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2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Alternative Products/Registered Funds with Alternative Strategies/Business Development Companies

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REGISTERED FUNDS AND ALTERNATIVE INVESTMENTS

- During the post-crisis period of low interest rates, which continues, traditional fixed income investments have produced low interest income while many equity markets have exhibited volatility.
- Investor demand increased for "alternatives“ to traditional equity and fixed income investments and strategies. Many advisers recommend such alternative allocations as part of an investor’s diversified investment portfolio.
- Advisers and "average" investors are comfortable with a traditional mutual fund form, and advisers seek alternative exposure for their clients. Registered funds thus have expanded the borders of traditional investments and strategies to meet demand.

REGISTERED ALTERNATIVE PRODUCTS

- Open-end and Closed-end Funds
  - Depends on liquid or illiquid nature of assets

- Registered alternative funds can involve alternative assets as well as alternative investment strategies

REGISTERED FUNDS WITH NON-TRADITIONAL ASSET CLASSES OR STRATEGIES

- Mutual funds using "hedge fund" like strategies
  - Long/short equity funds
  - “Macro” funds using multi-manager, multi-strategy model
  - “Macro” multi-strategy fund of funds
  - Event-driven funds (special situations)
  - Event-linked funds (catastrophe bond)
  - Global macro/managed futures
  - Risk weighted multi-asset funds
  - Emerging market or frontier market investments
- Commodities Exposure (also ETPs that are not investment companies)
- Energy master limited partnership funds (MLPs in open and closed-end funds)
- Closed-end funds and illiquid and less liquid strategies
- **Although these strategies and asset classes involve creativity at work, registered funds do have distinct limits - there always will be hedge funds**

MUTUAL FUNDS WITH “HEDGE FUND" STRATEGIES

- Long/short funds
  - Invest in long and short positions in securities
  - With a long position, the fund purchases a security outright; with a short position, the fund sells a security that it does not own and must borrow to meet its settlement obligations
  - Asset coverage requirements limit the amount of shorting by a registered fund
- Multi-manager, multi-strategy funds
  - Main adviser allocates fund assets to distinct sleeves managed by separate (often unaffiliated) sub-advisers
  - Sleeves may pursue same overall strategy using different sub-advisers, or different strategies
- Multi-strategy fund of funds
  - Access alternative investment strategies (e.g., convertible arbitrage, event driven (merger arbitrage), fixed income relative value, equity market neutral, long/short equity, global macro, managed futures and emerging markets) by allocating among in other investment companies
  - Similar objective to multi-manager, multi-strategy but using underlying funds

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MUTUAL FUNDS WITH "HEDGE FUND" STRATEGIES

- **Event-driven funds (special situations/activism)**
  - Invests in the securities of publicly traded companies involved in mergers, takeovers, tender offers, leveraged buyouts, spin-offs, liquidations, or similar events ("corporate reorganizations").
  - A variety of strategies can be employed to capitalize on the mispricing of corporate securities during corporate reorganizations, including transactions involving common and preferred stock, debt instruments and derivative securities.
  - Strategies often involve the use of arbitrage, which involves taking advantage of small price differences between two otherwise equivalent assets.
  - Such strategies considered to be less dependent on the overall direction of stock prices.
  - Can be "activist" as well, where fund adviser lobbies management of portfolio companies for change.
- **Event-linked funds (catastrophe bonds)**
  - Return of principal and payment of interest contingent on the non-occurrence of a specified trigger event(s) that leads to economic and/or human loss, such as an earthquake of a particular magnitude or a hurricane of a specific category.
  - The most common type of event-linked bonds is known as "catastrophe" or "CAT" bonds.
  - In most cases, the trigger event(s) will not be deemed to have occurred unless the event(s) happened in a particular geographic area and was of a certain magnitude or caused a certain amount of actual or modeled loss. If the trigger event(s) occurs prior to a bond's maturity, the fund may lose all or a portion of its principal and forgo additional interest.
  - Liquidity of the CAT bond market is biggest challenge, although increasingly liquid.
  - Uncorrelated to equity or bond markets.

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MUTUAL FUNDS WITH "HEDGE FUND" STRATEGIES

- Global Macro/Managed Futures
  - Focus on investing in instruments whose prices fluctuate based on the changes in economic policies, along with the flow of capital around the globe - instruments move based on systemic risk rather than security specific
  - In general, focus on trading futures in currency strategies, interest rates strategies, and stock index strategies
  - To run as a RIC, must use offshore subsidiary for any commodities futures that produce "bad income"
  - Utilize inherent or "economic" leverage in futures typically with programmatic trading
  - Asset coverage requirements
  - CFTC has "harmonized" requirements for such funds, which also are commodity pools

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COMMODITIES EXPOSURE

- Commodity RICs
  - Often similar/same as “managed futures” funds but focused on commodities futures rather than financial futures
  - Must use offshore subsidiary structure to be a RIC
  - Asset coverage requirements
  - CFTC harmony
- Commodity ETPs (exchange traded products)
  - Pool that holds only physical commodity (i.e., gold, silver, copper)
  - **Neither an investment company nor a commodity pool**
  - Exchange-traded issuer like a public company

MUTUAL FUNDS WITH “HEDGE FUND" STRATEGIES

- Risk weighted multi-asset funds
  - Focuses on allocation of risk among asset classes
  - Goal is to earn the steady level of return with less volatility and overall risk, or to realize better returns with an equal amount of risk and volatility (versus traditional asset allocation strategies)
  - May use pre-determined asset class allocation or dynamic balancing
  - If using futures/derivatives, asset coverage issues
- Emerging market and frontier market investment
  - Focus on securities of non-government issuers in developing countries
  - Liquidity may be an issue

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MLPS

- MLPs are "master limited partnerships" mainly in the energy/resources areas.
- MLPs are generally treated as partnerships for U.S. federal income tax purposes.
- A RIC is limited to 25% direct holding of MLPs. Registered funds that are RICs must diversify assets into MLPs, related companies or exposure to such companies through other instruments.
- Some MLPs are not RICs but are registered investment companies that operate as "C corporations" rather than as a RIC.
- To be treated as a partnership for U.S. federal income tax purposes, an MLP must derive at least 90% of its gross income for each taxable year from qualifying sources, including activities such as the exploration, development, mining, production, processing, refining, transportation, storage and certain marketing of mineral or natural resources.
- MLPs are generally publicly traded, are regulated by the SEC and must make public filings like any publicly traded corporation.
- Many MLPs operate oil, gas or petroleum facilities, or other facilities within the energy sector.
- Midstream MLPs may also operate ancillary businesses including marketing of energy products and logistical services. The MLPs in which the Fund invests may also engage in owning, managing and transporting alternative energy assets, including alternative fuels such as ethanol, hydrogen and biodiesel.

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WHAT ARE BUSINESS DEVELOPMENT COMPANIES ("BDCS")?

- BDCs are investment products which allow public access to generally illiquid strategies which consist primarily of investments in private domestic companies.
  - These assets may include private equity investments, but more often are middle market loans that are directly originated by the asset manager, or a "club deal" that involves a few asset managers collectively participating in the loan.
- BDCs are special closed-end investment companies created by the Small Business Investment Incentive Act of 1980 enacted in response to a perceived crisis in capital markets to facilitate public investment in small and developing companies.
- BDCs are subject to certain requirements of the 1940 Act - specifically Sections 54 through 65 and by incorporation, Sections 1-5, 6, 9, 10(f), 15 (a), (c), and (f), 16(b), 17 (f) through (j), 19(a), 20(b), 32 (a) and (c), 33 through 47, and 49 through 53 to the same extent as if it were a registered closed-end investment company.
- BDCs generally register under the Securities Act of 1933, the Securities Exchange Act of 1934, and are subject to the disclosure and reporting rules of those laws.
- BDCs must generally limit their investments to securities of private, smaller companies ("eligible portfolio companies") and must make available "significant managerial assistance" to those issuers.
- BDCs operate somewhat similarly to private equity funds, but BDC investors are generally not subject to the same income, net worth, or sophistication criteria.
- BDCs have greater flexibility than registered funds to co-invest with affiliates.
- BDCs can charge performance-based fees that traditional registered funds cannot pay.
- BDCs have greater flexibility to leverage their investments (200% asset coverage)
- BDCs can qualify for "pass-through" tax treatment if they comply with IRS portfolio diversification and income tests.

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HOW DO BDCS INVEST THEIR ASSETS

- A BDC is required to have at least 70% of its investments in eligible assets.
- Eligible assets, for purposes of Section 55(a), include, among other things:
  - securities of an "eligible portfolio company" that are purchased from that company in a private transaction,
  - securities received by the BDC in connection with its ownership of securities of an "eligible portfolio company,"
  - cash, cash items, government securities, or high quality debt securities maturing one year or less from the time of investment.
- An "eligible portfolio company" is any issuer that:
  - is organized and has its principal place of business in the United States,
  - not an investment company other than a small business investment company wholly-owned by the BDC
  - does not have any class of publicly-traded securities with respect to which a broker may extend credit (may have a class of securities listed on a national securities exchange, but must have an aggregate market value of outstanding voting and nonvoting common equity of less than $250 million)
- BDCs must offer to provide **"significant managerial assistance"** to the eligible portfolio companies in which they invest, and if accepted, they must provide such assistance. Significant managerial assistance includes arrangements in which a BDC, through its directors, officers, or employees, provides significant guidance and counsel concerning management, operations or business objectives and policies.

TYPES OF BDCS-INTERNALLY V. EXTERNALLY MANAGED

- **Internally Managed BDCs**
  - Pay the operating costs associated with employing investment management as opposed to an investment advisory fee
  - May issue performance based compensation including options, warrants, or rights pursuant to an executive compensation plan or a profit sharing plan
- **Externally Managed BDCs (predominant structure)**
  - Registered investment adviser subject to an advisory agreement
  - No equity-based compensation arrangement or profit-sharing plan
  - Typically pay a management fee equal to an annual rate of 1.5% to 2.0% of the gross assets of the BDC’s portfolio (including any borrowings), paid quarterly in arrears.
  - BDCs may also receive incentive fees – typically a 20% fee on interest income with a hurdle rate of 6% to 8%, and a 20% fee on realized capital gains.
  - The capital gains incentive fee requires BDCs to take into account both capital losses and unrealized depreciation, but excludes unrealized appreciation in a BDC’s portfolio.

TYPES OF BDCS-TRADED, NON-TRADED, AND PRIVATE

- **Traded BDCs**
  - Typically organized as a Delaware or a Maryland corporations
  - File Form N-54A to make an election to be regulated as a BDC
  - File an registration statement on Form N-2 under the Securities Act
  - Register a class of securities under the Exchange Act
  - IPO (or listing of previously non-traded BDC)
- **Non-Traded BDCs**
  - Similar process as Traded BDCs, but shares are not listed on an exchange
  - Shares are sold through continuous offerings subject to suitability requirements, FINRA review, and NASAA Omnibus Guidelines (State Blue Sky review).
  - Liquidity provided through periodic repurchase offers
  - 5-7 year period before exchange listing or other liquidity event
- **Private BDCs**
  - Shares are not listed on an exchange
  - Shares are sold through private placement offering and funding effected through a capital call model
  - File a registration statement on Form 10 to register a class of securities under the Exchange Act (No Form N-2 registration required) and make an election to be regulated as a BDC by filing a Form N-54A
  - Generally no liquidity prior to a qualifying IPO
  - Private placement structure eliminates need for "blue sky" registration process faced by traditional non-traded BDCs
- **All BDCs must file periodic reports under the Exchange Act, including 10-Ks, 10-Qs and 8-Ks, and file proxy statements pursuant to Section 14(a) of the Exchange Act**

COMMON BDC ISSUES AND EXEMPTIVE RELIEF

- **Valuation.**
  - Many BDC portfolio holdings are not liquid and thus there is no readily available market value for them.
  - BDCs must fair value their portfolio on a quarterly basis, with any unrealized gains or losses reflected on their income statements.
  - Fair value is determined through the cooperation of a BDC's Board and management with cooperation from third-party valuation firms.
- **Transactions with affiliates.**
  - Unlike traditional investment companies, in which certain "joint transactions" with affiliates are prohibited, BDCs pursuant to Section 57 may under certain circumstances enter into joint transactions with second-tier affiliates subject to approval by the BDC's independent directors.
  - Co-investment between a BDC and an affiliate generally requires SEC exemptive relief unless relying on the relief provided by the Mass Mutual no-action letters (i.e., no terms negotiated other than price).

Questions?