Introduction and Overview of 40 Act Liquid Alternative Funds

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Citi Prime Finance

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Section I: Introduction and Overview of 40 Act Liquid Alternative Funds

This document is an introduction to '40 Act funds for hedge fund managers exploring the possibilities available within the publically offered funds market in the United States. The document is not a comprehensive manual for the public funds market; instead, it is a primer for the purpose of introducing the different fund products and some of their high-level requirements. **This document does not seek to provide any legal advice.** We do not intend to provide any opinion in this document that could be considered legal advice by our team. We would advise all firms looking at these products to engage with a qualified law firm or outside general counsel to review the detailed implications of moving into the public markets and engaging with United States regulators of those markets. For introductions and referrals to qualified lawyers who have experience with these products, please contact us at prime.advisory@citi.com.

What is a '40 Act fund?

A '40 Act fund is a pooled investment vehicle offered by a registered investment company as defined in the 1940 Investment Companies Act (commonly referred to in the United States as the '40 Act or, in some instances, the Investment Company Act (ICA). Such pooled investment vehicles fall into two broad categorizations: open-end and closed-end. When combined with the Securities Act of 1933 (the '33 Act) and the Securities Exchange Act of 1934, the '40 Act defines the way in which these types of pooled investment vehicles can be packaged and sold to retail and institutional investors in the public markets, and places their governance under the responsibilities of the Securities & Exchange Commission (SEC). The '40 Act also contains a number of exemptions, including one for privately offered funds such as hedge funds, private equity funds, and real estate or infrastructure investment funds. All '40 Act funds are registered as securities with the SEC and are therefore considered to be publicly offered, a very different process than the creation of a private co-mingled fund (typically a limited partnership, or LP).

Both the 1933 and 1940 Acts were originally based upon a philosophy of disclosure, and require that the issuers of open-end or closed-end public funds fully disclose all material information that an investor would require in order to make the most informed decision about an investment. Unless they qualify for an exemption, securities offered or sold to the public in the United States must be registered by filing a registration statement with the SEC. The prospectus for the investment is included as part of the registration statement and must describe the offering, its management, details about the investments which will be made across asset classes and details of the key service providers for the security. This document will explain the different types of funds being offered and provide an overview of the key requirements.

What is an alternative '40 Act fund?

There is no universal definition that describes what makes a '40 Act fund 'alternative', but the tag can be applied broadly to any investment strategy that is not purely pursuing long-only investing in equities or debt instruments. The scope of alternatives therefore includes traditional hedge fund strategies (equity long/short, market neutral, global macro, event-driven, fixed income, relative value, etc.) and also includes investing in commodities and currencies. It also extends to private equity and real estate investment vehicles; however, for the purpose of this primer we will cover mainly the liquid public market strategies where investments can be bought and sold on exchanges, either bilaterally or via broker-dealers. An alternative '40 Act fund is therefore a fund structured to allow for the implementation of an investment strategy that engages in techniques or asset classes that differentiate them from fully paid for, long-security investments.

Section II: Overview of Alternative Open-End Mutual Funds

The alternative '40 Act products with the largest potential audience and the most uniform structure are the open-end funds. These products are commonly referred to as mutual funds in the United States, and they span both single manager and multi-manager, or multi-alternative, products.

All mutual funds must be brought to market by a sponsor that has the ability to create the proper structure for the mutual fund, file the regulatory documents, apply to the exchanges for a ticker symbol and set that symbol up for public access. There are a limited number of providers eligible to act as a sponsor for mutual fund products; those thinking about launching a product must access one of these providers.

Once the fund is officially launched, mutual funds are priced daily and accept orders for subscriptions and redemptions. They are incorporated either as corporations or unit trusts and can have unlimited investors in a variety of standard share classes, ranging from institutional to retail. As pooled investment vehicles there is no limit on their overall capacity, although there may often be minimum investment sizes that investors must meet to purchase fund shares. Mutual funds must provide daily liquidity to investors and subscribe to a set of trading rules that govern how they invest their capital. Under these trading rules they must:

- Maintain 85% of their portfolio in liquid assets and hold no more than 15% of their assets in illiquid securities (defined as instruments that take longer than a single day to liquidate in the public markets);
- Cover the full value of liabilities created by any use of short sales by holding an equivalent amount of collateral within a separate brokerage or custodial account;
- Limit any use of leverage in their portfolio to 33% of the gross asset value of the fund, using either derivates or securities as margin collateral.

Mutual funds are prohibited from charging performance fees. The investment sub-adviser and investment manager of alternative mutual funds typically charge a combined management fee of between 100 and 200 basis points of the fund's AUM for the institutional or investor share class, and then offer additional share classes with additional fees that are outlined in more depth in the marketing and distribution section of this primer.

All mutual funds in the United States issue a 1099 form at the end of each year to investors that categorizes the tax treatment of the fund's income and distributions. This differs from the privately traded hedge fund industry, in which investors are issued a K-1 form. Many individual investors view 1099s as superior because they must be issued by January 31 of the following calendar year, whereas K-1s have no mandated filing date. As such, most investors in mutual funds are able to file their taxes early in the year and benefit from any anticipated tax refunds.

There are three different types of mutual fund structures that are classified as 'liquid alternatives': single-manager funds, multi-alternatives, and commodities (or managed futures) funds.

Single Manager Mutual Funds

A mutual fund has both an investment manager (IM) and an investment adviser (IA) associated with the offering. There are two execution models for single-strategy mutual funds. The first model is one where the IM and the IA are the same company. This approach most closely resembles a typical hedge fund structure. The second model is one in which the hedge fund manager is a single sub-adviser (IA) to a mutual fund owned by a different investment manager.

The mutual fund is set up either as a corporation or a unit trust (we will discuss the pros and cons of each legal structure in the next section). An independent board of directors and set of service providers are assigned to provide custody, fund administration, transfer agency services, investor services and prime brokerage services. The fund has a single IA who has trading authority on the portfolio while staying in compliance with all of the trading rules previously discussed. The IM and the board are responsible for overseeing the IA, as well as the calculation of the daily NAV by the fund administrator.

Chart 1 below provides an overview of the single-fund mutual fund structure and the key relationships and service providers required.

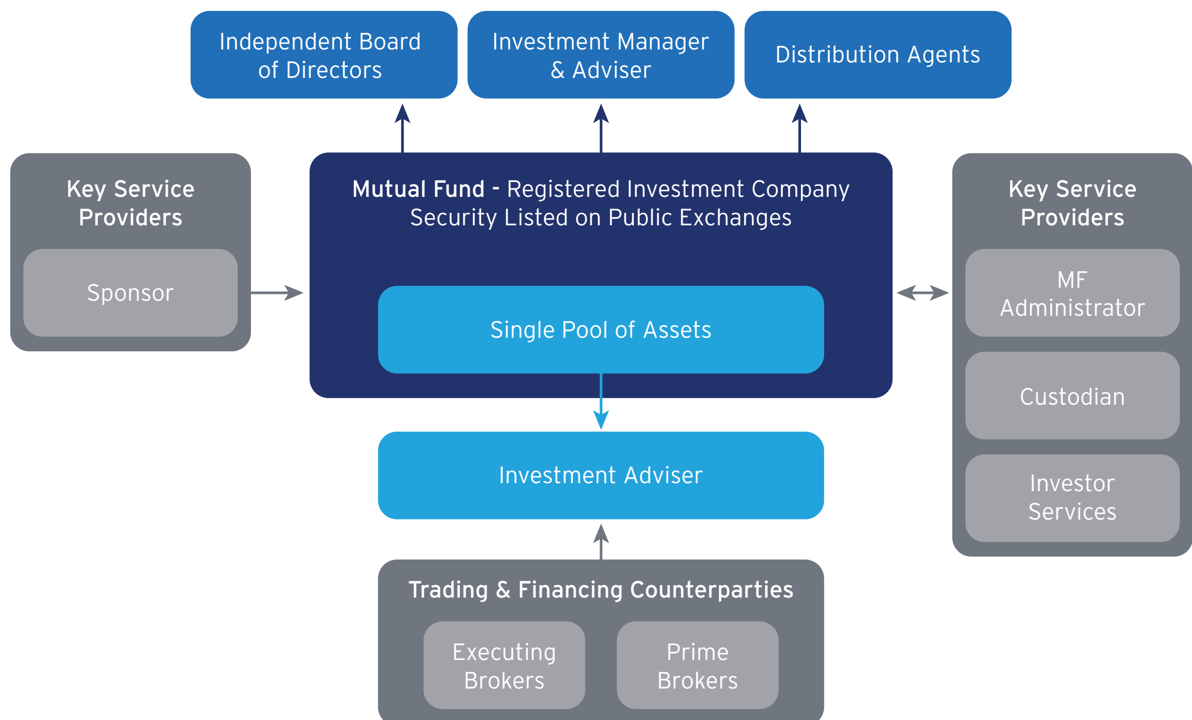
Due to the daily liquidity requirement, the most common alternative strategies being implemented in these single-manager mutual funds are equity long/short, equity market neutral and global macro. These strategies trade in highly liquid securities such as equities and listed derivatives. In order to meet the liquidity and leverage requirements of the '40 Act open-end funds, some hedge fund managers exploring these structures are refining the execution of their investment strategies to comply with the mutual fund trading limitations.

The most common way of achieving this aim is to carve out the most liquid subset of trading signals used in the manager's private fund offering and create a mutual fund wrapper around this set of trade ideas. As a result, these simplified trading strategies offer a different risk-return profile when compared with the hedge fund manager's private fund product. Articulating the difference in trading style between publically offered and privately offered funds helps the manager justify the divergent fee schedules and limit the potential of investors wanting to leave a higher fee product in favor of a lower fee offering. The management fee for the mutual fund can be shared between the IM and the IA depending on their arrangement and functions.

A good example of the single-manager alternative mutual funds is the PIMCO Long/Short Equity Fund (PMHAX), which was formed by PIMCO after acquiring hedge fund manager Catamount Capital Management in Q2 2012. They were able to convert Catamount's private fund into a mutual fund because it was determined that the historical performance was generated by the fund, which used strategies and leverage that was compliant with the '40 Act regulations. PIMCO now acts as both the IM and the IA to the fund. If a private fund can be converted into a mutual fund, it can maintain the track record of the hedge fund. If that track record is 3 years or longer, the IM can potentially have its fund more readily recognized on the mutual fund ratings sites such as Morningstar and Lipper, which can increase attention and interest in the product.

In the sub-adviser version of the single manager product, the IM is either affiliated or distinct from the IA and provides operations and oversight functions for the fund. The IM in this model is often also the primary distributor for the fund, offering either their own distribution network and/or ensuring that the fund is available via broker-dealers, wire-houses, mutual fund supermarkets and platforms as well as

Chart 1: Basic Open-End Mutual Fund Structure



directly to the RIA networks. The IA acts as a sub-adviser to the fund and is responsible for making and executing all trading decisions. Depending on their arrangement and roles, the IM and ISA will typically split the mutual fund's management fee.

A good example of a single-manager alternative mutual fund with an affiliated sub-adviser is the Mainstay Marketfield Fund (MFADX), which is owned by New York Life as the IM and is sub-advised by Marketfield Asset Management as the IA. New York Life is also the primary distributor for the fund. The fund has a broad mandate classified as Equity Long/Short by Morningstar and Lipper.

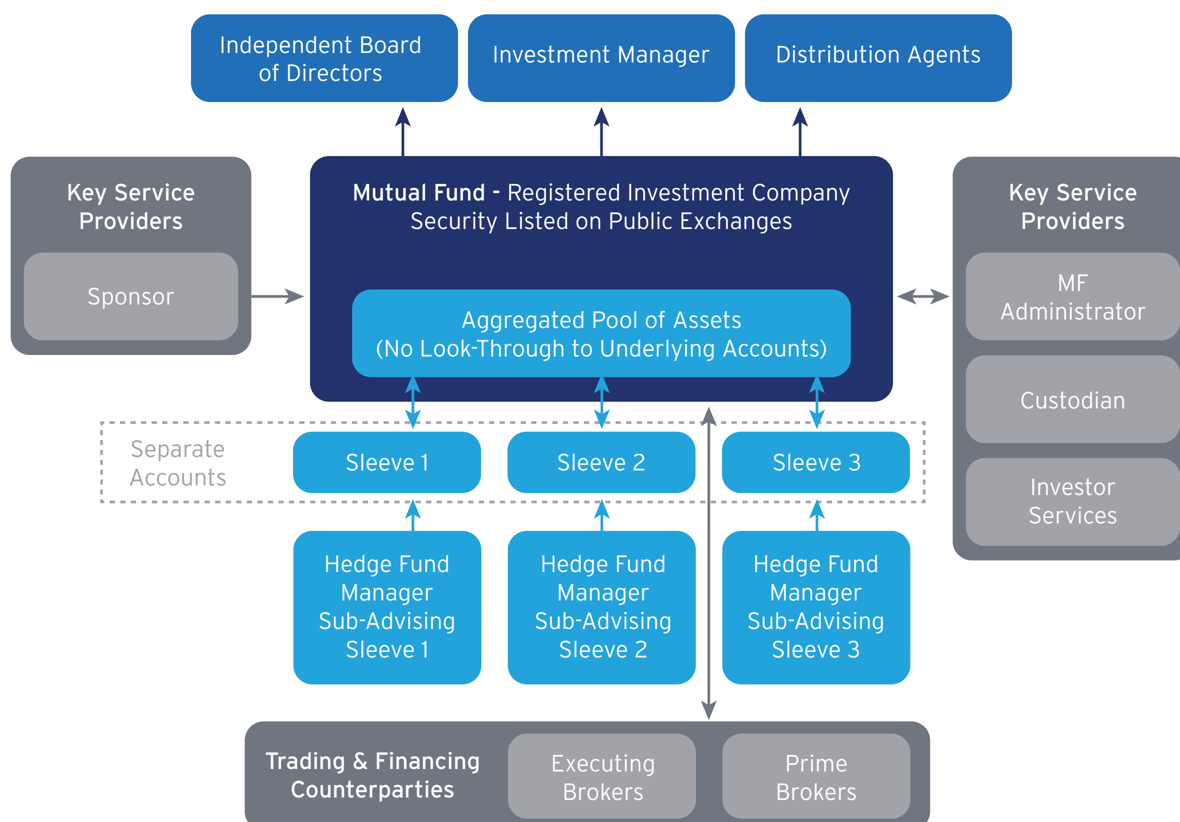
Multi-Alternative Mutual Funds

The second alternative mutual fund structure is a newer offering called the multi-alternative, or 'multi-alt'. This structure combines different sleeves of hedge fund strategies managed by different IAs into a single investment portfolio that is offered to the public. In many ways, the structure is similar to a traditional fund of fund offering in the hedge fund space. Rather than the IM making an investment into the IA's LP, however, the IM can set up a series of separately managed accounts managed independently by each IA.

Multi-alt funds engage with multiple sub-advisers who all need to be compliant with '40 Act operational and compliance standards, but do not need to be registered investment companies themselves. These funds offer a diversified return stream by allowing investors access to multiple strategies within a single-fund product. The fund must observe and fulfill the short selling requirements, leverage constraints, and liquidity parameters of the open-end fund structure. This structure is illustrated in Chart 2 below.

There are two models for how the multi-alt is administered by the IM. In the first, which is also the most common approach, each sub-adviser to the fund must individually subscribe to the trading restrictions laid out for '40 Act structures. This ensures that when the portfolio rolls up to the aggregate level, it will always be in compliance with the required liquidity and leverage guidelines. The second model is one in which some of the sleeves of the multi-alt may be more illiquid, and other sleeves may be highly liquid and potentially even long-only. In this model, the IM is responsible for ensuring that

Chart 2: Open-End Multi-Alternative Mutual Fund Structure



the aggregate portfolio remains in alignment with trading rules and portfolio limitations.

In both instances, it is the aggregated fund that faces off against trading and financing counterparties, including prime brokers. Thus, the underlying sub-advisers are required to use the broker-dealers and partners dictated by the IM. There are often additional operational challenges the IM must address with these structures, since they need to have oversight to ensure the fund remains in compliance with trading rules and can meet the daily liquidity and NAV requirements. Sub-advisers have an easier time operationally in the multi-alt structure because, as noted earlier, they typically contribute their sleeve of the fund's activity via a separately managed account (SMA). The fund's management fee earned by the IM is shared with the fund's sub-advisers.

A good example of the multi-alt mutual funds is the Arden Alternative Strategies (ARDNX) fund, which is sub-advised by hedge fund managers Babson, Chilton, CQS, Eclectica, E&P, JANA, MatlinPatterson, Numerica and York Capital. The fund has a distribution agreement with Fidelity Investments.

Managed Futures Mutual Funds

Managed futures products and commodity mutual funds have been in existence for many years, as the CTA product has always been well suited to a liquid public market. Since these funds do not invest in equities or debt securities, they are classified as alternative and fall under the classification of liquid alternatives.

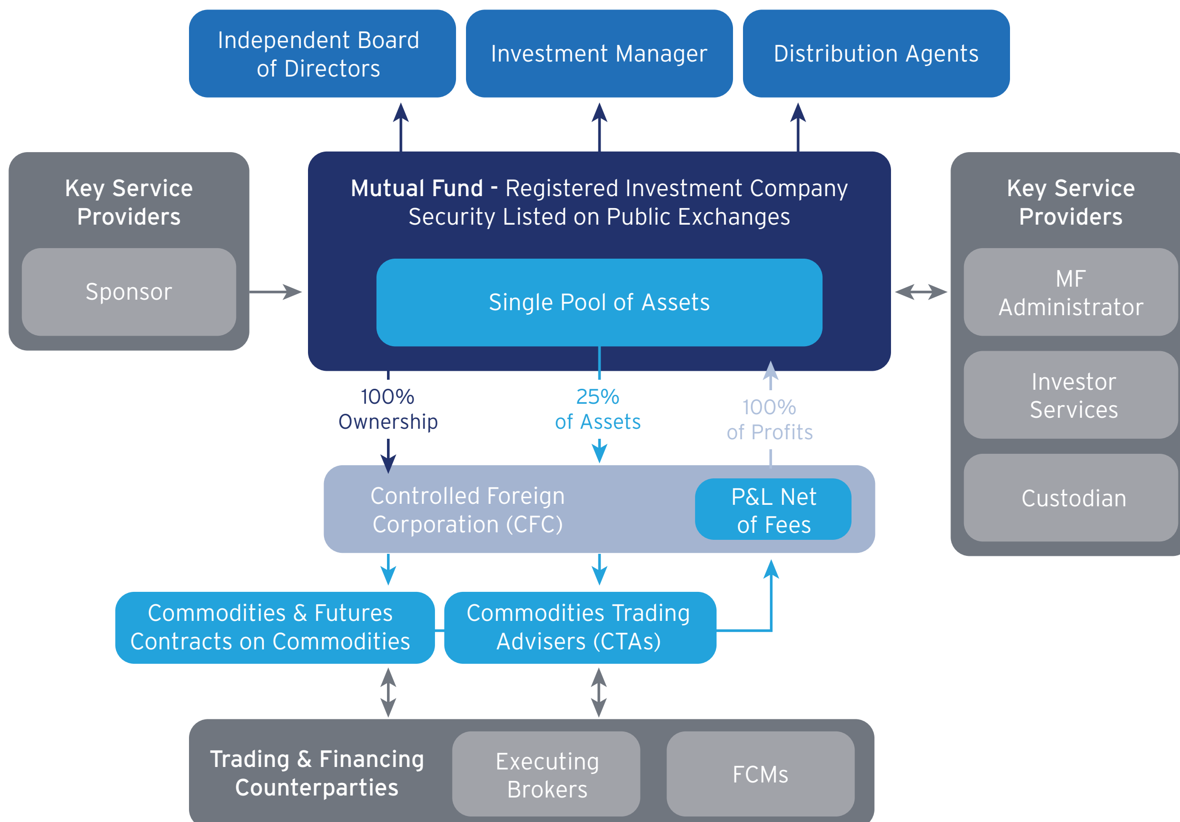
The main difference between commodity funds and other open-end '40 Act mutual funds is due to the type of income the funds receive from their investments. Traditional mutual funds receive income from dividends, coupons and price appreciation in the underlying securities, whereas commodity investments are typically executed using futures trading contracts, which do not realize the same type of income. The IRS considers the futures income to be bad income, and because the mutual fund is a regulated investment company (RIC) it can therefore not receive the profits or losses from transacting in futures contracts.

To address this income issue, commodity funds establish an offshore entity to block the bad income and pass back income to the onshore mutual fund as a dividend stream. The offshore entity is set up as a controlled foreign corporation (CFC) which is a wholly owned subsidiary of the mutual fund corporation or unit trust. The CFC then contracts with external CTAs, who are engaging in commodities investment strategies that primarily invest using futures. These CTAs act as sub-advisers to the CFC entity, which then passes back profits or losses to the parent mutual fund. This structure is illustrated in Chart 3 below.

The mutual fund is limited to investing only 25% of its assets into the CFC, but this type of offshore vehicle has no restrictions on leverage, so with sufficient trading margin the fund can achieve significant enhanced returns from just the 25% of assets invested. There are also no restrictions on paying a performance fee to the CTA manager acting as a sub-adviser to the CFC, so these structures can encourage high-quality managers to develop a partnership with the mutual fund investment manager. The challenge, however, with paying a full load 2/20 fee to the sub-adviser is that when fees are combined with IM management fee and a distribution agent fee the drag on performance can be significant, which can make the overall fund unattractive to retail investors. These fees will be discussed further in the marketing and distribution section.

A good example of the managed futures mutual funds is the Altegris Managed Futures Strategy Fund (MFTAX) which is sub-advised (via the CFC blocker) by Winton, Welton, Abraham, Lynx, Cantab, QIM and Capital Fund Management.

Chart 3: Open-End Managed Futures Mutual Fund



Section III: Overview of Alternative Closed-End Funds

The second category of '40 Act funds to consider are closed-end funds, or CEFs. These are the most flexible in terms of investment restrictions, making them the closest in structure to privately offered hedge funds. There are three types of CEFs considered by managers of alternative investment products. Exchange-traded and continuously-offered interval funds are formed as investment companies (either as a corporation or as a unit trust). The third type of CEF is formed as a Business Development Company, or BDC. The main characteristics of these funds are described in Chart 4 below.

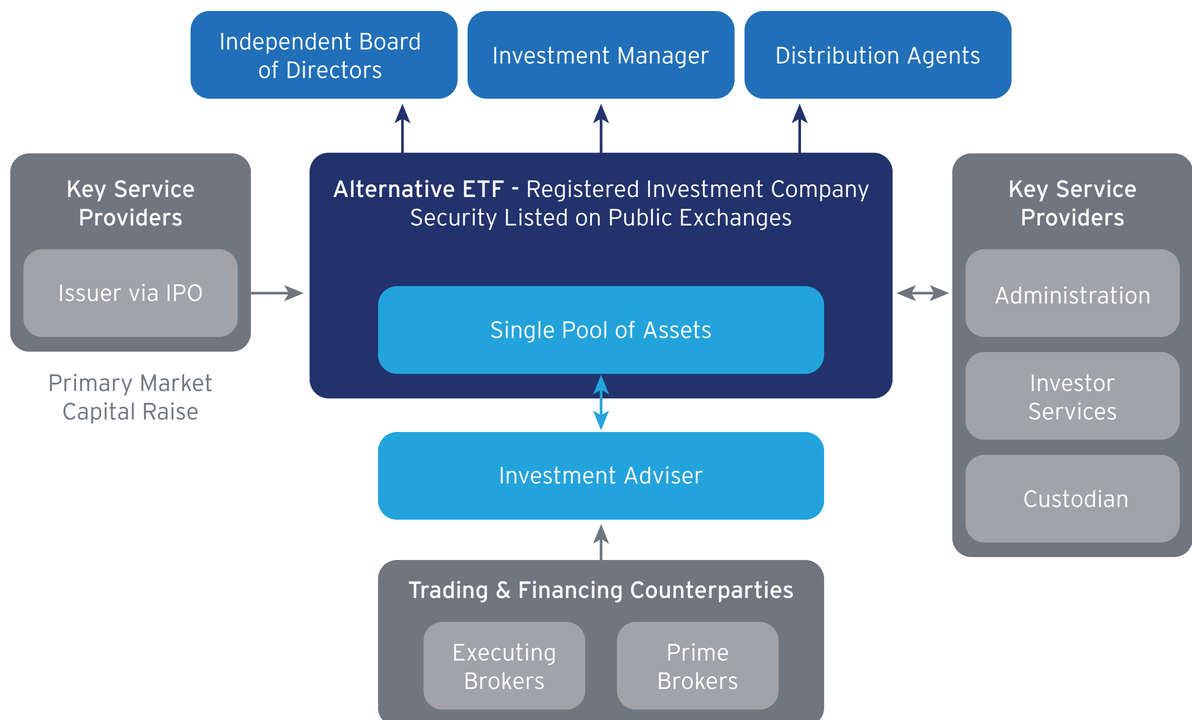
Alternative Exchange-Traded Funds

Alternative 'exchange-traded' closed-end funds that offer hedge fund-like strategies are a sub-set of the larger family of exchange-traded fund products (ETFs). The majority of ETFs are closed-end mutual fund structures that trade daily on the stock exchanges and track indices by investing in baskets of securities. The recent wave of 'alternative' ETFs does not track benchmarks; rather than tracking an index, they target delivering absolute returns.

These alternative ETF funds raise an initial amount of capital at inception via an IPO and can then invest in a range of equity-, bond-, or commodity-related strategies that are unconstrained and can include short selling and portfolio leverage (up to 33% of the value of the portfolio). Each alternative ETF would pursue its own unique strategy, such as a bear market fund, a non-traditional bond fund or a commodity ETF.

Secondary trading in alternative ETF shares occurs when the market is open as if they were stocks or bonds, but there is no redemption of the original capital raised. For this reason, many view these as permanent capital vehicles. The alternative ETF structure is illustrated in Chart 4. Like the open-end mutual funds, these products offer 1099 tax reporting to investors.

Chart 4: Alternative ETFs



Several firms are known for offering traditional ETFs, including Barclays Global Investors, which was subsequently acquired by BlackRock in 2009; State Street Global Advisors and Vanguard. These firms have all dominated the ETF marketplace since 2000, but there is now a newer set of entrants launching these alternative ETFs and pursuing more hedge fund-like strategies. These firms include PIMCO and Nuveen.

Continuously Offered Interval or Tender Offer Funds

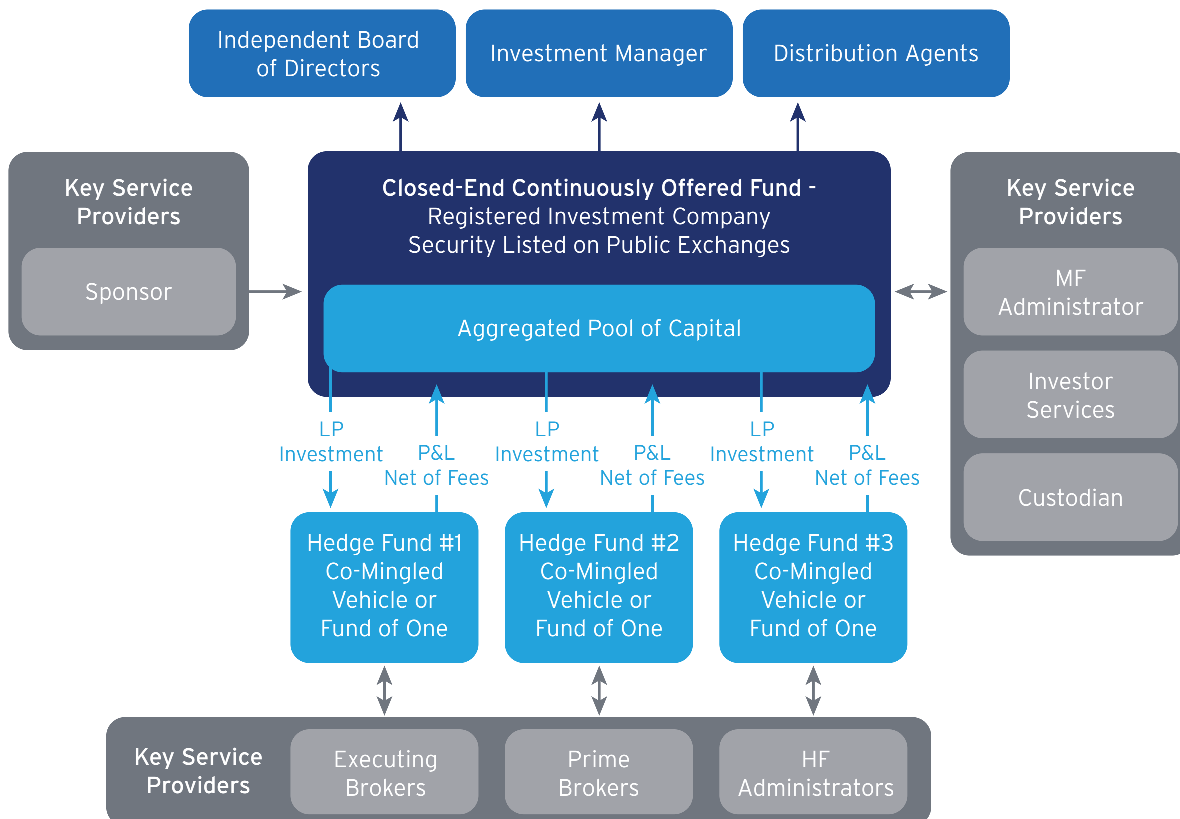
Continuously offered interval funds, or tender offer, are typically open monthly for subscriptions and offered to accredited investors (with at least $2 million in net worth). They can be distributed either directly by the fund manager or through the broker-dealer networks. Unlike the alternative ETF, where trading occurs only in the secondary market, these funds allow investors to withdraw their capital. Redemptions are structured as tender offers and are conducted at the discretion of the board of directors for the corporation or unit trust. Tenders are typically done quarterly to give investors an opportunity to exit the fund; therefore, liquidity of the fund is usually defined as quarterly.

The most common example we have seen come to market is an interval fund, which invests in nonaffiliated funds (i.e., invests into external hedge funds). In this model, the IA manages the CEF like a fund-of-fund investor, allocating capital directly to managers' existing commingled underlying funds. These underlying funds do not need to be registered investment companies and are either LP or LTD structures.

The CEF charges a fixed management fee that can be shared between the IM, IA and distributor. Although these CEFs do not charge a performance fee, the structure allow for a performance fee to be paid to the underlying hedge fund manager so the 2/20 fee structure can remain intact which can provide exposure to top-tier managers. All fees need to be fully disclosed in the prospectus of the CEF.

Minimum investments are typically $50,000 for a single share of the CEF, which is listed as a security with the SEC. Profits from these funds are paid out to shareholders annually because the requirement of

Chart 5: Closed-End Continuously Offered '40 Act Fund of Hedge Funds



the '40 Act mandates that 90% of profit, net of all fees, be paid out to the investors in the fund. Unlike a traditional hedge fund investment, investors into these continuously offered funds do not receive a K-1 for tax reporting; instead, they receive a 1099, similar to open-end mutual fund products and alternative ETFs.

Examples of these interval funds include the Blackstone Alternative Alpha Fund and the Private Advisors Alternative Strategies Fund, both of which were launched in 2012. The Blackstone fund is distributed directly through its broker-dealer and the Private Advisors fund is distributed by New York Life, which also acts as the IM overseeing the fund's operations.

Business Development Companies

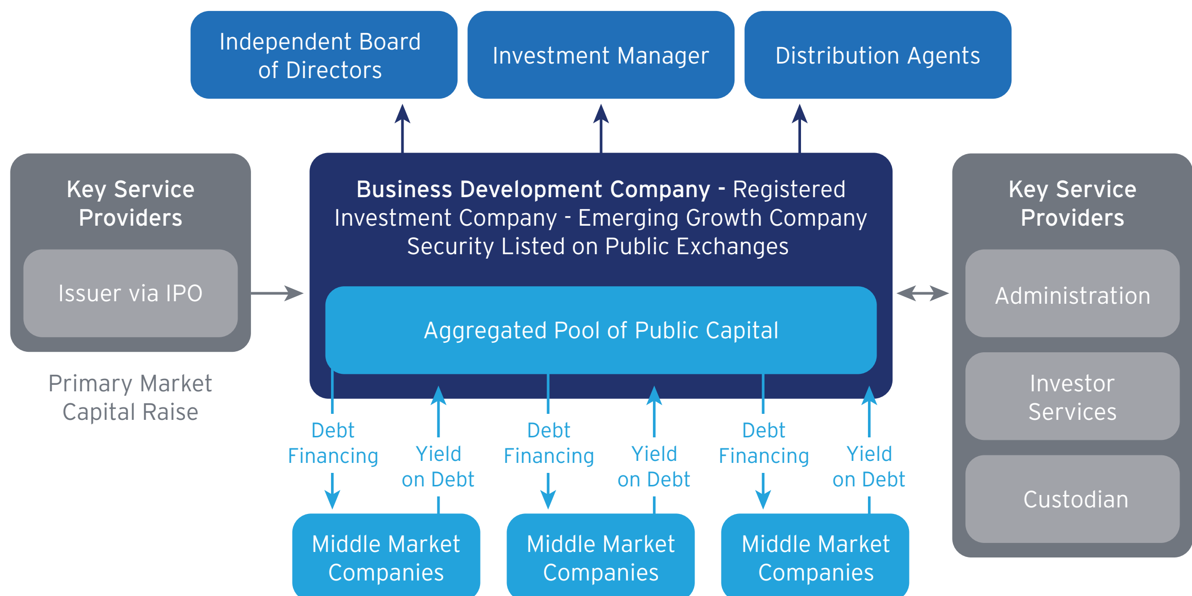
The final category of CEF that has emerged as a publically available alternative strategy is the business development company (BDC). The BDC is essentially a public private equity fund that is treated as an RIC for tax purposes and which qualifies as an emerging growth company for benefits under the Jumpstart Our Business Startups Act (JOBS Act).

The BDC raises capital in an IPO and then invests the capital in the stated investment strategy typically investing in small, upcoming businesses. The BDC is listed and trades on the stock exchange and, like the alternative ETF, this type of fund is considered a permanent capital vehicle. There is no direct ability to redeem capital from the fund. The fund pays out >90% of its net income to the investors on either a quarterly or annual basis, as defined in the prospectus.

By offering the BDC as a fund on the public market, the investment adviser can quickly raise substantial capital for the strategy and expand its potential audience beyond the traditional private fund high net worth and institutional audience. The investment adviser can also include a performance fee in the terms of the fund, typically over a defined hurdle return for the shareholders, and therefore earn an income stream similar to that of a privately offered PE or real estate fund. The BDC model is illustrated in Chart 6.

Good examples of BDCs include Apollo Investment Corporation (offering retail exposure to secured loans, subordinated debt and CLOs) and BlackRock Kelso Capital Corporation, which has a similar investment portfolio. These funds are providing financing to middle market companies and stepping into the traditional role of the investment and commercial banks, which have a lower appetite for riskier lending since the Global Financial Crisis.

Chart 6: Business Development Corporation



Unit Investment Trusts

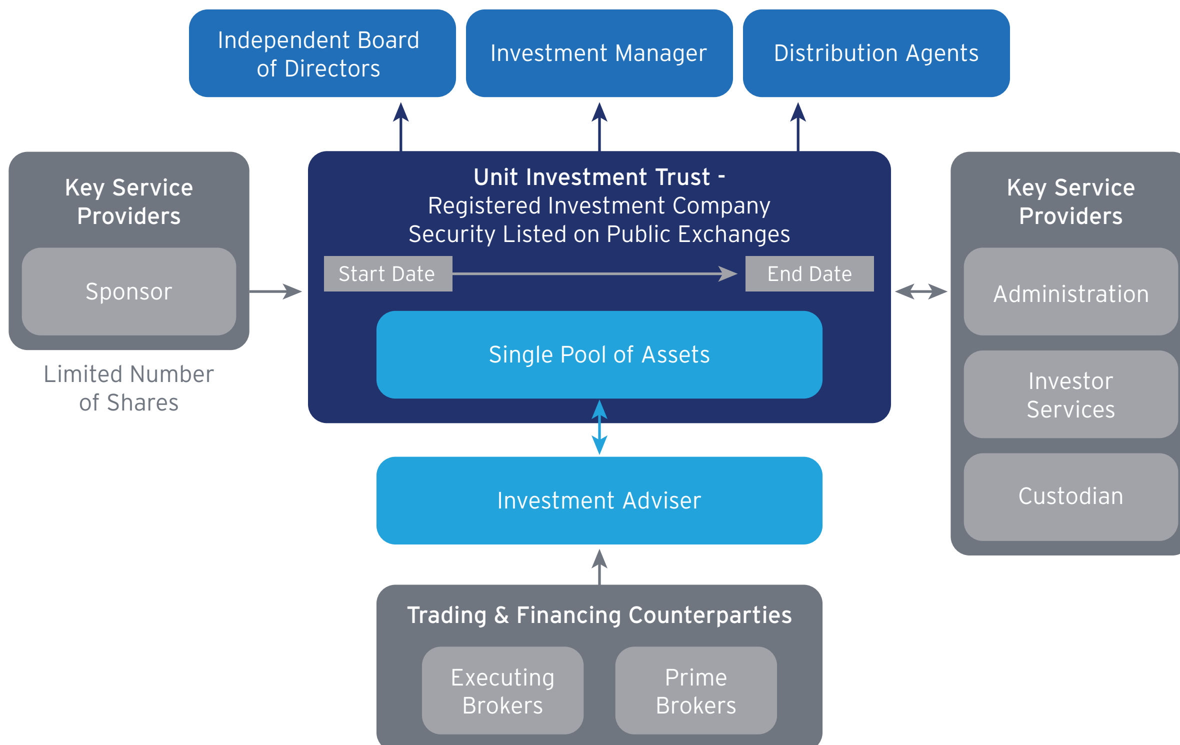
Unit investment trusts (UITs) are registered investment companies with some characteristics of both mutual funds and closed-end funds. Like mutual funds, UITs issue redeemable shares, called units. Like closed-end funds, UITs typically issue only a specific, fixed number of shares. In contrast to both open-end and closed-end funds, however, UITs have a pre-determined termination date that varies according to the investments held in the portfolio. UITs investing in long-term bonds may remain outstanding for 20 to 30 years. UITs that invest in stocks may seek to capture capital appreciation over a period of a year or a few years. When these trusts are dissolved, proceeds from the securities are either paid to unit holders or reinvested in another trust. The model for the UIT is illustrated in Chart 7.

UITs fall into two main categories: bond trusts and equity trusts. Bond trusts are divided into taxable and tax-free trusts. Equity trusts are divided into domestic or international/global trusts. The first UIT, which was offered in 1961, held tax-free bonds and, historically, the majority of UIT assets have been invested in bonds. However, beginning in the late 1990s, assets in equity UITs generally have exceeded assets in both taxable and tax-free bond trusts.

UITs employ a buy-and-hold investment strategy; once the trust's portfolio is selected, its securities typically are not traded. However, UITs may sell or replace a security if questions arise concerning the financial viability of the issuer or the security's creditworthiness. Most UITs hold a diversified portfolio of securities, with the extent of each trust's diversification described in its prospectus.

The securities in a UIT, which are also listed in its prospectus, are professionally selected to meet a stated investment objective such as growth, income or capital appreciation. Investors can obtain UIT price quotes from brokerage or investment firms, and some but not all UITs list their prices on NASDAQ's Mutual Fund Quotation Service. Some broker-dealers offer their own trusts, or sell trusts offered by nationally recognized independent sponsors.

Chart 7: Unit Investment Trust



Section IV: Requirements for 40 Act Liquid Alternative Funds

The requirements for '40 Act Funds are governed by the rules and regulations of the ICA, and each fund is registered as a security with the SEC as required by the Securities Act of 1933.

The rules specific to the '40 Act and '33 Act cover all necessary business requirements for a public fund, and should be reviewed in detail with your legal counsel and compliance consultant. For recommendations on specialist service providers, please contact us at prime.advisory@citi.com. The sections below cover some of the main business requirements, but this is not an exhaustive list and should be regarded as a high-level overview of key considerations.

Registration and Regulatory Filings

Unless they qualify for an exemption, securities offered or sold to the public in the United States must be registered by filing a registration statement with the SEC.

The prospectus, which is the document through which an issuer's securities are marketed to a potential investor, is included as part of the registration statement. The SEC prescribes the relevant forms on which an issuer's securities must be registered. Among other things, registration forms call for:

- A description of the securities to be offered for sale;
- Information about the management of the issuer;
- Information about the securities (if other than common stock); and
- Financial statements certified by independent accountants.

Registration statements and the incorporated prospectuses become public shortly after they are filed with the SEC. The statements can be obtained from the SEC's website using Electronic Data Gathering and Retrieval (EDGAR). Registration statements are subject to SEC examination for compliance with disclosure requirements.

Each new fund requires a fund sponsor to file the needed regulatory materials and, in the case of mutual funds, this fund sponsor must also underwrite the creation of the share classes to be offered by the fund. These sponsors are either independent or affiliated with a broker-dealer or bank in the United States; as of the end of 2012, there were approximately 776 financial firms offering investment management services to fund investors. One cost-effective fund sponsor model is called the series trust, and offers a management solution in which the fund sponsor arranges for a third party to provide certain services through a turnkey set-up; the overall cost is spread across the different funds in the trust.

Key Service Providers

Once created, funds are required by the '40 Act to assign both a custodian and a fund administrator to support the activities of the fund. For alternative funds that employ portfolio leverage or use short sales of securities or derivatives, a prime brokerage account is also typically required. The requirement for the fund to have a dedicated custodian is often a new relationship for a traditional hedge fund manager, who is more accustomed to private fund requirements for which the required service providers are typically just the prime broker and external fund administrator.

In addition to the custodian, the fund must also assign an independent board of directors to oversee the activities of the fund and approve key fund documents and reports. This function is linked to the fund's administration and is often provided as a service by the public fund administrators in the United States. As public funds are all onshore, the board of directors need to be resident within the United States.

The '40 Act fund also requires an independent transfer agent and investor services provider who can process share purchases and redemptions, and provide reporting to the end investor or the wealth adviser overseeing the portfolio. These services are typically bundled with the fund administration and can in some cases also be bundled with the custodian services for the fund.

In summary, an alternative '40 Act fund requires the same range of service providers as a private hedge

Footnote / Reference source: Investment Company Institute: 2013 Investment Company Factbook

fund, but with the addition of a custodian, onshore board of directors and transfer agent to oversee the activities of the fund. The expense for these three new fund-level requirements is borne by the investors and charged to the fund, which puts an additional fee layer onto the fund.

Key Service Providers

Compliance requirements apply to both the investment adviser and the IM, and are defined and governed by the SEC. For hedge fund managers who have registered as investment advisers following the implementation of the Dodd-Frank changes to the Advisors Act, the requirements will already be in place and well understood. The investment adviser must name a chief compliance officer and maintain detailed policies and procedures for all aspects of the fund's operations and governance.

The additional requirements dictated by the '40 Act apply to the governance of the fund and focus on the activities of the board and its oversight of the compliance function of the investment adviser, the fund sponsor, the fund administrator and the transfer agent. The rules cover reviews and approvals for policies and procedures, the sign-off process for the annual fund report, validation of pricing and valuation policies and reviews of the subscription and redemption process for fund shares. The board is therefore an active and integral part of the fund management process, and the relationship between the board and the key service providers is important to recognize and understand.

These requirements will be new to hedge fund managers and should be reviewed in detail with a qualified compliance consultant. For introductions and referrals to experts in this new requirement, please contact us at prime.advisory@citi.com.

Section V: Marketing and Distributing 40 Act Liquid Alternative Funds

Mutual Fund Share Classes

There are several classes of shares in the mutual fund industry, each of which has different fee implications. To better understand these share classes, we have outlined the various types of fees that can be applied to a mutual fund.

- **Listing Fees:** For certain share classes, there is a one-time listing fee that an IM pays to the distributor of its product to be included on the distributor's product platform.
- **Management Fees:** The management fee is paid annually to the IM (and its affiliates) for overseeing the fund's portfolio and may be split with the IAs. Depending on the arrangement the manager has negotiated with its distributor, this fee can range from 50 to 150 basis points. This management fee is deducted from the fund's assets.
- **Platform Fees:** Independent broker-dealers and registered investment advisers (RIAs) charge a platform fee of 40 basis points that is paid directly from the fund's assets annually for administering and overseeing the fund.
- **Marketing Fees:** If the mutual fund is being sold to a non-institutional investor, it also can charge a "marketing" fee or 12(b)-1 fee that covers distribution expenses, such as compensating a broker or others that sell fund shares and paying for marketing and printing costs related to the fund filings. An investment adviser must file a 12(b)-1 plan to collect these fees. The SEC does not have a limit on such fees, but FINRA has said that the fee cannot exceed 0.75% of the fund's average net assets per year. Another type of marketing fee that can be assessed by a manager is a shareholder services fee. FINRA limits this fee to 0.25% of the fund's average net assets per year. This fee can be collected as part of the 12(b)-1 expenses if it is included in the marketing plan; or, if there is no plan filed, it can be collected under the category of other expenses. Marketing fees are paid annually and deducted from the fund's overall holdings.
- **Trailer Fees:** Depending upon the distributor, there can sometimes be a trailer fee associated with a mutual fund. A trailer fee is an ongoing annual fee that the fund manager pays to the distributor of its mutual fund that remains in effect for as long as the client holds the mutual fund
- **Load Fees:** Load fees are less common today, but still persist for many fund offerings. Load fees are a sales charge that is typically paid to an outside broker that distributes a mutual fund offering. The SEC does not limit the size of the load a fund many impose, but FINRA has limited the charge to 8.5%. This is a maximum level and if the fund charges other types of fees, the cumulative set of fees cannot exceed this level. There are two types of loads. A front-end sales load is charged when an investor purchases a fund. The amount of the load is paid prior to purchasing the shares of the mutual fund and thus reduces the size of the buyer's purchase. There is also a deferred, or back-end, sales load that gets charged when an investor liquidates its investment. The load is subtracted from the value of either the fund's initial purchase or the liquidation proceeds, depending on which is smaller.
- **Redemption Fees:** The redemption fee is deducted from the sales proceeds of the mutual fund, much like the deferred sales load fees, but it is applied differently. The deferred sales load fee is used to pay brokers that distribute the fund. The redemption fee is instead paid directly to the investment adviser to help cover the costs of redeeming the fund shares. The SEC limits redemption fees to no more than 2% of the fund's value.

Combinations of these different fees are used in creating the various share classes we will now discuss.

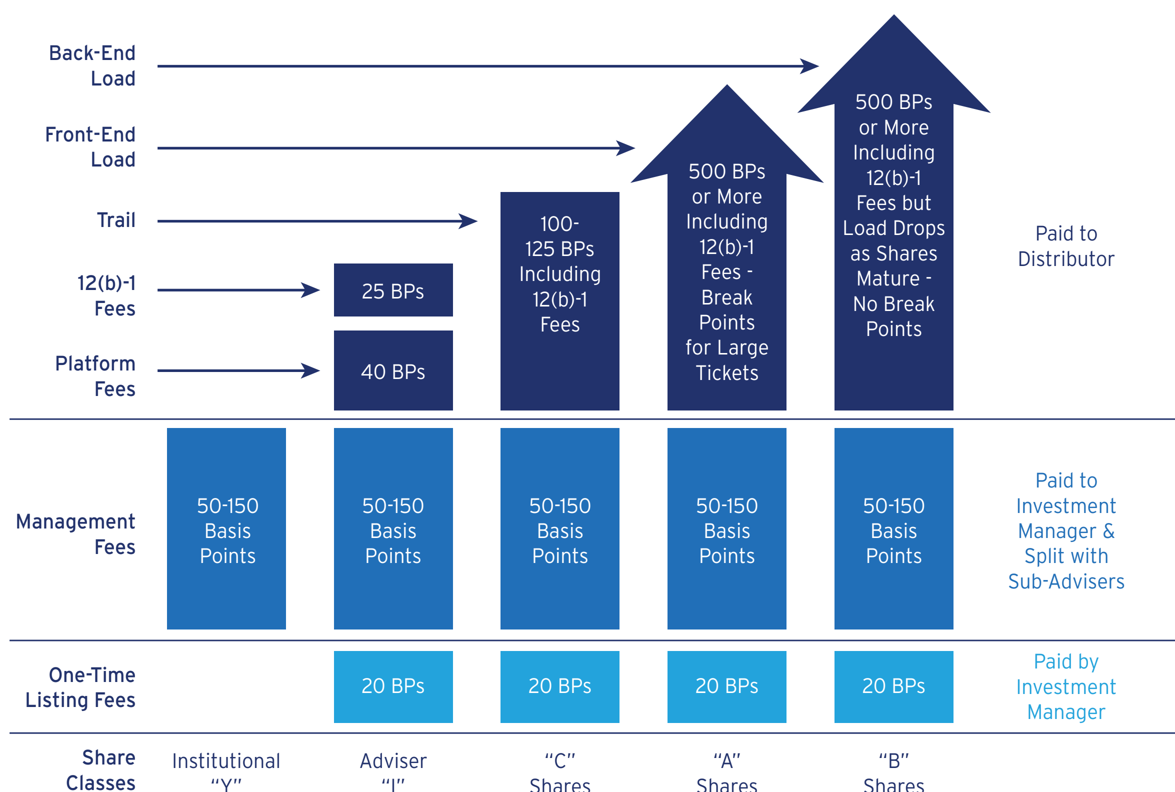
There are two types of institutional share classes that are not available to retail investors. The first is sold directly from the product manufacturer to an institution and is often known as the "Y" share class. The second is sold to wealth advisers who either have clients able to afford the large minimum purchase size (usually $5,000,000) or who have discretion over their client portfolios and can allocate a block purchase out across their set of accounts.

Institutional investors include banks, pension funds, insurance companies and investment funds. There is typically no load or trailer fees applied to an institutional share class and if the institution is buying directly from the product manufacturer, there may be no platform, marketing or 12(b)-1 fees. This is the lowest cost mutual fund product, and total fees may often approach 1.0% to 1.5% prior to other expenses. If a wealth adviser is purchasing these shares, there is usually a platform fee of 40 basis points, and some marketing fees included in the cost of the fund. There is also typically a one-time listing fee that the investment adviser pays to get onto the platform. The fees on these products can range from 1.00% to 2.15% on an ongoing basis. Chart 8 illustrates the set of fees associated with the institutional share classes.

The least expensive share class that can be accessed by the retail audience is the "C" share class. These share classes have a "level" load; i.e., they do not charge a front-end load and their trail is quite small, typically at 1.00%. That deferred load also vanishes if the investor holds the mutual fund for at least 1 year. The 12(b)-1 fees on these products can be quite large, however, making for a high overall expense ratio on the fund. This share class is favored by distributors that have entered into sub-advisery relationships with investment advisers in order to have them create products exclusively for their platform. Costs associated with promoting these products may be quite high, which is why the expense ratio can be so large. Broker-dealers with their own product platform (such as Merrill Lynch and Smith Barney) or a direct distributor (such as New York Life) are most likely to offer "C" shares.

By contrast, both Class B and Class A mutual fund shares are typically used by platforms that are directly accessed by retail buyers, such as mutual fund supermarkets or discount trading platforms. Class A shares have a front-end load that can be quite high, at times as much as 4.0% to 5.0% of the fund's value. They also have ongoing 12(b)-1 or marketing

Chart 8: Illustrative Open-End Mutual Fund Share Classes



fees that are assessed annually in addition to the management fee. All in, Class A shares can be in the range of 5.0% to 7.0% or more. If an investor puts in a sufficient amount of capital, it may be able to qualify for a breakpoint in its Class A fund purchase that allows them to qualify for a discount on the sales load. Class A shares are often seen as preferable for investors that have both a significant amount of investment capital and a long time horizon.

Class B shares usually have a deferred sales load, payable when an investor redeems their fund. The deferred sales load diminishes over time if the investor holds the fund for several years and can eventually convert to zero fee. When Class B shares reach this point they often convert to a Class A share, which is beneficial to the mutual fund owner because the annual marketing charges on Class B shares are higher than on Class A shares. There are no breakpoints on Class B shares regardless of the amount of capital the investor puts into their initial purchase, and the expense ratio on these shares is the highest of all the retail classes until the deferred sales load expires. Class B shares are seen as preferred vehicles if the investor has only a minimal amount of capital but plans on holding its purchases for an extended period; however, because of the high expense ratio, this is often not as popular a share class as the Class A and Class C shares.

Distribution Channels

There are multiple distribution channels that can be leveraged to access investors for publically traded alternative '40 Act funds. As shown in Chart 9, however, the choices available to the fund's investment manager are very much linked to the amount of capital in the fund.

Most new alternative mutual fund products launch with at least $20 million in capital provided by the sponsoring IM, and they begin by offering an institutional, or I, share class. Until a new fund surpasses $50 million in capital, distribution options are limited; it must consider either direct institutional sales or finding sponsorship within the RIA networks.

RIAs are individual wealth managers, each of which has discretion over its own client's pool of capital. Some RIAs are highly entrepreneurial and like to be in on new public fund launches as seed or as early stage investors, much like we see from many family offices in the hedge fund space. Accessing these RIAs typically requires a marketing relationship with a specialty firm. Outside this specialized group of early-stage investors, most RIAs operate as more traditional buyers. They will consider smaller funds for their clients, but often must be sold individually on the merits of the fund. Since there are literally thousands of such RIAs, this can be a daunting task without the right distribution relationships.

In 2011, Cerrulli Associates estimated that total assets controlled by RIAs, independent broker-dealers that operate like RIAs and dually registered representatives across the two types of entities totaled approximately $4.0 trillion. This is reported assets only, and the figure does not exclude potential double-counting with other channels. This potential asset pool and distribution approach is illustrated in Chart 9.

As a fund's AUM move up toward the $50 to $150 million zone, its distribution options expand. It is at this juncture that many alternative mutual funds add a C share class and begin to approach the wirehouses to be included on their sales platform. There are 4 main wirehouses in the U.S.—Morgan Stanley's Smith Barney network, Bank of America's Merrill Lynch network, Wells Fargo and UBS Wealth Management. The term wirehouse originated from the telegraph wires that were used to connect the many national branches of these firms to their headquarters and the exchanges.

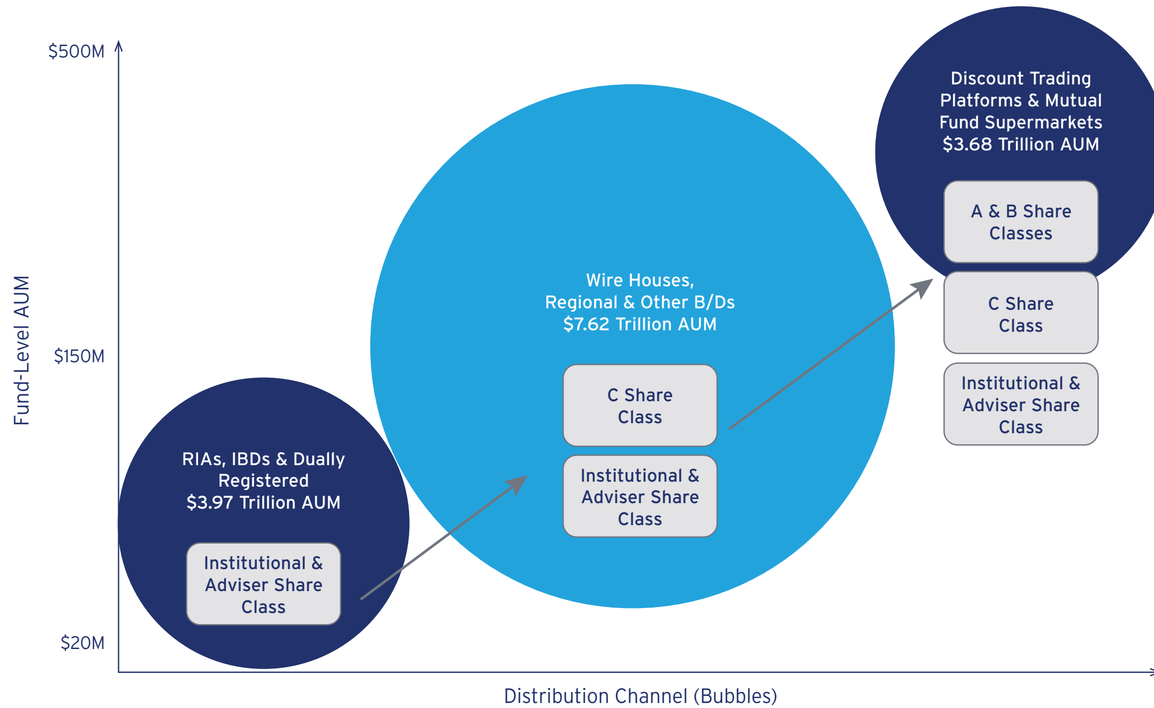
While more modern technologies have replaced the telegraph wires—which were considered an innovation at the time—the national reach of these wirehouses and large network of financial advisers at each of these firms still offer a powerful draw and an attractive source for accelerating capital-raising activities.

There is also an increase in the number of distribution platforms that mimic the national distribution networks of the original wirehouses. Bank broker-dealers and insurance company broker-dealers are additional outlets that each have their own distribution platforms and affiliated sales forces that can be used to promote alternative mutual fund products. Regional broker-dealers can also be an attractive option at this point in a fund's development, as they will often have extensive distribution teams within specific geographic locations.

Together, Cerrulli Associates estimated that these providers represented a total asset pool of $7.6 trillion, nearly double the size of the RIA, IBD and dually registered marketplace.

Finally, as an alternative mutual fund nears $250 to $500 million AUM, they can add their A and B share classes and begin pursuing the distribution platforms that are accessed directly by retail investors. Such distribution channels include the online brokerage

Chart 9: Open-End Mutual Fund Distribution Channels



Source: Citi Prime Finance Analysis.

firm platforms such as eTrade, TD Ameritrade, Charles Schwab and others, as well as the online mutual fund supermarkets that are typically sponsored by different asset managers that provide their investors the option to access multiple fund families from one sign-on location. Assets in this pool were listed by Cerrulli Associates at $3.7 trillion in 2011.

Marketing Strategy

The most important point for a hedge fund to consider when thinking about the marketing strategy for its alternative mutual fund products is that the investing audience is completely different from their traditional qualified investment purchaser (QIP) or institutional buyers. One illustrative quote we heard in gathering information on this space is that "hedge funds are bought, mutual funds are sold". This refers to the fact that there is a tremendous time and educational commitment required for those IMs interesting in offering alternative '40 Act product.

There are several paths a manager can take when deciding how to execute its marketing strategy, but all of these paths require the manager to have dedicated resources, either internally or externally, focused on the public investing audience and their advisers. To be successful in this endeavor, a fund manager will need senior management's commitment to this effort, and a well-understood brand strategy and marketing message that differentiates how the publically offered fund products differ from the manager's traditional private hedge fund offerings. If done successfully, the result of these efforts can significantly increase the firm's brand value in the marketplace and overall profitability of the management company.

One option is the commitment to expand their existing marketing function with a new team dedicated to the publically offered fund space. This approach has direct management company resource implications and bottom-line impact and, as such, may not be a good starting point as a hedge fund manager is considering its level of commitment to the publically offered fund space.

Other marketing strategies can make use of a range of strategic arrangements and relationships with existing distributors and fund sponsors. A manager may endeavor to simultaneously undertake more than one of these options to maximize its marketing and distribution efforts. Some of these decisions will be dictated by the fund's and manager's specifics dynamics, including size of fund, length of track record and strategy employed. We will explore some pros and cons of these options.

Build/Buy

The strategy that allows for the most control but requires the most commitment of time and resources by a fund manager is for a manager to develop its own wholesale distribution team. By building and hiring sales and marketing staff dedicated to selling alternative mutual funds, the manager is in control of the branding, messaging and development of its product. It has direct access to its investors and subsequently possesses greater understanding of their needs and requirements. Also, by developing these relationships directly, the manager is able to collect the full set of fees on the fund because it is not paying a portion of its fees to a third party for distribution.

Building or buying a wholesale distribution team will add to the manager's overhead and headcount expenses; the individuals comprising these teams will be full-time employees. Moreover, the individuals will be coming from a significantly different background in many instances, and may be accustomed to working at firms that are substantially larger than the typical hedge fund organization. This can cause cultural issues to surface. Finally, the number of resources required to focus on the publically traded fund space may be substantially larger than the hedge fund's traditional marketing team; the number of channels to be covered is substantially larger in the public domain, and the need for the sales force to be out in the field working across these channels is quite different from the "by appointment" nature of hedge fund sales.

Finally, this strategy can take a longer time to fully execute. The impact of adding individuals to focus on the publically traded fund space may be difficult to gauge until the team reaches a certain level of critical mass. Even if an existing wholesale team is acquired, integration into their new employer may be challenging.

Third-Party Marketers

Hiring a third-party marketing (TPM) firm is a strategy that requires less infrastructure and fewer dedicated management company resources to distribute alternative mutual funds. The fund manager does not employ additional people; instead, it engages with an existing firm with sales representatives that can distribute multiple products from multiple firms. TPM sales teams are registered representatives who have existing relationships with the target retail audience and RIA networks. This option of tapping into existing relationships of the TPM can be attractive to the fund manager as a way to speed their time to market and more quickly build the assets of their fund(s).

The fee arrangement with a TPM can be a retainer fee, a fixed percentage of assets raised or a combination of both. The asset-based fees apply to assets raised by the TPM, and are set either as a split of the management fees earned or as a fixed basis point fee on new assets raised.

A fund manager's degree of control and access to the TPM can be more limited in these arrangements, as the TPM may have multiple clients and will most likely be selling multiple products at any given time. Getting dedicated resources and attention from the TPM to sell your fund may prove challenging, because the fund manager is not in direct control of the sales team. Even if alternative mutual funds are positioned as better risk-adjusted solutions for retail investors' portfolios, TPMs may be more apt to promote the best-performing funds they represent. This may result in active product distribution being dependent on recent performance. Also, the branding and messaging of the fund and the asset manager are at risk of being lost on the end investor by introducing the TPM as an intermediary.

Mutual Fund Packagers

Another strategy is to work with a mutual fund packager that will assist in creating, structuring and packaging an alternative mutual fund in addition to actively distributing the fund. These firms provide the manager access to their existing fund structures for an off-the-shelf solution for fund creation. As part of this service, some of these platform providers will help with product design and construction while considering retail distribution needs and requirements. This design process will likely result in a product that is well-suited for the retail audience soon after launch.

Along with product design and creation, these firms also have distribution and wholesale teams that will promote the funds on their platform. Sales teams for these firms are knowledgeable about the benefits to an investor's portfolio of alternative mutual funds, and they have established relationships with the buyers of these funds including the RIA and wirehouse networks.

This strategy of working with a platform provider allows the manager to have some degree of control regarding the development of its alternative mutual fund product, but the ultimate responsibility for distribution and investor relationships still resides with the platform provider—not the manager. Some of these platforms co-brand these funds to leverage both their own and the hedge fund manager's brand and reputation.

Sign with a Fund Sponsor

The fourth strategy we want to discuss is the ability to connect with a fund sponsor that will promote funds to its large distribution networks under its brand umbrella. These fund sponsors typically promote established funds that have critical size and track records to their investor network. Because of their market brand and vast relationships with RIA networks distributing funds on their platform, fund sponsors can prove to be instrumental in raising significant assets for mutual funds.

For many fund sponsors to consider placing a fund on their platform, the mutual fund should have at least $200 million in assets in addition to the manager having significant assets under management in the same or similar strategy. This asset threshold is a validation test of sorts for the fund sponsor to justify offering the fund to their advisers. Also, these platforms typically work solely with funds that have an established track record that can help to provide the advisers with information on how the fund has responded to market conditions, even if only recent performance.

To get access to a fund sponsor's distribution network, the mutual fund may have additional fund fees, such as a platform fee, trailer fees and marketing fees (depending on the share class). These fees are paid directly from the fund to the fund sponsor. In addition, the fund manager may need to pay the sponsor a listing fee for accessing its clients. If agreed to with the fund sponsor, the fund manager may also provide the sponsor with a portion of the fund's management fee. This fee-sharing arrangement can be up to 50% of the management fee paid by the manager to the sponsor.

If the fund has the requisite assets and track record, by agreeing to the fee arrangements with a fund sponsor the manager's marketing strategy can be designed and executed while not committing to hire in-house wholesale marketing resources. The manager should, however, have resources to account for the continual updating and educating of the fund sponsors' financial advisers and investors.

Fund sponsor platforms are designed to be a full-service offering to their investor networks, so they need to have a full range of funds across assets classes, exposures and strategies. Connecting with a fund sponsor and providing its network of investors with a product that they do not currently offer, would likely prove valuable to raising assets for an alternative mutual fund manager. The burden of educating the sponsor's distribution agents on the attributes and benefits of the fund resides with the fund manager, which may entail regular contact and interaction with the sponsor's RIA networks.

Citi Prime Finance has developed a full set of resources that we can introduce across each of these models via our Capital Introductions & Business Advisory teams. Please contact us at prime.advisory@citi.com if you are interested in learning more about specific firms or if you are interested in accessing eligible individuals.

Conclusion

As illustrated throughout this guide, there are many areas that hedge fund managers must consider when thinking about expanding their product range into the '40 Act publically offered fund space. Such considerations include a broad set of products and specific restrictions on the types of investment techniques that can be used in each portfolio, new types of regulatory reports, compliance procedures and service providers, an entire range of share classes, a very different and resource-intensive distribution model and significant changes in the way they market their funds.

While this may seem daunting at first, the United States market for publically traded funds may be one of the largest remaining untapped pools of assets available for hedge fund managers to consider globally. In particular, retail investors in this market that have less than $5.0 million in net worth, and the wealth advisers that often have discretion over their accounts, have not had access to privately offered hedge fund strategies in the past. They see substantial potential in diversifying their portfolios to include funds that use hedge fund like techniques to create resiliency and stability in their portfolios, just as the institutional audience realized in the past.

Even many of the high net worth investors that do qualify for investment into privately traded hedge fund products may end up being interested in adding publically traded alternative '40 Act funds into their portfolios because of the 1099 versus K-1 tax treatment on such funds.

Citi Prime Finance stands ready to assist our clients in thinking through their approach to this marketplace and determining the right path for them going forward. Please contact us for additional information. http://www.citibank.com/icg/global_markets/prime_finance/business_advisory.jsp

Notes

Citi Prime Finance

New York 1.888.274.4650
San Francisco 1.415.617.8554
EMEA +44 (0) 207.986.3359
Hong Kong +852.2501.8353
Singapore +65.6432.1223
Sydney +612.8225.6424
Tokyo +813.6270.3165

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