

# Closed-End Funds: Interval and Tender Offer Funds

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# Agenda

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- Regulatory Considerations
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# Overview

# Interval Funds and Tender Offer Funds

- Interval funds and tender offer funds are similar types of closed-end funds registered under the Investment Company Act of 1940 (the “1940 Act”)
- They are often viewed as hybrids of open-end mutual funds and traditional closed-end funds
- An interval fund relies on Rule 23c-3 under the 1940 Act to make repurchase offers of between 5% and 25% of the fund’s outstanding shares at intervals of every three, six, or twelve months
- A tender offer fund relies on Rule 13e-4 under the Securities Exchange Act of 1934 (the “Exchange Act”) to make periodic tender offers for shares on a discretionary basis

# Ability to Implement Illiquid and Non-Traditional Strategies in a Regulated Product

- Interval and tender offer funds are not subject to the SEC's liquidity risk management rule (and related reporting and disclosure requirements), which limits a mutual fund's or an ETF's investment in illiquid assets to 15% of its net assets
- Interval and tender offer funds are subject to regularly scheduled repurchase offers or control the timing of their repurchase offers, and as a result can actively monitor their need for liquidity to satisfy repurchase requests. Importantly, repurchase offer amounts are subject to a board-specified cap
  - In contrast, mutual funds and ETFs must offer daily liquidity without limit
- As a result, interval and tender offer funds are able to pursue concentrated illiquid and non-traditional strategies (e.g., high-yield and distressed credit, real estate, private equity) without being subject to volatile cash flows
  - From the time that an interval fund sends a repurchase notice until the repurchase pricing date, the fund is required to hold liquid assets equal to 100% of the repurchase offer amount

# Comparisons With Traditional Closed-End Funds, Mutual Funds, ETFs, and Private Funds

# Continuous Offerings

- Interval and tender offer funds typically engage in a continuous offering of shares registered under the Securities Act of 1933 (the “1933 Act”) and may open and close to admit new investors as needed
  - Enables an interval or tender offer fund to replenish cash that can be used to satisfy periodic repurchase offers
  - Can alleviate the need to sell existing portfolio holdings to generate cash for new investments
  - Allows the fund to take in cash to pursue new investment opportunities

# Public Offerings

- Private funds may not engage in public offerings and are typically offered only to investors who are “accredited investors” and “qualified purchasers”
- Interval and tender offer funds can make public offerings to the broadest possible retail investor base by registering under both the 1940 Act and the 1933 Act, or, alternatively, can choose to make 1933 Act-exempt offerings to accredited investors pursuant to Regulation D
- Generally, the structure is used for continuous offerings without an exchange listing
- Note that the SEC staff has taken a position limiting certain types of investments (particularly related to investments in private funds) by interval and tender offer funds unless they limit their offerings of shares to accredited investors, even if the offerings are registered under the 1933 Act



# Performance Fees

- An interval or tender offer fund that limits sales of its shares to persons who are “qualified clients” (as defined under the Investment Advisers Act of 1940) may charge a performance fee
- An interval or tender offer fund that does not limit sales to qualified clients may charge a performance fee based only on income
- Any interval or tender offer fund may impose a “fulcrum fee,” which adjusts the adviser’s compensation both up and down based on the fund’s performance relative to that of a benchmark index (fulcrum fees are relatively uncommon)

## 1940 Act Requirements Apply

- Interval and tender offer funds are subject to the requirements of the 1940 Act, which govern a wide variety of fund operations, for example:
  - Independent board
  - Valuation
  - Leverage limitations (but less restrictive than open-end funds and ETFs)
  - Extensive reporting and disclosure obligations
  - Affiliated transactions
  - Service providers
  - Investing in other funds

# Key Comparisons

	Interval Funds	Tender Offer Funds	Listed Closed-End Funds	Open-End Funds	ETFs	Private Funds
May engage in continuous offerings	✓	✓	Possible	✓	✓	✓
Exchange listed	Possible	Possible	✓		✓	
May be offered to retail investors	✓	✓	✓	✓	✓	
Must have a highly liquid portfolio	Partial	Partial		✓	✓	
Must offer daily redemptions/NAV calculations	Daily NAV periodically			✓	✓	
Periodic repurchases	✓	✓				Possible
Performance fees	Possible	Possible				✓

# Regulatory Considerations

## Repurchase Offers – Interval Funds

- Interval funds make repurchases of their shares pursuant to Rule 23c-3 under the 1940 Act
- An interval fund must offer to repurchase between 5% and 25% of its outstanding shares at fixed periodic “intervals” of every three, six, or twelve months
  - The interval must be a fundamental policy
  - Shares must be repurchased for cash at net asset value within seven days
- If shareholders tender more than the repurchase offer amount, the fund may repurchase an additional amount of up to 2% of the fund’s outstanding shares
- If shareholders tender shares in an amount exceeding the repurchase offer amount (plus an additional 2%, if applicable), the fund is required to make repurchases on a *pro rata* basis, subject to certain potential exceptions

## Repurchase Offers – Tender Offer Funds

- Tender offer funds make repurchases of their shares pursuant to Rule 13e-4 under the Exchange Act
- Unlike an interval fund, a tender offer fund is not required to conduct tender offers on any fixed periodic basis or for any specific amount of outstanding shares
- Despite the flexibility, tender offer funds may adopt policies to conduct regular tender offers of certain minimum amounts
- If shareholders tender shares in an amount exceeding the tender offer amount, then like interval funds, a tender offer fund generally is required to make repurchases on a *pro rata* basis

## Timing of Repurchase Offers – Interval Funds

- Rule 23c-3 sets strict parameters around the timing of an interval fund's periodic repurchase offers, which must be set out in a fundamental policy that can be changed only with both board and shareholder approval.
- Following board approval of a repurchase offer amount, an interval fund must send a notice to shareholders, specifying the following, among other things:
  - Repurchase offer amount
  - Repurchase request deadline
  - Repurchase pricing date
  - Repurchase payment deadline
- An interval fund may not suspend or postpone a repurchase offer except under very limited circumstances
  - The suspension or postponement must be approved by the fund's board, including a majority of independent directors

## Timing of Repurchase Offers – Tender Offer Funds

- Following board approval of a tender offer, a tender offer fund must send a notice to shareholders with certain information regarding the tender offer
  - A filing on Schedule TO must be made with the SEC (along with payment of a fee)
- A tender offer fund must keep the tender offer open for at least 20 business days from the date of the offer's commencement, after which the repurchase price is determined
- A tender offer fund must make payment of redemption proceeds “promptly” after the termination of the tender offer



## Portfolio Liquidity – Interval Funds

- From the time that an interval fund sends a repurchase notice until the repurchase pricing date, the fund is required to hold liquid assets equal to 100% of the repurchase offer amount
- “Liquid” for this purpose means:
  - (i) assets that can be sold or disposed of in the ordinary course of business, at approximately the price at which the company has valued the investment, between the repurchase request deadline and the repurchase payment deadline, or
  - (ii) assets that mature by the next repurchase payment deadline
- An interval fund’s board is required to adopt written procedures to ensure that the fund’s assets are sufficiently liquid so that the fund can comply with its fundamental policy on repurchases and the requirement to hold liquid assets equal to 100% of the repurchase amount

## Portfolio Liquidity – Tender Offer Funds

- Tender offer funds have more flexibility with regard to portfolio liquidity than interval funds
- Because the timing of repurchase offers is at the discretion of the Board, tender offer funds have more flexibility to match the timing of payment of repurchase proceeds with the liquidity of the underlying investment portfolio
- As a result, tender offer funds can invest in a broader range of asset categories than interval funds and time the payment of repurchase proceeds with the liquidity of their underlying investments

# Leverage

- Interval and tender offer funds are generally subject to the same limitations under Section 18 of the 1940 Act on incurring leverage
- Interval and tender offer funds may issue senior securities representing indebtedness, provided that at the time of borrowing the fund has asset coverage of at least 300%
- Interval and tender offer funds may also issue senior securities representing stock, provided that the fund maintains asset coverage of at least 200%
- Interval funds are subject to an additional restriction under Rule 23c-3 that any senior security issued or other indebtedness must either:
  - (i) mature by the fund's next repurchase pricing date; or
  - (ii) be redeemable, callable, or repayable without penalty or premium by the fund's next repurchase pricing date so that the fund can meet its repurchase obligations

## Determination of NAV

- An interval fund is required to calculate its NAV at least once weekly and on each day that the fund offers its shares for sale
- In connection with repurchase offers, an interval fund is required to calculate its NAV on the repurchase pricing date and on each of the five business days prior to the repurchase request deadline
- Unlike interval funds, tender offer funds are not required to calculate NAV at least once weekly
- Instead, similar to private funds, interval funds typically calculate NAV on days that investors are allowed to purchase or redeem shares, as determined by the fund

# Distribution

- An interval or tender offer fund whose shares are registered under the Securities Act may distribute and sell fund shares to retail investors without regard to whether such investors are qualified purchasers or accredited investors
- Sales efforts may include, as with mutual funds, entering into arrangements with financial intermediaries to access fund “supermarkets” or other retail investor platforms
- Traditionally, mutual funds have also offered multiple share classes with differing fee structures to take advantage of varying distribution opportunities
- Broker-dealers recommending interval or tender offer funds to retail customers are subject to FINRA’s suitability rule and Regulation BI
- Among other things, Regulation BI requires broker-dealers and registered representatives to:
  - Consider the risks, rewards, and costs of a recommended investment in light of a customer’s investment profile and have a reasonable basis to believe that the recommendation is in the customer’s best interest

# Marketing and Advertising

- Rule 482 under the 1933 Act is the primary rule governing advertisements of 1940 Act-registered funds
  - The Rule includes specific disclosure requirements
  - Rule 482 advertisements are filed with FINRA
- Broker-dealers are permitted to publish issuer-specific research reports concerning certain tender offer and interval funds in accordance with 1933 Act rules
- The SEC staff has allowed the use of “related performance” – e.g., track-records of substantially similar private funds – in fund registration statements

# Multi-Share Class Relief

- Interval and tender offer funds must obtain exemptive relief from the SEC to offer multiple share classes and to permit the fund, an affiliate, or principal underwriter to enter into arrangements whereby payments are made by the fund to finance distribution of fund shares
  - Exemptive relief permits fund sponsors to take advantage of diverse distribution channels and the flexibility to craft tailored share classes (e.g., different sales loads)
  - Although time consuming, the process of obtaining exemptive relief has become standardized
  - The multi-share class exemptive orders granted to interval and tender offer funds require them to comply with certain 1940 Act rules that apply to open-end funds as if those rules applied to the funds that have received the relief

# Affiliated Transactions

- Under the 1940 Act, interval and tender offer funds are subject to a number of restrictions on transactions involving “affiliated persons”
  - Extends to two levels of affiliation
    - (1) the fund’s affiliates; and
    - (2) the affiliates of such affiliates
- Main restrictions
  - Section 17(a) makes it unlawful for any affiliate of a registered fund (or an affiliate of such an affiliate) acting as principal to knowingly purchase from or sell assets to an interval or tender offer fund
  - Section 17(d) and Rule 17d-1 make it unlawful for any affiliate of an interval or tender offer fund (or an affiliate of such an affiliate), acting as principal, to participate in or effect any transaction in connection with a “joint enterprise or other joint arrangement” in which the fund is a participant



# Affiliated Transactions

- Section 17(d) and Rule 17d-1, in particular, pose challenges for sponsors that manage interval or tender offer funds alongside private funds because the prohibitions on joint transactions may effectively prohibit co-investments in private placement transactions, absent compliance with certain no-action letters or SEC exemptive relief
- No-Action Letters and Co-investment exemptive relief
  - Under the relevant line of no-action letters, a registered fund may co-invest alongside an affiliate in private transactions where all of the affiliated parties participate on the same terms, there are no terms negotiated other than those that are price-related, and allocations of opportunities are made fairly and pursuant to established policies
  - To permit co-investments in private placement transactions that involve negotiation of terms other than price, many closed-end funds and their advisers have obtained individualized exemptive relief that typically requires funds to abide by numerous conditions concerning, among other things, the identification, allocation and approval of investments. The exemptive relief process and compliance with the conditions may be essential for any sponsor who seeks to manage an interval or tender offer fund alongside one or more private funds

# Other Considerations

# Board Governance

- An interval or tender offer fund's board has ultimate responsibility for the management of the affairs of the fund and must, among other things:
  - Approve the fund's advisory contract initially, and then annually thereafter following an initial two-year term
  - Approve any distribution or underwriting agreements and other service provider agreements
  - Approve the compliance program, and appoint the fund's chief compliance officer and approve his or her compensation
  - Oversee the valuation of the fund's investments
  - Approve the fundamental policy governing periodic repurchase offers (interval funds only)
  - Approve the procedures to maintain liquid assets to satisfy repurchase requests (interval funds only)
- Members of the board are subject to fiduciary duties in carrying out their responsibilities
- The 1940 Act, and certain rules adopted under the 1940 Act, place limitations on the composition of a fund's board

# Service Providers and Fund Operations

- The 1940 Act includes provisions governing a fund's relationship with service providers, including transfer agents, underwriters, custodians, and accountants
- Sponsors and distributors must comply with FINRA Rule 2341 related to the prompt payment for transactions in investment company shares
- Funds or financial intermediaries that limit distribution to accredited investors may require orders to be reviewed and evaluated for compliance with applicable eligibility requirements

# SEC Registration

- Must file a registration statement on Form N-2, which requires comprehensive information about the fund's investment objectives, fees, risks, management personnel, conflicts of interest, tax structure, distribution arrangements, service providers, and other information
  - Initial registration statement subject to SEC review and comment by the Division of Investment Management
  - Registration under the 1933 Act typically takes between 90 and 120 days, but there is no fixed timeline, and it may take longer depending on a number of factors, including the complexity of a fund's investment strategy
  - Prior to effectiveness, a publicly offered interval or tender offer fund is required to have at least \$100,000
  - A fund that wishes to engage in a continuous public offering must file annual updates to its registration statement, which are not subject to SEC review except in special circumstances
- Prospectus must identify the principal types of investment instruments that may be used by the fund and the types of risks that such usage entails
- Fund advertising should be consistent with the prospectus disclosures

# Investments in Other Funds

- Rule 12d1-4 under the 1940 Act permits both interval and tender offer funds to acquire shares of other registered investment companies in excess of the limits of Sections 12(d)(1)(A), (B), and (C) of the 1940 Act, subject to certain conditions:
  - An acquiring fund is prohibited from controlling an acquired fund, and an acquiring fund that holds more than a certain percentage of an acquired fund's outstanding voting securities must vote those securities in a prescribed manner
    - An acquiring fund that is part of the same fund group as the acquired fund and an acquiring fund that has a sub-adviser that acts as adviser to the acquired fund is not subject to these conditions
  - Certain evaluations and findings must be made before an acquiring fund invests in an acquired fund
  - Funds that do not share the same investment adviser must enter into a fund of funds investment agreement memorializing the terms of the arrangement
  - Funds generally are prohibited from creating three-tier fund of funds structures, except in certain circumstances
- The SEC staff has informally taken a position that securities issued by a closed-end fund can be sold only to accredited investors if the fund invests more than 15% of its assets in private funds