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Making the Case for Interval and Tender Offer Funds – Hedge Fund and Private Equity Sponsors Can Increase Their Investor Base and Provide ?Liquidity to Investors

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Introduction

We often hear from hedge fund and private equity sponsors that private funds are too limiting for their capital formation needs. Private funds are collective investment vehicles that rely on the Section 3(c)(1) and Section 3(c)(7) exclusions from definition of an "investment company" in the Investment Company Act of 1940, as amended (the "1940 Act").

- Section 3(c)(1)'s[1] 100 investor limit forces sponsors to require high minimum investment from each investor to raise enough capital; and
- Section 3(c)(7)'s[2] "qualified purchaser"[3] requirement forces sponsors to court a small and often difficult to access community – many of whom have bars to investment with new sponsors.[4]

Many private fund sponsors also shy away from traditional open-end and closed-end funds because they believe that compliance with 1940 Act and other regulatory requirements of registered funds are too burdensome and incompatible with their strategies. Traditional open-end mutual funds, which can continuously offer new shares and provide the greatest investor liquidity, require sponsors to hold significant amounts of liquid assets inapposite to most sponsors' strategies. Traditional publicly traded closed-end funds usually raise capital only once, which restricts their ability to grow. In addition, closed-end funds that trade in a secondary market often trade at a significant discount to the fund's per share net asset value or "per share NAV".

From the investor side, we hear that (i) private fund minimum investment requirements can be too high, (ii) investor criteria are too stringent, (iii) disclosures may not be as fulsome as the investors might like, and (iv) private funds often do not provide sufficient liquidity to allow for proper financial planning or the ability to manage unexpected cash requirements.[5]

Sponsors may want to take a fresh look at interval and tender offer funds as a potential lower-cost, lower regulatory-burden, middle ground between private funds and traditional 1940 Act registered funds.

In this article, we provide a short overview of recent regulatory changes that favor interval and tender offer funds, some key highlights of these two types of funds, and a summary of the regulatory requirements for sponsors and their 1940 Act registered funds.

Regulatory Changes Increase the Attractiveness of Interval and Tender Offer Funds

While interval funds and tender offer funds have been available for many years, recent changes to investor protections and fee transparency requirements, harmonization of closed-end fund reporting procedures, and updates to Rule 486 under the Securities Act of 1933, as amended (the "1933 Act"), which streamlines registration processes for tender offer and other closed-end funds, make a strong case to revisit these capital formation options.

New fee disclosure requirements mandated by FINRA Regulation Notice 15-02[6], and the enactment of Regulation Best Interest[7] under the Securities Exchange Act of 1934, as amended (the "1934 Act"), have driven greater transparency on fund fee structures and greater duties for the advisers and brokers who sell these products. Regulation Best Interest requires sponsors to fully disclose fees and the actual value of the account to investors. As a result, brokers and advisers are required to examine higher fee products to determine if those products are appropriate for their clients.

Changes to 1933 Act Rule 486, effective as of April 2020, permit tender offer funds and other closed-end funds to benefit from immediate or automatic effectiveness of amendments to registration statements, which may reduce the risk that a fund will need to suspend continuous share sales pending SEC review of those filings.

We believe that interval and tender offer funds may have been brought to market less often because the fees to sponsors and the distribution channels were not as attractive as other investment products. As an example, until recently, non-publicly traded real estate investment trusts ("non-traded REITs") were a popular investment option for long-term investors. Non-traded REITs typically charge high upfront fees, sometimes as much as 15% of the offering price. The upfront fees are paid to distributors for their marketing efforts and may be used by sponsors to offset the high organizational and offering costs incurred to form and market the fund. The upfront fees reduce the amount of capital that the non-traded REIT has to invest, which results in lower returns to the investors. In addition to high upfront fees, non-traded REITs can be weighed down by high operational costs such as property acquisition and property management fees. Due to the new fee transparency requirements and investors' realization of inherent costs, sales of non-traded REITs have plummeted.

We believe that interval and tender offer funds can (i) be efficient capital raising and investment management vehicles with lower operational costs than traditional registered funds, (ii) provide sponsors with greater strategy flexibility similar to private funds, and (iii) provide investors with greater disclosure and liquidity options as compared to private funds and greater asset allocation options as compared to traditional registered funds.

The Basics about Funds

Interval and tender offer funds (i) are organized as "closed-end" registered[8] investment companies, (ii) can continuously offer shares at NAV to an unlimited number of investors, and (iii) have relatively predictable liquidity requirements, which allow those funds to invest in alternative strategies. These funds provide investors with

access to a broader array of investment strategies than open-end mutual funds while providing the comfort of increased disclosure and the ability to cash-out at certain intervals compared to private funds. We note that a fund's ability and frequency to market shares depends on its ability and the cost to calculate NAV. Funds that hold publicly traded assets can calculate NAV more frequently and less expensively than funds that hold less liquid assets that require third-party valuations. Funds that hold only publicly traded assets may calculate NAV each business day that the assets trade, while funds that hold real estate or loan portfolios, for instance, may calculate NAV less frequently due to the cost and effort required to value bespoke assets. Interval funds are required by regulation to calculate NAV at least once per week. Tender offer funds do not have the same requirement – tender offer funds calculate NAV periodically as needed for sales and repurchases of shares.

Because sales of interval and tender offer fund shares are registered under the 1933 Act, the funds do not require a private placement exemption from the 1933 Act, such as Regulation D, Rule 506, which in practice mandates that all private fund investors meet the "accredited investor"[9] standard.

Traditional open-end funds (i) provide daily liquidity to investors through an end of day repurchase process; (ii) do not usually trade on an exchange (other than exchange traded funds or "ETFs")[10]; and (iii) continuously offer shares and acquire additional assets that meet its investment portfolio criteria. An open-end fund generally cannot invest more than 15%[11] of its assets in illiquid securities. For this purpose, a security is generally deemed "illiquid" if it cannot be sold within seven days at the approximate price used by the fund to determine NAV.

Traditional closed-end funds do not continuously offer shares. They raise capital once by issuing a fixed number of shares in an initial public offering ("IPO"). Those shares are usually registered under Section 12 of the 1934 Act and listed on a stock exchange. The offering is "closed" after the initial sale, and future purchases and sales of shares are transacted between selling and buying investors on an exchange. The downside to publicly traded closed-end funds is that the share price is determined by supply and demand rather than NAV. This investor demand (or lack of demand) can lead to shares trading at a premium or more often at a significant discount to NAV.

Closed-end funds usually register under the 1940 Act and register sales of their shares under the 1933 Act; closed-end funds do not usually register to trade their shares under Section 12 of the 1934 Act. These closed-end funds effectively act as a tender offer fund because they can continuously market shares at NAV pursuant to 1933 Act Rule 415 and offer to repurchase shares pursuant to 1940 Act tender offer rules. Like tender offer funds, traditional closed-end funds do not have specific requirements for calculating NAV other than to comply with regulations to sell or repurchase shares. It is also possible for a 1940 Act registered closed-end fund to register sales of their shares under the 1933 Act and conduct an IPO of its shares but not trade on an exchange.

Due to the heavy liquidity requirements of open-end funds, sponsors often look to closed-end funds for alternative strategies. Closed-end funds liquidity requirements are driven more by the practicalities of repurchase programs than regulatory drivers.

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Interval Funds

An interval fund differs from traditional closed-end funds because Rule 23c-3 of the 1940 Act requires interval funds to repurchase shares from their investors at specified "intervals", at NAV. Interval funds are considered closed-end funds because they are not permitted to offer daily liquidity. Interval funds are usually managed by a board of trustees or a board of directors, depending on the entity form and domicile. The board of a registered investment company must have a majority of independent directors.[12]

Pursuant to Rule 23c-3, an interval fund must offer to repurchase between 5% and 25% of its outstanding shares each period; the specific amount of the repurchase is determined by the fund's board, usually based upon the advice of the fund's sponsor, in advance of each repurchase offer. Absent an exemption from the U.S. Securities and Exchange Commission (the "SEC"), the fund must create a fundamental policy to set repurchases quarterly, semi-annually or annually. Any change to a fund's fundamental policy requires investor consent unless there are extreme extenuating circumstances that are acknowledged and approved by a majority of the fund board's independent directors. An interval fund may seek exemptive relief from the SEC to allow it to make repurchase offers at more or less frequent intervals. In addition to periodic repurchases mandated by an interval fund's fundamental policy, 1940 Act Rule 23c-3(c) permits an interval fund to make additional, discretionary repurchase offers to all holders of the stock once every two years in accordance with 1934 Act Rule 13e-4.

Repurchases under the fundamental policy must be made at the NAV determined as of the date set forth in the repurchase offer. Shareholders, however, are not required to sell their shares back to the fund. If a shareholder does elect to participate in a repurchase offer, it may tender up to all of its shares in any offer. A shareholder is allowed to withdraw or modify its repurchase request up to the repurchase request deadline, but not after. Interval funds are required to calculate NAV at least weekly on the day and time established by the board, on any day that shares are purchased or sold, and during the five days preceding a repurchase deadline.

If a repurchase offer is oversubscribed, the interval fund may limit each investor to sell only a *pro rata* amount. Additionally, an interval fund may also set certain priority exceptions in its fundamental policies that allow it to prioritize (i) shares tendered by investors who hold fewer than one hundred shares, if the investor tenders all of his or her shares; (ii) shares tendered in connection with required minimum distributions from an IRA or other qualified retirement plan; and/or (iii) shares tendered by investors who tender all shares held by them and who have made an "all or none" or "minimum or none" election.

An interval fund may also increase the repurchase offer by up to an additional 2% of its outstanding shares to accommodate some or all of the oversubscribed repurchase offers. Concurrently with each repurchase offer, an interval fund is required to have sufficient liquid assets to fund the amount of the repurchase. For this purpose, an asset is deemed to be "liquid" if it (i) can be sold or disposed of within the period between the repurchase request deadline and the repurchase payment date at approximately the price at which the fund has valued the security, or (ii) matures by the repurchase payment date. The interval fund board is required to adopt written procedures reasonably designed, taking into account current market conditions and the interval fund's investment objectives, to ensure that its portfolio is sufficiently liquid to fund its fundamental policy on repurchases.

An interval fund may charge a redemption fee of up to 2% of the redemption amount for shares tendered in a repurchase offer. The redemption fee must be "reasonably designed to compensate the fund for expenses directly related to the repurchase".

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Tender Offer Funds

Tender offer funds are organized as closed-end funds registered under the 1940 Act. Like interval funds, tender offer funds may continuously offer shares pursuant to Rule 415 under the 1933 Act and do not usually register their shares under Section 12 of the 1934 Act or list shares on a stock exchange. A tender offer fund must also constitute its board with a majority of Independent Directors consistent with Section 2(a)(19) of the 1940 Act ?.

Unlike interval funds, however, tender offer funds are not permitted to establish a fundamental policy or to conduct pre-determined periodic repurchases of shares. Instead, the fund board must determine, usually based upon the advice of the fund's sponsor, when a tender offer will be commenced and the amount of shares to be redeemed at each tender offer. Prior to approving a tender offer, however, the board must meet and find that the tender offer will be fair and in the best interest of the fund and its investors. Many tender offer funds institute a repurchase policy that sets a schedule as to when investors can expect the fund to tender for the repurchase of shares. However, the fund must reserve for board approval as noted above prior to commencement each tender offer.

Registered closed-end funds, other than interval funds, are required to conduct share repurchases in accordance with Section 23(c)(2) of the 1940 Act, Sections 13 and 14 of the 1934 Act (anti-fraud provisions), and Rule 13e-4 thereunder.

Section 23(c)(2) of the 1940 Act generally requires the fund to (i) conduct each tender offer in accordance with the terms of its constituent or securities offering documents; (ii) offer to repurchase shares, if less than all shares of a class or series are included in the offer, from all investors holding a class or series of securities on (x) a *pro rata* basis or (y) in such other manner as will not discriminate unfairly against any holder of the securities of such class or series; (iii) file notice of its intention to call or redeem such securities with the SEC (x) at least 30 days prior to the date set for the repurchase or (y) if notice of repurchase is required to be published in a newspaper or otherwise, file the notice with the SEC at least 10 days in advance of the date of publication.

Rule 13e-4 under the 1934 Act requires a closed-end fund conducting a tender offer of its own securities to file Schedule TO with the SEC and provide notice to the fund's investors. As noted above, the tender offer documents may either be delivered to investors or published in a nationally circulated publication. Unless withdrawn:

- the tender offer must remain open: (i) at least 20 business days following its commencement and (ii) at least 10 business days following the date of any change notice, e.g. notice of an increase or decrease in the securities to be purchased, the price for the securities or any change in soliciting fees;
- permit investors to withdraw tendered shares so long as the tender offer remains open;
- as noted above pursuant to 1940 Act Section 23(c)(2), accept shares from tendering investors on a *pro rata* basis[13] if more shares are tendered than the company is seeking to purchase (in addition, if tenders exceed the tender offer amount, the fund board has discretion to increase the offer by up to 2%);
- pay the same price for all repurchased shares; and
- Unlike interval funds, tender offer funds are not required to repurchase shares at NAV. In most cases, however, the tender offer price is usually at or close to NAV.
- Tender offer funds are not required to hold any specific amount of liquid assets. As a practical matter, however, the fund should have access to sufficient liquid assets in order to pay for tender offer repurchases and

expenses, and fund distributions. Therefore, tender offer funds have greater flexibility to invest in illiquid assets compared to interval funds. Additionally, tender offer funds are required to calculate NAV only when selling or repurchasing shares, which can be an expense differentiator when compared to interval funds.

Requirements Shared by Interval and Tender Offer Funds

Interval and tender offer funds offer investors and financial intermediaries the regulatory safeguards of a registered investment company while allowing investors greater exposure to illiquid investments with potentially higher yields and opportunities to invest in inverse strategies. Interval funds and tender offer funds may (i) offer shares to an unlimited number of non-accredited investors, (ii) price share sales at NAV and repurchases at NAV for interval funds or near NAV for tender offer funds, and (iii) provide investors with liquidity through repurchase and tender offer mechanisms. Since both interval and tender offer funds issue and repurchase shares directly from investors, they help eliminate the supply and demand trading price discounts that haunt most traditional closed-end funds.

Performance Fee Limits

Interval and tender offer fund sponsors are prohibited from charging a traditional performance fee unless all investors are "qualified clients" as defined in Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") which is commonly known as the $2 million[14] net worth standard. The sponsor may also (though rarely) charge a "fulcrum fee" as defined in Section 205(b)(2) of the Advisers Act even if not all investors are qualified clients or accredited investors. A fulcrum fee allows the sponsor to increase its fee when the fund's performance exceeds its benchmark over a designated period (at least one year) or decrease the fee when the fund under-performs the benchmark over such period. A key requirement of Section 205(b)(2) is that the increase and decrease in fees for out-performance and under-performance must be symmetrical[15]. As with any investment product, the broker should perform a suitability analysis for each client before recommending and selling any interest in an interval fund.

Multiple Share Classes and Leverage

Closed-end investment companies are generally limited to only one class of interests unless they obtain exemptive relief from the SEC. Most closed-end funds that request exemptive relief to offer multiple share classes are approved subject to compliance with requirements similar to those set forth in 1940 Act Rule 18f-3 (which permits multiclass share structures for open-end funds), including the requirement to comply with a prohibition on charging different advisory and custodial fees within the same fund. Many interval and tender offer funds launch with one share class and then seek exemptive relief to offer multiple share classes if and when new distribution channels emerge.

On Oct. 28, 2020, the SEC adopted new Rule 18f-4, which provides certain exemptions from the leverage and "senior securities" limits set forth in Section 18 of the 1940 Act.[16] New Rule 18f-4 can be used by registered investment companies (RICs), including open-end mutual funds (other than money market funds), ETFs, closed-end funds (including interval and tender offer funds), and business development companies or "BDCs".

The new rule generally caps funds that engage in derivatives transactions to an outer limit of 200% leverage based on a comparison of the fund's value at risk or "VaR" compared to the VaR of a "designated reference portfolio" for the fund. If the fund cannot identify an appropriate reference index, it can use its own portfolio limited

to 20% of the value of the fund's net assets excluding the value of the derivatives in the portfolio. In order to rely on the new Rule 18f-4 exemptions, the fund must adopt a risk management program that includes policies and procedures that are reasonably designed to manage the fund's "derivatives risks", and include risk guidelines, stress testing, back testing (no less than weekly), internal reporting, escalation and program review elements. The fund must also appoint a "derivatives risk manager" who (i) reports directly to the fund's board, (ii) is not part of the sponsor's portfolio management team, and (iii) has relevant experience regarding the management of derivatives risk. Funds that rely on Rule 18f-4 will also be subject to certain reporting and recordkeeping requirements regarding their derivatives investments.

Distribution of Shares

Rule 486 under the 1933 Act enables funds that continuously offer shares under Rule 415(a)(1)(xi) under the 1933 Act (in practice, only interval funds)[17] to file post-effective registration statement amendments that are (i) immediately effective upon filing pursuant Rule 486(b), if the registration statement amendments relate solely to the update of fund financial statements or make certain other specified changes, or (ii) automatically effective 60 days after filing pursuant to Rule 486(a), if the amendment contains material changes to the fund's disclosures. Immediate or automatic effectiveness of post-effective registration statement amendments reduce the potential that a fund could be required to suspend marketing its shares due to a lapse in its registration statement.

Other closed-end funds, including tender offer funds, are not eligible to use Rule 415(a)(1)(xi) under the 1933 Act. Instead, those funds rely on Rule 415(a)(1)(ix) under the 1933 Act[18] to continuously market their shares.

On April 8, 2020, the SEC expanded the scope of Rule 486 to include closed-end funds that rely on Rule 415(a)(1)(ix). This expansion enables tender-offer funds to raise capital without delay by permitting them to more efficiently maintain effective registration statements while they engage in a continuous offering.

ERISA – Exempt from Plan Asset Rule

Private investment funds generally limit investment by employee benefit plans, including ?individual retirement accounts (IRAs), to avoid becoming subject to stringent fiduciary ?responsibility and prohibited transaction rules under the Employee Retirement Security Act of ??1974, as amended (ERISA). Because interval funds and tender offer funds are registered ?under the 1940 Act, they are not subject to the look-through rule of ?ERISA's plan asset regulations and can have an unlimited number of pension fund and IRA ?investors.??

Tax Considerations

Interval and tender offer funds may be structured to qualify as "regulated investment companies" or "RICs" under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"), for U.S. federal income tax purposes to avoid income taxes at the fund level. Typically, a RIC is a domestic corporation (which can include entities like business trusts that make certain elections) that is registered under the 1940 Act and that satisfies an asset-based diversification test and an income-based test. These tests are separate tests imposed under the Code. The asset-based diversification test is intended to limit the types of entities that can qualify for RIC status (e.g., it generally prevents financing vehicles, holding companies, and operating companies from qualifying as RICs). The income-based test is intended to result in a RIC generating substantially all of its income from

investments. To maintain RIC status and avoid income tax on its income, there are various distributions requirements that must be satisfied requiring substantially all of the RIC's investment income and gains to be distributed annually to its investors. In general, the character of the income and gain that a RIC distributes passes through to its investors. Due to these distribution requirements, funds structured as RICs generally need to employ effective cash management plans.

A detailed overview of the RIC asset-based diversification test, the RIC income-based test and the publicly traded partnership rules are beyond the scope of this article. We note, however, that a fund's mandate, particularly to invest in certain alternative assets, may include investments that may not be clearly permitted by the RIC tests. To ensure that the requirements of the RIC tests are still satisfied, funds may be structured to invest indirectly in such assets (e.g., by investing in a foreign subsidiary corporation that invests in something that the RIC could not hold directly). Failure to satisfy RIC requirements could have serious adverse impacts on a fund and should be addressed on a case-by-case basis with qualified tax and corporate counsel.

A registered fund that does not qualify as a RIC may still be eligible for pass-through tax treatment by electing to be taxed as a partnership. The fund must meet a number of conditions to avoid becoming a publicly traded partnership taxable as a corporation, including limiting the frequency of its repurchase offers and restricting transfers of its shares. Subject to specific factual review, it may be possible to structure both interval and tender offer funds to receive pass-through tax treatment without triggering publicly traded partnership taxation issues. Investors in a partnership would receive a year-end tax report on Schedule K-1, rather than a Form 1099-DIV from a RIC. A detailed overview of the publicly traded partnership limitations that a fund may need to comply with are beyond the scope of this article.

1940 Act Registration Documents

To register under the 1940 Act, the interval or tender offer fund must file with the SEC (i) a notice of registration on Form N-8A, (ii) a registration statement on Form N-2 (which can also be used to register shares under the 1933 Act), and (iii) a Statement of Additional Information ("SAI"). Form N-2 is designed to disclose detailed information that may be relevant to investors who are considering buying shares of the fund. It is also designed to ensure that the registrant complies with the SEC's other regulations (other than those under the 1934 Act).

An SAI contains information about the fund that may not be found in its broader prospectus, including disclosure of more detailed information regarding the fund and its sponsor, and financial statements. An SAI must be updated regularly and will often include the fund's financial statements and detailed information about the officers, directors and other people controlling the investment direction of the fund. The SAI is delivered to shareholders upon request.

Before going effective,

- Section 14(a) of the 1940 Act requires an initial investment to the fund of at least US$100,000, called "seed capital";
- The 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 before the SEC Staff will declare the registration statement effective; and
- There must be an organizational meeting to approve or ratify all of the fund documents and agreements,

including the 1940 Act Rule 15(c) review of the adviser and distributor arrangements.

1940 Act Reporting Considerations

Registered investment companies must file regular portfolio valuations and periodic disclosures. Unlike 1934 Act registrants, however, interval and tender offer funds do not file traditional 1934 Act reports – i.e. Forms 10-K, 10-Q and 8-K, etc. Instead, interval and tender offer funds are required to file annual (audited) reports on Form "N-CEN" pursuant to Rule 30a1 under the 1940 Act[19] no later than 75 days after the end of its fiscal year reporting information about its portfolio and performance. Interval and tender offer funds also file certified shareholder reports with the SEC on "Form N-CSR" pursuant to Rule 30b2-1. Form N-CSR is due no later than 10 days after a shareholder report is transmitted to shareholders. Additionally, closed-end funds must file Form N-PORT within 60 days following the end of each calendar quarter to report information about their portfolios and each of their portfolio holdings as of the last business day, or last calendar day, of the quarter.

Distribution and Platform Marketing

Marketing channels for closed-end funds differ from most private funds. Interval and tender offer funds, for instance, do not take capital commitments and cannot call capital as needed to fund asset acquisitions. When an interval or tender offer fund sells a share, it needs to put the money to work quickly or its returns will suffer. Interval and tender offer sponsors therefore must be able to synchronize share sales with asset acquisitions. If the fund's portfolio targets readily available publicly traded assets, then sales of fund shares and asset acquisition is relatively simple. If the fund targets portfolio assets that are less common, the sponsor might need to queue asset acquisitions to close concurrently with share sales. Depending on the degree of difficulty to match share sales and portfolio construction, the sponsor may need to build an internal sales force or have close participation with third-party marketing firms, registered investment advisors (RIAs) and/or large family offices.

Funds that target portfolios of liquid assets may be eligible to market on RIA mutual fund platforms. RIAs generally have two types of platforms – one for mutual funds and the other for alternative funds. Interval funds that calculate NAV daily and have quarterly redemptions are generally able to list on mutual fund platforms rather than the alternative investment platforms. Mutual fund platforms tend to have lower fees and greater client distribution. Mutual fund platforms also allow for automated trading via National Securities Clearing Corp., and removes the requirements for many manual processes. Tender offer funds and other funds that do not calculate daily NAVs are in most cases marketed on alternative product platforms. Marketing shares on a mutual fund platform may provide a distinct advantage to funds. However, the mutual fund platform's requirement for daily NAVs and quarterly redemptions may be impractical for funds that target asset classes that do not have readily available valuation markets.

Prior to listing, the marketing platform will conduct due diligence on the fund and its sponsor, which can take 6 to 8 weeks or more depending on the platform, the fund's strategy and the sponsor's track record. RIA platforms generally charge the fund onboarding and listing fees that can vary based upon the type of platform, the target investors and the services required. Many funds have differing share classes and fee structures that are designed to align with the distribution channel fees. Please note that in most cases, sponsors cannot charge different management fees for different share classes.

Fund of Fund Investment Restrictions

1940 Act Section 12(d)(1) generally restricts registered funds from investing in one another. The policy behind Section 12(d)(1) was to prevent fund of funds arrangements that create (i) inappropriate fee "pyramiding", (ii) overly complex structures and (iii) conflicts of interest through the exercise of control over another fund or the threat of large-scale redemptions. Section 12(d)(1)(A) specifically limits a registered fund's investment in another fund, subject to certain exemptions set forth in Rule 12d1-2 and other exemptive notices, to no more than (i) 3% of the other registered fund's outstanding voting securities, (ii) 5% of the investing fund's total assets in another registered fund, and (iii) 10% of the investing fund's total assets in other registered funds in the aggregate.

On October 7, 2020, the SEC rescinded Rule 12d1-2 and certain exemptive relief measures that it had granted from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act that permitted certain fund of funds arrangements. Rule 12d1-2 permitted a fund relying on section 12(d)(1)(G) to: (i) acquire the securities of other funds that are not part of the same group of investment companies, subject to the limits in section 12(d)(1)(A) or 12(d)(1)(F); (ii) invest directly in stocks, bonds, and other securities; and (iii) acquire the securities of money market funds in reliance on rule 12d1-1.

Concurrently with rescinding Rule 12d1-2, the SEC added new Rule 12d1-4. New Rule 12d1-4 permits an acquiring fund to acquire the securities of any other registered investment company in excess of the Section 12(d)(1) limits, generally subject to various conditions. Those relevant to interval and tender offer funds are: Rule 12d1-4 (i)prohibit an acquiring fund and its "advisory group"[20] from controlling an acquired fund, except in certain limited circumstances; (ii) requires an acquiring fund and its advisory group to use mirror voting if it holds more than 25% of an acquired open-end fund or unit investment trust ("UIT") due to a decrease in the outstanding securities of the acquired fund and if it holds more than 10% of a closed-end fund, with the ability to use pass-through voting when acquiring funds are the only shareholders of an acquired fund; (iii) requires investment advisers of acquiring and acquired funds that are management companies[21] to make certain findings regarding the fund of funds arrangement, after considering specific factors; (iv) requires funds that do not have the same investment adviser to enter into an agreement prior to the purchase of acquired fund shares in excess of Section 12(d)(1)'s limits (a "fund of funds investment agreement"); and (v) imposes a general three-tier prohibition with certain enumerated exceptions. The aforementioned findings include the principal underwriter's conclusion that the fund of funds arrangement does not result in duplicative fees. In addition to these exceptions, Rule 12d1-4 also allows an acquired fund to invest up to 10% of its total assets in other funds (including private funds), without regard to the purpose of the investment or types of underlying funds.

CFTC Considerations

A fund that trades futures, over-the-counter foreign currencies ("forex"), swaps, or any related derivatives, is generally required to register as a commodity pool operator ("CPO") with the Commodity Futures Trading Commission ("CFTC"). The CFTC leverages the services of the National Futures Association ("NFA") which is a self-regulatory organization or "SRO" that assists the CFTC to administer and enforce the Commodities Exchange Act, as amended ("CEA"). There are several exemptions from CPO registration that are commonly known as the: (i) investment club exemption; (ii) small pool exemption; and (iii) the *de minimus* exemption.

A commodity trading advisor ("CTA") is an individual or organization that, for compensation or profit, advises

others, directly or indirectly, as to the value of or the advisability of trading futures contracts, options on futures, retail off-exchange forex contracts or swaps. CTAs who manage or have discretion over customer accounts must register with the NFA. CFTC Regulation 4.14 details the criteria for exemption from CTA registration. Those exemptions include individuals or entities that: (i) provided advice to 15 or fewer persons during the prior 12 months and the entity does not generally hold itself out to the public as a CTA; (ii) is registered with the CFTC and its advice is solely incidental to its business or profession; or (iii) provide advice that is not based upon knowledge of or tailored to a customer's particular trading account or trading activity.

A detailed discussion of requirements of the CEA, CTA and CPO registrations and exemptions therefrom are beyond the scope of this article. We note further that if a fund's target portfolio includes derivatives or other senior securities, the fund will need a careful review of the proposed portfolio against the requirements of 1940 Act Section 18 and new Rule 18f-4, an area that is in transition and for which guidance may not be available. Breach of CEA requirements could have a serious adverse impact on a fund and should be addressed on a case-by-case basis with qualified counsel.

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Conclusion

With recent changes to investor protections, greater fee transparency and recent updates to Rule 486 that facilitate continuous offering of both interval and tender offer fund shares, fund sponsors and investors may want to take new look at interval and tender offer funds which allow access to broader investor base, better distribution channels, and greater asset allocation options. This paper is intended as a guide only and is not a substitute for specific legal or tax advice. Please reach out to the authors for any specific questions. We expect to continue to monitor the topics addressed in this paper and provide future client updates when useful.

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?1. Section 3(c)(1) of the 1940 Act provides an exclusion from the definition of investment company to "any issuer whose outstanding securities (other than short-term paper) are ?beneficially owned by not more than one hundred persons and that is not making and does not at that time propose to make a public offering of such securities".
?2. Section 3(c)(7) of the 1940 Act, provides an exclusion from the definition of investment company to "any issuer, the outstanding securities of which are owned exclusively by ?persons who, at the time of acquisition of such securities, are "qualified purchasers", and which is not making and does not at that time propose to make a public offering of such ?securities".
?3. Qualified purchaser is defined in Section 2(a)(51)(A) of the 1940 Act to mean a person that meets at least one of the following criteria: the purchaser is (i) an individual or family ?owned business that owns $5 million or more in investments (if the purchaser is a family owned business, it cannot be formed solely for the purpose of investing in the fund); (ii) a ?trust sponsored and managed by qualified purchasers, which wasn't formed for the sole purpose of investing in the fund; or (iii) an individual or other entity that invests at least $25 ?million, either for their own accounts or on others' behalf (which was not formed for the specific purpose of investing in the fund).
?4. In addition to Section 3(c)(1) and Section 3(c)(7), there are other investment company exemptions such as Section 3(c)(5)(C) which is also known as the real estate exemption, ?though it contains limits on permitted types of real estate investments.?

?5. We note that most hedge funds have redemption programs that provide some liquidity as compared to PE funds that, absent a secondary market, lock up investments for an ?average of 7 to 12 years.
?6. Effective on April 11, 2016.
?7. Codified at 17 CFR § 240.15l-1, and effective as of September 10, 2019.
?8. Interval and tender offer funds register under the 1940 Act and the rules thereunder. Rule 23c-3 requires interval funds to make periodic repurchase offers. Section 23(c)(2) of ?the 1940 Act authorizes the organization of tender offer funds. The shares of interval and tender offer funds are registered for sale under the 1933 Act, pursuant to Rule 415 ?thereunder. While shares of interval and tender offer shares do not trade in a secondary market, certain aspects of the 1934 Act apply to interval and tender offer funds, ?particularly as they relate to periodic financial reporting and repurchases of shares.
?9. See Rule 501(a) of Regulation D under the 1933 Act for a definition of “accredited investor”.
?10. An ETF is an open-end fund that trades on an exchange and can be purchased or sold intra-?day like a stock. Similar to traditional open-end funds, an ETF creates more shares ?by acquiring ?additional underlying assets and builds a block of shares called a “creation unit”.
?11. *See* 1940 Act Rule 22e-4
?12. Section 2(a)(19) of the 1940 Act authorizes the SEC to issue an order finding that a person is an “interested person” due to a material business or professional relationship with a ?fund or certain persons or entities. A director who is not an “interested person” is referred to herein as an “Independent Director”.
?13. Like an interval fund, tender offer funds can add priority purchase ?procedures for small lots, minimum distributions from an IRA?, etc., similar to those described above for ?interval funds.?
?14. Now adjusted for inflation to $2.1 million net worth.
?15. The SEC staff has provided guidance that allow fulcrum fees to decreases faster than they increase.
?16. Section 18 of the 1940 Act generally limits the ability of registered investment companies to issue or sell “senior securities, which are defined in Section 18(g) as, subject to ?certain exceptions, any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over ?any other class as to distribution of assets or payment of dividends; and “senior security representing indebtedness” means any senior security other than stock.
?17. Rule 415(a)(1)(xi) provides “[s]hares of common stock which are to be offered and sold on a delayed or continuous basis by or on behalf of a registered closed-end investment ?company or business development company that makes periodic repurchase offers pursuant to § 270.23c-3 of this chapter.”
?18. Rule 415(a)(1)(ix) provides “[s]ecurities, other than asset-backed securities (as defined in 17 CFR 229.1101(c)), the offering of which will be commenced promptly, will be made ?on a continuous basis and may continue for a period in excess of 30 days from the date of initial effectiveness; . . .”
19. See 17 CFR 270.30a-1.
20. Rule 12d1-4 requires an acquiring fund to aggregate its investment in an acquired fund with the investment of the acquiring fund’s advisory group to assess control. Rule 12d1-??4(b)(1)(i) defines “advisory group” to mean “either: (a) an acquiring fund’s investment adviser or depositor, and any person controlling, controlled by, or under common control ?with such investment adviser or depositor; or (b) an acquiring fund’s investment sub-adviser and any person controlling, controlled by, or under common control with such ?investment sub-adviser.” An acquiring fund would not combine the entities listed in clause (a) with those in clause (b). The SEC’s final release notes that complex financial ?institutions may manage their advisory group(s) by use of information walls and other compliance measures.
?21. See generally 15 U.S.C. 80a-4, which defines a “management company” as an investment company other than a face amount certificate company or unit investment trust. ?Interval and tender offer funds are generally

management companies.?

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