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Risk Management Update
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ALTERNATIVE MUTUAL FUNDS

Alternative investments can be an attractive option for clients who wish to diversify their portfolios. Traditional alternative investments, such as limited partnerships and REITs, have long been used in this capacity. More and more, however, advisers are turning to alternative mutual funds as an affordable means to offer their clients this asset class.

Generally speaking, alternative mutual funds are made available either as an open-end mutual fund (which are priced daily), or as an Exchange Traded Fund ("ETF") (which is traded on the secondary markets). An alternative mutual fund usually holds non-traditional investments (such as real estate or commodities), and may employ hedging strategies, hold long and short positions, use derivatives and have complex trading strategies. Investment objectives for alternative mutual funds vary greatly, and because of their unique characteristics, the risks associated with these types of investments increase.

On June 11, 2013, the Financial Industry Regulatory Authority ("FINRA") released a New Investor Alert entitled "Alternative Funds Are Not Your Typical Mutual Funds"[1] (the "Alert"), which describes, the characteristics of such funds, the distinctions between alternative funds and hedge funds, and risks associated with such investments. This includes, among others:

Strategy Risks - Strategies employed by alternative funds may include long-short equity, merger arbitrage, and hedging and leverage through the use of options, futures and derivatives.

Investment Risks – Holdings may include futures, such as currencies, precious metals, and/or commodities and/or illiquid securities such as limited partnerships.

Investment Structure Risks: Due to the structure of the product, there may be less transparency or inability to reallocate, which could impact the performance of the fund. Moreover, dependent upon the strategy employed, there can be turnover risk that results in higher costs to the investor. Generally, operating costs also are higher than traditional mutual funds.

Market Risk / Limited Performance History: Many alternative funds have limited performance histories. For example, several funds may have been launched after 2008, so it is not known how they might perform in various periods in both up and down markets.[2]

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[1] *See* http://www.finra.org/Newsroom/NewsRelease/2013/P278031.
[2] *Id.*

The Investment Company Institute issued their 2013 Investment Company Fact Book,[3] which stated that there were a total of 7,596 mutual funds in 2012. Morningstar specifies that there were 357 alternative mutual funds available in 2012, with over half (207) created post-2008. As their popularity continues to rise, compliance departments need to become more familiar with alternative mutual fund products, including evaluating the inherent risks associated with this type of investment; assessing what internal controls the firm may wish to consider to monitor the sales of alternative mutual funds; and ensuring that supervisors have knowledge of the product.

When evaluating, establishing and implementing such controls, consider taking the following steps:

1. Perform in-depth due diligence on both the fund and its management team to assess potential risks associated with the investment.
2. Read the fund prospectus to understand the fund's strategy associated with the investment selections.
3. Determine whether the firm has the infrastructure and controls to survey alternative mutual fund transactions and enhance accordingly.
4. Assess which clients would be most suitable for each alternative mutual fund product.
5. Consider adding disclosures, as appropriate, to the firm's Form ADV that discuss the risks associated with those alternative mutual funds offered by the firm.
6. Carefully review and disclose, as appropriate, the fee structure that alternative mutual funds provide for daily liquidity, and the fact that a lower fee would be charged by a hedge fund, but a higher fee than would be charged by a traditional fund.
7. Perform periodic reviews of client portfolios which hold alternative mutual funds, to help ensure compliance with client's investment objectives and time horizons.

Conclusion

Broker- Dealer and Investment Advisory firms may be looking for innovative investment strategies that set them apart. Choosing to provide alternative products may accomplish this objective. Traditionally alternative products, such as private funds, were available only to high net-worth investors who are accredited investors or qualified purchasers with a high minimum investment requirement. With the emergence of alternative mutual funds in the marketplace, firms now have access to liquid alternative investments for their retail clients.

As the Securities and Exchange Commission ("SEC") has stated in its National Examination Program Priorities 2013,[4] released February 21, 2013, that their focus will include alternative mutual funds; therefore, firms should carefully evaluate their risk

[3] *See* http://www.ici.org/pdf/2013_factbook.pdf
[4] *See* http://www.sec.gov/about/offices/ocie.shtml

management controls for this product. Consider the guidance provided by the Alert, and assess the strength of the firm's policies and procedures relating to alternative mutual fund products.

For more information, or to learn about how Core Compliance & Legal Services, Inc. ("CCLS") may be of assistance with your annual review process and procedures, please do not hesitate to contact us at (619) 278-0020.

Author: Kris Gruben, Compliance Consultant; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.