

## MEMORANDUM

To: Use of Derivatives by Registered Investment Companies and Business Development Companies Proposal File

From: James Maclean  
Attorney-Adviser, Division of Investment Management (“IM”)

Date: June 15, 2016

Re: Meeting with Representatives of Blackstone Alternative Investment Advisors LLC (“Blackstone”)

On June 14, 2016, Diane Blizzard (Associate Director, IM), Brian McLaughlin Johnson (Senior Special Counsel, IM), Penelope Saltzman (Senior Special Counsel, IM), Christopher Stavrakos (Senior Financial Analyst, IM), Thoreau Bartmann (Branch Chief, IM), Roberta Ufford (Senior Special Counsel, IM), Adam Bolter (Senior Counsel, IM), Jamie Lynn Walter (Senior Counsel, IM), James Maclean (Attorney-Adviser, IM), Christof Stahel (Assistant Director, Division of Economic and Risk Analysis (“DERA”)) and Yue Tang (Economist, DERA) met with the following representatives of Blackstone:

- Peter Koffler (Senior Managing Director);
- David Mehenny (Managing Director);
- James Hannigan (Vice President, Legal); and
- Kevin Michel (Associate, Legal).

Among other things, the participants discussed the Commission’s proposal relating to the use of derivatives by registered investment companies and business development companies. Information provided by Blackstone in connection with this meeting is set forth in Annex A.

## **Annex A**

# **Proposed Rule 18f-4**

**Meeting between Blackstone Alternative Investment Advisors LLC  
("BAIA") and Representatives of the Securities and Exchange  
Commission ("Commission")**

June 14, 2016

**Materials prepared exclusively for meeting  
between BAIA and the Commission**

## Blackstone's Alternative Mutual Funds are Part of its Hedge Fund Solutions Business

Blackstone

- ▶ Founded in **1985**; went public in 2007
- ▶ **2,000+** employees in 17 offices globally
- ▶ **A+ / A+** ratings from Standard & Poor's / Fitch, respectively<sup>(1)</sup>

Real Estate

Private  
Equity

Hedge  
Fund  
Solutions

Credit

### Hedge Fund Solutions

- ▶ Creator of investment solutions designed to help investors generate risk-adjusted returns across a variety of asset classes and strategies
- ▶ **116** investment professionals; **281** total professionals
- ▶ **\$68 billion** of assets under management<sup>(2)</sup>

### Regulated Open- End Funds

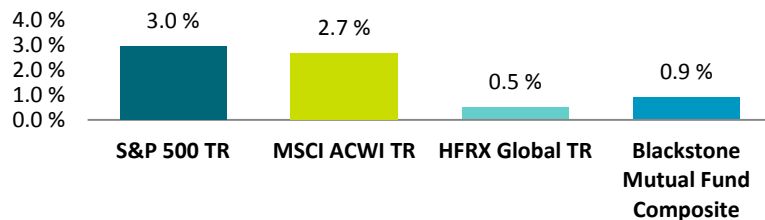
- ▶ Launched in **2013**; currently open-end funds with about **\$5.7 billion** aggregate net asset value
- ▶ Sponsored by Blackstone Alternative Investment Advisors LLC ("BAIA")
  - SEC-registered investment adviser; subsidiary of The Blackstone Group L.P.

(1) Standard & Poor's rating as at December 2013. Fitch rating as at November 2015.

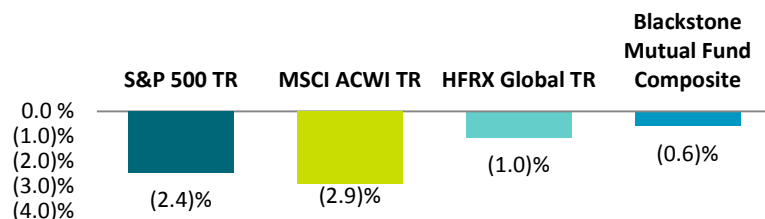
(2) AUM as of 3/31/2016, estimated and unaudited.

# Inception to Date Results: Blackstone's Alternative Mutual Funds Have Exhibited Low Volatility<sup>(1)</sup>

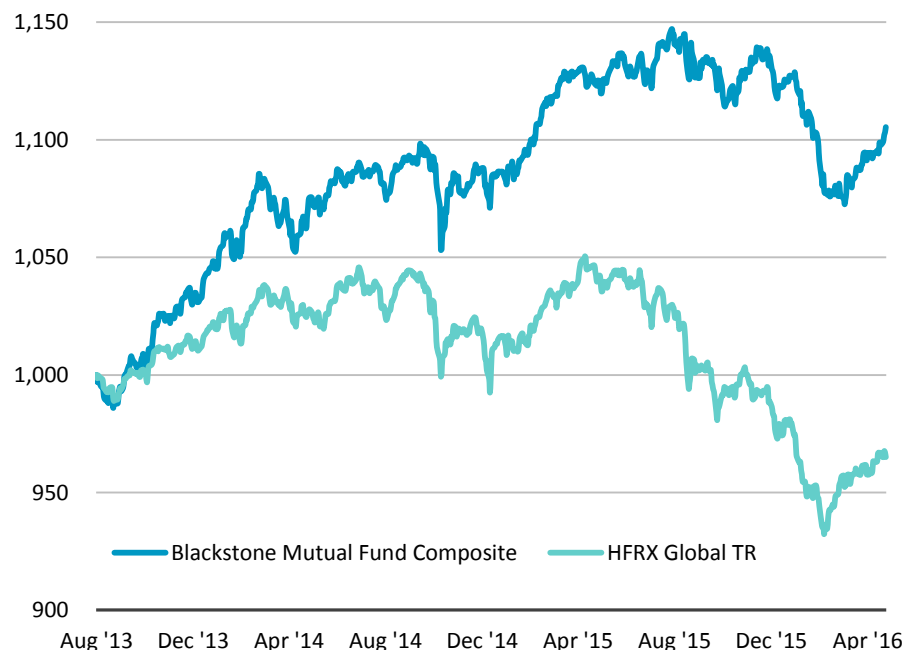
**Upside Capture – Months When S&P 500 Was Positive<sup>(2)</sup>**  
August 6, 2013 through April 30, 2016



**Downside Capture – Months When S&P 500 Was Negative<sup>(2)</sup>**  
August 6, 2013 through April 30, 2016



**Cumulative Returns – Mutual Fund Composite vs. HFRX Global TR**  
for Period Ending April 30, 2016<sup>(1)</sup>



Statistic <sup>(2)</sup>	Blackstone Mutual Fund Composite	S&P 500 TR	MSCI ACWI TR	Barclays US Agg Bond TR	JPM Domestic High Yield TR	HFRX Global TR	HFRI FoF Conservative TR
Annualized Return	3.6 %	9.7 %	4.9 %	3.8 %	3.1 %	(1.3)%	1.8 %
Volatility	3.9 %	13.5 %	11.1 %	3.2 %	4.1 %	3.7 %	2.4 %
Sharpe	0.91	0.71	0.43	1.15	0.74	(0.37)	0.74

(1) Materials prepared exclusively for comment meeting between BAIA and the Commission discussing proposed Rule 18f-4. Past performance is not indicative of future results.

(2) The "Blackstone Mutual Fund Composite" is an asset-weighted composite, net of fees, of the two open-ended liquid alternative mutual funds managed by Blackstone Alternative Investment Advisors LLC. The first mutual fund had an inception date of August 6, 2013 and officially commenced liquidation on April 6, 2016. As such, returns for this fund included in the Mutual Fund Composite start and end on these dates. The second fund has an inception of June 16, 2014 and is still active. As such, returns for the second fund included in the Mutual Fund Composite start at its inception and run through 4/30/2016.

Source: Bloomberg. For illustrative purposes only. The volatility of the indices may be materially different from that of the Composite. The indices employ different investment guidelines (available upon request) than the funds comprising the Composite. The performance of the indices has not been selected as a benchmark for Composite performance, but rather is disclosed to allow for comparison to that of widely recognized indices.

## **Leverage Increases Investment Risk Because Its Use Increases Volatility**

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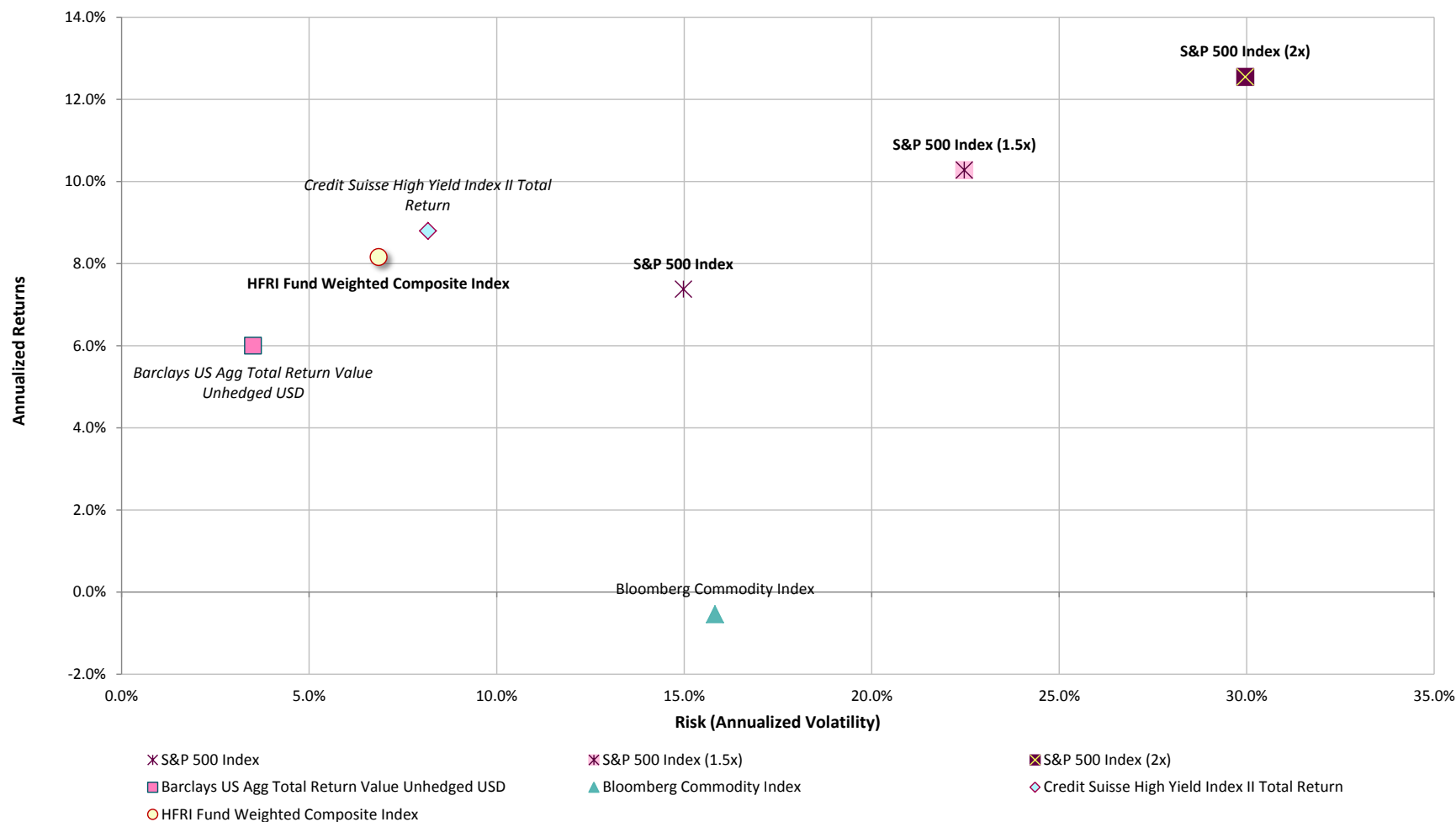
- ▶ Rule 18f-4 was proposed to increase investor protection, in part, by imposing a limit on the leverage a fund may obtain through the use of derivatives.
- ▶ BAIA is supportive of the Commission's initiative to limit unintended consequences of risk to investors.
- ▶ The use of leverage may increase investment risk if its use increases the volatility of a fund.

**BAIA Proposal:** The Commission should create an additional eligibility criteria for the 300% risk-based portfolio limit that would be available to any fund whose overall portfolio VaR is no more than 1½ times the VaR of a basket of medium- to large-cap U.S. listed equity securities designated by the Commission, such as the S&P 500 Index.

## **Volatility is a better proxy for investment risk than notional exposure**

- ▶ Select investments risks are presented through charts on the following pages.
- ▶ A test based on relative VaR more effectively addresses investment risk in a more consistent framework similar to other international regulatory regimes.

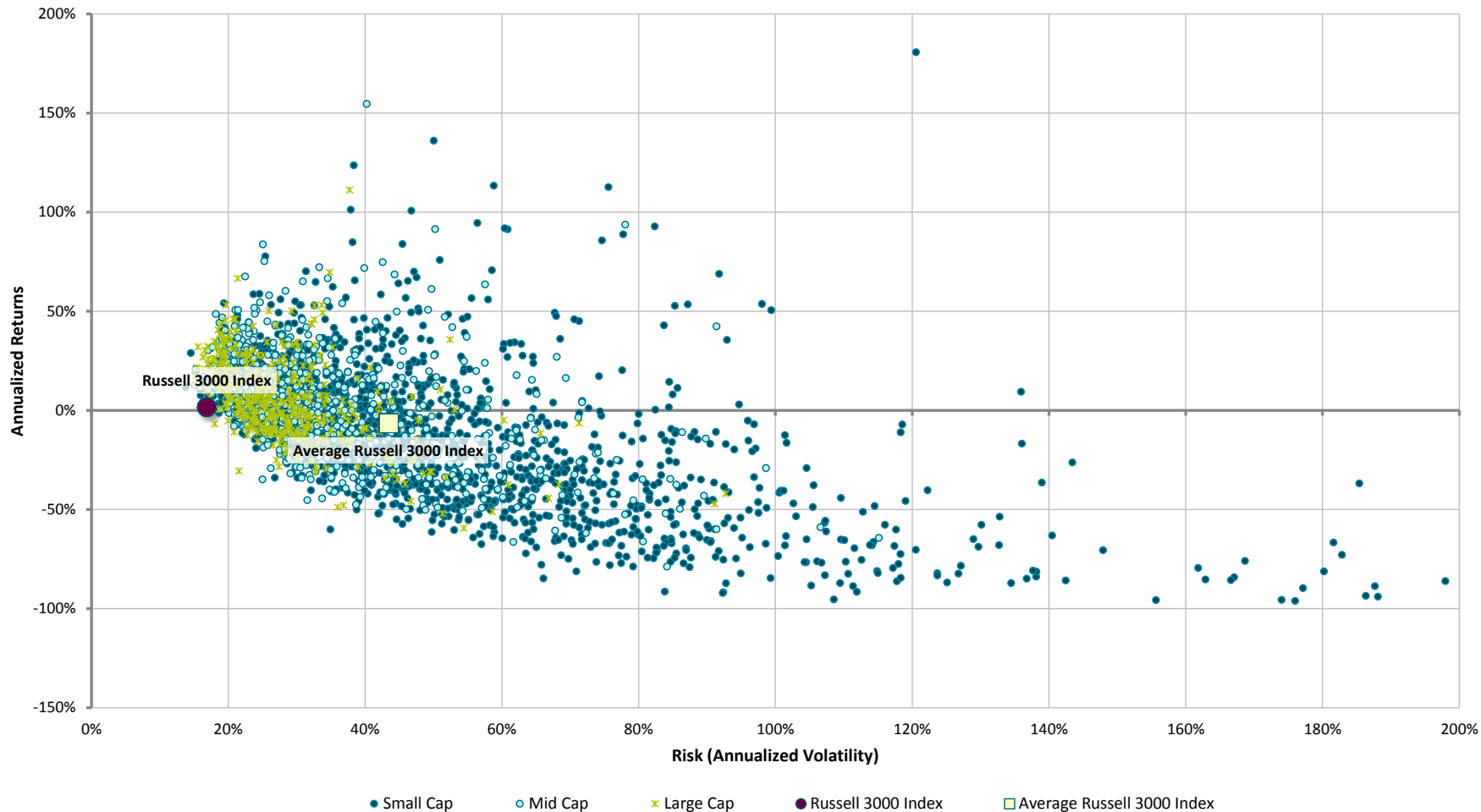
# Asset Class Risk



(1) Returns and volatilities shown are annualized based on monthly returns data from 12/30/1994 through 5/31/2016.

(2) Source: Bloomberg. For illustrative purposes only.

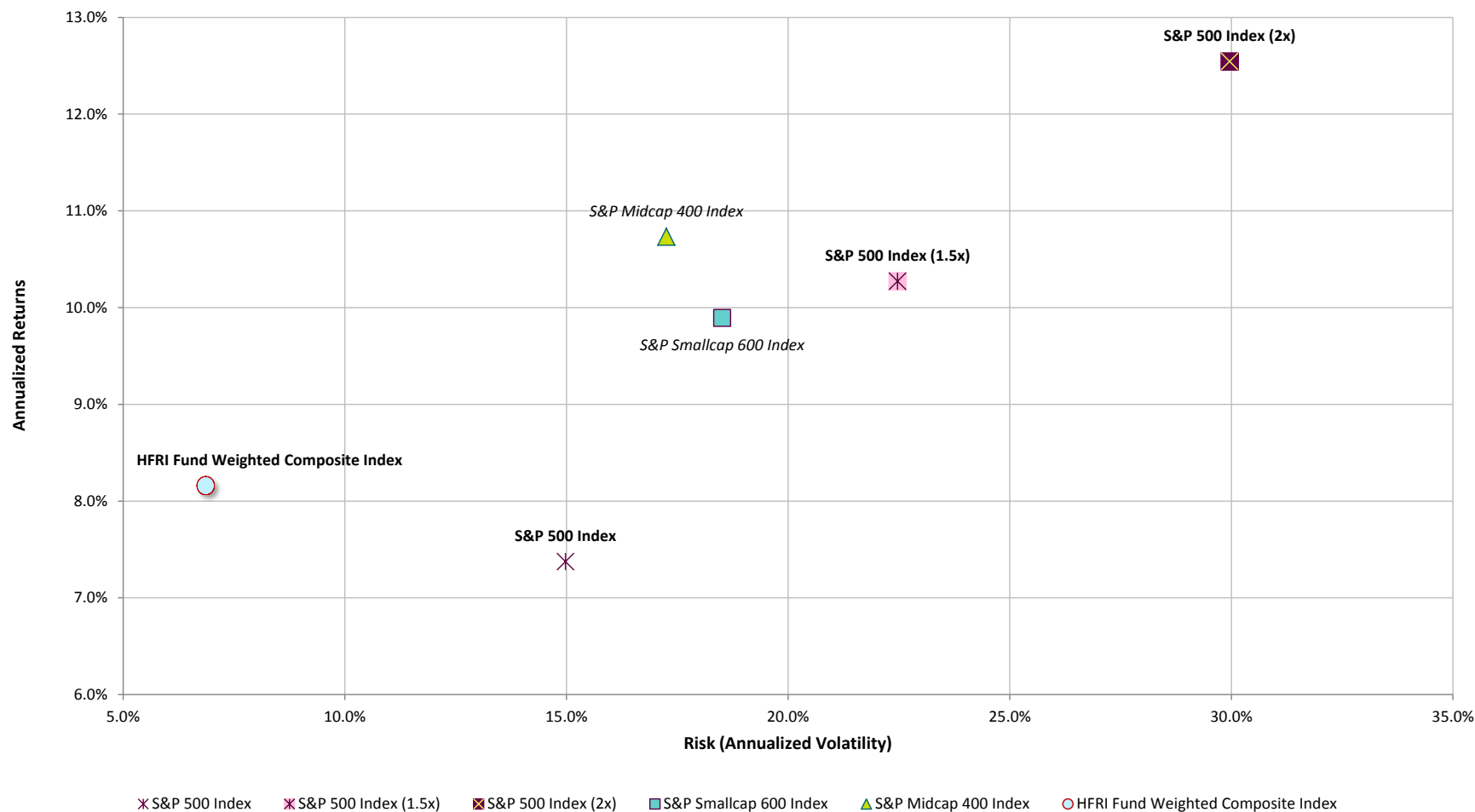
## Concentration and Size Risk



- (1) Returns and volatility for trailing 12 months through 6/7/2016.
- (2) Underlying constituents of the Russell 3000 Index shown based on market capitalization. Small Cap represents companies with market capitalization lower than \$2 billion, Mid Cap represents market capitalization between \$2 billion and \$10 billion, while Large Cap represents market capitalization greater than \$10 billion.
- (3) Average Russell 3000 Index shows average 12-month returns and volatility for the underlying constituents of the index (i.e. not capitalization weighted).
- (4) Source: Bloomberg. For illustrative purposes only.

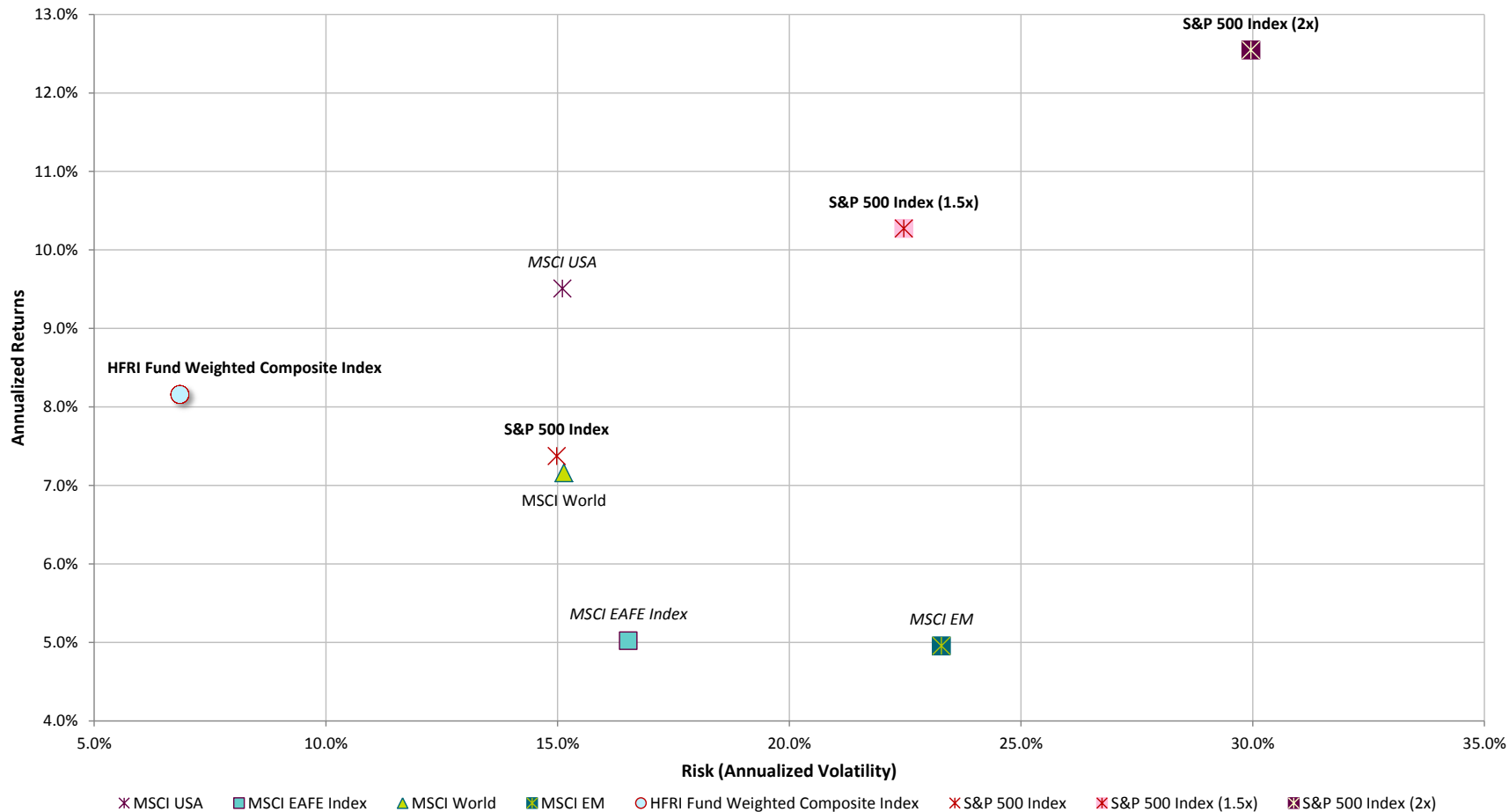


# Size Risk Factor



- (1) Returns and volatilities shown are annualized based on monthly returns data from 12/30/1994 through 5/31/2016.  
 (2) Source: Bloomberg. For illustrative purposes only.

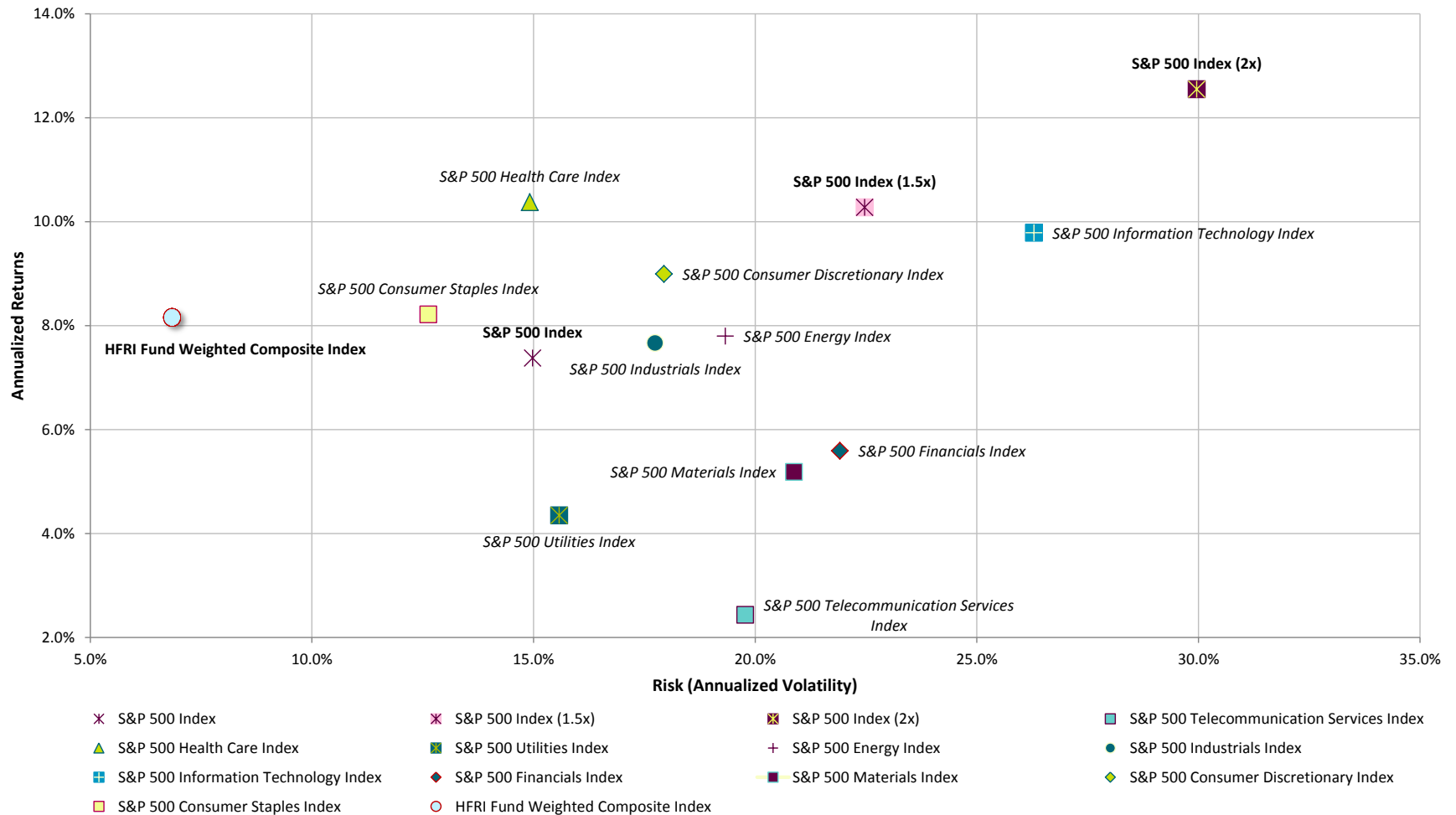
## Geographical Exposure Risk Factor



(1) Returns and volatilities shown are annualized based on monthly returns data from 12/30/1994 through 5/31/2016.

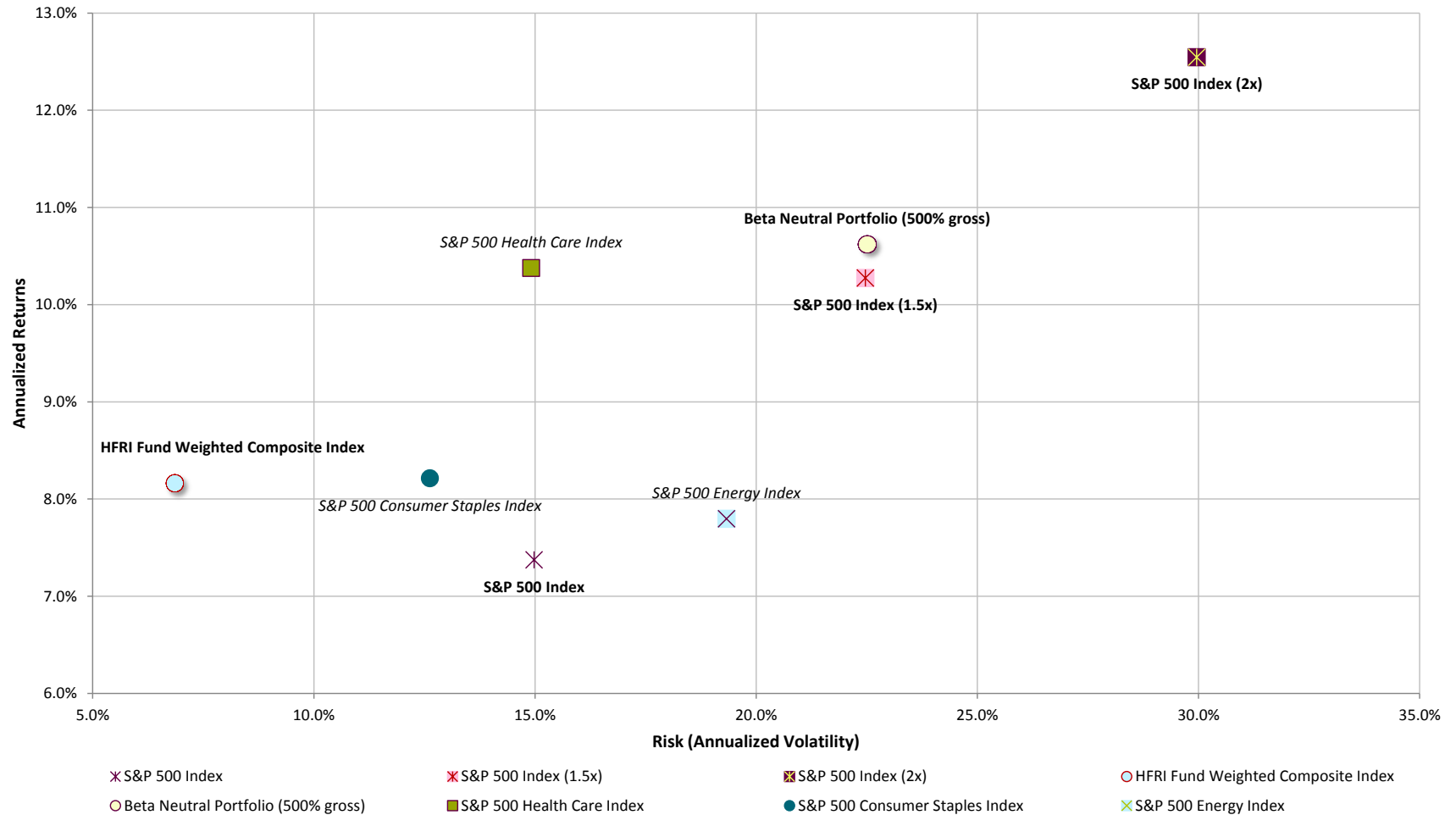
(2) Source: Bloomberg. For illustrative purposes only.

# Sector Risk Factor



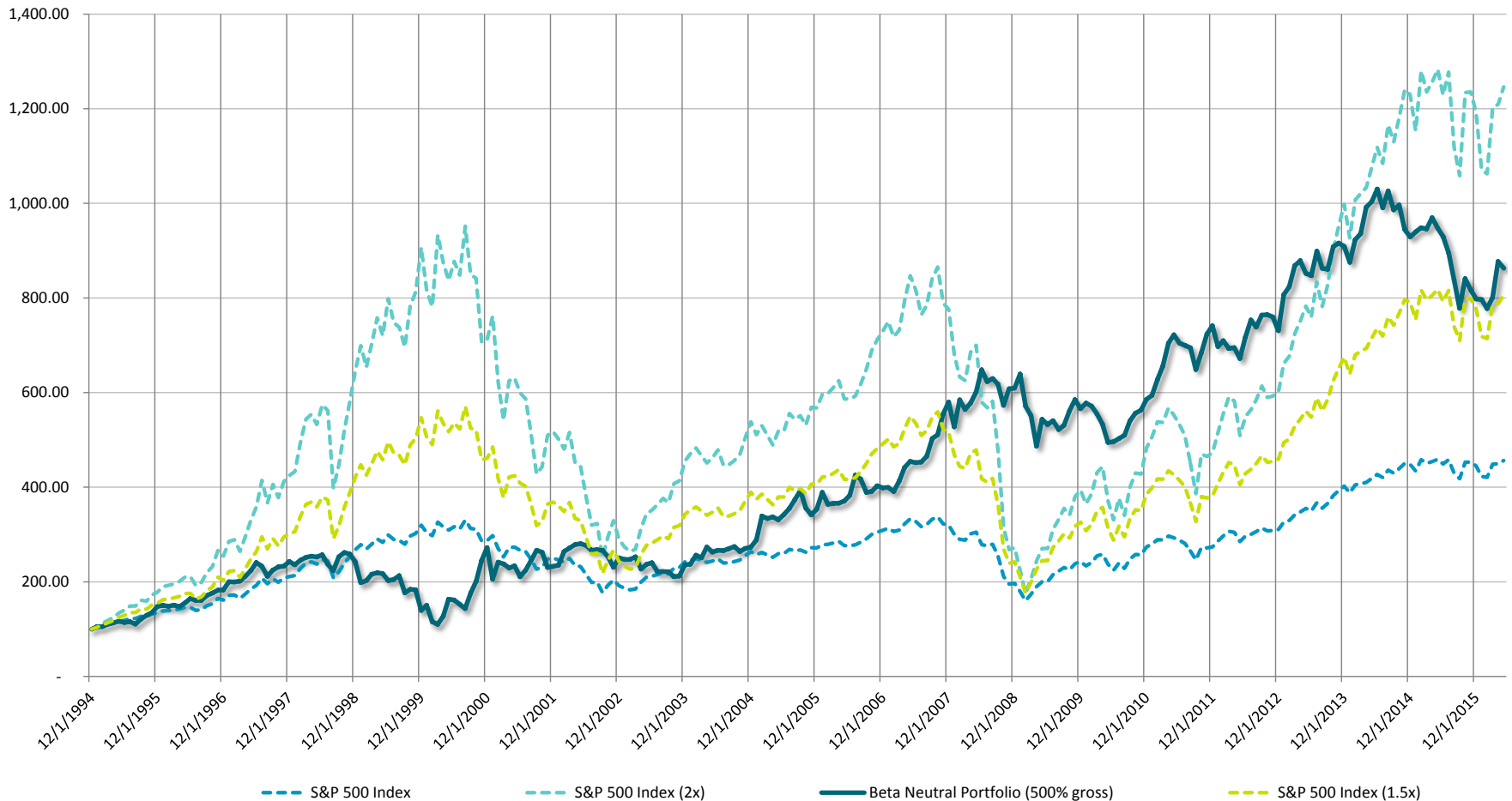
- (1) Returns and volatilities shown are annualized based on monthly returns data from 12/30/1994 through 5/31/2016.
- (2) Source: Bloomberg. For illustrative purposes only.

## Beta Neutral and Gross Exposure Risk



- (1) Returns and volatilities shown are annualized based on monthly returns data from 12/30/1994 through 5/31/2016.
- (2) Beta Neutral Portfolio represents long investments of 100% in S&P 500 Health Care Index, 100% in the S&P 500 Consumer Index and 100% in the S&P 500 Energy Index representing gross long exposure of 300%, in addition to a short exposure of 199% in the S&P 500 Index. The portfolio is intended to serve as a hypothetical example and was constructed to be beta neutral to the S&P 500 Index solely for illustrative purposes. The portfolio does not represent actual client accounts.
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- ▶ **Additional Eligibility Criteria:** BAIA proposes that the Commission create an additional eligibility criteria for the 300% risk-based portfolio limit that would be available to any fund whose overall portfolio VaR is no more than 1½ times the VaR of a basket of medium- to large-cap U.S. listed equity securities designated by the Commission, such as the S&P 500 Index.
- ▶ **Enhancement to Risk Management Program:** For funds relying on the additional eligibility criteria, the Commission should require that their derivative risk management program include an assessment of whether, based on the fund's investment objective and strategy, the VaR limit should be lower than the upper limit noted above (1½ times the VaR of the basket of Commission-designated equities).
- ▶ **Stress/Back Testing:** BAIA recommends that the Commission require designated risk managers to run additional stress testing and back testing of the VaR models at least monthly, and include the results in the reporting to a fund's board contemplated in Proposed Rule 18f-4.
- ▶ **Haircutting:** BAIA supports the recommendation put forth by the *Investment Company Institute* and *Simpson, Thacher & Bartlett LLP* that any limit based on notional amount should use risk-weighting or "haircutting".
- ▶ **Calculation Frequency:** BAIA proposes that the Commission address the administrative difficulties for multi-manager and multi-strategy funds related to the timing of a fund's calculation for compliance with the derivatives limits.