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SEC Update

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Interval Funds: An Alternative to "Liquid Alternative" Funds? Part 1

This is Part I of a two part series addressing interval funds. Part I discusses the regulatory history behind the development of interval funds and the operation of interval funds pursuant to Rule 23c-3 under the Investment Company Act of 1940, as amended (1940 Act). Part II will compare the attributes of interval funds to those of private funds, liquid alternative mutual funds, and closed-end tender offer funds. Part II is intended to assist alternative fund sponsors in their evaluation of which product type is the most appropriate for their particular alternative investment strategies and potential investments and the investor markets they wish to access.

The "retailization" of hedge fund strategies is not a new phenomenon. For some time, private fund managers have used various investment vehicles, such as registered funds of hedge funds, pension plans and other institutional accounts, to offer their strategies to mass affluent and retail investors.[1] Recently, mutual funds have become the registered investment vehicle of choice for private fund managers to expand beyond their traditional client bases. Since 2010, so-called "liquid alternative" mutual funds have been among the fastest growing segments of the mutual fund marketplace, and many industry observers expect such growth to continue.[2]

While private fund managers have targeted retail clients in recent years, one potentially overlooked client base is the so-called mass affluent. While definitions of the mass affluent market vary, the segment generally consists of households with liquid assets between $250,000 and $1,000,000.[3] One product that may appeal to the mass affluent market, but has yet to gain widespread adoption is the interval fund. An interval fund is a closed-end fund registered under the 1940 Act that offers to repurchase its securities from shareholders at periodic, predetermined intervals in accordance with Rule 23c-3 under the 1940 Act. While the Securities and Exchange Commission (SEC) adopted Rule 23c-3 in 1993, fund managers have been slow to use interval funds due to their less-mature distribution channels, the managers' unfamiliarity with the requirements of Rule 23c-3, and investors' unfamiliarity with the product structure. However, recently there has been an uptick in interval fund registrations, indicating an increased interest from managers, distribution partners, and their client base.

Interval funds may appeal to mass affluent investors seeking to diversify into more traditional hedge fund strategies, but are unwilling to accept the uncertainty of the more limited liquidity offered by traditional hedge fund products. These investors also may be attracted to interval funds because of the various protections afforded to them under Rule

23c-3 relative to an investment in a private fund, including more frequent net asset value (NAV) calculations, restrictions on the fund's use of leverage, and transactions with affiliates, strict custody requirements, and more comprehensive board governance requirements.

The Regulatory History of Interval Funds

The Staff of the SEC's Division of Investment Management introduced the concept of interval funds in its 1992 report entitled "Protecting Investors: A Half Century of Investment Company Regulation" (Protecting Investors),[4] in which the Staff published the results of a two-year study of the investment management industry. In Protecting Investors, the Staff observed that Section 5 of the 1940 Act rigidly divides management investment companies into two categories: open-end companies and closed-end companies. Open-end companies are investment companies that issue redeemable securities, which entitle the holder to receive its proportionate share of the open-end fund's net assets upon request.[5] All other management companies are defined as closed-end. The Staff noted that the impact of issuing redeemable securities is significant because open-end funds, whose shareholders may redeem their shares at any time (subject to certain limited exceptions), face constant redemption pressure. This redemption pressure is further enhanced due to the fact that open-end funds also must pay redemption proceeds within seven days.[6] In order to better position open-end funds to meet these requirements, the SEC requires open-end funds to limit their holdings in illiquid assets to no more than 15 percent of their net assets.[7]

Closed-end funds, however, do not issue redeemable securities, and, therefore, do not face the same degree of redemption pressure as open-end funds. Accordingly, there is generally no limit to the amount of illiquid assets in which certain closed-end funds may invest. This freedom to invest in illiquid assets theoretically should make closed-end funds a popular choice among fund sponsors that wish to offer investors a less-liquid investment strategy. Closed-end funds also enjoy other portfolio management advantages. For example, closed-end funds generally can be fully invested because they do not have to hold cash to honor daily redemption requests. Further, closed-end fund managers may manage their portfolios without taking into account the constant and largely unpredictable cash inflows and outflows that open-end funds experience.

Notwithstanding these advantages, the Staff observed in Protecting Investors that closed-end funds significantly lagged open-end funds in popularity. One possible reason for the lack of popularity of closed-end funds is that closed-end fund shares, the majority of which historically have traded on securities exchanges, often trade at a discount to NAV for various reasons. Trading at a discount may have adverse consequences for both shareholders and sponsors. Shareholders who participate in a closed-end fund's initial public offering lose money when discounts develop. When discounts persist, sponsors have a more difficult time successfully launching new closed-end funds. Discounts also limit a closed-end fund's options to raise new capital because the 1940 Act generally prohibits a closed-end fund from selling new shares below their NAV.[8] Closed-end funds have used various techniques in an attempt to minimize their discounts, with varying degrees of success.[9]

The Staff explained in Protecting Investors that Section 5 of the 1940 Act forces management investment companies to choose between operating as open-end funds, and thus be highly liquid, or closed-end funds, and thus be less popular with investors and potentially subject to a discount. Further, the SEC Staff recognized that this "rigidity of the [1940] Act's classification system [had] become a limitation on sponsors' ability to offer innovative products."[10] However, the Staff also observed that, shortly before the publication of Protecting Investors, a new type of closed-end fund began to emerge. These funds, referred to in this Update as "tender offer funds," were registered under the 1940 Act, continuously offered shares registered pursuant to Rule 415 under the Securities Act of 1933, as amended (1933 Act) at NAV, not at a discount, and their shares were not traded on an exchange. In order to provide liquidity to their shareholders, these funds conducted periodic, discretionary tender offers pursuant to Section 23(c)(2) of the 1940 Act[11] and the applicable rules under the Securities Exchange Act of 1934, as amended (1934 Act).

While the Staff noted that tender offer funds were an effective mechanism to counter closed-end fund discounts, it recognized that complying with the 1934 Act's tender offer rules could be cumbersome. Therefore, in an effort to "chart new territory between the two extremes of the open-end and closed-end forms," the Staff recommended a series of reforms that would allow a "vehicle for offering portfolios that have substantial, but not complete liquidity."[12] These recommendations, after formal proposal and modification in response to industry comments, eventually were adopted as Rule 23c-3 under the 1940 Act.

As adopted, Rule 23c-3 requires interval funds to offer shareholders periodic repurchase offers where shares of the fund are repurchased at the then-current NAV. This feature of interval funds provides shareholders a certain amount of guaranteed liquidity and also avoids having fund shares being sold at a discount to NAV. At the same time, Rule 23c-3 provides fund sponsors with increased flexibility to pursue investment strategies involving less liquid investments since shareholder redemptions are limited to periodic intervals set by the fund's board taking into consideration the recommendation of the fund sponsor.

Operating an Interval Fund Under Rule 23c-3

Rule 23c-3 was proposed in 1992 and adopted in 1993 pursuant to the SEC's authority to permit closed-end funds to repurchase shares under circumstances it establishes by rule.[13] In general, Rule 23c-3 allows a closed-end fund to offer to repurchase its shares from all shareholders at NAV at predetermined intervals (repurchase offer) pursuant to a fundamental policy. The following is a discussion of the material requirements of Rule 23c-3.

Frequency of Repurchase Offers

Rule 23c-3 requires interval funds to make periodic repurchase offers pursuant to a fundamental policy that sets forth important terms of the offers. Specifically, an interval fund must adopt a fundamental policy that provides (i) that the fund will make periodic repurchase offers, (ii) the periodic intervals between "repurchase request deadlines" (defined below), (iii) the schedule of the repurchase request deadlines or the means of determining the repurchase request deadlines, and (iv) the maximum amount of time between each repurchase request deadline and the next repurchase pricing date (defined below). The fundamental policy can be changed only by a vote of a majority of the interval fund's outstanding voting securities. Due to the cost and time involved with changing a fundamental policy, before choosing an interval fund structure, fund sponsors must evaluate whether the fund's investment strategies and proposed investments are consistent with conducting a mandatory repurchase offer at a set interval.

An interval fund's periodic interval between repurchase offers may be every 3, 6, or 12 months.[14] This broad range of permissible repurchase intervals should provide enough flexibility to accommodate most alternative strategies. In order to provide an interval fund with some stability at the beginning of its operations and to allow the fund to more fully implement its investment program, an interval fund may delay its initial repurchase offer for an additional one interval after the effective date of its registration statement.[15] For example, a new interval fund with a six-month repurchase interval may schedule its first repurchase request deadline up to 12 months from the effective date of its registration statement. After the initial repurchase offer, an interval fund must conduct each repurchase offer at the periodic interval specified in its fundamental policy.

An interval fund may suspend or postpone a repurchase offer only under limited circumstances where conducting a repurchase offer could affect the fund's tax status as a regulated investment company under Subchapter M of the Internal Revenue Code, as amended, or cause the fund to be delisted from the securities exchange on which it trades (if applicable), or in circumstances analogous to which open-end funds are permitted to suspend redemptions under Section 22(e) of the 1940 Act.[16]

Discretionary Repurchase Offers

Interval funds are permitted to make one discretionary repurchase offer every two years. This option is designed to provide interval funds with a limited amount of flexibility to conduct repurchases without circumventing their required fundamental policy concerning the frequency of repurchase offers. Discretionary repurchase offers are subject to many of the same restrictions as periodic repurchase offers.[17] Given the relatively limited availability of discretionary repurchase offers for interval funds, it is important for a fund sponsor to carefully consider which repurchase interval fits best with its fund's strategies and investments and investor expectations.

Amount of a Repurchase Offer

At each periodic interval, an interval fund must offer to repurchase between five percent and 25 percent of its common shares outstanding on the repurchase request deadline.[18] Before each repurchase offer, the interval fund's board of directors/trustees must approve the repurchase offer amount for that repurchase offer.[19] The fund's board may approve a different amount to repurchase in connection with each repurchase offer so long as the amount falls within the required five percent to 25 percent range.

Rule 23c-3 sets forth specific actions an interval fund may take if shareholders tender more than the repurchase offer amount. Under such circumstances, an interval fund may repurchase up to an additional two percent of the amount of shares outstanding on the repurchase request deadline. If shareholders tender more than this amount, then the interval fund must repurchase shares *pro rata*, except that it may repurchase the entire amount of an odd lot tender of less than 100 shares and, in certain circumstances, an all-or-nothing tender.[20]

Taken together, the required repurchase offer amount and frequency of repurchase offers should provide interval fund sponsors with the broad flexibility they need to operate a fund pursuant to alternative investment strategies. This is because, at a minimum, an interval fund is simply required to conduct a repurchase offer once a year and is required to offer to repurchase only five percent of its shares. Of course, fund sponsors must weigh this flexibility with the ability to sell the fund to its targeted investor base.

Timing of a Repurchase Offer

Rule 23c-3 contains several key definitions that govern the timing of an interval fund's repurchase offer.

- **Repurchase request deadline:** the date by which shareholders must notify the fund of their participation in the repurchase offer.
- **Repurchase pricing date:** the date on which the shares being repurchased are valued.
- **Repurchase payment deadline:** the date by which the fund must pay participating shareholders the consideration for their shares tendered.

The repurchase request deadline can be no more than 42 days and no less than 21 days from the date that an interval fund sends notice of a repurchase offer to shareholders.[21] Shareholders are provided at least 21 days' notice so that they have enough time to determine whether to participate in a repurchase offer. The 42-day maximum notice period is intended to prevent a fund from sending notices so far in advance that shareholders forget about the offer. Shareholders are permitted to withdraw or modify their repurchase requests until, but not after, the repurchase request deadline.[22]

The repurchase pricing date can occur no later than 14 days after the repurchase request deadline, unless the 14th day is not a business day, in which case the repurchase request deadline is the next business day.[23] Interval funds, therefore, have up to 14 days' advance notice of the amount of shares that shareholders desire to have repurchased. This 14-day period is designed to allow an interval fund's investment adviser greater flexibility to manage the fund's assets in a manner that can meet repurchase requests.[24]

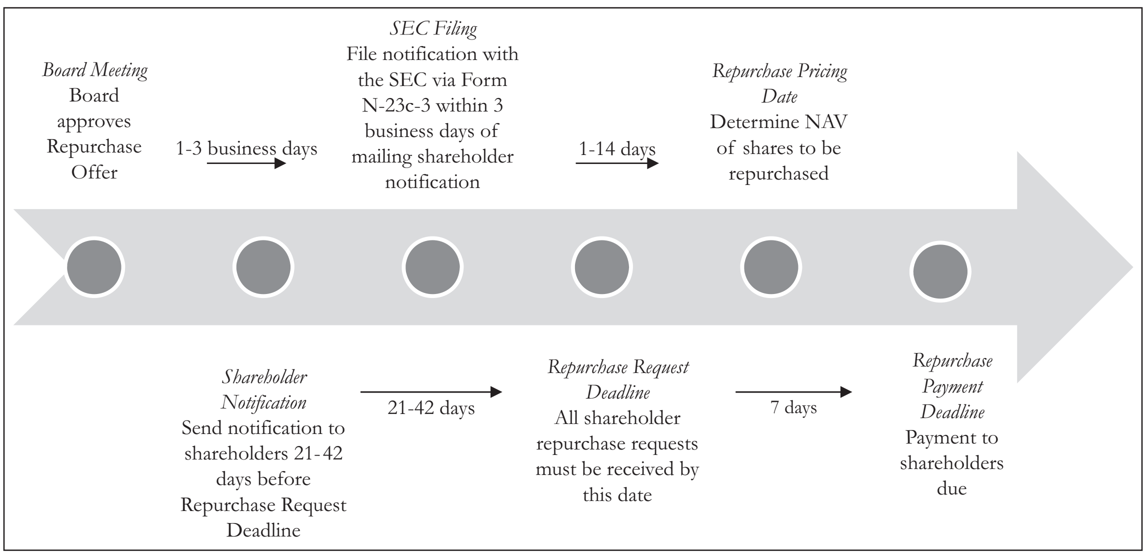
The repurchase payment deadline can occur no later than seven days after the repurchase pricing date.[25] An interval fund must pay 100 percent of the redemption proceeds in cash to the redeeming shareholders no later than seven days after the repurchase pricing date. This seven-day payment deadline is intended to mirror the seven-day payment deadline that applies to redemptions from open-end funds. This deadline and the requirement to pay shareholders 100 percent of their redemption proceeds in cash should be carefully reviewed by fund sponsors (particularly fund of hedge fund sponsors) to determine whether the fund's investment strategies and investments allow for this requirement to be met. For example, the interval fund rules do not permit the typical hedge fund redemption process where investors receive 95 percent of their redemption proceeds 30 or 60 days after the redemption date and then receive the remaining five percent after the fund's annual audit.

Exhibit A below provides a chart that shows how the repurchase request deadline, repurchase pricing date and repurchase payment deadline function together in a particular repurchase offer.

Notification to Shareholders

As noted above, shareholders must receive between 21 and 42 days' advance notice of a repurchase offer. This notice must be sent directly to shareholders, rather than by publication in a nationally distributed periodical. The notice must disclose the following basic terms of the repurchase offer: (i) that the fund will commence a repurchase offer; (ii) any repurchase fees (up to two percent); (iii) the repurchase offer amount; (iv) the dates of the repurchase request deadline, repurchase pricing date, and repurchase payment deadline; (v) the risk that the fund's NAV will fluctuate between the repurchase request deadline and the repurchase

Exhibit A—Interval Fund Repurchase Offer Timeline



pricing date; (vi) the ability of the fund to set an earlier repurchase pricing date under certain circumstances[26]; (vii) the procedures to make a repurchase request and the right to modify or withdraw it; (viii) the procedures that the fund would use to purchase shares *pro rata;* (ix) the circumstances under which the fund could suspend or postpone the repurchase offer; (x) the fund's NAV as of a date within the previous seven days; and (xi) the fund's market price if it is traded in a secondary market.[27] An interval fund must file a copy of each notice sent to shareholders with the SEC on Form N-23C3A within three days after sending it.[28] As will be discussed in more detail in Part II of this Update, complying with the interval fund rules governing the notification of shareholders of a repurchase offer are generally less burdensome than complying with the tender offer rules under the 1934 Act that govern tender offer funds.

Annual Report Disclosure

In order to ensure that investors who purchase shares in the secondary markets have access to relatively recent disclosure about an interval fund's repurchase procedures, interval funds must disclose in their annual reports to shareholders information about the following: (i) the number of repurchase offers that occurred during the period covered by the report, (ii) the repurchase offer amount for each such repurchase offer, (iii) the amount of shares tendered in each such repurchase offer, and (iv) certain information related to any oversubscriptions.

Determination of NAV

An interval fund must calculate its NAV at least weekly on such day and time as determined by its board.[29] Further, similar to a mutual fund, an interval fund must calculate its NAV each day that investors purchase shares of the fund or, as discussed earlier, redeem shares of the fund.[30] In addition, an interval fund must calculate its NAV daily during the five business days preceding a repurchase request deadline.

In light of the requirement to calculate an interval fund's NAV at least weekly, it is important for fund sponsors to evaluate the transparency they will have into their fund's underlying investments to determine whether such investments lend themselves to weekly valuations.

Liquidity

From the time that an interval fund sends shareholders the repurchase offer notice until the repurchase pricing date, the fund must hold liquid securities equal to 100 percent of the repurchase offer amount.[31] The interval fund's board must adopt written procedures that are reasonably designed, taking into account current market conditions and the fund's investment objectives, to ensure that the fund's assets are sufficiently liquid so that the fund can meet its obligation to repurchase its shares and is in compliance with its fundamental policy on conducting repurchase offers. The fund's board must review the liquidity of the fund's portfolio "as the board deems necessary."[32] An annual review of the fund's liquidity is likely not necessary in all circumstances because an annual review requirement originally was proposed by the SEC, but was removed in favor of the "as necessary" standard. Interval funds are not otherwise restricted in their ability to invest in illiquid assets. Given that an interval fund is only required to maintain liquidity sufficient to support its repurchase offers and repurchase offers can be as low as five percent of the fund's shares, fund sponsors generally should not be overly burdened by the interval fund's liquidity requirements.

Issuance of Senior Securities

Interval funds, like open-end funds and other closed-end funds, are subject to the SEC's and its Staff's interpretation that investments in derivatives and other leveraged instruments may involve the issuance of senior securities subject to the prohibitions and asset coverage requirements of Section 18 of the 1940 Act. However, the SEC and its Staff also have stated that fund investments in certain derivatives and other leveraged instruments will not be considered "senior securities" if the fund segregates an appropriate amount of assets, or otherwise "covers" its obligations under the instruments, consistent with SEC and Staff guidance. This position applies to all registered investment companies, including interval funds.

Interval funds may issue two types of senior securities: (i) those maturing by the next repurchase pricing date and (ii) those whose terms provide for redemption, call, or repayment by the repurchase pricing date as necessary to permit the repurchase. These limitations relative to the types of senior securities other closed-end funds may issue[33] are intended to ensure that outstanding senior securities will not prevent an interval fund from carrying out its repurchase offer obligations. In addition, interval funds, like other closed-end funds, can borrow money from non-bank lenders. Because liquid alternative mutual funds may borrow only from a bank, this feature of interval funds may be advantageous to fund sponsors who have pre-existing lending relationships with non-bank lenders, such as prime brokers.

Exemptions from Other Federal Securities Laws

Simultaneous with or shortly after the adoption of Rule 23c-3, the SEC amended other federal securities laws to allow interval funds to operate within their confines. For example, the SEC amended Rule 13e-4 and adopted Rule 14e-6 under the 1934 Act to exempt interval fund repurchase offers from the requirements of rules applicable to tender offers conducted under the 1934 Act.[34] With respect to the 1933 Act, the SEC adopted new subsection (a)(xi) to Rule 415 under the 1933 Act, which governs shelf offerings, to allow interval funds to engage in a continuous or delayed offering. Without this new subsection, interval funds would have been forced to offer shares pursuant to Rule 415(a)(ix), which allows only continuous, not delayed, offerings and only permits funds to initially register with the SEC the amount of securities they reasonably expect to sell in two years. The SEC also adopted new Rule 486 under the 1933 Act, which allows interval funds to update their registration statements by filing post-effective amendments that become automatically effective similar to the process followed by open-end funds. In total, these amendments generally provide interval funds with certain advantages over tender offer funds with respect to complying with various 1933 Act obligations relating to the registration and offering of their shares. For example, because of the application of Rule 486 under the 1933 Act interval funds are not subject to the cost and possible delays that tender offer funds experience as a result of having to obtain SEC Staff approval of annual updates to their registration statements each year.

Interval funds also are granted an exemption from Financial Industry Regulatory Authority (FINRA) Rule 5110, which requires FINRA to review and approve the distribution terms and arrangements with respect to offerings by certain investment companies, such as tender offer funds. Because FINRA is not obligated to complete its review within any established time frame and Rule 5110 reviews may be lengthy and detailed depending on the nature of the offering, this exemption generally reduces the time and costs related to bringing an interval fund to market as compared to a tender offer fund.

Part I of this Update discussed the regulatory history of interval funds and how the SEC Staff viewed them as a form of hybrid fund that offers the ability to invest in a greater amount of illiquid assets similar to a closed-end fund, but also provide greater liquidity to investors similar to an open-end fund. Recognizing that few fund sponsors are familiar with the rules governing the operations of interval funds, Part I also reviewed the requirements of Rule 23c-3 in order to illustrate how to operate an interval fund. Part II of this Update will compare the essential features of interval funds to those of private funds, liquid alternative mutual funds, and tender offer funds. Part II is intended to assist alternative fund sponsors in their evaluation of which product type is the most appropriate for their particular alternative investment strategies and potential investments and the investor markets they wish to access.

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NOTES

1 *See* Staff of the Securities and Exchange Commission, "Implications for the Growth of Hedge Funds 80–83" (Sept. 2003), available at *https://www.sec.gov/news/studies/hedgefunds0903.pdf* (expressing the Securities and Exchange Commission (SEC) Staff's concerns about the ability of retail investors to gain exposure to hedge funds through various types of accounts).

2 *See, e.g.*, Reshma Kapadia, "The New, New Thing: Liquid Alts," *Barron's* (Apr. 4, 2015) (citing research from Lipper Inc. that notes that "since 2010, assets in the [liquid alternatives] category have more than doubled, to $449 billion, with the number of mutual funds in the group mushrooming to 581 from 202"); McKinsey & Company, "The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management" (June 2012) (analyzing the recent adoption of alternative investment strategies by retail investors and predicting the strategies' continued growth).

3 *See, e.g.*, The Nielsen Company, "Affluence in America: A Financial View of the Mass Affluent at 2" (2012), available at *https://www.bai.org/libraries/lob-sps-downloads/5512_mass_affluence_paper_final.sflb.ashx* (defining the mass affluent market as "households within seven distinct segments with assets between $250,000 and $1,000,000.").

4 Division of Investment Management, Securities and Exchange Commission, "Protecting Investors: A Half Century of Investment Company Regulation" (May 1992) at 436, available at *https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf* (hereinafter, *Protecting Investors*).

5 1940 Act §2(a)(32).

6 Rule 22c-1 under the 1940 Act.

7 *See Revisions of Guidelines to Form N-1A*, Investment Company Act Release No. 18612 (Mar. 12, 1992) (defining an illiquid asset for purposes of the 15 percent limitation as "an asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books").

8 1940 Act §22(b).

9 *See Protecting Investors*, *supra* n.4, at 436 (providing examples of techniques designed to cure a closed-end fund's discount such as converting to an open-end fund and adopting a dividend reinvestment plan).

10 *Protecting Investors*, *supra* n.4, at 424.

11 Section 23(c)(2) provides that no "registered closed-end company shall purchase any securities of any class of which it is the issuer except … pursuant to tenders, after reasonable opportunity to submit tenders given to all holders of securities of the class to be purchased."

12 *Protecting Investors*, *supra* n.4, at 424.

13 1940 Act §23(c).

14 Rule 23c-3(a)(1).

15 Rule 23c-3(a)(7).

16 Rule 23c-3(b)(3)(i).

17 Rule 23c-3(c).

18 Rule 23c-3(a)(3).

19 An interval fund's board must satisfy the "fund governance" standards set forth in Rule 0-1(a)(7) under the 1940 Act. Rule 23c-3(b)(8).

20 Rule 23c-3(b)(5).

21 Rule 23c-3(b)(4)(i).

22 Rule 23c-3(b)(6).

23 Rule 23c-3(a)(1)(5).

24 An interval fund may set an earlier repurchase pricing date if it pays redemption proceeds within

seven days of such earlier date and using the earlier date is not likely to dilute the fund's shares. For example, an interval fund with sufficient cash in its portfolio at the repurchase request deadline may set the repurchase pricing date as early as the next business day.

25 Rule 23c-3(a)(1)(4).

26 *See* n.24, *supra*.

27 Rule 23c-3(b)(4)(i).

28 Rule 23c-3(b)(4)(ii).

29 Rule 23c-3(b)(7)(i).

30 Rule 23c-3(b)(7)(iii).

31 Rule 23c-3(b)(10)(i).

32 Rule 23c-3(b)(10)(iii).

33 Section 18(a) of the 1940 Act allows closed-end funds to issue a senior class of debt subject to a 300 percent asset coverage requirement and a senior class of equity subject to a 200 percent asset coverage requirement. While Section 18(a) imposes certain obligations and restrictions on a closed-end fund's issuance of senior debt and equity, unlike Rule 23c-3, Section 18 does not require that a closed-end fund's senior securities mature or be redeemable, callable or repayable by a certain date.

34 For a discussion of the requirements governing interval funds, *see* the sub-section entitled "Notification of Shareholders" above. In connection with the adoption of Rule 23c-3, the SEC also exempted interval funds from Rule 10b-6 under the 1934 Act, which prohibited persons engaging in a distribution of securities from bidding on or purchasing those or certain related securities during their participation in the distribution. Rule 10b-6 has since been replaced by Rule 102 of Regulation M, and Rule 102 provides an express exemption for interval funds (and tender offer funds).

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