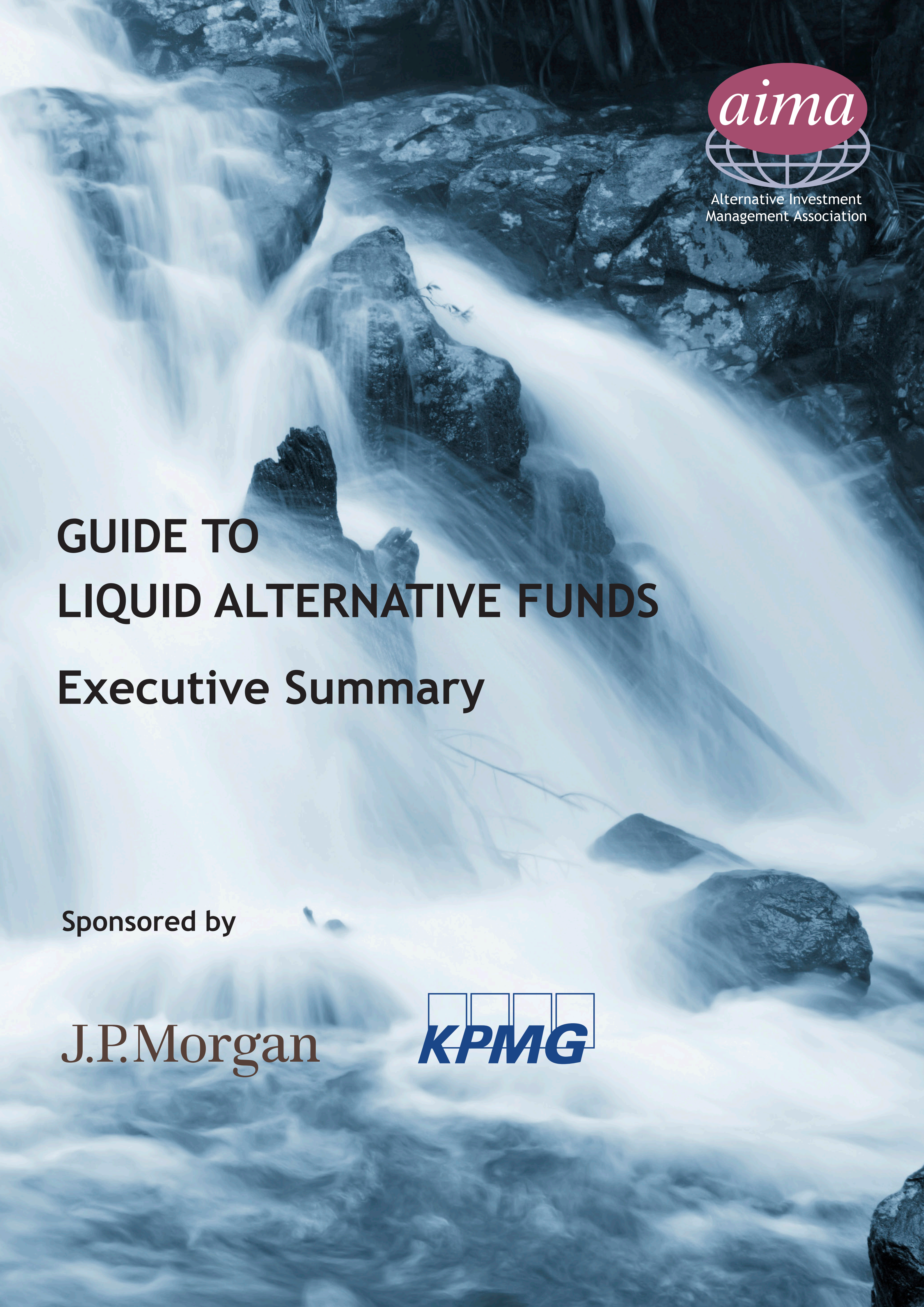

Alternative Investment Management Association

GUIDE TO LIQUID ALTERNATIVE FUNDS

Executive Summary

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Executive summary

The liquid alternative funds industry represents an opportunity for hedge fund managers to grow their asset base by accessing new sources of capital. According to a recent survey of hedge fund managers, 26% and 15% of respondents expect to develop at least one alternative UCITS and one alternative mutual fund, respectively, in the next five years.[1]

This Guide is designed for hedge fund managers that are considering adding a Liquid Alternative Fund to their product offering in the form of a UCITS or an AMF. Below is a brief discussion of each of the topics covered in the Guide and some overall considerations.

Investment strategy and liquidity considerations

Liquid Alternative Funds are required to offer more frequent liquidity than typical hedge funds. In practice, both AMFs and most UCITS offer their investors daily liquidity, even though there is more flexibility in this regard for UCITS. In the UCITS environment, a 10% bridge loan and gating are available to provide liquidity for redemptions. Depending on the strategy, Liquid Alternative Funds that tend to be un-correlated or negatively correlated to stock markets may turn out to have fewer liquidity issues than other types of UCITS or U.S. mutual funds.

UCITS and AMFs also have restrictions on the type of assets they can invest in, as well as limits on the use of derivatives and other means of creating leverage. Hedge fund managers will need to evaluate whether their strategy is suitable for a UCITS or an AMF format, and whether it can maintain an investment portfolio with sufficient liquid assets to meet the stringent liquidity requirements that exist under the UCITS and the AMF regimes.

Even though regulators have cut certain flexibility in terms of investment strategy in the aftermath of the financial crisis, most liquid alternative investment strategies can still be implemented under both regimes.

Regulatory regime, governance and operational infrastructure

Liquid Alternative Funds are highly regulated products. The selection of an appropriate fund structure is likely to be affected by the investment manager's intended strategy and distribution target. A variety of different vehicles are available to cater for market needs, especially in "fund hubs" like Luxembourg and Ireland.

Hedge fund managers are likely to find that managing a Liquid Alternative Fund will require an enhancement of the fund's compliance and operational infrastructure. The funds' regulatory framework may deeply affect many aspects of their operations, including, among others, the use of leverage and derivatives, collateral management, custody of assets and counterparty risk management. As an upside, investors may favour the robust legal framework of a Liquid Alternative Fund vehicle versus a hedge fund environment where the investment manager has often greater power to customise contractual terms.

Liquid Alternative Funds place significant reliance on the board as the party that is ultimately responsible for the fund's governance function. Regulators have emphasised the board's oversight responsibilities in a number of key areas, including most notably, valuation, conflicts of interest and communications with investors.

Liquid Alternative Funds require robust governance mechanisms also at the level of the investment manager. Investment managers that have in place the infrastructure required to address AIFMD, CFTC and/or SEC requirements are likely to find that, while there are additional requirements pertaining to Liquid Alternative Funds to consider, they will already have a strong basis to address those effectively.

Business strategy

Hedge fund managers should carefully consider their target investor base and their fund's distribution strategy. Alternative UCITS have traditionally targeted institutional investors in the EU, and, to a lesser extent, in Latin America and Asia, and can also be used as a vehicle for non-taxable U.S. investors. AMFs, on the other hand, have typically focused on the U.S. market. Both can be used to access retail capital.

Hedge fund managers that are planning to launch a Liquid Alternative Fund should be aware that conflicts of interests in the management of their fund entities may arise, for instance in critical areas such as valuation and the allocation and timing of trades. Even if there is an intent for funds to trade *pari passu*, Liquid Alternative Funds are unlikely to mirror perfectly the trades of their parallel hedge funds, if only due to the timing of trades needed to maintain liquidity and to respond to different redemption terms. Hedge fund managers should also make sure that their business strategy is adequately differentiated between their Liquid Alternative Funds and their hedge funds to help avoid the risk of cannabalisation of investors from one product to another.

Distribution

One of the major advantages of Liquid Alternative Funds over hedge funds is the ability to access large and sophisticated distribution networks, which can help to grow an investment manager's asset base significantly. In order to access a broad market, a Liquid Alternative Fund will most likely have to "fit" into the product range of fund "supermarkets", distribution platforms or other mass distribution channels, which will likely involve extensive cooperation by the investment manager with the parties that control the distribution function.

Different types of platforms are available to assist investment managers in implementing a Liquid Alternative Fund. Whether to use any of these platform services depends on the individual investment manager's business strategy. For example, a stand-alone fund may be a viable option for investment managers that are planning to have a permanent and large presence in the markets where their investors are located.

[1] AIMA-KPMG-MFA, *Growing Up, A New Environment for Hedge Funds* (2015).

Revenue streams and costs

Liquid Alternative Funds provide investment managers with the opportunity to significantly grow their asset base and profitability, primarily through the investment management fees that are based on assets under management. On the other hand, legislators in the U.S. have placed significant restrictions on the investment manager's ability to charge performance based-fees. In the UCITS space performance fees are generally available, but increasingly uncommon. In terms of costs, the opportunity for economies of scale is significant, and ultimately may results in cost savings above a certain asset-level, which varies depending on the type of strategy and jurisdiction.

Role of service providers

Liquid Alternative Funds are likely to rely on a broader range of service providers for their operations than typically found in a hedge fund environment. In the hedge fund space, the use of prime brokers is fairly common; for UCITS however in reality only synthetic prime brokerage arrangements are permissible and the custody rules applicable to AMFs likewise limit traditional prime brokerage.

A third party valuation services provider is likely to be involved in the valuation process for Liquid Alternative Funds. Custody rules often require reliance on a party separate from the prime broker for safe-keeping of assets. An investment manager may also choose to rely on fund-platforms for a subset of their service provider needs.

Tax and financial reporting considerations

Liquid Alternative Funds are broadly tax neutral. Distribution into certain on-shore jurisdictions, however, may de facto require the fund to file tax reports locally. Liquid Alternative Funds are subject to financial reporting requirements in their local jurisdiction which are generally more extensive and frequent than the requirements applicable to private funds.

Summary considerations

Liquid Alternative Funds provide the opportunity to participate in a fast growing area of the alternative investment industry, and can be a significant source of new capital and revenue for investment managers. As investors continue to look for ways to increase the liquidity and risk-adjusted performance of their portfolio, Liquid Alternative Funds may offer a suitable vehicle to achieve such objectives in a robust regulatory environment that is designed to enhance investor protection.

Contents of the Guide -

This Guide covers a variety of topics that include:

- **Investment strategy considerations**
- **Fund structures**
  - Corporation, trusts and contractual structures
  - Multiple sub-funds/series and share classes
  - Master-feeder funds
- **Governance**
  - Board composition
  - Board governance and responsibilities
- **Investment management function**
  - UCITS management company
  - Investment manager
- **Regulatory framework affecting investment considerations**
  - Liquidity of investments
  - Investment universe - UCITS
  - Investment universe - AMFs
  - Use of derivatives
  - Diversification requirements and concentration
  - Leverage
- **Redemptions**
  - Redemption requirements
  - Redemption barriers, discouragements and suspensions
  - Redemption fees
- **Valuation**
  - Introduction
  - Accounting framework
  - Valuation process
- **Investment performance**
  - Introduction: Regulatory framework
  - Starting a fund: Use of related performance
  - Benchmark selection
  - Performance in marketing materials
- **Managing hedge funds and UCITS/AMFs**
  - Effect of new products on existing strategies
  - Conflicts of interest
- **Risk management**
  - Risk management process
  - Liquidity risk management
  - Leverage risk management
  - Counterparty risk management
  - Other considerations
  - Conflicts of interest in risk management
  - Consistency of policies
- **Fees**
  - Investment management fees and operating costs
  - Performance fees
  - Fees and multiple share classes
- **Expenses**
  - Costs
  - Break-even and synergies
  - Who bears the costs? Fund or investment manager?
- **Other service providers**
- **Distribution and types of potential investors**
  - General distribution considerations
  - UCITS specifics
  - AMF specifics
- **Distribution and own infrastructure/platforms/multi-manager funds**
  - Own infrastructure
  - Platform
  - Multi-manager funds
  - Multi-manager funds/platforms - Decision points
- **Tax considerations**
  - UCITS tax considerations
  - AMF tax considerations
- **Reporting**
  - UCITS reporting
  - AMF reporting
- **Fund set up and registration**
  - Setting up a UCITS
  - Setting up an AMF
- **Regulatory scrutiny, enforcement and future regulatory change**
  - UCITS developments
  - AMF developments
  - Future regulatory change

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- Guide to Liquid Alternative Funds
- Guide to Managed Accounts *
- Implementing MiFID II *
- Side Letter Guidance

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* *Forthcoming* ^ *Update in progress*

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About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,600 corporate members in over 50 countries. AIMA has an active influence in policy development and provides leadership in industry initiatives such as educational programmes and areas of sound practices. AIMA has developed long-term relationships with regulators worldwide and has built a close collaboration with many investors in alternative funds.

AIMA provides a vibrant global network for its members. Its primary membership is drawn from the alternative funds industry whose managers pursue a wide range of modern asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

For further information, please visit AIMA's website, www.aima.org.

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The Guide is not a substitute for specific advice, whether legal, regulatory, tax or other advice, nor for professional judgement. It does not seek to provide detailed advice or recommendations on the wider ranging corporate governance issues.