may be similar, directors should consult with counsel and the fund's adviser for particular issues regarding closed-end funds.
- 7 IM Guidance Update No. 2013-05, August 2013 ("IM Guidance Update"). Available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf>
- 8 Id.
- 9 The report is available at [http://www.mfdf.org/images/uploads/resources\\_files/MDFDRiskPrinciplesforFundDirectorsApril2010.pdf](http://www.mfdf.org/images/uploads/resources_files/MDFDRiskPrinciplesforFundDirectorsApril2010.pdf).
- 10 Rule 22c-1 under the 1940 Act requires transactions in open-end mutual funds and Unit Investment Trusts to be at price based on the net asset value of its shares.
- 11 The report is available at <http://www.mfdf.org/images/uploads/newsroom/Valuation-web.pdf>.
- 12 See *Revisions to Guidelines to Form N-1A*, Investment Company Act Release No. 18612 (March 12, 1992).
- 13 See Former Guideline 4 to Form N-1A.
- 14 *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Securities Act Release No. 6862 (April 23, 1990).
- 15 See Investment Company Act Release No. 10666 (April 18, 1979).
- 16 Subchapter M of the Internal Revenue Code has a similar, but not identical diversification requirement. Subchapter M, discussed below, is the provision of the Internal Revenue Code that permits funds to distribute income and long-term capital gains to shareholders without incurring tax at the fund level.
- 17 See Section 5(b)(1) of the Investment Company Act.

- 18 The ABA's *Report of the Task Force on Investment Company Use of Derivatives and Leverage* (available at <http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf>) discussed these issues, and recommended that the reference asset should be used for testing diversification, allowing for counterparty issues to be addressed under Section 12(d)(3) for all funds, including those that are not diversified. The SEC's concept release on derivatives, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940* requested comment on the proper treatment of derivatives for purposes of diversification.
- 19 See Section 8(b) of the 1940 Act.
- 20 See Guide 19 of Form N-1A
- 21 For more information, see ICI 2013 Fact Book, [http://www.icifactbook.org/fb\\_appa.html](http://www.icifactbook.org/fb_appa.html).
- 22 The diversification requirements for purposes of Subchapter M differ from the previously discussed diversification requirements under the 1940 Act.
- 23 The IRS requires that investments with respect to any one issuer may not represent more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer.
- 24 Rules 38a-1 and 17j-1 under the 1940 Act.
- 25 The report is available at [http://www.mfdf.org/images/uploads/resources\\_files/Sub-AdviserGuidance.pdf](http://www.mfdf.org/images/uploads/resources_files/Sub-AdviserGuidance.pdf).
- 26 Section 15(b)(1) of the 1940 Act
- 27 Letter from Barry D. Miller, Associate Director, Division of Investment Management, to Karrie McMillan, General Counsel, Investment Company Institute (July 30, 2010)



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