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Investments Overview: Regulation; Structures; Alternative Funds and Recent Developments

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Topics

- Why are different investments structured as they are?
- Why are various investment managers registered with different regulators (or not registered at all)?
- What should investors focus on when considering alternative investments?
- What’s new in the world of alternative investments?

Contents

- Overview of U.S. regulations.
- Investment structures and their implications.
- Alternative investments.
- Recent developments.

Regulation of U.S. Investment Managers

- Regulation of U.S. investment managers split between securities world and futures world.
- Futures world governed by the Commodity Exchange Act and the Commodity Futures Trading Commission (CFTC).
- Securities side governed by the Investment Advisers Act of 1940 (Adviser Act), the Investment Company of 1940 (Investment Company Act) and the Securities and Exchange Commission (SEC).
- Each side has its own self-regulatory organization: the National Futures Association (NFA) on the Commodities side and the Financial Industry Regulatory Authority for securities (does not regulate investment advisers – yet).

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Securities World

- The term ‘‘security’’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘‘security’’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
- Firms that give advice with regard to securities must register as investment advisers under the Advisers Act (or similar state securities statutes) unless an exemption applies.
- Funds that invest in securities must comply with the Investment Company Act unless a exemption applies.

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Futures World

- Commodity Exchange Act regulates the trading of commodity futures in the United States. Passed in 1936, it has been amended several times, most recently by Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) to add swaps other than securities-based swaps to the CFTC's oversight.
- Firms that give advice with regard to trading futures and non-securities based swaps must register as Commodity Trading Advisors (CTAs) unless an exemption applies.
- Firms that sponsor commodity pools must register as Commodity Pool Operators unless an exemption applies.
- Funds investing in futures must register as Commodity Pools unless an exemption applies. The exemptions under the CEA are narrow and firms/funds trading a significant amount of futures must register with the CFTC (exemption for registered in vestment companies).

Structuring Investments: Funds v. Managed Accounts

- In both the futures and securities worlds, the two dominant investment structures are co-mingled funds and managed accounts.
- Managed accounts: investor sets up and account with a custodian or FCM and allows the adviser to manage.
- In a co-mingled fund, the investor participates in the adviser's strategy as an owner of the fund. Examples include mutual funds, exchange traded funds (ETFs), hedge funds, private equity, venture capital, real estate, *et al*.

Managed Accounts

- Advantages:
  - The investor controls the account. Typically can withdraw trading authority and/or move assets out of the account at any time.
  - Strategy often customized for the particular investor.
  - Easier to exclude certain securities or industries.
- Challenges:
  - Typically much higher minimums than a co-mingled fund.
  - Difficult to administer in strategies with capital calls (RE, VC, PE).
  - Generally not conducive to certain longer-term strategies.
  - Investor can be responsible for account maintenance costs and other expenses.
  - Potential for unlimited liability.

Comingled Funds

- Advantages:
  - Typically much lower investment minimums.
  - Allows wide array of investment strategies – everything from S&P index fund to wide array of hedge funds and venture capital.
  - Investor typically has no responsibilities to administer funds.
  - Limited liability.

Comingled Funds – continued

- Challenges:
  - Typically unable to customize investment strategy.
  - No direct ownership of fund assets.
  - Divergent interests among the investors.
  - Investments may be illiquid.
    - Open-end registered funds allow for daily liquidity.
    - ETFs trade on exchanges near their net asset value. Closed-end funds may trade at premiums or discounts.
    - Interval funds, and other less common funds registered under the Investment Company Act can be very illiquid.
    - Hedge funds typically allow withdrawals subject to lock-up periods, suspensions of withdrawals, gates, etc.
    - PE, VC and RE funds typically have no withdrawal rights and make distributions over a finite term (often 8 to 10 years). Can be difficult to liquidate the last assets.

Regulatory Implications of Managed Accounts or Comingled Fund Structure

- Futures world:
  - Advisers to a managed account will be CTAs.
  - General Partner of commodity pool will be a CPO.
  - Any adviser to the commodity pool will also be a CTA (affiliates or third parties).
  - CFTC exemptions
    - 4.7 – disclosure relief. Qualified eligible participants (QEPs) only.
    - 4.13(a)(3) – de minimis exemption if < 5% used as initial margin or <100% notional value.

Regulatory Implications of Managed Accounts or Comingled Fund Structure – continued

- Securities world:
  - Structure made a big difference before Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Pre Dodd-Frank the Advisers Act had an exemption from registration if an adviser had 15 or fewer clients (other and registered investment companies).
  - Dodd-Frank eliminated 15 or fewer exemption, but did add “Exempt Reporting Adviser” exemption for venture capital advisers and private fund managers with less than $150 million in regulatory assets under management.
  - Result was mass registration of hedge fund and private equity managers in March 2012.

Registered Investment Advisers v. Exempt Reporting Advisers

- Exempt Reporting Advisers
  - are not subject to substantive provisions of the Advisers Act.
  - are required to file an annual report with the SEC (shorter version of Form ADV).
  - May still have a state registration requirement.
  - Have not yet been subject to SEC's examination program.

Registered Investment Advisers v. Exempt Reporting Advisers – continued

- Registered Investment Advisers
  - Subject to all provisions of the Advisers Act.
    - Required to file all of Form ADV and deliver Part 2A to clients (can be delivered to funds).
    - Restrictions on advertising and past performance reports.
    - Chief compliance officer and a comprehensive compliance program.
    - Anti-insider trading program.
    - Code of ethics and policies for personal trading.
    - Recordkeeping obligations.
    - Custody Rule applies (deemed to have custody of private fund assets).
  - Subject to SEC staff examination.

Alternative Funds (Alts)

- **Alternative to what?**
  - Alternative funds are generally thought of as alternatives to registered investment companies.
  - Investment funds that qualify for federal securities law exemptions to avoid registration requirements and investment limitations.
- **“Private” Investment Funds**
  - Interests in the funds sold by a private offering under the Securities Act.
    - Regulation D safe harbor so long as no advertising and no more than 35 non-accredited investors.
      - New JOBS Act Rule 505(c) allows for advertising if other requirements met.
      - Allowing non-accredited investors opens up funds to considerable liabilities.

Alts – Exemptions from Investment Company Act Registration

- 3(c)(1) – no more than 100 “beneficial owners.” Counting to 100 can be harder than you’d think:
  - Husband and wife with a joint account are one beneficial owner.
  - Don’t count the managers “Knowledgeable Employees.”
  - Look-through for funds investing in other funds.
  - Similar 3(c)(1) funds can be “integrated.”
- 3(c)(5) – real estate funds.
- 3(c)(7) – all investors must be “qualified purchasers.”
  - An individual with $5 million in “Net Investments.”
  - A company with $25 million in Net Investments.
  - A company that is owned exclusively by qualified purchasers.
  - Knowledgeable employees.

Alts – Main Categories

- Hedge Funds
- Private Equity
- Venture Capital
- Real Estate

Alts – Hedge Funds

- Avoid the restrictions on trading, leverage and compensation imposed by the Investment Company Act.
- U.S. funds usually structured as a limited partnership but sometimes a limited liability company. Investors usually taxable U.S. investors.
- The Adviser: can be general partner of fund or separate entity.
- The Investors: limited partners or members
- Taxation: partnership
- Offshore funds typically structured as an exempted limited partnership or exempted corporation. Most U.S. managers structure offshore products in the Cayman Islands. Offshore fund investors are usually non-U.S. investors or U.S. tax-exempt investors seeking to avoid unrelated business taxable income (UBTI).

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Hedge Funds – continued

- Generally open-ended. Allow regular subscriptions and withdrawals with certain restrictions.
  - Lock-up periods;
  - Gates;
  - Side pockets;
  - Suspensions.
- Fees typically include a management fee and incentive compensation. 2% and 20% was standard years ago. Highly sought after managers often charge a premium.
- Strategies vary widely.
  - Long/short equities;
  - Directional trading;
  - Event driven;
  - Relative value;
  - High frequency;
  - Funds of hedge funds;
  - Etc.

Alts – Private Equity

- Similar entities to hedge fund set up: Delaware funds for U.S. investors and offshore fund if UBTI or effectively connected income (ECI) is expected.
- Investments are generally in private companies.
- No withdrawal rights. Investors make capital commitments and capital calls.
- Typically have an investment period of 3-5 years and a fixed term of 8-10 years with annual extensions possible.
- Management fees typically charged on committed capital initially and switch to a percentage of unrealized investments after the commitment period.
- Typically some type of investor advisory board.
- “Carried interest” provisions give the general partner a portion the limited partnership distributions, typically after a return of invested capital and a preferred return.
  - Distribution waterfalls can be calculated based on each investment (“American Style” or “Per Investment”) or based on the return of all investments (“European Style” or “Whole Fund”).
  - Typically provide for a clawback if the general partner gets more than its fair share of distributions.

Alts – Venture Capital

- Structures very similar to private equity with capital commitments, capital calls, investment periods, finite term, etc.
- Focus tends to be on small, early-stage or emerging companies with significant potential for growth.
- Lower expected success rate than private equity.
- Fund sponsors more hands-on with business.
- Preferred return less common.
- May be concentrated in a certain industry or part of the country.

Alts – Real Estate

- Structures very similar to private equity with capital commitments, capital calls, investment periods, finite term, etc.
- Underlying investments are in real estate.

Recent Developments

- Increased Regulatory Focus
- Investor Driven Changes
- Registered Alternative Funds
- Emerging Investment Strategies

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Increased Regulatory Focus

- SEC has had considerable amount of enforcement actions in private fund space in the past few years.
- Newly registered hedge fund and private equity firms that registered as investment advisers under Dodd-Frank.
- Increased focus on undisclosed fees, loans to managers, and breaches of fiduciary duties.
  - Break-up and other fees avoided by employee PE funds.
  - Actions related to fiduciary duties in co-investment allocations and providing additional reporting and transparency to certain investor by side letter.
  - Focus on funds picking up expenses that should have been paid for by the adviser.

Investor Driven Changes

- Institutional investors have picked up on SEC areas of focus, particularly with regard to expenses and preferential treatment of certain investors.
- Preference of managed account platforms.
- Move to funds-of-one. Multiple structuring options, in each case giving the investor more rights than is typical in a co-mingled fund.
  - Ability to veto individual investments.
  - Right to kick out the general partner under certain circumstances.

Registered Alternative Funds

- Registered investment company under the Investment Company Act.
- Typically a hedge fund or other alternative fund tweaked to fit within the Investment Company Act rules.
- Very popular 4-5 years ago. Less so after years of bull markets and rise of passive investing.
- Can start out as a hedge fund or other private fund project and then merge with or convert into a registered fund.
- More popular option with the rise of “turnkey” registered fund options.

Emerging Investment Strategies

- Socially responsible investing.
  - Often called sustainable investing, green or ethical investing.
  - Diversity, environmental stewardship, human rights.
  - Invest in certain industries while avoiding others.
  - Driven in large part by millennials.
- New asset classes.
  - Bitcoin, other cryptocurrencies, initial coin offerings, related futures and other derivatives.
  - Cannabis funds.

Cryptocurrencies and Related Investments

- Explosion in value of cryptocurrencies and initial coin offerings (ICOs).
- Private funds have been launched in the U.S. and offshore.
- Lack of certainty around regulatory status.
  - SEC has said that ICOs are very likely securities (investment contracts). Any ICO in the U.S. would need to be registered or exempt.
  - CFTC views bitcoin and other cryptocurrencies as commodities will regulate any futures, options or other derivatives on cryptocurrencies.
- U.S. regulated products
  - CFTC approved swaps an options on bitcoin began trading in October 2017.
  - CME group announced last week that it plans to introduce bitcoin futures by the end of the year.
  - SEC reject a bitcoin ETF in march of this year. Launch of bitcoin futures may make SEC approval of bitcoin ETF more likely.
  - Potential for significant institutional investments into a regulated product.

Cannabis Funds

- State legalization has created a huge market for investment. Legal in 29 states and District of Columbia (19 and DC have dispensaries).
- New and established private equity shops are focusing on this newly legal industry.
- Seen as a fragmented industry ripe for consolidation.
- Positive regulatory developments.
  - Rohrabacher-Farr Amendment is legislation prohibiting the DOJ from spending $ to interfere with state marijuana laws. Must be reauthorized annually.
  - Cole Memorandum is guidance to all U.S. attorneys on how to work with cannabis businesses in legal states.
  - 2014 guidance from Treasury Department and U.S. Attorney General's office providing relief for banks under the CEA and the Bank Secrecy Act.

Cannabis Funds – continued

- Significant legal/regulatory hurdles remain.
  - Illegal under federal Controlled Substances Act. Could be subject to seizure. Schedule I controlled substance with no medical use and high potential for abuse.
  - Banks slow to embrace cannabis businesses.
  - Section 280E of the Internal Revenue Code prohibits cannabis companies from deducting what would be ordinary business expenses for any other business.
  - U.S. Patent and Trademark Office does not currently register trademarks for cannabis retailers or for products that contain cannabis, creating potential for unfair competition.

Questions and Comments