# Chapter 2: The Environment of Alternative Investments

## Demonstrate knowledge of participants in the alternative investing environment.

* Identify buy-side participants, and describe their roles in the alternative investing environment

Def **buy** **side** refers to the institutions and entities that buy large quantities of securities for

the portfolios they manage

Def **sell** **side**: focuses on distributing securities to the public

Examples of buy side institutions with emphasis on perspective of alternative investing

1. **Plan** **sponsors**: designated party, such as a company or an employer, that establishes a health care or retirement plan (pension) that has special legal or taxation status
2. **Foundations** and **endowments**: a foundation is non-for-profit organization that donates funds and support to other organizations for its own charitable purposes. An endowment is a fund bestowed on an individual or institution to be used by that entity for specific purposes and with principal preservation in mind
3. **Family office and private wealth:** family office and private wealth institutions are private management advisory firms that serve ultra high-net-worth investors; family office is a group of investors joined by familial or other ties who manage their personal investments as a single entity, usually hiring professionals to manage money for members of the offices
4. **Sovereign wealth funds:** state-owned investment funds held by state’s central bank for the purpose of future generations and or to stabilize the state currency
5. **Private limited partnership:** form of business organization that potentially offers benefits of limited liability to organization’s limited partners, but not to its GP
6. **Private investment pools:** HF, FoF, PE funds, managed futures funds, CTAs, that focus on serving as intermediaries between investor and alternative investments; LP are investors; while GP manages the fund
7. **Separately managed accounts:** SMAs are individual investment accounts offered by a brokerage firm and managed by independent investment management firms. SMAs can be thought of as being similar to pooled investment arrangements, such as mutual funds, in that a customer pays a fee to a money manager for managing the customer’s investment. There are 5 differences
8. A fund investor owns shares of a fund, whereas SMA investor actually owns the invested assets a owner on record
9. A fund invests for common purpose of multiple investors, whereas SMA may have objectives tailored to suit the specific needs of its only investor, such as tax efficiency
10. A fund is often opaque to its investors to promote confidentiality; while a SMA offers transparency to its investors
11. Fund investors may suffer adverse consequences from other investor’s redemptions (withdrawals) and subscriptions (deposits), but SMA provides protection from these liquidation issues for its only investor
12. Fund structure allow investors to have limited liability, SMA format may allow losses to be greater than capital contribution when leverage or derivatives are used
13. **Mutual** **funds** (**’40** **Act** **Funds**): registered investment pools offering their shareholders pro rata claims on fund’s portfolio of assets.
14. **Master** **LP** (**MLPs**): publicly traded investment pools structured as LP and offer owners pro rata claims; MLP are traded in major stock exchange, but have legal and tax structures similar to those of private LP

* Identify sell-side participants and describe their roles in the alternative investing environment

Sell-side institutions includes large dealer banks and brokers

1. **Large** **dealer** **banks**: major financial institutions that deal in securities and derivatives; Large banks also have large asset management divisions that cater to investment management needs of institutional and wealthy individual clients. It involves custody of securities, cash management, brokerage, and investment in alternative investment vehicles

The role of large banks in primary market is to intermediate between issuers and investors, to provide liquidity, and to act as underwriters of investments. In 2nd securities markets, large dealer banks trade with one another and with brokers/dealers directly over the computer or phone, as well as play an intermediating role of facilitating traders

1. **Brokers**: retail brokers and receive commissions for executing transaction and that have research departments that make investment recommendations. Advantages: expertise in trading process, access to other traders and exchanges, and ability to facilitate clearance and settlement

Def **house** **account**: the brokerage firm’s proprietary trading operations involve firm’s own account. The major cost of running brokerage firm: labor: the brokers and other employees who provide firm’s services to clients

* Identify outside service providers and describe their roles in the alternative investing environment

1. **Prime** **brokers**: allow an investment manager to carry out trades in multiple financial instruments at multiple broker-dealers while keeping all cash and securities at a single firm. Primary functions: clearing and financing trades for its client; providing research; arranging financing; producing portfolio accounting
2. **Accountants** and **auditors**: provide services to HF or to another alternative investment fund should include an experienced auditor and tax adviser
3. **Attorneys**: help determine best legal structure for a fund’s unique investment strategies, objectives, and desired investors. The attorney takes care of filing any documents required by government (federal or other levels) and creates the legal documents necessary for establishing and managing a HF and other investments, including: private-placement memo; partnership agreement; subscription agreement; and management company operating agreement
4. **Fund** **administrators**: responsible for bookkeeping, 3rd party info gathering, and securities valuation functions for all of their funds, both onshore and offshore. They maintain a general ledger account, marks the fund’s books, maintains its records, carries out monthly accounting, supplies its monthly P/L statements, calculate returns…
5. **HF** **infrastructure**. It may have 3 main components: platforms; software; data providers
6. **Consultants**: to provide a number of roles and services that center on advice, analysis and investment recommendations
7. **Depositories** and **custodians**: very similar entities that are responsible for holding their clients’ cash and securities and settling clients’ trades. Depository Trust Company (DTC): principal holding body of securities for traders all over world and is part of DTCC, which provides clearing, settlement and information services
8. **Banks:** commercial banks focus on accepting deposits and making loans, with modest investment-related services. An investment bank focuses on providing sophisticated investment services, including underwriting and raising capital, as well as brokerage services, mergers, and acquisitions

## Demonstrate knowledge of the financial markets involved in alternative investments.

* Define primary capital markets, and describe their roles in alternative investments

New issues are sold in primary capital markets and distributed by an underwriter

Another source of securities issued in primary capital markets is securitization, which involves bundling assets, especially unlisted assets, and issuing claims on bundled assets.

* Define secondary capital markets, and describe their roles in alternative investments

After their initial offering, many securities are traded in secondary capital markets, which provides greater liquidity and a continuous flow of price information.

* Define third, fourth, and private markets, and describe their roles in alternative investments

Def **third** **markets**: regional exchange where stocks listed in primary secondary markets can also be traded. Third markets represent a segment of OTC market where non-member investment firms can make markets in and trade securities without going through exchange

Def **fourth** **market**: electronic exchanges that allow traders to quickly buy and sell exchange-listed stocks via electronic communications systems offered by these markets

## Demonstrate knowledge of the regulatory environment as it applies to alternative

**investments**

* Define and explain the concept of systemic risk

Systemic risk is the potential for economy-wide losses attributable to failures or concerns over potential failures in financial markets, financial institutions, or major participants

* Recognize the four primary forms of hedge fund regulation

1. Requirements regarding establishing a hedge fund, including registration, licensing, minimum capital, and waiting periods

2. Registrations or restrictions on investment advisers and hedge fund managers

3. Restrictions on distribution and marketing of hedge funds, including which marketing channels may be used (e.g., banks), whether advertising is permitted, and to whom funds may be sold

4. Restrictions on operation of a hedge fund, including leverage, liquidity, risk, reporting, and location of outside service providers

5. Requirements regarding ongoing reporting

HF may also be subject to varying levels of taxation and to special taxes, fees, or licensing costs

* Describe key components of U.S. regulations affecting securities issued to the public, including exemptions commonly applied to hedge funds

US regulation of HF registrations may be divided into 2 areas

1. Regulation of securities issued to public (primary market): offers to sell securities are regulated by US Securities Act of 1933 (Securities Act). In US, HF are not registered, but must register as investment advisor with SEC. The only exemption is base don size
2. Regulation of advisors to investment pools Investment: US Investment Company Act of 1940 (the ’40 Act). Advisers have an obligation to act in best interest of client, disclose to client all facts that the client might consider relevant, employ a reasonable degree of care in provision of their advice, and avoid misleading clients through either misstatements or omissions of relevant facts

Def **soft** **dollar** **arrangement**: refers to an agreement or an understanding by which an investment adviser receives research services from a broker-dealer in exchange for a fee => soft dollar must be disclosed to clients

Def **Regulation T margin rule**: Fed requires a deposit of at least 50% of purchase cost or short sale proceeds of a trade (margin)

* Describe key components of European regulations affecting hedge funds, and recognize major European regulatory institutions

Undertakings for Collective Investment in Transferable Securities [UCITS]: are carefully regulated European fund vehicles that allow retail access and marketing of HF-like investment pools

Markets in Financial Instruments Directive [MiFID]: EU law establishes uniform regulation for investment managers in European Economic Area. MiFID is one of primary pieces of European legislation dealing with regulation of investment services, including management services

* Describe key components of hedge fund regulations outside the United States and European Union, and recognize major regulatory institutions in these regions

**UK**: FCA and Prudential Regulatory Authority are primary regulators of investments. UK is the European center for HF management

**France**: AMF, which allows 3 types of HF: FoF, unleveraged funds, and leveraged HF

**German**: BaFin, which regulates HF closely

**Switzerland**: FINMA. S is a major world banking center, playing a modest role in HF world

**Australian**: ASIC, do not regulate HF differently from other managed funds

**Brazil**: CVM, which regulates funds through classification system and controls eligible investors, valuation standards, and reports

**Canada**: most HF are distributed as principal protected notes, which can provide retail access to HF. CAS regulated registration of advisers, registration of dealers

**Japan**: FSA, which regulates relatively loose of HF

**Singapore**: MAS, whose regulations have been loosened these years

**South** **Africa**: introduced regulation in 2008; not access to retail; Taxation treatment unclear

United Arab Emirates: part of GCC (Gulf Cooperation Council). GCC seeks cooperation and agreement among its member states to harmonize regulation and taxation. Taxes are almost 0

## Demonstrate knowledge of liquid alternative investments.

### Define liquid alternative investments

Def **liquid** **alternatives** are investment vehicles that offer alternative strategies in a form that provides investors with liquidity through opportunities to sell their positions in a market

### Recognize the five distinct types of liquid alternative investments

1. **Unconstrained** **clones**: These liquid funds follow virtually the same strategy as private placement products with underlying liquid assets, such as some hedge funds or managed futures funds
2. **Constrained** **clones**: These liquid funds implement a similar strategy as private placement products but are limited in risk exposure by leverage, concentration, or liquidity constraints
3. **Liquidity**-**based** **replication** **products**: These liquid funds are designed to mimic illiquid private placement investments, using liquid securities as proxies
4. **Skill**-**based** **replication** **products**: These liquid funds are designed to mimic a highly skilled private placement strategy using a simplified and more mechanical strategy
5. **Absolute** **return** or **diversified** **products**: These liquid funds are designed to offer absolute returns and/or diversifying returns not directly related to opportunities historically available in private placements and potentially inconsistent with alternative strategies as typically deployed.

### Describe the factors driving the growth of liquid alternative investments

1. Retail investors are projected to continue to diversify into alternative strategies to lessen their percentage exposure to traditional stock and bond strategies if traditional asset market continue to offer historically low interest rates and high equity valuations
2. Shift of retirement assets from a focus on defined benefit plans to defined contribution plans means that retail access to alternative investments will increase

### Recognize regulatory constraints that affect liquid alternative investments

Some alternative investments strategies appear unable to be implemented through liquid retail structure, such as US mutual funds

1. Sophisticated HF strategies often require substantial use of leverage, which is restricted within US mutual funds by regulation. 300% asset coverage rule to mutual fund
2. Regulatory constraints on concentration (i.e. lack of diversification)
3. Illiquidity constraints (e.g. <= 15% of mutual fund can be invested in illiquid assets)

Def **HF** **replication**: attempt to mimic the returns of an illiquid or highly sophisticated HF strategy using liquid assets and simplified trading rules

### Recognize the main reasons that contribute to differences between the returns of private placement vehicles and those of liquid alternatives

Returns from private placement vehicles and liquid alternatives may differ primarily due to 4 important factors (2 about flexibility; 2 about fees)

1. Permissible investment strategies differ. Private placements often enjoy important flexibility w.r.t. leverage (magnitude of short positions) and concentration (lack of diversification)
2. Investment flexibility to hold more illiquid assets, potentially receive higher liquidity premiums
3. Fees differ between liquid alternatives and private placements. Liquid alternatives tend to have lower fees because most do not have incentives fees, especially asymmetric incentive fees wherein managers benefit from sharing upside profits but are limited in their exposure to downside losses
4. Managerial skill may differ. The higher potential fees from asymmetric incentive fees of private placements may attract managers with greater skill. Some liquid alternative funds implement simplified trading rules rather than hiring sophisticated management teams

## Demonstrate knowledge of taxation of investments

* Recognize income tax conventions

1. **Progressive** **taxation**: higher percentage taxation on individuals and corporations with higher incomes
2. **Deferred** **taxation**: investment income taxes are not assessed until the funds are withdrawn or distributed
3. Taxation of interest and dividends is generally assessed in the period in which the dividends and interest are distributed. Capital gains tend to be taxed when realized <= cash basis

* Recognize non–income tax conventions

1. Real estate tax: assessed by local jurisdictions to fund local services such as schools, and governmental services such as law enforcement
2. Estate tax: high for wealthy individuals
3. Value-added tax