THE NEED FOR YIELD – Why Should Asset Managers Consider Launching an INTERVAL or TENDER OFFER FUND, and What Do They Need to Know

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As we have returned to a period of ultra-low interest rates, investors have a genuine need for products that may offer reasonable yields. That need is across the board, regardless of the wealth and education level of the investor. Yet under typical fund structures investors either see the benefit of the compliance and risk protections inherent to '40 Act mutual funds or the limited availability of private/hedge funds. Neither offers a way to provide a diversified pool of securities that legitimately could offer yield to a broader base of investors.

While much has been written about Interval and Tender Offer Funds in recent years, the hybrid structure they offer, and the differences between the two types of funds, are still not widely understood. In short, either type of fund provides many of the benefits of traditional '40 Act funds, as they operate under the '40 Act, with the ability to follow strategies beyond that of traditional mutual funds. As such, asset managers and investment advisers could benefit from the following detailed information to help them assess whether adding this type of fund to their product mix would provide diversification to attract a broader audience.

Deconstructing the Differences Between Interval and Tender Offer Funds

Interval and Tender Offer Funds are often described interchangeably. Though there is significant overlap in the way the structures are organized and operated, there are key differences that impact their respective operational models and potential distribution footprint.

To start, with the structural similarities, both are organized as unlisted closed-end funds under the Investment Company Act of 1940. The unlisted closed-end fund format allows asset managers to hold more illiquid investments than could typically be offered in daily subscription/redemption mutual funds. Many of the prominent interval and tender offer funds in the marketplace today invest in illiquid credit, real estate, hedge, private equity or other alternative asset classes.

Below we outline common features that apply to both types of unlisted closed-end fund formats:

	Interval Fund and Tender Offer Funds
SEC Filings	• Form N-2 • Schedule TO and Amended Schedule TO or Form N-23c-3 • Forms N-CSR, N-CSRS, N-PORT, N-CEN, N-PX, Fidelity Bond 17g-1
Adviser Fees	• Asset Management Fee (1.5% to 2.5% of net assets standard) • Subordinated Income Incentive • Fee (20% or hurdle), though uncommon • No Capital Gains Fee unless all investors are "qualified clients" • Under Section 205(b)(2) of the Advisers Act and Rule 205-1, closed-end funds may charge a "fulcrum fee"

	Interval Fund and Tender Offer Funds
Leverage Limitations	• 33.33% leverage ratio (300% asset coverage ratio)
Co-Investment/ Affiliated Transaction Limitations	• Co-investment transactions with close and remote affiliates prohibited without SEC exemptive order
Investor Suitability Requirements	• No minimum requirement • Notice Blue Sky filings to states, no substantive review • No subscription agreement or five-day waiting period required • Electronic order entry possible
Ability to Issue Multiple Classes	• Yes, with SEC exemptive order (routinely granted)

Generally, tender offer funds will hold more illiquid securities (because of their favorable liquidity provisions) and cater to an accredited or qualified investor, whereas interval funds require a greater degree of available portfolio liquidity. The more frequent liquidity provisions have become widely accepted by a retail audience that may consume these strategies in a daily structure through their pre-existing traditional mutual fund platforms. This generalization is not a hard and fast rule but there is some level of market feedback where they mostly hold true.

The differences matter. The liquidity-return trade-off is an important consideration for advisers making structuring decisions - there is more and more creativity occurring on how to best structure these products that shouldn't necessarily be discounted.

Operations Comparisons

	Interval Funds	Tender Offer Fund
NAV Calculation	• Must calculate NAV on a daily or weekly basis	• Flexible – daily, monthly, quarterly • *Most Tender Offer products calculate NAV monthly or quarterly*
Tax Reporting	• Form 1099	• Form 1099 or Schedule K-1 (depends on underlying investments)
Portfolio Liquidity	• Must maintain liquid assets sufficient to meet repurchase offers during repurchase offer period • From the time an interval fund sends the shareholders notice of the repurchase offer until the repurchase pricing date, the fund must hold highly liquid securities equal in value to one hundred percent of the repurchase offer amount	• Portfolio can be 100% illiquid • No liquidity restrictions even when the tender offer period is open • Required to pay redemption proceeds 'promptly'
Liquidity Repurchase/ Redemptions	• Defined in the Fund Prospectus (Fundamental Policy) • Mandatory share repurchase program conducted every 3, 6, or 12 months • 5%-25% of shares outstanding each quarter • Tender offers under Rule 23c-3 under the 1940 Act (the "Interval Fund Rule") - Form N-23c-3	• Discretionary share redemption program conducted quarterly (Board discretion) • Limitation of 2.5% to 5% of shares outstanding for prior calendar quarter • Tender offers under Rule 13e-4 under the Securities Exchange Act of 1934 - Schedule TO
Share Registration	• Treated like an open-end fund, with registration fees based on net sales	• Initial registration of shares offering amount; thereafter must register additional shares prior to sale (not automatically effective) and pay filings fees

	Interval Funds	Tender Offer Fund
Tender Offer Period	• Shareholders must receive tender notifications no less than 21 and no more than 42 days before each repurchase request deadline.	• Unless withdrawn, the tender offer must remain open until the expiration of: (1) at least 20 business days from its commencement, and (2) at least 10 business days from the date that notice of an increase or decrease in the in the percentage of the class of securities being sought (e.g., above the soft-gate)
Oversubscribed Repurchase	• Pro rata application but Rule 23c-3 permits interval funds to purchase an additional number of tendered shares, not to exceed 2% of the fund's outstanding shares to avoid having to apply the pro rata result.	• If offers for repurchase exceed the amount of repurchased shares authorized, the fund can extend the offer or accept tendered interests on a pro rata basis. • Many advisers receive board approval to accept more than the published gate (this is called the "soft-gate") • Shares are accepted on a pro rata basis, provided that the fund may accept (i) all shares from a holder owning less than 100 shares and tendering all of their shares, before pro-rating shares tendered by others; or (ii) by lot shares tendered by a holder tendering all of their shares who elects to have either 'all or none' or 'at least a minimum amount or none' accepted so long as the fund first accepts all shares from holders who did not make such election.
Repurchase Notifications	• Disclosure and notification requirements of Rule 23c-3 do not permit notification by publication in a newspaper (as is permitted for tender offer funds), so an actual mailing to interval fund shareholders each quarter (or other period set) is necessary. The fund must send to each holder of shares subject to the repurchase offer a notification providing certain required information no less than 21 and no more than 42 days before each repurchase request deadline.	• Notification to shareholders of tender offers may be conducted through notification in a national (i.e., The Wall Street Journal) and/or regional publication rather than direct notification mailings as required for interval funds.

Repurchase/Redemption Differences

As previously discussed, the share repurchase provisions create the most meaningful differences in managing an interval or tender offer funds – specifically, the way the portfolio can be managed. Effectively, the tender offer fund can be 100% invested in illiquid securities since the positions do not need to be redeemed until the underlying positions are unwound. Further, the tender offer periods, both in occurrence and amount, are at the discretion of the adviser and Board.

For an interval fund, the repurchase/redemption periods are prescribed in the Fund's Prospectus. Most interval funds operate a quarterly repurchase program at somewhere between 5-25% of the portfolio. From the time an interval fund sends the shareholders notice of the repurchase offer until the repurchase pricing date, the fund must hold highly liquid securities equal in value to one hundred percent of the repurchase offer amount and they must be paid no later than 7 days after the repurchase Pricing date.

A more compressed frequency (monthly) results in overlapping tender offer process periods and a more complex operational support model. Longer durations (bi-annually or annually) remove that issue but generally are shied away from by potential retail distribution partners.

Distribution Comparisons

	Interval Funds	Tender Offer Fund
Investors	• No fundamental restrictions (1933 Act registration) • Holdings may impact eligible investors • *Common on retail mutual fund platforms* • *Typically designed for retail audience*	• No fundamental restrictions (1933 Act registration) • Holdings may impact eligible investors • *Primarily distributed through alternative investment platforms, certain strategies may require sub-docs* • *Typically designed for HNW investors, often with the accredited or qualified standard*
Compensation	• Underwriting compensation based on whether a fund has an upfront sales load, distribution fee, and contingent deferred sales load • Subject to FINRA 2341 which imposed limitation based on “gross new sales” • 5.75% selling commission standard • 0.75% distribution fee; 0.25% shareholder servicing fee	• 8% of gross offering proceeds limitation imposed by FINRA • Subject only to FINRA Rule 5110 (as of September 16, 2020 - Tender Funds no longer need to make a FINRA filing under Rule 5110 related to their underwriting arrangements)

Valuation Intertwined with Distribution

Both interval and tender offer funds have a flexible design when it comes to valuing the portfolio. Valuation interestingly also plays a critical role when it comes to distribution. Daily valuation is required to access NSCC Fund/Serv electronic trading, purchase orders must also be accepted daily. Fund/Serv allows for automated trading via NSCC and removes the requirements for forms or manual processes.

Assuming the fund is made available on the various RIA platforms, an adviser wishing to buy the product simply submits a purchase order on their internal sales system as they would for any other mutual fund product. Without a daily valuation, the product is transmitted through DTCC AIP (alternative investment platform) which is configured to handle the more manual nature of those transactions/products.

The securities found in more illiquid portfolios are difficult to value daily, particularly in the instance of private equity, credit or other esoteric fund holdings. A robust valuation procedure and potentially third-party valuation agents can be used to help strike a daily NAV. Most private funds are supplying a quarterly statement which the fund accountant can use to true-up the portfolio. Since in many cases, those underlying holdings are unsuitable for a non-accredited investor the drive for a daily NAV becomes a moot issue and will more likely be valued monthly or quarterly.

As the products have gained wider acceptance between platforms and broker-dealers, requests for specific features have resulted in shareclass with different compensation mechanics that cater to those individual requests (i.e. many funds sport and L share class for LPL and Cetera). As a result, most funds seek to obtain exemptive relief to offer multiple shareclasses. Typically, sales channels will require higher compensation for due diligence and ongoing service to offer unlisted closed-end funds, advisers must weigh whether the market opportunity of a potential partner outweighs the costs.

As with other 1940 Act Funds, unlisted closed-end funds are prohibited from offering different advisory fees within their various shareclasses of the same fund. As a means to create different advisory fees, some advisers have opted for a master-feeder arrangement. This Feeder funds typically invest substantially all of their assets in the master fund, however since each fund is registered under the 1933 and 1940 Act, it can dramatically increase the cost to operate the portfolio for the adviser. There are a number of Tender Offer Funds employing this structure, but it has become less common in recent years.

Conclusion

Laying out the operational and distribution nuances of Interval and Tender Offer funds side by side may help asset managers and investment advisers decide which product is best suited for their product mix and for their investor audience. The skilled and knowledgeable team at Ultimus can also help you determine which product is best. To learn more or start the process of launching an Interval or Tender Offer Fund, contact Ultimus at 800.813.1421 and ask for Nick Darsch.

ABOUT THE AUTHOR

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Nickolaus Darsch joined Ultimus in July 2019 as Senior Vice President, Business Development. In this position, he focuses on building strategic relationships with investment advisers to help support product, operations and asset growth. Nick is also responsible for contributing to firm growth strategies, market analysis and reporting as well as cultivating partnerships with centers of influence.

Prior to Ultimus, Nick held multiple roles within SS&C Technologies (including predecessor firms DST Systems, ALPS and Boston Financial Data Services) in sales, strategic relationship management, product and research groups. In 2016, he was named a "Rising Star" in the Asset Management industry in by Fund Directions.

Nick received B.S. from Bentley University in Economics and Finance and an MBA from the McCallum Graduate School of Business at Bentley University.

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