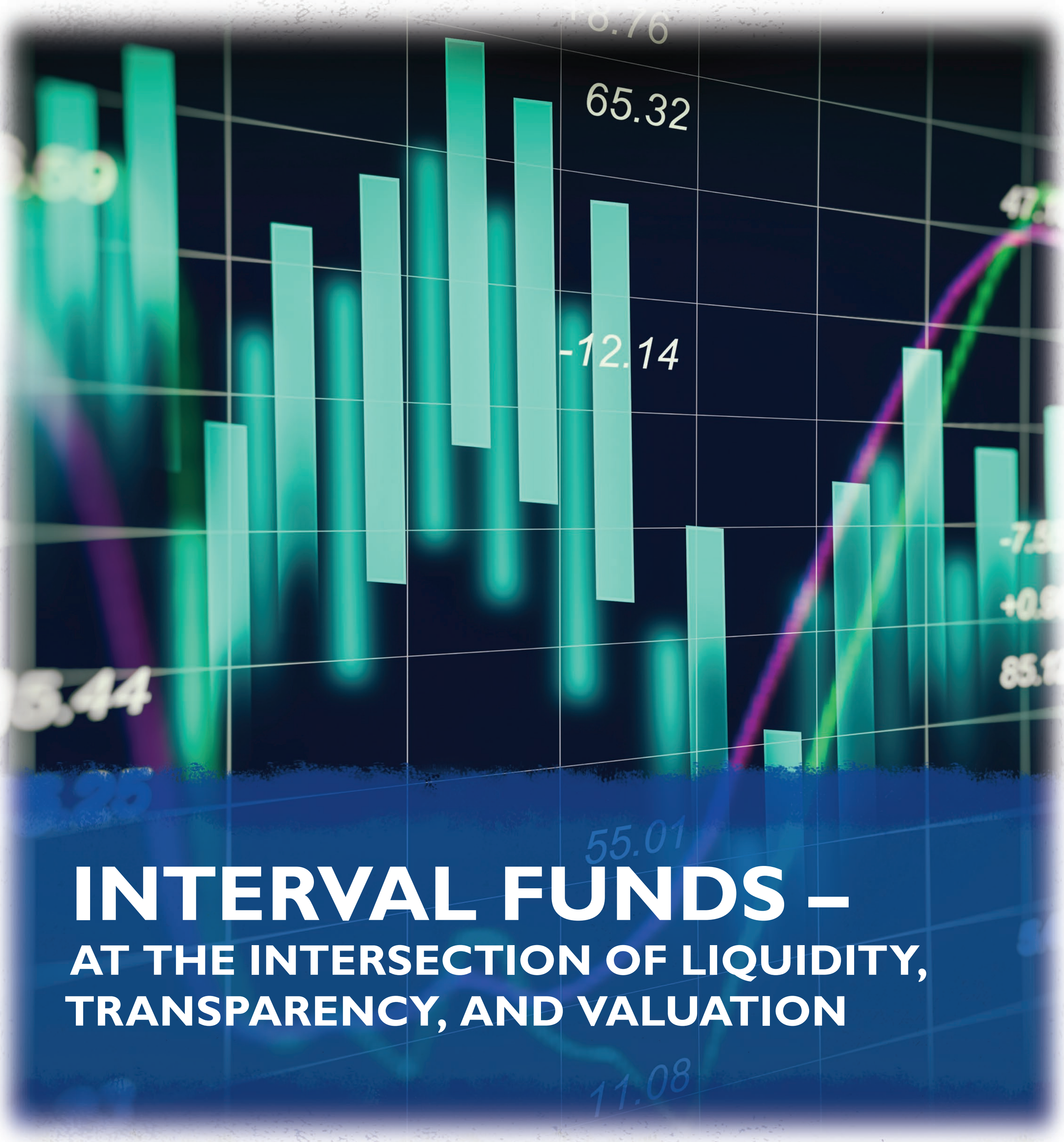

INTERVAL FUNDS –

AT THE INTERSECTION OF LIQUIDITY, TRANSPARENCY, AND VALUATION

DLA PIPER

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AT THE INTERSECTION OF LIQUIDITY, TRANSPARENCY, AND VALUATION

As yet another demonstration of the industry's ability to develop or tailor investment products to meet the demands of investors and their advisers, we now have the "interval fund." These funds are SEC-registered closed-end funds that engage in continuous offerings of their securities. They typically price and sell their shares daily, but do not list them on an exchange. And they redeem shares by making periodic repurchase (tender) offers at net asset value in compliance with Rule 23c-3(b) of the Investment Company Act of 1940.

Why does this matter? What do interval funds do that other pooled investment vehicles in the marketplace do not do (or do differently)? The answer is that interval funds give shareholders and financial professionals the transparency, valuation and investor protection elements of the 1940 Act. Importantly, they also permit investments in underlying assets that are (or may be) illiquid, yet offer investor liquidity on a periodic basis. This means that an interval fund can be a suitable vehicle in which to run "alternative" strategies – *i.e.*, strategies that are designed to produce returns that are not highly correlated to the broader stock and bond markets. Interval funds also mesh well with certain noteworthy regulatory initiatives – for example, FINRA's new customer statement rule (RN 15-02), and the Department of Labor's fiduciary rule and accompanying BIC exemption – making them attractive vehicles for use by independent broker-dealers and other financial advisors that must operate within the complex regulatory environment.

The aim of this concise handbook is straightforward − to place interval funds squarely in their regulatory framework, discuss how they operate from a mechanical standpoint, and then cover the various investment approaches that they can incorporate, including a discussion of SEC staff positions on how interval funds may invest in private funds available to accredited investors.

UNDERSTANDING INTERVAL FUNDS AND THE INVESTMENT COMPANY ACT

A. Important terms and key features

i. **“Registered under the 1940 Act”** – Interval funds own securities and register as investment companies with the SEC, whether or not they opt to make their shares available for public sale. Choosing to register under and comply with the 1940 Act is no small decision, as the Act establishes a host of legal and procedural requirements applicable to registrants and their affiliates, impacting everything from the composition of their governing boards to the terms of their advisory and distribution contracts.

ii. **“Closed-end”** – Shares of closed-end funds are not redeemable on a daily basis. Because they do not offer daily redeemability, interval funds are classified as “closed-end funds” under the 1940 Act. Interval funds are distinguishable from other closed-end funds, however, in that they are required to offer to repurchase shares from their shareholders at specified periods (known as intervals), at their net asset value (NAV).

iii. **“Continuously offered”** – Non-exchange traded interval funds differ from exchange traded closed-end funds in that they continuously offer their shares at a price based on NAV. In other words, there is no a one-day initial public offering or IPO; rather, there is an organized process to sell shares and raise capital for the fund over a period of years at prices that reflect the value of the fund’s assets net of liabilities at the time of purchase.

iv. **“Redemption”** – As noted above, interval funds do not provide daily liquidity. Rather, interval funds make tender offers at net asset value pursuant to Rule 23c-3 under the 1940 Act. The rule requires interval funds to establish a fundamental policy regarding these repurchase offers; the policy is changeable only by the shareholders of the company.

v. **“Interval”** - Pursuant to the rule, interval funds make periodic repurchase offers to shareholders every three, six, or twelve months. The frequency of these offers is disclosed in the fund’s prospectus.

B. Basic parameters

Having clarified what we mean when we say that interval funds are closed-end funds that register under the 1940 Act, make continuous offerings of their shares and further make tender offers at NAV at stated intervals, it is time to discuss the 1940 Act and related statues and regulations that apply to and otherwise bear on the operations of interval funds.

i. Structure and governance

- Interval funds are generally organized as Delaware statutory trusts or Massachusetts business trusts, and are governed by a declaration of trust and by corporate bylaws.
- Interval funds are managed by a board of trustees (similar to a board of directors), a majority of the members of which cannot be "interested persons" of the fund or its investment adviser ("Independent Trustees"). Board members serve terms defined by the fund's governing documents, and funds are permitted to not have annual shareholder meetings to elect the board if they choose.

ii. Independent auditor; audit committee

- Interval funds must engage an independent auditor and prepare annual audited financial statements. The board must appoint, from its members, an audit committee meeting the independence standards of the SEC. The audit committee must have at least one "audit committee financial expert" as that term is defined in Item 407(d)(5)(ii) of Regulation S-K (this requirement is tougher than the rule for open-end funds, which must merely disclose whether their audit committees have an audit committee financial expert and if not, why not).
- SEC rules require closed-end funds (as well as all public companies) to include in their annual report to shareholders a report from the audit committee stating that the committee reviewed and discussed the financial statements with management, discussed the audit with the fund's independent auditors, confirmed that the auditors met independence standards and recommended to the board that the audited financial statements be included in the annual report to shareholders. The fund must also disclose the names of each member of the audit committee, identify which member(s) of the audit committee are audit committee financial experts and state the fees paid to the independent auditors.

iii. Investment adviser

- The fund's investment adviser must be registered under the Investment Advisers Act of 1940, and the advisory contract is subject to special statutory provisions, including:
  - The investment advisory agreement can have a maximum initial term of two years, and is subject to board approval (including approval by the fund's Independent Trustees), annually thereafter. The board and the Independent Trustees have a duty to ask for, and the investment adviser has a duty to provide, information relevant to their decision to renew the agreement each year.
  - The advisory agreement and all material amendments thereto must be approved by the fund's board (including a majority of the Independent Trustees) and the fund's shareholders.
  - The advisory agreement must provide that it can be terminated without penalty at any time upon notice by the fund's board or its shareholders.
  - The adviser has a fiduciary duty as to the compensation it receives from the fund, and must obtain approval from the board and its independent members annually based on a series of judicially developed factors.
  - The advisory fee cannot vary by class of shares, and must be paid uniformly by all shareholders of the fund.
  - The adviser cannot receive compensation tied to the fund's capital gains and losses unless shareholders are restricted to "qualified clients" (*i.e.*, persons with at least $2.1 million in net worth or at least $1 million under the management with the adviser).

    IMPORTANT NOTE: This last point does NOT apply to performance fees tied to income.

iv. Principal underwriter

- The fund's principal underwriter (called a dealer manager in other contexts), acts on a best efforts basis to distribute the fund's shares. It must be registered as a broker-dealer with the SEC under the Securities Exchange Act of 1934 (1934 Act), and be a FINRA member firm.
- The distribution or principal underwriting agreement can have a maximum initial term of two years, and is subject to board approval (including approval by the fund's Independent Trustees), annually thereafter. The board and the Independent Trustees have a duty to ask for, and the principal underwriter has a duty to provide, information relevant to its decision to renew the agreement each year. The principal underwriting agreement must provide that it can be terminated without penalty at any time upon notice by the fund's board or its shareholders.

v. Other service providers

An interval fund requires a number of support services in addition to investment advice and distribution. Paramount among these other services are those provided by the following entities:

- An administrator, which generally oversees administration of the fund (*e.g.*, accounting, NAV calculation, and financial statement preparation).
- A transfer agent, which is responsible for recording ownership of fund shares, processing dividends, and sending shareholder and tax statements.
- A custodian, typically a bank. The 1940 Act establishes strict rules for custody of fund assets, generally requiring funds to maintain their assets with a bank.
- Counsel, which may be counsel solely for the Independent Trustees.
- Independent Trustees.

vi. Liquidity

- Although closed-end funds generally do not have to maintain any specific level of portfolio liquidity, interval funds are required under Rule 23c-3 to keep on hand during the repurchase offer period "liquid" assets at least equal to the full amount of the repurchase offer.
- Liquid assets are those: (i) that the fund can realize the approximate carrying value thereof in ordinary course in the period measured by the time between a repurchase request deadline and the repurchase payment deadline; or (ii) that mature prior to the repurchase payment deadline.

vii. Compliance

- The 1940 Act requires that investment companies adopt a program designed to ensure compliance by the fund with the federal securities laws, which program must include procedures to oversee the compliance programs of the fund's various service providers.
- The fund must engage the services of a chief compliance officer (CCO) – outsourced CCO arrangements are permitted, and the CCO can also be an employee of another service provider to the fund (*e.g.*, investment adviser).
- A fund's compliance program must be evaluated annually, and the CCO must submit a report on the fund's compliance program and those of its material service providers on an annual basis.

viii. Taxation

- Interval funds, like other closed-end funds, generally elect to be treated as regulated investment companies (or RICs), under Subchapter M of the Internal Revenue Code of 1986, as amended.
- If a fund does not qualify as a RIC in any taxable year, it is taxed in the same manner as an ordinary corporation on its taxable income; distributions to shareholders would not be deductible in computing its taxable income.
- Qualifying RICs are required to distribute substantially all of their income and capital gains to shareholders annually. Distributions of net investment income and net short-term capital gains realized by a fund are taxable to shareholders as ordinary income.
- Distributions of net capital gain (*i.e.*, the excess of net long-term capital gain over net short-term capital loss) are taxable as long-term capital gain, regardless of the length of time a shareholder owns the shares with respect to which such distributions are made.

C. Other operating requirements and limitations

i. Repurchase offers

Interval funds periodically notify their shareholders of upcoming repurchase dates. When the fund makes a repurchase offer to its shareholders, it specifies a date by which shareholders must accept the repurchase offer. The actual repurchase will occur at a later, specified date. The price that shareholders will receive on a repurchase will be based on the per share NAV determined as of a specified (and disclosed) date. This date will occur sometime after the close of business on the date that shareholders must submit their acceptances of the repurchase offer (but generally not more than 14 days after the acceptance date).

ii. Investments in other investment companies

Section 12(d)(1)(A) limits the ability of registered investment companies to invest in securities issued by other investment companies. Section 12(d)(1)(C) limits the ability of any investment company to purchase or otherwise acquire shares issued by a closed end fund if, immediately after such purchase or acquisition, the acquiring investment company, together with other investment companies in its fund complex, own more than 10 percent of the total outstanding voting stock of the closed-end fund.

iii. Leverage

Section 18 of the 1940 Act effectively limits the amount of direct leverage in which an investment company can engage. This section limits a closed-end fund's issuance of an evidence of indebtedness, unless the fund has 300 percent asset coverage, and preferred stock, unless the fund has 200 percent asset coverage. In the case of debt securities, asset coverage is calculated as the ratio of the value of total fund assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of debt securities.

iv. Derivatives

In December 2015, the SEC proposed Rule 18f-4 which, if adopted as proposed, would significantly affect the ability of a closed-end fund to use derivatives to create leverage and would require a closed-end fund to have assets available to meet its obligations arising from such transactions. In addition, closed-end funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives would have to establish a derivatives risk management program. As of this writing, however, the rule is still in the proposal stage and subject to public comment and further review.

v. Plan of distribution

FINRA amended its rules to exempt interval funds from the Corporate Financing Rule and instead to subject them to the Sales Charge Rule, which regulates the distribution and sales charges of open-end funds.

- The amendment to subparagraph (b)(8)(C) of the Corporate Financing Rule provides that closed-end fund offerings are exempt if the fund makes periodic repurchase offers pursuant to Rule 23c-3(b) and it offers its shares on a continuous basis pursuant to Rule 415(a)(1)(xi) under the Securities Act of 1933.
- Closed-end funds that do not meet these requirements continue to be subject to the Corporate Financing Rule.
- The Sales Charge Rule provides for a series of load variations and maximums, and generally combine to limit sales compensation to 8.5 percent.

vi. Investor eligibility

Any investor can invest, and there is no limit on the number or type of investors. 401(k) and other retirement and employee benefit plans can invest without limit, and interval funds can take in an unlimited number of investors. Interval funds can, unlike hedge funds, can take in an unlimited number of ERISA and IRA investors

vi. Disclosure documents

A prospectus (or summary prospectus) must be delivered before or at time of sale. A statement of additional information (SAI) must be delivered upon request. Shareholder reports must be provided after investment on an on-going basis.

vii. SEC reporting

NOTE: some of the forms below are subject to change under newly adopted SEC reporting rules for investment companies):

Interval funds are required to prepare and file the following documents:

- Form N-2 (the registration statement, which includes the prospectus)
- Form N-CSR: Interval funds are required to file Form N-CSR, the certified shareholder report for registered investment companies, on a semi-annual basis. Form N-CSR must be accompanied by a certification of a fund's principal executive officer and principal financial officer(s) that, among other things, they are responsible for establishing and maintaining disclosure controls and procedures and internal controls over financial reporting and that such procedures have been designed to ensure that material information regarding the fund is reported to such officers
- Form N-SAR: Form N-SAR requires closed-end funds to disclose whether they have adopted a code of ethics for their senior financial officers as required by Section 406 of the Sarbanes-Oxley Act, and if not, why not. The code of ethics required by the Sarbanes-Oxley Act should address: resolution of actual or apparent conflicts of interest between personal and professional relationships; compliance with disclosure obligations; and compliance with other legal or regulatory obligations
- Form N-Q: Interval funds, like all closed-end funds, must file Form N-Q, the quarterly schedule of portfolio holdings, for their first and third fiscal quarters. The filing must include a certification of the fund's principal executive officer and principal financial officer(s) similar to that set forth above with respect to Form N-CSR
- Proxy voting record (Form N-PX)
- Tender offer statements

ORGANIZING AND FORMING AN INTERVAL FUND

A. Required steps

The following steps are required to go down the interval fund path:

- SEC prospectus filing and review
- Initial board meeting
- Seed capital contribution and associated audit
- Creation of selling syndicate

B. Timing

It takes at least 4 - 6 months for a new registrant to be declared effective and ready to sell its shares to the public (a much shorter period, of course, if there is no public offering). The sponsor must select the fund's board, draft and review all relevant disclosure documents and contracts, draft and file the organizational documents with the state, file form N- 8A (notice of registration) and Form N-2 (registration statement) with the SEC.

The sponsor typically will receive comments from the SEC on the prospectus (Form N-2) about 45 - 55 days from filing. It typically takes another 2 - 4 months to gain final approval and to have the prospectus declared effective for a public offering.

The sponsor generally seeds the fund and commences offering after the SEC grants effectiveness. Minimum capital requirement is $100,000.

PORTFOLIO COMPOSITION AND MANAGEMENT

A. Investment objectives, policies and strategies

- As investment companies, interval funds engage primarily in investing, reinvesting or trading in securities.
- Eligible securities for interval funds run the gamut from equity to debt, and include both direct investments (*i.e.*, individual securities), as well as those held indirectly through funds and other pooled investment vehicles – such as trusts, LLCs, partnerships, or joint ventures.
- Interval funds are required to adopt and disclose an investment objective (*e.g.*, growth of capital, income or total return), and to identify their principal investment policies, strategies and investments intended to help them reach their stated objective.

B. Investments in other funds

- One of the critical decisions involved in creating and launching an interval fund is deciding how much of the fund's investment portfolio will be invested in other pooled investment vehicles (*e.g.*, hedge funds, commodity pools).
- An interval fund may be managed, with due regard for liquidity (see below), through investments in other funds, including open- and closed-end funds, private funds, commodity pools and other managed vehicles. There are various and important reasons to use funds in portfolio construction:
  - The vehicle might provide exposure to an asset or investment type that cannot be acquired directly by the fund (*e.g.*, real estate)
  - The vehicle might allow the fund to have exposure to an asset class or investment type in an efficient or cost effective manner (*e.g.*, hedge funds or commodity pools) or
  - The vehicle might offer a means of getting diversified exposure to an asset class or investment type (*e.g.*, REITs or funds that own multiple securities or assets).
- Funds may investment without limit in funds that are registered for public offer and sale under the 1933 Act. The primary considerations are:
  - Liquidity (as discussed elsewhere herein) and

  - The anti-pyramiding limitations found in Section 12(d) of the 1940 Act and applicable to investments in other registered investment companies and certain funds excluded from the 1940 Act (see below)

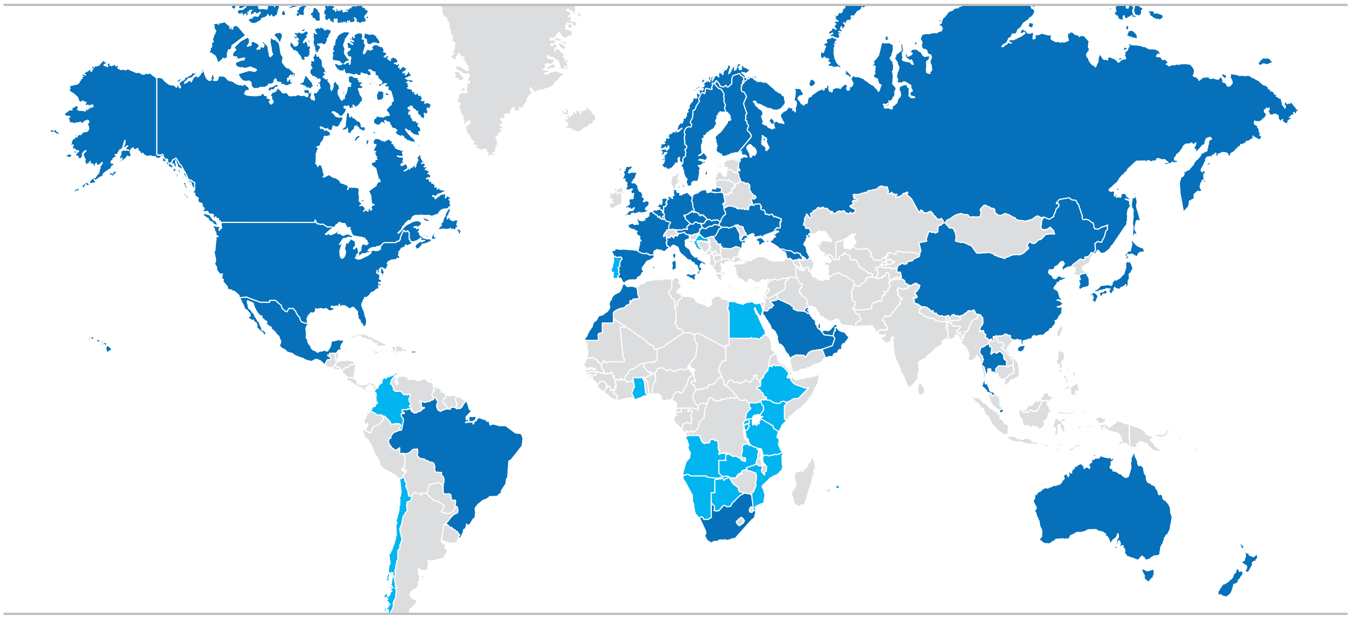
- Another issue is the SEC staff's limits on investment in private funds that are available only to accredited investors (or qualified purchasers). There is a 15 percent of assets maximum for investments by the interval fund in hedge funds and other private funds (*e.g.*, private equity funds), that are excluded from investment company regulation by virtue of Sections 3(c)(1) and/or Section 3(c)(7) of the 1940 Act.

C. Liquidity

- The requirement is a floor, not a ceiling. Interval funds respond to this requirement in various ways, depending on how they view the impact of holding liquid securities on their performance and portfolio metrics – some use liquid securities in significant amounts to produce income or otherwise provide returns, while others minimize the amount of liquid securities and hold only enough to meet the requirements of the next tender offer. Of course, funds that hold only enough liquid assets to meet the next tender offer purchase amount have to then have a plan to raise liquid assets for subsequent tender offers.

- While counting on new cash flows is one approach, most managers avoid overreliance on that source of funds to generate new liquid assets and either arrange for puts on portfolio securities or otherwise identify securities that can be sold if necessary without significant notice or diminution in value.

OUR GLOBAL REACH



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