Occupy the SEC

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November 25, 2014

Mary Jo White
Securities Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: The Commission's Investigation Into "Liquid Alternative" Mutual Funds and Accompanying Rulemaking

Dear Ms. White,

Occupy the SEC[1] ("OSEC") is pleased with recent reports that the Securities and Exchange Commission ("SEC") has begun a sweeping investigation into the potential risks that so-called "liquid alternative" mutual funds present to investors and the economy. The SEC is taking an important step towards becoming proactive as opposed to reactive in addressing market risks by these funds.

Background

The impetus behind the proliferation of liquid alternatives is understandable and apparent. The Federal Reserve has implemented quantitative easing policies that have kept interest rates low (with the aim of promoting real job growth and economic output). As a consequence of this low-interest rate environment, asset managers have had to deal with low yields across product classes. Alternative investment strategies therefore seem to be attractive options for these yield-hungry managers. Naturally, the SEC has come under pressure from the asset management industry and its agents to loosen the regulatory reins on mutual fund regulation so as to broaden access to high-yield alternatives.

Nevertheless, the SEC must remain vigilant in protecting mutual fund investors and others affected by fund activities. It is vital to recognize that a low-yield environment does not necessarily equate to a low-risk environment. Notwithstanding the incremental expansion of

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[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.

regulatory oversight under Dodd-Frank, "financial innovation" has continued unabated such that the markets are rife with extremely complicated and opaque financial instruments. There is no bona fide market for many of these products - they are plainly illiquid. Many others are only ostensibly liquid - benefiting from a robust market that flourishes during normal times but *vanishes during times of stress*. The demise of Lehman Brothers testifies to the fact that seemingly robust markets can evaporate at the exact moment that their robustness is most crucial for overall financial stability. Exposing retail investors (or pension funds acting on behalf of lay investors) to these fickle "alternative investment" markets is, frankly, a recipe for disaster.

In light of the causative role that "high-yield" financial instruments played in the last financial crisis, it would behoove the SEC to be wary of expanding their availability to mutual fund investors. According to one industry estimate, alternative assets are expected to grow by 9% a year, reaching $20 trillion by 2020.[2] The SEC must take strong steps to firmly seal this Pandora's box before it grows to be too unwieldy for effective management.

We urge to SEC to promulgate regulations that prudently circumscribe the availability of alternative investment strategies to mutual funds. In particular, we wish to highlight the following areas of concern:

Liquidity Requirements Under the Investment Company Act

Under the Commission's mutual fund guidelines, a "liquid" position is one that can be liquidated "in the ordinary course of business within seven days." *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-1612 (Mar. 12, 1992). We contend that firms' use of a seven-day termination window for sale of derivative instruments cannot by itself transform an illiquid instrument into a "liquid" one. Liquidity is not a matter of mere contractual convenience. For instance, the SEC itself has typically accounted for broader market conditions in assessing liquidity.[3] In evaluating liquidity under these circumstances, the SEC must account for the full notional value of instruments such as credit default swaps ("CDS") and corporate bonds, which can suffer from transient market conditions. We recognize that some instruments such as futures and options are less prone to measurement difficulties and that Dodd-Frank is likely going to result in some degree of transparent exchange trading. The difficulty in measuring the value and risk associated with exotic instruments such as CDS, however, has resulted in reliance on private, for-profit institutions for ratings of these instruments. There is an inherent conflict in that ratings structure because of the role that ratings committee members play in issuing and trading such instruments. This set of conflicts is an untenable web that inhibits proper measurement or ascertainment of the **real risks and valuation** that these instruments present.

The Investment Company Act of 1940 ("1940 Company Act") requires that mutual funds limit the number of illiquid securities in the portfolio to 15% of net assets, calculate Net Asset Value

[2] PWC, *Asset Management 2020: A Brave New World* (Dec. 2013)
[3] Mark Perlow & Matthew Rich, *Alternative Mutual Funds: Current Issues in Compliance and Risk Management*, Practical Compliance & Risk Management for the Securities Industry, *fn9, Sept-Oct. 2014 (citing Letter from Arthur Levitt, Chairman, SEC, to Edward J. Markey and Jack Fields, Representatives, U.S. Cong., at 2, n. 2 (Sep. 26, 1994) (the letter and the accompanying memorandum convey the SEC derivatives study), http://www.sec.gov/news/studies/deriv.txt).

on a daily basis, and satisfy redemption requests on a daily basis.[4] Our concern is that many liquid alternatives will not be able to meet these requirements *during times of stress*. During its investigative sweep, the SEC must test compliance with 1940 Company Act liquidity requirements not only under current conditions, but also under unforeseeable tail event scenarios. As noted above, markets that appear to be stable during normal conditions may virtually disappear with little notice during times of stress. Complicating matters is the fact that many alternative investments cannot be reliably valuated for a host of reasons including structural complexity, financial and legal barriers to entry of market participants, and high capital costs. Many liquid alternatives operate in markets that are simply not robust enough to allow for daily redemptions or even daily valuation. Further, even if a particular liquid alternative meets liquidity requirements today, will it necessarily do so tomorrow?

Material Misstatements in the Marketing of Liquid Alternatives

Liquid alternatives are currently being marketed to retail investors as financial chimeras - promising high yields on the one hand and stability borne of the 1940 Company Act's stringent liquidity requirements on the other. Our concern is that many of these promises are indeed chimerical. The 1940 Company Act's liquidity requirements were implemented for the express purposes of keeping yields (and risk) low. Some financial assets are winners and others are losers. A truly diversified and liquid portfolio can hardly be expected to greatly outperform the market (in the absence of insider information). Yet, liquid alternatives are being purveyed as both low-risk and high-reward. Are investors being misled? Our concern is that they are. If the expansion of liquid alternatives truly constituted a stunning advance in risk-less profitability, the mutual fund industry would not be stagnating vis-à-vis the S&P 500. The reality is that most mutual funds actually underperform this baseline index, even before management fees are considered.[5]

Liquid alternative funds may not be in compliance with Rule 35d-1, which requires that mutual funds adopt appropriately descriptive names.[6] Given the numerous restrictions on liquidity and leverage that the 1940 Company Act imposes on mutual funds, "liquid alternative" funds may have little leeway to truly separate themselves from more traditional mutual funds. Thus, their self-description as "alternatives" may prove to be misleading. At the same time, liquid alternative mutual funds having names portraying a sense of safety or stability may not be in compliance with Rule 35d-1, given the inherent riskiness of many truly "alternative" investment strategies.

Leverage Requirements Under the 1940 Company Act

The 1940 Company Act prohibits mutual funds from issuing senior debt, with the aim of protecting the distribution rights of fund investors (shareholders) in case of bankruptcy.[7] By investing in highly leveraged derivatives and short sales, liquid alternative funds expose their investors to similar risk of loss.

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[4] *See, e.g.*, Investment Company Act Release No. 18612 (Mar. 12, 1992).
[5] *See* Vanguard, *The Mutual Fund Graveyard: An Analysis of Dead Funds* 2 (Jan. 2013).
[6] *See* 17 C.F.R. § 270.35d-1.
[7] *See* 1940 Company Act, Sec. 18(f).

The SEC has permitted mutual funds to expose themselves to such highly leveraged instruments so long as the fund maintains offsetting assets sufficient to cover those exposures. Unfortunately, the SEC has also allowed funds to meet this offsetting requirement by only posting an amount equal to mark-to-market margins (instead of the full exposure).[8] This approach is doubly flawed. First, "offsetting" assets may not truly be perfect hedges for the exposures taken on by the fund. Pure investment banks (and not mutual funds holding retail investors' money) are the kind of entities that should be concerned about mismatched exposures and "basis risk." Second, mark-to-market methodologies may prove to be grossly inaccurate in pricing exposures, especially under stress conditions. Consequently, any margins posted as the result of a margin call may be wholly inadequate to offset a fund's eventual borrowing exposures. The proliferation of liquid alternatives is especially troubling in this context given that alternative instruments can be notoriously difficult to price or sell during troubled times.

The 1940 Company Act was passed with the express intention of limiting investor risk arising from leveraged risk-taking by mutual funds, and the SEC's indirect borrowing scheme (especially as it is applied to liquid alternatives) flies in the face of that Congressional intent.

Portfolio Requirements

The Commission should be wary that alternative mutual funds may not be in compliance with the 1940 Company Act's diversification and principal business requirements. A fund is required to maintain status as a diversified or non-diversified fund, with certain tax consequences if it is not diversified.[9] Diversification requires that at least 75% of assets are in stocks, bonds, or cash, with no more than 5% of total assets or 10% of voting securities of an issuer.[10] The fund must also declare its policies regarding operations in a certain industry and is regarded as concentrated if more than 25% of assets are invested within that industry.[11]

We contend that if covered parties measure their diversification through mark-to-market as opposed to notional values, they may have an insufficient range of investment and capital to be able to contend with the pressures that a sudden collapse in prices would entail. We recommend that the concentration limit under Rule 12d3-1 should also be effectively deployed to limit the extraordinary risk posed by high concentrations of CDS or other alternative investments.

Similarly, we urge the SEC to remain vigilantly aware that "liquid alternatives" typically involve investments in shallow, illiquid markets featuring few competitors and high levels of counterparty risk. As the Lehman crisis made clear, the claims of counterparties can often be so tightly interconnected that they cannot be unraveled.

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[8] *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979).
[9] *See* 1940 Company Act, Sec. 8(b).
[10] *Id*. at Sec. 5(b).
[11] *Id*. at Sec. 8(b)(1).

Incapacity of Private Fund Managers to Comply with 1940 Company Act Requirements

In order to understand the fundamental nature of liquid alternative funds, it is useful to remember the historical distinction between private funds and mutual funds. Mutual fund managers are generally familiar with the 1940 Company Act's requirements, and have developed sophisticated compliance and recordkeeping systems to effect compliance with applicable regulations. Hedge and private fund managers, in sharp contrast, have until recently operated nearly free of regulation, but for the most basic restrictions like Rule 10b-5. Most private fund managers simply have no experience in complying with the 1940 Company Act.

Unfortunately, liquid alternative funds are largely managed by managers with private fund experience. Thus, we expect that many, if not most liquid alternatives are grossly noncompliant with the 1940 Company Act's strictures. Such a scenario would be troubling even if liquid alternative funds invested in the stablest securities like U.S. Treasuries. The fact that they actually invest in some of the most unmarketable securities available only serves to compound their danger to retail investors. Even more vexing is that fact that hedge funds both underperform and fail at higher rates than mutual funds.[12]

New players in the alternative funds market may lack the capability to institute the array of compliance measures, such as daily reporting, measurement, and custody requirements, that are required under the1940 Company Act.

More significantly, they may also lack effective risk-management tools to gauge risk and prevent calamitous drops in earnings. These problems may be especially common where funds invest in markets without extensive history or significant trading volume and for which information is either opaque or vulnerable to the manipulation of insiders. Indeed, there are problems with predicting the performance of alternative instruments even in instances where there is reliable market data.[13]

Retail investors seeking to sail safely through turbulent financial waters should not be forced to deal with the Scylla of unprofitability or the Charybdis of regulatory inexperience on the part of liquid alt managers. The 1940 Company Act was passed to create a safe harbor for retail investors, and the SEC must not allow yield-seeking managers to circumvent that statute's protections.

Protecting All Investors Through Fiduciary Requirements

Securities law generally imposes relaxed requirements when the investor in question is sophisticated or has high net worth. We see this area of loosened regulation as a weak point in

[12] *See* Tyler Durden, *88% of Hedge Funds, 65% of Mutual Funds Underperform Market in 2012*, Jan. 5, 2013, http://www.zerohedge.com/news/2013-01-05/88-hedge-funds-65-mutual-funds-underperform-market-2012.

[13] *See, e.g.*, Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, Fed. Res. Bank of New York Economic Policy Review (April 1996) (noting incongruities between VaR modeling and actual conditions). VaR risk measurements often suffer from foundational failures, especially in light of changed conditions. *See* Taleb, Nassim Nicholas, Canetti, Elie R.D. , Kinda, Tidiane, Loukoianova, Elena & Schmieder, Christian, *A New Heuristic Measure of Fragility and Tail Risks: Application to Stress Testing* (August 2012) IMF Working Paper No. 12/216, *available at* http://ssrn.com/abstract=2156095.

the overall structure of mutual fund regulation. The Long Term Capital Management debacle lays testament to the fact that the failure of a single, highly-sophisticated investor can threaten the entire financial system. We are concerned that allowing such investors, however sophisticated, to enter into illiquid markets endangers their financial well-being and moreover poses broader challenges to the maintenance of the financial system.

Investment advisors owe a fiduciary duty to their clients under the Investment Advisers Act of 1940, including both duties of care and loyalty.[14] These duties apply regardless of who the client is. The SEC can avoid the worst consequences of alternative instruments in mutual funds by ensuring that the 1940 Advisers Act's protections, such as the fiduciary duty to clients, cover high-net worth individuals. The protections of that Act, we stress, should apply not only to small-scale investors but also to relatively wealthy investors who have achieved exemption on the basis of their supposed sophistication.[15] The fiduciary duty to clients must remain the lodestar by which to guide the actions of firms offering the most risky and alternative mutual funds.

Conclusion

Alternative Mutual Funds, it is clear, have the potential to produce significant risks and create new social welfare problems in the event of a market collapse. The increased retail access of these funds threatens to reintroduce into the personal investment sphere the same problems of risky proprietary trading that the Volcker Rule was intended to address. The collapse of these funds could wipe out millions or billions in retirement savings. The federal government would then be required to bear a heavy welfare burden of supporting the impoverished elderly, and would face pressure to bail out the most risky investment funds (and thereby socialize private losses).[16] Such a scenario would only create perverse incentives for financial malefactors to repeat and continue risky activities.

These problems are even more troubling because mutual fund investors are often reliant on the advice of investment advisers, and are likely unaware of the deeper risks of their investments. Other government agencies have surveyed these risks and are installing new safeguards to protect ordinary investors. The Department of Labor, for instance, has announced that it plans to propose rules requiring investment advisors to abide by a heightened fiduciary duty (for instance providing fuller information about fees) when advising individuals to transfer their 401(k) savings to other, ostensibly higher-yield, savings accounts.[17] The possible costs to retail investors and the public welfare are not ones that the SEC can reasonably countenance.

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[14] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191-192 (1963).

[15] *See* Paul Sullivan, NY Times, Your Money, Wealth Matters, *Regulatory Changes May Restrict Pool of Private Investors* (Sept. 26, 2014).

[16] History is replete with examples of pension funds succumbing to overleveraging, including the recent example of a fund for Brazilian postal workers, which lost over 50 percent of its value after losses on securities linked to Argentine government debt, Paula Sambo et al., *Argentina Default Punishes Mailmen as Pension Fund Loses*, Bloomberg, Aug. 6, 2014, and earlier failures during the Great Depression. *See* Thomas Piketty, Capital in the Twenty-First Century 489 n.45 (2014).

[17] *As Brokers Urge IRA Rollovers, Ex-Workers Ditch Their Low-Fee Federal Retirement Plan*, Washington Post, Business, Aug. 16, 2014 (reprinted from Bloomberg News); Yves Smith, *How Your Pension Fund Became a*

By permitting the proliferation of alternative mutual funds, and by failing to properly account for salutary protections available in the 1940 Company Act, the SEC would be setting the stage for disaster for retail investors. As we have argued above, the SEC must jealously guard its prerogatives in examining funds' portfolio management, liquidity, leverage, and valuation. Mere disclosure requirements regarding the complexities of alternative instruments will not be sufficient to resolve the problems posed by liquid alternative funds.

The 1940 Company Act, unlike other federal securities enactments that rely on disclosure, incorporates affirmative provisions aimed at forestalling the collapse or retrenchment of mutual funds.[18] The statute achieves its purpose of actively protecting often-unsophisticated investors through safeguards which, *inter alia*, limit leverage and illiquid investments and require a modicum of diversification. There is no plausible justification at this juncture for abandoning those protections at a time when sophisticated institutions such as CALPERS are abandoning hedge fund trading (in part because of exorbitant fees), and other institutions are facing extensive losses from CDS and other exotic instruments. The Commission has already primed the pump of disaster with its latest significant concession to industry: permitting ETFs to include CDS in their array of instruments.[19] Further deregulation of the mutual fund industry would only exacerbate extant risks to lay investors.

We ask that you vigorously implement the considerable responsibilities that have been discharged to you by Congress, remain faithful to the 1940 Company Act's intent, and consider the comments contained in this letter.

Thank you.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Neil Taylor
Eric Taylor
George Bailey
et al.

Casino, Bloomberg View, Wall Street, opinion, Aug. 19, 2014 (examining deficiencies in ERISA protection of investors and role of portfolio theory).

[18] Anita K Krug, *Downstream Sec. Reg'n*, 94 B.U. L. Rev. 1589 (2014), *at* http://ssrn.com/abstract=2420091.

[19] *See* Self-Regulatory Organizations; BATS Exchange, Inc.; Order Granting Approval of a Proposed Rule Change To List and Trade Shares of Certain Funds of the ProShares Trust, 79 Fed. Reg. 27023 (May 12, 2014).