The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 22, NO. 11 • NOVEMBER 2015

REGULATORY MONITOR

SEC Update

By Sean Graber, David W. Freese, and Christine M. Nassauer

Interval Funds: An Alternative to "Liquid Alternative" Funds?-Part II

This article is Part II in a two-part series addressing interval funds. Part I of this series reviewed the regulatory history behind the development of interval funds and discussed the operation of interval funds under Rule 23c-3 under the Investment Company Act of 1940, as amended (1940 Act). This article compares the attributes of interval funds to those of private funds, liquid alternative mutual funds and closed-end funds that make periodic tender offers pursuant to applicable rules under the Securities Exchange Act of 1934, as amended (1934 Act) (tender offer funds), which are similar to interval funds but also differ in several important ways, and which also have been gaining in popularity among fund managers recently. These comparisons are meant to give fund managers an overview of their options in providing alternative strategies to the mass affluent marketplace.

Private fund managers are faced with several choices when deciding the most appropriate registered investment vehicles for their particular alternative investment strategies and the investor markets they wish to access. Although mutual funds have been the recent investment vehicle of choice for private fund managers looking to expand beyond their traditional client bases, other registered fund structures offer their own unique advantages. One such investment vehicle is the interval fund, a closed-end fund registered under the 1940 Act that offers to repurchase its shares from shareholders at periodic, predetermined intervals in accordance with Rule 23c-3 under the 1940 Act. Interval funds may appeal to private fund managers who are interested in offering more traditional hedge fund strategies to investors, but are willing to provide investors with guaranteed, periodic liquidity and the protections of the 1940 Act, which include restrictions on the funds' use of leverage and transactions with affiliates, strict custody requirements, and more comprehensive board governance requirements. Because an interval fund is only one of several vehicles that private fund managers may use to offer alternative investment strategies to the mass affluent marketplace, this article compares various attributes of the interval fund to two such other vehicles -- liquid alternative mutual funds and tender offer funds -- as well as to traditional unregistered private funds. Appendix A to this article provides a chart summarizing the discussion below.

Interval Funds Compared to Other Alternative Structures

To Whom May Shares Be Sold?

Private fund managers generally structure their funds to comply with either Section 3(c)(1) or 3(c)(7) of the 1940 Act to avoid registering such funds as investment companies under the 1940 Act. Section 3(c)(1) is available only to funds that have 100 or fewer beneficial owners, and Section 3(c)(7) is available to funds whose beneficial owners are "qualified purchasers."[1] In addition, private fund managers offer shares of their funds in private offerings under Regulation D of the Securities Act of 1933, as amended (1933 Act), to avoid registering such shares under the 1933 Act. This generally is accomplished by limiting investors in the private fund to only "accredited investors."[2]

Liquid alternative mutual funds, which are structured as open-end investment companies (referred to as mutual funds), must register as investment companies under the 1940 Act and generally register their shares under the 1933 Act by filing registration statements on Form N-1A. By registering their shares under the 1933 Act, liquid alternative mutual funds may engage in public offerings and, therefore, are not limited in the number or types of investors that may invest.

Interval funds and tender offer funds, which are closed-end investment companies, register as investment companies under the 1940 Act by filing registration statements on Form N-2. Interval funds and tender offer funds may elect to either register or not register their shares under the 1933 Act. A fund may determine not to register its shares under the 1933 Act if, for example, it intends to offer its shares in private placements to targeted accredited investors. Alternatively, an interval fund or tender offer fund may elect to register its shares under the 1933 Act and engage in a public offering to all investors. Therefore, assuming registration of the shares under the 1933 Act, liquid alternative mutual funds, interval funds and tender offer funds each offer private fund managers the ability to offer their funds to the broadest possible universe of investors. In contrast, shares of private funds are restricted to investors that are, at a minimum, accredited investors.

How Are Shares Redeemed?

Private fund managers are generally free to establish their own liquidity and redemption restrictions with respect to the funds they offer to clients. For example, private fund managers may offer only semiannual or annual redemptions in their funds, may limit the aggregate amount of redemptions on any particular redemption date, may restrict the timing of the payment of redemption proceeds, and may hold back a portion of the redemption proceeds for a period (for example, an audit holdback).

As discussed in more detail below, a liquid alternative mutual fund must stand ready to redeem its shares daily at the fund's net asset value (NAV) per share next computed after receipt of a redemption request.[3] Redemption proceeds must be paid to investors within seven days following receipt of the request pursuant to Section 22(e) of the 1940 Act.[4] In contrast, an interval fund conducts periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act, whereby the fund offers to repurchase a portion (between five percent and 25 percent) of its shares from all shareholders at NAV at predetermined intervals (repurchase offer). Rule 23c-3 requires interval funds to establish a fundamental policy that governs the timing of their repurchase offers to shareholders. As a result, interval funds are required to repurchase their shares on a quarterly, semiannual, or annual basis. This frequency is generally established at the time of the funds' launch, and may be changed only by shareholder vote. Similar to a mutual fund, interval funds must pay shareholders 100 percent of their redemption proceeds within seven days following the relevant repurchase offer pricing date.

Tender offer funds offer liquidity to their investors by conducting tender offers pursuant to Section 23(c)(2) of the 1940 Act. Section 23(c)(2) provides that no closed-end fund shall purchase any of its securities except pursuant to tenders after providing all shareholders a reasonable opportunity to participate in the tender offer. Tender offers conducted pursuant to Section 23(c)(2) must comply with the requirements of Rule 13e-4 under the 1934 Act, which sets forth the specific requirements with respect to the information that must be disclosed to shareholders, the manner in which the information must be disseminated and the manner in which tender offers must be conducted.[5]

Rule 13e-4 does not require a tender offer fund to conduct tender offers at set intervals, nor does it require a fund to conduct a minimum number of tenders in any given year. Rather, the fund's board may determine the frequency with which to conduct tender offers, generally taking into account the recommendation of the fund's investment adviser. After the board determines to conduct a tender offer, detailed tender offer documents must be prepared and sent to shareholders or published in a nationally circulated publication. The tender offer must remain open for at least 20 business days, after which the repurchase price for the tendered shares is determined. Tender offer funds may delay the payment of tender offer proceeds beyond seven days from the tender offer repurchase date because they are not subject to Section 22(e) of the 1940 Act (which applies to open-end funds) or Rule 23c-3 under the 1940 Act (which applies to interval funds). Instead, tender offer funds must pay shareholders consideration for the shares tendered "promptly" in accordance with Rule 14e-1(c) under the 1934 Act. In addition, similar to private funds, tender offer funds are not required to pay investors the entire amount of their redemption proceeds and may hold back a portion until a later date (for example, after the completion of the funds' audit).

The freedom to conduct tender offers when deemed appropriate and to delay payment and hold back a portion of the tender offer proceeds provides tender offer funds and their managers with private fund-like control over the withdrawal of fund assets. For example, a tender offer fund is able to replicate the typical private 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. As a result, sponsors of registered funds of hedge funds typically gravitate toward tender offer funds as opposed to interval funds, which are required to pay shareholders 100 percent of their redemption proceeds in cash within seven days. It should be noted, however, that the tender offer process required by Rule 13e-4 is generally more burdensome and expensive than the periodic repurchase offer process mandated by Rule 23c-3, which is outlined in detail in Part I of this series. Because they must stand ready to honor redemptions on a daily basis, liquid alternative mutual funds provide fund managers with the least flexibility to manage the withdrawal of fund assets.

How Often Are Shares Valued?

Private funds, mutual funds, and closed-end funds generally value their shares on any day they allow investors to purchase or sell shares. Private fund managers may choose how often to allow purchases and sales and, therefore, have control over the frequency of their share calculations. As a practical matter, most private fund shares are valued at the price next computed after receipt of a purchase or redemption order, even though such forward pricing is not required by law as it is for mutual funds and closed-end funds, as discussed below.

Liquid alternative mutual funds, which issue redeemable securities by definition,[6] must stand ready to redeem shares daily at the funds' NAVs next computed after receipt of redemption requests pursuant to Rule 22c-1 under the 1940 Act. Subject to limited exceptions, Rule 22c-1, therefore, requires mutual funds to value their shares each business day so that they can honor (or stand ready to honor) daily redemption requests.

As discussed in Part I of this series, interval funds are required to calculate their NAVs at least weekly.[7] In addition, interval funds also must calculate their NAVs in connection with shareholder purchases and, with respect to repurchase offers, on the actual repurchase offer pricing date and daily on the five business days preceding the repurchase offer request deadline. Because interval fund sponsors have control over the timing of shareholder purchases and fund repurchases, interval fund sponsors effectively have control over how frequently their interval funds must calculate their NAVs, subject to the minimum NAV calculations required by Rule 23c-3.

Tender offer funds do not issue redeemable securities and, therefore, are not required to calculate their NAVs daily in order to anticipate daily redemptions. In addition, tender offer funds do not operate in reliance on Rule 23c-3 like interval funds and, therefore, are not required to calculate NAVs at least weekly. Tender offer funds, like private funds, typically calculate their NAVs on days that investors are allowed to purchase or sell fund shares, as determined by the sponsor.

As one might expect, liquid alternative mutual funds are subject to the most rigid NAV calculation requirements (generally daily NAV calculation) as compared to interval funds and tender offer funds, but, depending on the underlying fund investments, the weekly NAV calculation requirement imposed on interval funds may present a burden for some fund sponsors. To this end, it is important for fund sponsors to evaluate the transparency they will have into their fund's underlying investments to determine whether such investments are consistent with the NAV calculation requirements for their desired investment vehicle.

Launching a New Fund

When a private fund manager wishes to launch a new fund, it typically creates the fund as a new, stand-alone entity (generally a limited partnership or limited liability company). In addition to the entity formation documents, the private fund manager will issue an offering memorandum with respect to the fund, but this memorandum generally is not subject to prior regulatory review or approval before the fund can be offered to investors. As a result, the launch time line for a private fund generally is determined by the private fund manager and is not materially impacted by regulatory filings and/or reviews.

Section 18(f)(2) of the 1940 Act allows an open-end investment company, such as a liquid alternative mutual fund, to be organized as a "series company" or a single business trust established under one set of organizational documents and a single board of trustees, but offering investors several investment portfolios (mutual funds). This structure affords mutual funds various operational cost savings each time a new mutual fund is launched by avoiding the need to: (i) create a new legal entity, (ii) provide at least $100,000 in seed capital for that entity pursuant to Section 14(a) of the 1940 Act (as discussed below), and (iii) file a new registration statement. Therefore, liquid alternative mutual funds may be added to an existing fund registration statement via a post-effective amendment rather than having to file an entirely new registration statement, which is required to be declared effective by the SEC Staff. To add an additional mutual fund, the fund company files a post-effective amendment to its existing registration statement pursuant to Rule 485(a). This amendment is subject to SEC Staff review and comment, but becomes automatically effective 75 days after filing.

In contrast to mutual funds, Section 18(f)(2) is not available to closed-end funds, and no analogous provision of the 1940 Act allows closed-end funds to operate as series companies. Therefore, interval fund and tender offer fund sponsors cannot rely on an existing fund's effective registration statement to launch a new fund. Instead, a new registration statement for each interval fund and tender offer fund must be filed with the SEC and declared effective by the SEC Staff. This process is generally estimated to be around 90-120 days, but may be extended for funds that present novel issues or have complex investment strategies. Further, because each new closed-end fund is its own legal entity, each new interval fund and tender offer fund is required to be seeded with at least $100,000 of capital pursuant to Section 14(a) of the 1940 Act. Further, this seed capital needs to be audited by an independent public accounting firm appointed by the fund's board and the resulting seed capital financial statements need to be included in the fund's registration statement in order for the SEC Staff to declare the registration statement effective.

In addition to SEC considerations, closed-end fund sponsors must consider whether the offering and distribution of their funds is subject to review by the Financial Industry Regulatory Authority (FINRA). Specifically, FINRA Rule 5110 governs the participation of FINRA member broker-dealers in public offerings and, a FINRA member firm, which includes an investment company's principal underwriter, cannot participate in a public offering unless certain documents relating to the offering have been filed with FINRA and FINRA has issued a "no objections" opinion. Private fund offerings are not subject to Rule 5110 because private funds do not engage in public offerings. In addition, offerings of liquid alternative mutual funds' and interval funds' securities are expressly exempt from Rule 5110.[8] Tender offer funds registered under the 1933 Act, however, are not exempted from Rule 5110 and, therefore, must undergo FINRA reviews of the offerings and distribution of their funds. This requires tender offer funds to file certain documents with FINRA, including the funds' registration statements, other SEC filings, underwriting agreements and other offering-related documents that FINRA may request. 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. Further, Rule 5110 filings are subject to a filing fee based on the total offering amount.

Liquid alternative mutual funds have a distinct advantage over interval funds and tender offer funds with respect to cost and timing of bringing a product to market. Liquid alternative mutual funds can simply be created as a new series of an already existing legal entity and, therefore, avoid the cost and time delay that interval funds and tender offer funds must incur by having to establish a new legal entity under state law and conduct an organizational board meeting for each new fund. Further, new liquid alternative mutual funds can be brought to market in 75 days because of the automatic effectiveness of their registration statement amendments under Rule 485 under the 1933 Act, whereas each interval fund and tender offer fund is subject to an unpredictable time line for the SEC Staff's review and approval of the fund's registration statement, which generally increases costs and time to market. In addition, FINRA Rule 5110 subjects tender offer funds to an additional regulatory hurdle to which liquid alternative mutual funds and interval funds are not subject. As a result of the application of FINRA Rule 5110, tender offer funds must file their offering-related documents and other information with FINRA, pay filing fees and wait to receive "no objections" opinions prior to offering shares publicly. These additional hurdles generally will cause a tender offer fund's launch time line and launch costs to be greater than the launch time line and costs associated with an interval fund.

Registration Statement Updates

Private funds are not required to update their offering memoranda on an annual basis and generally update their offering memoranda every few years depending on changes to the funds' investment strategies and risks and applicable securities and tax laws. Updated private fund offering memoranda are generally not subject to prior regulatory review or approval before they can be used.

In contrast, a liquid alternative mutual fund is required to amend its registration statement annually to provide its shareholders with updated financial information and current information regarding the fund's operations, such as current fees and expenses, investment strategies and risks.[9] A liquid alternative mutual fund satisfies this annual update requirement by filing a post-effective amendment to its registration statement with the SEC pursuant to Rule 485 under the 1933 Act. A fund seeking to make material changes to its registration statement must file an amendment pursuant to Rule 485(a), which is subject to SEC Staff review and comments but becomes automatically effective 60 days after filing. A fund that is simply updating its financial statements and not making material changes to its registration statement may forgo a Rule 485(a) filing and file a Rule 485(b) filing, which becomes effective automatically upon filing and is not subject to prior SEC Staff review and comment. It should be noted, however, that the SEC has authority pursuant to Section 8(e) of the 1940 Act to issue a stop order that would prevent a Rule 485 post-effective amendment from becoming effective. This authority, however, is not typically exercised because the SEC Staff generally will communicate to the fund any material issues that the Staff identifies with a post-effective amendment filing prior to the amendment going effective. Without Rule 485, each mutual fund registration statement amendment would not become effective until the SEC Staff issued an SEC order declaring the amendment effective. As a result, the automatic and immediate effectiveness provisions under Rule 485 allow a liquid alternative mutual fund to offer shares to investors on a continuous basis and, therefore, offset constant redemptions that result from offering redeemable securities. Further, Rule 485 eliminates the need for a mutual fund to worry on an annual basis whether the fund will need to suspend the offering of its shares because the SEC Staff may not declare its registration statement amendment effective in a timely manner.

The 1940 Act generally does not require a closed-end fund to annually update its registration statement, provided the fund furnishes its shareholders with certain information in the fund's annual shareholder report.[10] However, similar to mutual funds, closed-end funds with shares registered under the 1933 Act that are engaged in continuous offerings (generally pursuant to Rule 415 under the 1933 Act) are required to annually update their registration statements by virtue of Section 10(a)(3) of the 1933 Act. The process by which interval funds and tender offer funds annually update their registration statements is a material difference between the two investment vehicles.

Interval funds are permitted to file post-effective amendments pursuant to Rule 486 under the 1933 Act to update their registration statements. Similar to Rule 485 and the process used by mutual funds, Rule 486 provides for automatic or immediate effectiveness of interval fund post-effective amendments, which forgoes the need for the SEC Staff to declare each amendment effective.[11] Rule 486 was enacted by the SEC to allow interval funds to offer shares continuously in an effort to replenish assets that could be depleted by mandatory, periodic share repurchases without risking the suspension of their offerings each year because the funds are waiting for the SEC Staff to declare their registration statement amendments effective.

Tender offer funds, however, may not rely on Rule 486 or Rule 485. Instead, tender offer funds file post-effective amendments pursuant to Section 8(c) of the 1933 Act to update their registration statements annually. Section 8(c) does not provide for automatic or immediate effectiveness. Instead, the SEC Staff must declare a posteffective amendment filed pursuant to Section 8(c) effective.[12] As such, liquid alternative mutual funds and interval funds offer a more predictable process for registration statement updates than tender offer funds and, absent unusual circumstances, do not carry the risk of having to suspend the offering of shares until the SEC Staff declares the funds' registration statement amendments effective. Further, liquid alternative mutual funds and interval funds are not subject to the additional costs that are generally associated with having to obtain SEC Staff approval of each annual amendment to their registration statements.

Availability of Multiple Share Classes

Private fund managers are not restricted in their ability to offer different classes of shares with different expense structures to investors in their private funds. In practice, it is very common for private fund managers to establish multiple share classes of their funds for the purpose of offering multiple fee arrangements to their investors. The 1940 Act, however, imposes restrictions on the ability of liquid alternative mutual funds, interval funds and tender offer funds to offer multiple share classes of the same fund with different expense structures. In general, under the 1940 Act these different expense structures within the same fund could be deemed to result in the creation of a "senior security," which is generally prohibited under Section 18 of the 1940 Act.[13] In fact, prior to 1995 multiclass arrangements for both mutual funds and closed-end funds were prohibited without first obtaining exemptive relief from the SEC.

In 1995, the SEC adopted Rule 18f-3 to allow mutual funds to offer multiple share classes if certain conditions are met. As a result, most liquid alternative mutual funds offer multiple share classes that are customized to the needs of the various distribution channels in which the funds are offered. These separate share classes may impose differing fees for distribution services, shareholder services and administrative services, but, importantly, may not impose different advisory fees or custodial fees.

The process for offering multiple share classes of an interval fund and tender offer fund is more burdensome because Rule 18f-3 does not apply to closed-end funds and there is no equivalent rule applicable to closed-end funds. Therefore, an interval fund or tender offer fund may offer multiple share classes only if it first receives exemptive relief from the SEC. Fortunately for closed-end fund sponsors, the multiple share class exemptive application process has become more common in the past few years, resulting in a more streamlined and quicker process. In general, once a closed-end fund receives the necessary SEC exemptive relief, the closed-end fund has the ability to offer multiple share classes subject to the same conditions as a mutual fund, including the prohibition on having different advisory fees charged within the same fund.

Liquid alternative mutual funds offer the greatest flexibility to establish multiple share classes with varying fee structures within a single investment company in light of the relief provided by Rule 18f-3. Interval funds and tender offer funds are forced to incur the cost and time delay related to filing an SEC exemptive application prior to offering multiple share classes. However, it is common for interval funds and tender offer funds to launch with only one share class and seek the necessary exemptive relief to offer multiple share classes if and when new distribution channels emerge. Fund sponsors deciding to launch interval funds or tender offer funds should review the needs of the various distribution channels in which the funds will be offered in order to evaluate whether the funds will need to file SEC exemptive applications to establish multiple share classes.

Ability to Impose Fees for Distribution

Private funds are not restricted in their ability to impose asset-based distribution fees on their investors in order to finance the distribution of the funds out of the funds' assets. In contrast, Section 12(b) of the 1940 Act prohibits a mutual fund from distributing its own securities, except through an underwriter, in contravention of SEC rules. The SEC adopted Rule 12b-1 under the 1940 Act to allow mutual funds to finance the sale of their shares from fund assets if certain conditions are met. Pursuant to Rule 12b-1 and FINRA rules applicable to broker-dealers that sell fund shares, mutual funds may impose an asset-based distribution fee not to exceed 0.75 percent of the funds' average daily net assets, although many funds impose a 0.25 percent fee. Since its adoption in 1980, Rule 12b-1 fees have become a fundamental component of mutual fund distribution arrangements with financial intermediaries.

When adopting Rule 12b-1, the SEC also adopted Rule 17d-3 under the 1940 Act, which provides an exemption from the affiliated joint transaction prohibitions imposed by Section 17(d) of the 1940 Act and Rule 17d-1 under it to permit mutual funds to make distribution payments to their principal underwriters and affiliates.[14] Similar to Rule 18f-3 discussed above, Rule 17d-3 exempts only mutual funds, and, therefore, it could be argued that financing distribution payments by an interval fund or a tender offer fund violates Section 17(d) and Rule 17d-1. As such, it is customary for interval funds and tender offer funds, when requesting the multiple share class exemptive relief discussed above, also to include in such applications requests for exemptive relief from Section 17(d) and Rule 17d-1 that would allow for the implementation of a distribution charge similar to a Rule 12b-1 fee.

Liquid alternative mutual funds offer the greatest flexibility to impose asset-based distribution fees because Rule 12b-1 and Rule 17d-3 specifically grant mutual funds the authority to impose such fees. Similar to multiple share class arrangements, interval funds and tender offer funds are forced to incur the cost and time delay related to filing SEC exemptive applications prior to imposing asset-based distribution fees, although the request for such relief may be combined with the funds' requests to offer multiple share classes. Given the importance of asset-based compensation in distributing funds, fund sponsors should evaluate the need to charge asset-based distribution fees when considering the various choices among investment vehicles. Further, fund sponsors deciding to launch interval funds or tender offer funds should take into account the cost and possible delay associated with filing SEC exemptive applications to impose asset-based distribution fees.

Ability to Charge Performance Fees

Private fund managers are permitted to charge performance fees for management of private funds if all of the funds' investors are "qualified clients" as defined in Rule 205-3 under the Investment Advisers Act of 1940, as amended (Advisers Act).[15] Generally, private fund managers charge performance fees or carried interest on the realized and/or unrealized investment profits of a fund, subject, in some cases, to a "high water mark" or outperformance of a particular benchmark index.

Liquid alternative mutual funds, interval funds and tender offer funds may charge performance fees similar to those charged by private funds if all fund shareholders are limited to qualified clients, but, in practice, it is rare for mutual funds to restrict their universe of potential investors in such a manner. If a liquid alternative mutual fund desires to charge a performance fee, it likely would impose a "fulcrum fee" pursuant to Section 205(b)(2) of the Advisers Act. Importantly, Section 205(b)(2) does not require a fund to limit its shareholders to qualified clients. Section 205(b)(2) allows a mutual fund and closed-end fund to charge a fee that increases when performance exceeds the fund's benchmark over a designated period (at least one year) or decreases when performance lags the benchmark over such period. Under Section 205(b)(2), the reward for out-performance and the penalty for under-performance must be symmetrical. This is a key difference between a fulcrum fee and the typical performance fee charged by private funds, which may cause fulcrum fees to be less desirable to private fund managers. However, the advantage of being able to distribute a fund with a fulcrum fee to the broadest possible universe of investors (that is, no restrictions on investor eligibility) may outweigh the disadvantage of accepting some downside performance risk.

Charging traditional performance fees, and limiting shareholders to qualified clients, is more common in the closed-end space, where a more targeted distribution strategy may be considered and potential shareholders may be more willing to accept, and more accustomed to paying, these types of fees. Therefore, a private fund manager that seeks to charge a traditional performance fee in a registered product may find an interval fund or tender offer fund more desirable.

Liquidity Restrictions

A private fund is restricted from investing in particular instruments only by its own investment strategies as determined by its sponsor and appropriately disclosed to fund investors. As discussed in Part I of this series, due to the fact that it issues redeemable securities, a liquid alternative mutual fund may not invest more than 15 percent of its net assets in illiquid investments, which are investments that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment on its books. An interval fund is required to hold liquid assets equal to 100 percent of the amount of its repurchase offer to shareholders (between 5 percent and 25 percent of the fund's assets) beginning from the time the fund notifies shareholders of the repurchase offer until the repurchase pricing date. As a result, with respect to a particular repurchase offer, an interval fund may be required to hold liquid assets in the amount necessary to satisfy the repurchase offer amount from anywhere between 21 to 56 days depending on when it sends the repurchase offer notification and establishes the repurchase offer pricing date.[16] Tender offer funds are not subject to any explicit liquidity requirements, although they may need to hold a certain amount of liquid assets in order to facilitate tender offers and pay expenses and distributions. Therefore, tender offer funds provide the greatest flexibility in managing an illiquid portfolio, with liquid alternative mutual funds providing the least flexibility. While interval funds provide less flexibility in managing an illiquid portfolio than tender offer funds, fund sponsors generally should not be overly burdened by an interval fund's liquidity requirements given that an interval fund is only required to maintain liquidity sufficient to support its repurchase offers, which can be as low as five percent of the fund's shares and, at a minimum, are only required once a year.

Issuance of Senior Securities

Private funds are not restricted with respect to their ability to engage in investment strategies that involve short sales, derivatives, leveraged transactions, and borrowings so long as such information is appropriately disclosed to fund investors. However, when these investments and investment strategies are engaged in by a registered fund (a liquid alternative mutual fund, interval fund or tender offer fund), the fund is subject to the SEC's and its Staff's interpretation that such investments and strategies may involve the issuance of senior securities subject to the prohibitions and asset coverage requirements of Section 18 of the 1940 Act. The Section 18 asset coverage requirements restrict a registered fund's use of short sales, derivatives, leveraged transactions, and borrowings by requiring the fund to earmark or segregate liquid assets in an amount necessary to cover the fund's obligations under these transactions.[17] Assets set aside to cover a fund's obligation are generally frozen and unavailable to the fund for any other purpose, including other leveraged transactions.[18] By taking these assets "out of circulation," the asset segregation requirement serves as a de facto limit on the amount of leverage transactions in which a registered fund may engage. In general, many registered funds use the cost to close out their obligations under the investments when determining the appropriate coverage amount, which in some cases may be a net "marked-to-market amount" or the full notional amount of the obligations. However, Section 18 requires 300 percent asset coverage for a registered fund's traditional bank borrowings, except for temporary borrowings in an amount not exceeding five percent of the value of the fund's total assets.[19] Further, Section 18 restricts liquid alternative mutual funds to borrowing only from banks, whereas interval funds and closed-end funds may borrow from nonbank entities, which may be advantageous to fund sponsors who have preexisting lending relationships with nonbank lenders, such as prime brokers.

Section 18 of the 1940 Act treats mutual funds and closed-end funds differently in some additional areas. For example, tender offer closed-end funds may issue one class of senior debt, subject to a 300 percent asset coverage requirement, and one class of preferred stock, subject to a 200 percent asset coverage requirement. Mutual funds are not permitted to issue senior debt or preferred stock. Rule 23c-3 imposes additional senior security restrictions on interval funds. As noted in Part I of this series, an interval fund may issue only two types of senior securities: (i) those maturing by the next repurchase offer pricing date or (ii) those whose terms provide for redemption, call, or repayment by the repurchase offer pricing date as necessary to permit the repurchase. These provisions are intended to provide shareholders with assurance that outstanding senior securities or other indebtedness will not prevent an interval fund from carrying out a scheduled repurchase offer. Tender offer funds are not subject to these restrictions. Therefore, interval funds are more limited than tender offer funds in their ability to issue senior securities.

In light of the above, private fund managers that desire the flexibility to offer senior classes of securities may consider tender offer funds the most attractive option, with interval funds having more flexibility to offer senior securities than liquid alternative mutual funds. However, all registered funds are subject to the asset coverage requirements of Section 18 of the 1940 Act, which may prevent the utilization of certain highly leveraged investment strategies that are common to private funds.

Conclusion

Private fund managers may use various investment vehicles to provide investment management services to the mass affluent, including interval funds. While interval funds do not hold every advantage over other investment vehicles, they do represent a potentially underused option for private fund managers to access the mass affluent marketplace. As shown above, interval funds fall between traditional private funds, which offer investors limited protections and liquidity, but offer fund sponsors the most flexibility, and liquid alternative mutual funds, which offer investors the most protections and liquidity, but offer fund sponsors less flexibility.

Tender offer funds are similar to interval funds in how their features compare to traditional private funds and mutual funds. Compared to tender offer funds, interval funds offer investors guaranteed liquidity at preestablished intervals, while tender offer funds are similar to private funds in that there is no mandatory requirement for the fund sponsor to offer shareholders liquidity at set intervals. This flexibility to conduct tender offers only when deemed appropriate does come at a cost because the tender offer process generally is more burdensome and expensive for funds than the interval fund periodic repurchase offer process.

Compared to traditional private funds, interval funds may appeal to investors who are seeking to diversify into more traditional hedge fund strategies, but who are unwilling to accept the uncertainty of the more limited liquidity offered by such products. These investors may also 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 NAV calculations, restrictions on the funds' use of leverage and transactions with affiliates, strict custody requirements, and more comprehensive board governance requirements. Compared to liquid alternative mutual funds, interval funds may appeal to investors seeking a degree of liquidity, but who are willing to sacrifice the daily liquidity of a mutual fund for the ability to invest in a vehicle allowed to hold significant positions in illiquid assets and/or pursue more illiquid investment strategies.

Sean Graber is a partner, and **David W. Freese** and **Christine M. Nassauer** are associates, in the investment management practice of Morgan, Lewis & Bockius LLP.

NOTES

1 Section 2(a)(51) of the 1940 Act defines the term "qualified purchaser" to include, among others, any natural person who owns at least $5 million in investments or any company that owns at least $25 million in investments. Private fund managers generally limit the investors in their Section 3(c)(7) funds to 1999 investors in order to avoid the reporting obligations imposed under the 1934 Act.

2 Rule 501(a) of Regulation D under the 1933 Act defines the term "accredited investor" to include, among others, any natural person whose net worth, or joint net worth with that person's spouse, exceeds

$1 million at the time of purchase (exclusive of a natural person's primary residence), or whose income exceeded $200,000 in each of the two most recent years or joint income with that person's spouse exceeded $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

3 Rule 22c-1 under the 1940 Act.

4 Section 22(e) of the 1940 Act.

5 Unlike interval funds, tender offer funds are also subject to Rules 14e-1 and 14e-2 under the 1934 Act. However, like interval funds, tender offer funds are exempt from Regulation M's restrictions on the activities of issuers during distributions of their securities pursuant to Rule 102(b)(ii) of Regulation M.

6 Section 5(a)(1) of the 1940 Act.

7 Rule 23c-3(b)(7)(i) under the 1940 Act.

8 FINRA Rule 5110(b)(8)(C).

9 *See* Rule 8b-16(a) under the 1940 Act and Section 10(a)(3) of the 1933 Act.

10 *See* Rule 8b-16(b) under the 1940 Act.

11 Similar to the SEC's power under Rule 485(b) under the 1933 Act, the SEC also has authority to issue a stop order that would prevent a Rule 486 post-effective amendment from becoming effective.

12 Certain exchange-listed closed-end funds have obtained exemptive relief from the SEC Staff that permits them to rely on Rule 486 to allow a post-effective amendment to become immediately effective on the filing date. *See, e.g.*, Nuveen Credit Strategies Income Fund, Nuveen Energy MLP Total Return Fund, and Nuveen Real Estate Income Fund, SEC Staff No-Action Letter (Nov. 7, 2014); The Mexico Fund, Inc., SEC Staff No-Action Letter (Dec. 31, 2013). However, each such no-action letter expressly provides that no other closed-end fund may rely on it. Therefore, tender offer funds either must file posteffective amendments that must be declared effective by the SEC Staff annually or file for a SEC Staff no-action letter to allow reliance on Rule 486.

13 Section 18(f)(1) of the 1940 Act prohibits an open-end fund from issuing any class of senior securities, and Section 18(g) defines "senior security" to include any class having a priority over any other class as to distribution of assets or payment of dividends. Section 18(c) prohibits a closed-end fund from offering a senior equity security that has "a preference or priority over any other series upon the distribution of the assets of such registered closed-end company or in respect of the payment of interest or dividends." Section 18(i) requires that every share of stock issued by an open-end fund or closed-end fund be voting stock, with the same voting rights as every other outstanding voting stock.

14 Section 17(d) of the 1940 Act prohibits any affiliated person of or a principal underwriter for an open-end fund or closed-end fund, or an affiliated person of such a person, acting as principal, from effecting any transaction in which the fund is a joint or a joint and several participant with the affiliated person in contravention of SEC regulations. Section 17(d)'s prohibitions also apply to a company controlled by an open-end fund or closed-end fund.

15 Rule 205-3 under the Advisers Act defines the term "qualified client" to include, among others, natural persons or companies with at least $1 million in assets under management with the adviser or who have a net worth of more than $2 million (exclusive of a natural person's primary residence).

16 An interval fund may send notice to shareholders no more than 42 days and no less than 21 days prior to the repurchase request deadline, and the repurchase pricing date can be no later than 14 days after the repurchase request deadline and no earlier than the close of business on the repurchase request deadline.

17 *See Securities Trading Practices of Registered Investment Companies*, Inv. Co. Act Rel. No. 10666 (April 18, 1979).

18 *See e.g.*, *id.*

19 Section 18(f) of the 1940 Act.

Appendix A

Comparison of Investment Vehicles

	Hedge Fund	Interval Fund	Tender Offer Closed-End Fund	Liquid Alternative Mutual Fund
Who Can Invest?	3(c)(1): Accredited investors 3(c)(7): Qualified purchasers	Any investor, if 1933 Act registered	Any investor, if 1933 Act registered	Any investor
How Many Investors Can Invest?	3(c)(1): 100 investors 3(c)(7): 1999 investors to avoid reporting obligations under the 1934 Act	No limit, if 1933 Act registered	No limit, if 1933 Act registered	No limit, if 1933 Act registered
How Often Are Shares Valued?	Generally on days that investors are permitted to buy and sell shares, as determined by the sponsor (*e.g.*, monthly or quarterly)	• At least weekly • On each repurchase offer pricing date • Daily on the five business days preceding each repurchase offer request deadline • Generally on days that investors are permitted to buy shares, as determined by the sponsor (*e.g.*, monthly or quarterly)	Generally on days that investors are permitted to buy and sell shares, as determined by the sponsor (*e.g.*, monthly or quarterly)	Generally each business day
Performance Fee?	Yes, if limited to "qualified clients"	Yes, if limited to "qualified clients"	Yes, if limited to "qualified clients"	Yes, if limited to "qualified clients," but rarely seen in practice
12b-1 Fee?	N/A	Yes, but exemptive relief required	Yes, but exemptive relief required	Yes
Multiple Share Classes?	Yes	Yes, but exemptive relief required	Yes, but exemptive relief required	Yes
Asset Liquidity Restrictions?	None	Must maintain liquid assets sufficient to meet repurchase offers during time between notice of repurchase offer to shareholders and repurchase pricing date	None	Illiquid securities limited to 15% of net assets
Liquidity Structure?	As determined by the manager of the fund	Repurchase offers required at interval chosen by fund (*e.g.*, quarterly, semi-annually or annually), unless changed by shareholders	Frequency and amount of tender offers is at the discretion of the board	Must stand ready to meet daily redemptions

Can Payment of Redemption Proceeds Be Delayed?	Yes	No; repurchase payment deadline must occur seven days after the repurchase pricing date	Yes	No; must pay redemption proceeds within seven days following receipt of a redemption request
Subject to FINRA Rule 5110 Registration Statement Review?	No	No	Yes, if 1933 Act registered	No
How Is the Registration Statement Updated?	N/A	If registered under the 1933 Act: • Annual update filing via Rule 485 under the 1933 Act • Automatic effectiveness	If registered under the 1933 Act: • Annual update filing • Must request effectiveness each year	• Annual update filing via Rule 485 under the 1933 Act • Automatic effectiveness
May Senior Securities Be Issued?	• Not subject to asset coverage requirements of Section 18 of the 1940 Act • May issue senior classes of debt and equity • May borrow from banks and nonbank entities	• Short sales, derivatives, leverage and borrowings subject to asset coverage requirements of Section 18 of the 1940 Act • May issue a senior class of debt and equity in accordance with Section 18 of the 1940 Act and Rule 23c-3 under it • May borrow from banks and nonbank entities	• Short sales, derivatives, leverage and borrowings subject to asset coverage requirements of Section 18 of the 1940 Act • May issue a senior class of debt and equity in accordance with Section 18 of the 1940 Act • May borrow from banks and nonbank entities	• Short sales, derivatives, leverage and borrowings subject to asset coverage requirements of Section 18 of the 1940 Act • No senior class of debt or equity may be issued • May borrow only from banks