



Alternative Strategy Mutual Funds: Current Regulatory Issues

Presented by:
Joshua Deringer, Diana McCarthy and David Matteson
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Alternative Strategy Mutual Funds

- > These are products that pursue alternative investment strategies and are registered as open-end investment companies (mutual funds) under the Investment Company Act of 1940 (the “1940 Act”).
- > Includes Managed Futures, Commodity Funds, Long/Short Funds and other hedge fund strategies.



Issues Facing Alternative Strategy Mutual Funds

- > Use of Leverage
- > Asset Segregation
- > Disclosure
- > Custody
- > Tax Compliance and Strategies
- > Regulation by the U.S. Commodity Futures Trading Commission (CFTC)
- > Compliance and Risk Management



Use of Leverage

- > Use of derivatives involves leverage
- > Section 18 limits on leverage/senior securities
- > Investment Company Act significantly limits the ability of a fund to issue “senior securities”
- > Any type of indebtedness leverage can result in a senior security
- > SEC Guidelines under no-action letters
 - Segregation of assets
 - Liquid, marked to market
 - Serves to limit amount of leverage
- > ABA recently published a report to the SEC on use of derivatives



Asset Segregation

- > SEC releases and no-action letters provide guidance on segregation guidelines
 - Investment Company Release No. 10666



Disclosure

- > SEC's July 2010 request to the ICI that funds evaluate their disclosure regarding use of derivatives
 - Registration statement disclosures
 - Financial statement disclosures



Custody

- > Section 17(f) of the Investment Company Act establishes a regulatory regime for the custody of an investment company's assets
- > That framework has resulted in most funds using a bank custodian
- > Custody rules apply to collateral posted in connection with short sales and derivative instruments
 - Results in the need to enter into tri-party agreements between the fund, the custodian and the broker



Tax Compliance and Strategies

- > Commodities, futures on commodities and swaps on commodities produce “bad income” for purposes of qualifying as a regulated investment company under the Internal Revenue Code (“IRC”).
 - In order to create “good income” when investing in commodity-linked instruments, funds invest in structured notes or through an offshore subsidiary.



Tax Compliance and Strategies (cont'd.)

- > Use of Commodity Swaps and Structured Notes
 - IRS interpretation regarding swaps as securities for ICC and 1940 Act purposes
- > Structured notes qualify as securities if certain requirements met
 - IRS Private Letter Rulings
 - Typical structured note characteristics



Tax Compliance and Strategies (cont'd.)

> Offshore Subsidiary

- Most are unregistered, wholly-owned offshore fund subsidiaries
- Limited to 25% of fund assets
- Income and gain treated as ordinary income; no limitation income from commodity sources
- Must comply with certain 1940 Act requirements
 - Leverage
 - Affiliated transactions
 - Investment restrictions



Regulation by the CFTC

- > Possible Registration with CFTC
 - Pre-2003 conditions to Reg. 4.5
 - 2003 revisions to Reg. 4.5
 - The Five Percent Test; “No Marketing”
 - New proposed amendments to Reg. 4.5 may require registration by adviser, fund or perhaps board members as CPOs
 - Compliance with NFA reporting, marketing, recordkeeping, disclosure and other requirements
- > Conflicting SEC and CFTC Regulations
 - Disclosure of performance/financial information; “break-even” analysis
 - Delivery and acknowledgment of disclosure documents
 - Possible compromise “brokered” by NFA



Compliance and Risk Management

- > Alternative Strategy Mutual Funds require:
 - Experienced compliance and operations personnel
 - Additional risk monitoring, disclosures, and review of marketing materials
 - Additional compliance procedures
 - Asset segregation
 - Close attention to valuation and liquidity restrictions
 - Updated technology/computer systems

Drinker Biddle



Joshua B. Deringer
Partner
Drinker Biddle & Reath LLP
Philadelphia
(215) 988-2959
Joshua.Deringer@dbr.com



Diana E. McCarthy
Partner
Drinker Biddle & Reath LLP
Philadelphia
(215) 988-1146
Diana.McCarthy@dbr.com



David M. Matteson
Partner
Drinker Biddle & Reath LLP
Chicago
(312) 569-1145
David.Matteson@dbr.com

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