

MMI Alternative Investments Forum  
May 13, 2015

# Liquid Alts in the Regulatory Crosshairs

Christine Lombardo  
Morgan, Lewis & Bockius LLP

Steven Stone  
Morgan, Lewis & Bockius LLP

# Liquid Alts in the Regulatory Crosshairs

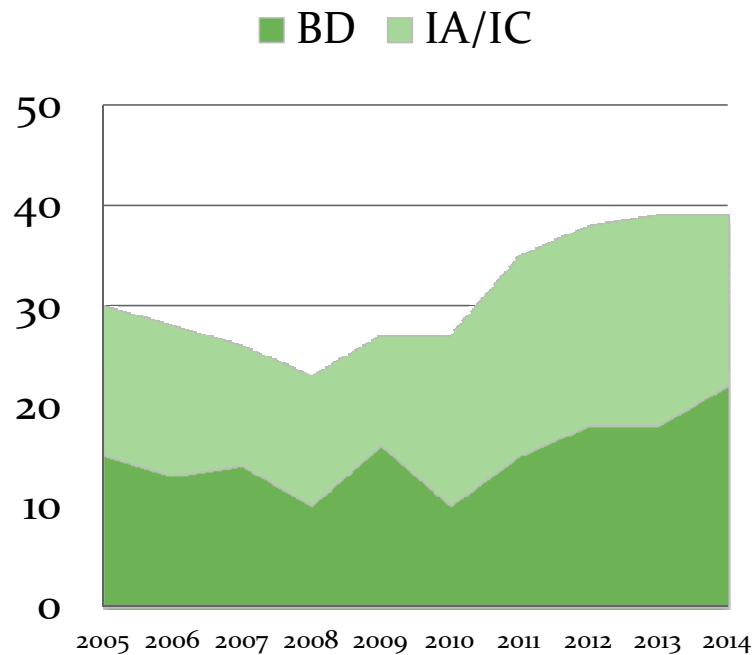
- Liquid Alts - SEC Exam Focus
- 2014 Enforcement Statistics & Areas of Focus
- 2015 SEC Initiatives Impacting Liquid Alts
- 8 Liquid Alts Risks to Consider

# Liquid Alts - SEC Exam Focus

- “Alternative” Investment Companies
  - Leverage, liquidity, and valuation policies and practices
  - Adequacy of internal controls
  - Marketing of funds to investors
- Fixed-Income Investment Companies
  - Focus on whether funds have implemented procedures and investment and trading controls consistent with disclosures
  - Ensure that investment and liquidity profiles fit disclosures
- Never-Before-Examined Investment Companies

# 2014 Enforcement Statistics

Percentage of Investment Adviser,  
Investment Company & Broker-  
Dealer Cases



Type of Case	Number of Actions	Percentage
Broker-Dealer	166	22%
Investment Advisers and Investment Companies	130	17%
Securities Offering Cases	103	15%
Delinquent Filings	107	14%
Issuer Reporting and Disclosure	81	11%
Market Manipulation	63	8%
Insider Trading	52	7%
Miscellaneous	37	5%
FCPA	7	1%
Municipal Securities and Pension Plans	6	1%
Transfer Agent	7	1%

# Selected 2014 SEC Enforcement Cases

- Pay-to-Play
  - TL Ventures Inc. (June 20, 2014)
- Compliance Policies and Internal Controls
  - Barclays Capital Inc. (Sept. 23, 2014)
  - Wells Fargo Advisors, LLC (Sept. 22, 2014)
- Custody
  - Sands Brothers Asset Management LLC (Oct. 29, 2014)
  - Water Island Capital LLC (Feb. 12, 2015)
- Performance Advertising
  - F-Squared Investments, Inc. (Dec. 22, 2014)
- Conflicts of Interest
  - Revenue Sharing
    - The Robare Group, Ltd. (Sept. 2, 2014)
  - Private Equity – Fund Expense Allocations
    - Clean Energy Capital, LLC (Feb. 25, 2014)
    - Lincolnshire Management, Inc. (Sept. 22, 2014)
  - Hedge Funds
    - Steven R. Markusen, Jay C. Cope, and Archer Advisors LLC (Sept. 8, 2014)
- Principal Trades and Cross-Trades
  - Western Asset Management Co. (Jan. 27, 2014)
  - Paradigm Capital Management, Inc. (June 16, 2014)
  - Strategic Capital Group, LLC (Sept. 18, 2014)

# SEC Initiatives Impacting Liquid Alts

- Enhanced Data Reporting
  - SEC staff considering expansion of data reporting by mutual fund and separate account investment advisers
- Portfolio Risks from Derivatives
  - SEC staff concerned that use of derivatives creates excessive leverage, which can implicate Section 18 of the Investment Company Act
  - SEC issued a Concept Release in 2011 and has addressed derivatives issues on a case-by-case basis
  - SEC staff looking to take a more comprehensive and systematic approach to derivatives, including possibly requiring funds to establish broad risk management programs

# SEC Initiatives Impacting Liquid Alts

- Portfolio Risks Associated with Liquidity
  - Mutual funds must satisfy redemption requests within seven days and, accordingly, the SEC has said that mutual funds should maintain a high degree of liquidity to honor redemptions
  - Liquidity risks are potentially significant for managers seeking to replicate strategies that hold illiquid assets
  - From 1969 through 1992, the SEC's view was that illiquid securities should not exceed 10% of a mutual fund, a position that was changed in 1992, when it increased the percentage to 15%
  - SEC staff is now considering recommending new comprehensive approach to management of liquidity risks, including updating liquidity standards and disclosures of liquidity risks



## 8 Liquid Alts Risks to Consider

1. Many liquid alt investment advisers that traditionally managed alternative strategies through private funds have little experience with the Investment Company Act
  - Conversely, traditional mutual fund advisers seeking to add liquid alts have little experience with alternative investment strategies
2. Extensive use of derivatives can raise complicated compliance questions and challenges in oversight
3. Liquid alts are new product for retail investors for which redemption behavior is uncertain
4. Managing daily liquidity, including daily NAV calculations, can be challenging to advisers who lack extensive experience





## 8 Liquid Alts Risks to Consider

6. Liquid alts present risk of overpromising because Investment Company Act restrictions may result in liquid alts being “watered down” versions of hedge funds
  - Leverage limits
  - Diversification requirements
  - Allocations of trades
7. Retaining service providers with adequate expertise and resources may be difficult
8. Evaluating performance may be difficult for liquid alts
  - Short performance track records
  - Challenges identifying appropriate peer groups
  - Identification of appropriate benchmark

MMI Alternative Investments Forum  
May 13, 2015

# Liquid Alts in the Regulatory Crosshairs

Christine Lombardo  
Morgan, Lewis & Bockius LLP

Steven Stone  
Morgan, Lewis & Bockius LLP