Interval funds

Asset management's well-kept secret

Why you should act now

Frank Atalla, CPA, Audit Partner, KPMG

The time appears to be right for private and retail fund managers alike to pay attention to interval funds. Although not yet widely known, interval funds are beginning to make their mark in the investment management industry.

For fund managers in the retail space, or private fund managers thinking about expanding their investor base, interval funds can be an attractive option for gathering assets. Interval funds allow fund managers to consider a wider range of investment strategies, including strategies that hold less liquid securities than typically found in open-end funds. At the same time, they offer investors some degree of liquidity with the potential for greater diversification and higher returns.

Currently, the interval fund space is relatively small, but it is growing rapidly. Total fund assets exceed $23.8 billion, which is up over 55 percent from the prior 12-month period. And with a robust pipeline of new interval fund registrations—there are currently 23 pending with the U.S. Securities and Exchange Commission (SEC)—continued growth is likely throughout 2018.[1] They employ a wide variety of investment strategies, although credit is by far the most prevalent. (See Exhibit 1 on page 1).

[1] **Interval Fund Tracker**, January 1, 2018

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Why now?

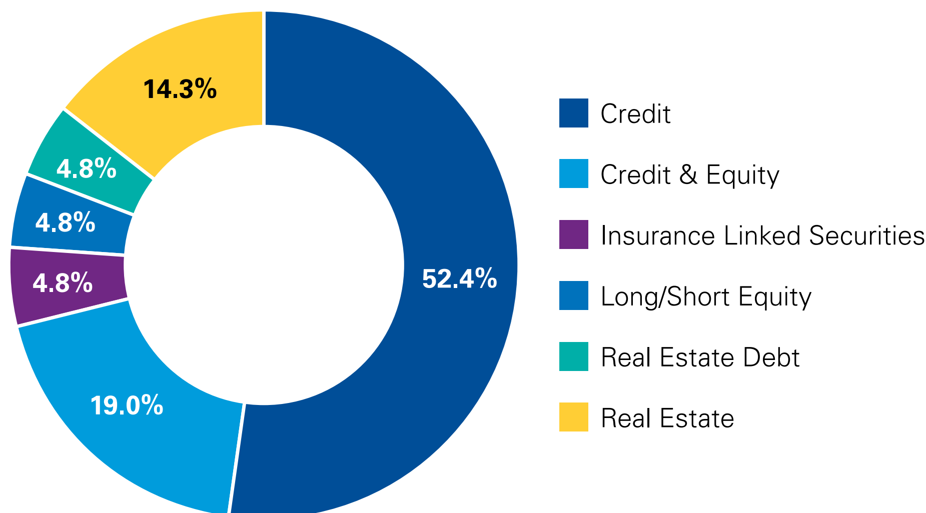
Although the potential to use interval funds have been around for decades, they are currently making their mark for a variety of reasons. In the past, many private fund managers avoided the retail space due to a commonly held belief that their investment strategy was not well aligned with '40 Act regulations.[2] And retail investment managers traditionally struggled with expanding their investment strategy into more illiquid investments due to similar concerns.

What is more, interval funds have proven to be a very useful vehicle for alternative strategies with limited liquid investments such as peer-to-peer lending funds operating in this space.

These days, we are seeing a convergence in asset classes and a far greater willingness by private and retail asset managers to move out of their own "lanes" in search of business opportunities.

"Interval funds have emerged as an investment vehicle that provides potential liquidity to shareholders while allowing sponsors and managers to invest in illiquid assets and illiquid strategies," noted John H. Grady, a partner with the DLA Piper LLP (US) law firm. "Interval funds are well positioned to compete with other 'alternatives' in the marketplace."

Exhibit 1
Interval fund tracker: Pending registration
Percent of funds by strategy



"Interval funds are well positioned to compete with other 'alternatives' in the marketplace."

— John H. Grady, Partner, DLA Piper LLP (US) law firm

[2] The 1940 Investment Companies Act (often referred to as the '40 Act), builds on the Securities Act of 1933 which requires registration of securities. The '40 Act details the required obligations of an investment company's product offerings.

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Below are some questions that fund managers should consider before deciding whether to launch an interval fund. (Also, see the chart on page 5 for a comparison of various investment vehicles, including open-end mutual funds, closed-end funds, and hedge funds).

Q. What are the key features of an interval fund?

There are two notable features of an interval fund. The first is that fund managers generally can invest a high percentage of the fund's net assets in illiquid investments. (Compare this to open-ended '40 Act funds, for example, mutual funds, which are restricted to 15 percent illiquid investments.[3]) This allows fund managers to invest in a wide variety of assets and employ strategies that could not otherwise be used for mutual funds.

The other key feature is that the fund only needs to offer to buy back a portion of its shares from shareholders at specified times or **intervals**, typically quarterly, semiannually or annually. Since interval funds typically are not traded on exchanges, these "intervals" are the only time that investors can "cash out" or redeem a portion of their shares. The fund is required to offer to repurchase between five and 25 percent of its outstanding shares at each interval (as determined by the fund's board). Typically, most funds will limit the repurchase percentage to five percent per quarter.

A different type of interval fund, called a tender offer fund, is not "locked into" specific redemption time frames, like every quarter. A tender offer fund can make more frequent repurchase offers if it wants, without having to file for special permission with the SEC.

Q. Why do fund managers like interval funds—and why now?

As noted above, although interval funds have been available for years, fund managers have recently begun to take advantage of them. It has more to do with the current investment environment where the potential for new assets outweighs the regulatory hurdles (for private fund managers) and a greater willingness to get involved with a different asset class (for retail managers).

Interval funds allow fund managers to execute investment strategies involving relatively illiquid assets suited to longer holding periods. This might include investments in large tracts of real estate (developed or otherwise), business or private loans, such as the securities of private companies, structured credit or real estate debt.

Because there is no need for daily liquidity, interval fund managers do not have to worry about having to raise cash on a daily basis to meet potential redemption requests. (They do, however, need to keep enough liquid assets on hand during the repurchase period to meet the repurchase offer.[4]) What is more, fund managers generally have to calculate net asset value (NAV) on a weekly basis[5] (versus daily for mutual funds), which reduces their administrative burden. (However, during the five business days prior to the repurchase offer deadline, NAV must be calculated daily.)

Another benefit is that interval funds can have an unlimited number of investors, and there are no investor eligibility requirements as long as the fund's shares are registered; in other words, they are not limited to accredited or qualified investors, like private investment funds. Interval funds can also have an unlimited number of IRA and pension fund investors without being subject to ERISA rules.

Interval fund managers can also charge a "performance fee" that is similar to what private funds assess for their services. For example, a percentage (typically 20 percent) of net performance earned by investments would be charged to the fund as the investment adviser's fee. But in that case, investors must be considered "qualified" clients; that is, they must have a minimum net worth of $2 million (exclusive of primary residence) or $1 million under management with the adviser.[6]

Finally, interval funds generally can issue Forms 1099-DIV to investors rather than the more cumbersome and complicated-to-prepare Form K-1s (provided the investment strategy meets and maintains the Regulated Investment Company (RIC) IRS qualifications). Interval funds satisfying the IRS requirements to qualify as a RIC also can avoid paying tax at the entity level.

[3] Investment Company Act, Rel. No. 18612 (March 12, 1992)

[4] Investment Company Act Rule 23c-3(b)(10)(i)

[5] Investment Company Act Rule 23c-3(b)(7)(i)

[6] Investment Advisors Act, Rule 205-3

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Q. What is in it for investors?

Interval funds can give investors access to asset classes they ordinarily could not afford or acquire, the potential for higher yields, and greater portfolio diversification. Also, interval funds typically have relatively low investment minimums (e.g., $5,000, $10,000). This compares favorably to the higher floors typically set by private investments like hedge funds, which need to be concerned about running out of allowable investor "slots" mandated by regulation.

Interval funds can also deliver tax savings for foreign investors in private funds. If these foreign investors have heavy exposure to U.S. dividend income, they can potentially reduce the 30 percent withholding tax on U.S. dividend income by a significant amount with an interval fund structure that elects RIC status.[7]

The interval fund could continue to operate similarly to a private fund, with monthly subscriptions, limited quarterly redemptions, management fees, and incentive fees. The investment manager could also file for exemptive relief with the SEC to allow for monthly periodic repurchase offers, making the interval fund more closely resemble a hedge fund.

Since interval funds are registered with the SEC, they offer investors many of the same regulatory protections that mutual fund investors receive, including regulatory oversight and transparency. What is more, investors typically receive Forms 1099-DIV instead of Form K-1s, making their tax reporting easier. This is especially important to pension fund investors who will not be subject to Unrelated Business Taxable income (UBTI) that might flow through on a form K-1.

Q. What are the potential drawbacks of interval funds?

As discussed earlier, investors need to be acutely aware of an interval fund's liquidity restrictions. They may only be able to redeem shares every three, six, or twelve months, and there are limits on how many shares they can cash out. Plus there is no established secondary market for interval fund shares. So they need to be comfortable holding interval funds as a long-term investment and not worried about finding themselves in need of cash.

Interval funds may also charge relatively higher fees than mutual funds (although interval fund fees may be lower than a typical hedge fund). So unless the fund delivers sufficient returns, gains can be more than offset by the fees.

Fund managers need to be prepared to comply with the operational, compliance, and reporting requirements that accompany a registered fund. For example, they will need to file annual audited financial statements with the SEC, semiannual unaudited financial statements, and the new monthly reporting required on Form N-Port. In addition, its investment advisor must be a registered investment adviser (RIA). This should not come as a surprise to managers already operating mutual funds as the requirements are the same, but may pose some challenges for private funds managers.

What is more, the investment valuation process will need to be robust. For one thing, NAV has to be calculated more frequently. In addition, the valuation process is more challenging and onerous because it is dealing with illiquid investments.

Fund managers also need to be prepared to align their portfolio investment and distribution strategies with the IRS rules that accompany favorable tax treatment for RICs. To qualify as a RIC, an interval fund must:

- Meet quarterly asset diversification requirements
- Derive at least 90 percent of its gross income from investments in stocks, securities, and related investments
  - Nonqualifying or "bad" income would include income from direct holdings in real estate or commodities and fees for services.
- Distribute substantially all of its net investment income to shareholders annually. (The fund will be subject to tax on any undistributed net income or gains.)

[7] That is because any withholding tax would be applied on the net ordinary taxable income amount and not the gross amount of the U.S. dividend income.

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Q. Will an interval fund potentially cannibalize a fund manager's other products?

The goal of launching an interval fund is to tap into a pool of investors that managers have not been able to reach with their existing products, not simply to move current investors from one product into another.

So, for example, hedge fund managers may consider offering an interval fund with the same or similar investment strategy (where permitted by regulation) as their current hedge fund in order to have access to a far wider group of potential investors.

The potential drawback of this strategy is that the fees are typically lower in an interval fund, and many will not include a performance fee. As a result, investors may opt to leave a manager's hedge fund and invest in the interval fund if the investment strategies are identical or substantially similar in strategy.

So while fund managers may build up assets in their interval fund, they may lose hedge fund investors who opt for the lower fee fund; thus, there is no real net gain in the near term for the investment manager. One potential solution is to structure the interval retail alternative funds strategy in a way that is sufficiently different than the hedge fund strategy.

In this way, fund managers may be able to minimize this potential cannibalization issue, as the interval fund will have different characteristics and likely attract a different audience. (This may not be as much of an issue for mutual fund managers as the interval fund would almost certainly have a different investment strategy and invest in different assets than the mutual fund.)

The bottom line here is that when it comes to the cannibalization quandary, it is critical to understand who your investors are and what their risk/reward profile is. When you understand who your primary audience is, then you can develop products that meet their specific needs. It will also help you weigh the cost-benefits of the structure in relation to the competitive landscape when deciding whether an interval fund is right for you.

Q: Can a fund manager use its track record in, for example, a hedge fund to promote its interval fund?

If the fund manager has an existing hedge fund and converts it to an interval fund without changing its investment strategy in any respect, it can probably use its hedge fund track record to promote the interval fund. Note that the investment manager will likely need to include the financial statements of the private hedge fund in the registration statement of the interval fund in order to utilize the performance track record.

In the case of mutual fund managers launching an interval fund, the investment strategies would probably not be the same. So they would not be able to use the mutual fund track record to market the interval fund.

In any case, investment managers looking for performance portability should work closely with legal counsel to determine if and how it can be achieved as the rules are nuanced.

This is the right interval

Now is an ideal time to consider launching an interval fund. It is still a relatively unknown investment vehicle that can offer advantages to both fund managers and investors. And unlike with exchange traded funds (ETFs), there is no single manager or fund that currently dominates the market.[8]

So that leaves a lot of room for new players to come in, get in on the ground floor, and mark their territories. But there are a host of regulatory requirements and strategic considerations that need to be addressed, including the issue of cannibalization, before you decide to launch one.

[8] Five funds account for approximately 40 percent of the total AUM, but those five funds are managed by four different asset managers. Hedgeweek.com, October 26, 2017

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Interval funds vs other popular fund vehicles

	Category	Interval fund	Interval fund (under Tender offer rule)	Mutual funds	Private hedge fund
Capital raising	Investor limits	Unlimited number	Unlimited number	Unlimited number	Limited
	Minimum investor eligibility	No, if no performance fee is assessed on gains If fund pays performance fee on gains, client must have a $2 million net worth	No, if no performance fee is assessed on gains If fund pays performance fee on gains, client must have a $2 million net worth	No	Accredited investors with at least $1 million of net worth or qualified purchasers with $5 million or more in investment
	Minimum investment ($000)	No specific minimums (amounts can be low since there are no limits on the number of investors)	No specific minimums (amounts can be low since there are no limits on the number of investors)	No specific minimums (amounts can be low since there are no limits on the number of investors)	No specific minimums (but minimums tend to be relatively high since there are limits on the number of investors)
Investing/ restrictions	15% Illiquidity limit	No	No	Yes	No
	ERISA requirements apply	No	No	No	Subject to ERISA requirements if ERISA and IRA capital exceeds 25% of funds' assets
	Redemption frequency	Limited redemptions either quarterly, semiannually, annually (as set by fund)	Limited redemptions depending on the frequency of the tender offers	Daily	Typically monthly or quarterly

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	Category	Interval fund	Interval fund (under Tender offer rule)	Mutual funds	Private hedge fund
Organizational structure	Entity type	Corporation	Corporation	Corporation	Typically either a Limited Partnership or Limited Liability Company
Filing requirements	NAV reporting	Weekly However, daily for five business days prior to repurchase offer request deadline	No set requirement, but typically either weekly or monthly	Daily	Typically monthly
	1099 reporting	Yes	Yes	Yes	No
	Audits	Conducted in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB)	Conducted in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB)	Conducted in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB)	Conducted in accordance with Generally Accepted Auditing Standards (GAAS)

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