

Interval funds

An unexpected revival for an old vehicle structure

July 2018



Building a better
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Active managers, facing significant fee pressures, understand the importance of being able to differentiate themselves in an uber-competitive market by innovating their product offerings to investors. This search has brought increased interest in the use of interval funds. As a cross between registered open-end and closed-end funds, interval funds are designed to provide investors with the benefits of both. Interval funds are vehicles with the ability to enter into illiquid investments while providing investors of the fund with increased liquidity.

The interval fund structure was first established in 1993 via SEC Rule 23c-3 in response to complaints about the very large market discounts to the net asset value (NAV) that closed-end funds often have. Closed-end funds generally are attractive because they allow investment managers to take advantage of a stable portfolio to achieve the potentially higher long-term investment returns that may be expected to accrue from illiquid investments. To achieve this stable portfolio, closed-end fund investors typically can't redeem or sell their shares back to the fund, as is the practice with open-end funds. Instead, closed-end fund investors must look to sell their interests on the secondary market for potential investment liquidity. Closed-end funds often trade at a discount from the NAV on the secondary market. By agreeing to make periodic repurchase offers to repurchase (and to offer) investor shares on a quarterly, semiannual or annual basis at the NAV, interval funds trade at NAV. Aside from periodic repurchase dates, interval funds can also continually offer their shares at the NAV.

Administratively, a registered interval fund is similar to a typical open-end or closed-end mutual fund. As they similarly are registered under the Investment Company Act of 1940, all three types of funds have many of the same regulatory, operational and tax requirements. Implementing robust controls, especially around the repurchase process, will provide potential investors with redemption offers that will be executed efficiently and without error. Interval funds are required to be priced at least weekly, but many price daily. While the redemption requests are significantly less frequent than the daily offering available to investors in open-end funds, interval fund managers still need to consider the ability to convert fund investments into cash to correspond to potential interval asset inflows and outflows. This consideration may cause an investment manager to make investment decisions to increase portfolio liquidity above what might be seen with closed-end funds. However, with proper portfolio management, the impact of this on investment returns can be minimized.

Formation

The first step in creating an interval fund is to file a registration statement with the SEC on Form N-2, which is the same form used by closed-end funds when they first register to operate under SEC rules. Once the SEC has approved the fund to commence operations, the manager typically will seed the fund (subject to the minimum capital requirements per Section 14(a) of the Investment Company Act of 1940)¹ and focus on fundraising.

¹ Investment Company Act of 1940, 1940, Section 14(a)



Many interval funds are focused primarily on generating income for investors and secondarily on maintaining a specific level of liquid investments to meet periodic repurchases. Since they do not need to provide daily liquidity, interval funds can invest in illiquid asset classes, such as those targeted by other “alternative” providers, including hedge and private equity funds. Hedge funds may even have a disadvantage in that they may be more at the mercy of redemption surges during market downturns (especially with event-driven and distressed funds). Interval funds may, therefore, offer advantages to investors and managers because they not only give managers the flexibility to invest without the threat of an unexpected redemption, but they also provide investors with the ability to trade at the NAV, compared with investors at other closed-end vehicles who will likely trade at a price different from the NAV.

Other than direct investments in debt and equity, interval funds may also invest in investment companies, such as trusts, limited liability companies, and partnerships. Such indirect investments are useful for generating excess returns but offer limited liquidity due to extended investment periods. The direct investments often targeted by interval funds include structured credit (mortgaged-backed securities and asset-backed securities), term loans, distressed debt (mezzanine and subordinated corporate debt, sovereign debt), real estate and other types of high-yielding investments. Some of these direct investments fall under Level 2 in the fair valuation hierarchy of the Financial Accounting Standards Board’s Accounting Standards Codification Topic 820 (ASC 820) – *Fair Value Measurements*. Level 2 considers quoted prices for similar assets or liabilities in active or inactive markets and other observable inputs (e.g., obtaining yield observability for similar debt instruments when pricing a specific issuer’s corporate debt). However, depending on the market observability of the valuation inputs for specific securities, especially for distressed investments with limited trading, an ASC 820 classification as Level 3 may be in order.

Managers of interval funds need to be cognizant of the protocols that will need to be put in place to ensure that valuations are accurate. Indirect investments, such as those in alternative funds that are, unobservable to any non-investor, are generally valued at the NAV of the underlying fund. Typically, an investment committee is established to meet on a frequent basis and evaluate the positions described above that warrant a Level 3 classification, as well as investments in alternative funds that are not valued at the NAV. Such an evaluation includes analyzing key assumptions used to internally model certain investments that do not have enough trade data or market-observable pricing. Since interval funds hold many debt positions, a yield analysis may be performed to compare the implied yield (based on the purchase price and date) of the investment to market yields and changes in observed yields of comparable investments. For positions in alternative funds, the investment committee should perform thorough initial due diligence procedures on the underlying manager and continue this diligence on an ongoing basis. Obtaining audited financial statements from the underlying manager will provide support for using the NAV of the underlying fund (that may be used as a proxy for measuring the fair value of

the interval fund's investment). For Level 2 investments, all reasonable efforts should be made to obtain multiple sources. A pricing policy should require management/ the fund to obtain a primary, secondary and, often, a tertiary source. Sources could be vendors (such as IDC and Reuters) or brokers, although many in the asset management industry are moving to vendors as their primary source, for cost-saving reasons. It may be useful for interval fund managers to perform initial and ongoing due diligence on the vendors and brokers used. Such procedures may include performing conference calls or on-site visits and running analytics (from the depth of coverage, or the average percentage difference from the broker price) to evaluate the efficiency and quality of vendor prices vs. brokers (which tend to be closer to the market than vendor, and can provide "better" pricing, albeit at a higher cost). If broker pricing is used to corroborate vendor prices, analytics may compare prices from primary brokers against those from secondary brokers to determine which brokers provide the best and most reliable pricing (e.g., comparison of individual broker prices to the mean or to within a certain standard deviation threshold). Backtesting prices against purchases and sales of similar securities can also help corroborate that the fair value of the investment was in line with what the market was willing to pay.





Because interval funds are required to fulfill repurchase offering obligations, as described above, fund managers need to maintain a portion of their assets in liquid securities, such as public equities and highly rated liquid debt securities. The specific amount portfolio managers may choose to invest in such liquid securities varies and depends on the ability to meet repurchase offers which, according to Rule 23c-3, is mandatory². Interval funds, similar to some of their counterparts in the closed-end space, may use a substantially larger percentage of illiquid debt investments to generate excess returns than open-end funds, which are required to maintain daily liquidity. Accordingly, interval funds are able to operate with a higher level of risk. Derivatives may be used by closed-end fund managers to enhance leverage. However, SEC Rule 18f-4³, proposed in December 2015, would add restrictions to derivative investing by requiring the maintenance of “qualifying coverage assets” to enable the fund to meet all derivative obligations. The proposal would also require the establishment of a formalized derivative risk management program. This proposal has not yet been adopted, but interval fund managers should monitor this proposal in the event that they aim to use derivatives to generate additional returns.

Interval fund managers must adopt the right policies and procedures at the onset of launching the fund, and continue to review and update those policies and procedures on a periodic basis. Frequent updates (at least on an annual basis) will help ensure that the portfolio investments within the fund are properly priced with respect to the most current fair valuation guidance issued by the SEC.

² Investment Company Act of 1940, 1940, Section 270.23c3

³ SEC Proposed Rule 18f-4, Use of Derivatives by Registered Investment Companies and Business Development Companies, Securities and Exchange Commission, 2015

Interval funds are similar to other investment companies registered under the 1940 Act (registered investment companies, or RICs) when it comes to governance protocols and mandatory filing requirements. They are required to have a board of trustees or directors that serves subject to the fund's governing documents, and the majority of this board cannot be interested persons of the fund or the advisor. This board must also appoint an audit committee, with at least one member from the committee being a "financial expert." The annual audited financial statements are structured similarly to other RICs, with additional disclosure around each repurchase offer made during the period (the repurchase offer amount and amount tendered), and a disclosure of the extent to which the fund repurchased stock when there are excess repurchase requests in any repurchase offer (as explained in the Operating protocol section below).

Typical service providers for interval funds include:

1. An administrator that performs accounting and financial reporting for the fund (although these functions can be separated)
2. An investment advisor
3. A custodian (required by the 1940 Act) with whom the fund assets are maintained
4. Legal counsel
5. An independent auditor (independent under SEC rules)
6. A transfer agent that processes dividends, maintains the shareholder register, and sends periodic tax and holdings statements to shareholders

Interval funds may elect to be treated as regulated investment companies (tax RIC) under Subchapter M of the 1986 IRS code⁴. As a qualified tax RIC, an interval fund would need to follow various income and diversification requirements and would be required to distribute substantially all of its income and capital gains to shareholders on an annual basis. Distributions of net investment income and short-term capital gains are taxable as ordinary income to shareholders. Shareholders retain the long-term gain character of any distribution of net long-term capital gains regardless of the shareholder's length of ownership in the fund. For tax purposes, these distributions are treated as deductions from the net income of the tax RIC. So, to the extent tax RICs distribute 100% of net income, no tax would have to be paid at the RIC level. Qualification of tax RICs is a continuing process. If these structures do not qualify in any particular year, they may be taxed as ordinary corporations and they would not be able to deduct distributions to shareholders when computing the taxable income.



⁴ Internal Revenue Code of 1986, 1986, Subchapter M



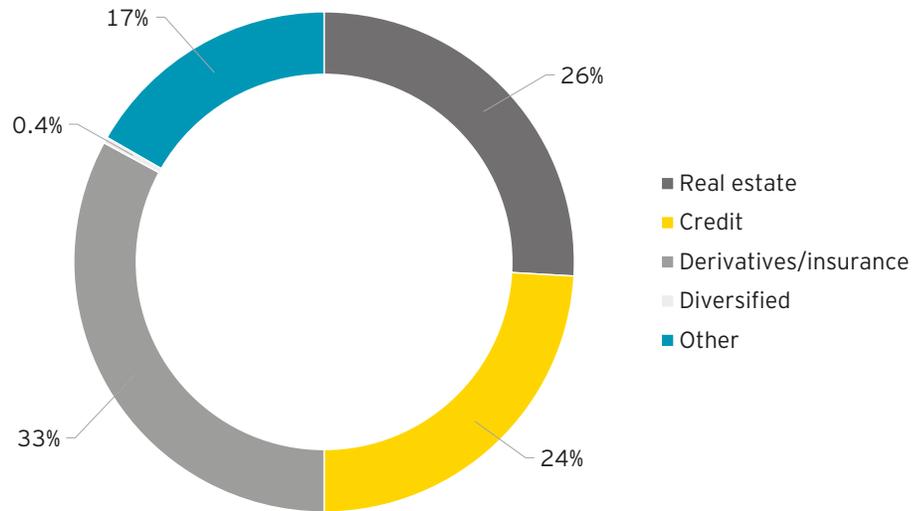
As described previously, one of the main selling points for investors investing in interval funds instead of other closed-end vehicles is the increased investor liquidity provided via periodic repurchase offers. Repurchases can happen on a quarterly, semiannual, or annual basis and the exact date of repurchase is communicated periodically, including the date of expiration of such an offer. Such timing of repurchases has to be built into a policy document at the initiation of the fund and can only be changed by shareholder vote. The exact date of repurchase is also important to shareholders because the repurchase price will equal the NAV per share of the fund on that date. Because of the importance of NAV as the price of the repurchase, the SEC mandates that interval funds calculate the NAV during each of the five business days preceding the repurchase request deadline. Further, per Rule 23c-3, the fund must also calculate the NAV at least weekly (the date and time of calculation will be determined by the board), each day investors purchase shares in the fund (because shares are continually offered and not necessarily aligned with repurchase dates) and also on the repurchase date⁵. NAV calculations could be challenging, depending on the ability to determine the fair value of certain investments.

Rule 23c-3 states that interval funds cannot offer less than 5% or more than 25% of the outstanding common shares when making a repurchase offer⁵. Because some funds stick to the minimum required offer of 5%, investors in these funds may be disadvantaged if total redemption requests exceed the offered number of shares. Excess repurchase requests are allocated on a prorata basis if the manager decides not to repurchase additional stock (limited to 2% of the outstanding common stock as of the repurchase deadline). The SEC allows interval funds to deduct a redemption fee from repurchase proceeds (not to exceed 2% of the proceeds) as compensation for expenses related to the repurchase. Interval funds are allowed to charge these redemption fees in addition to management fees⁵.

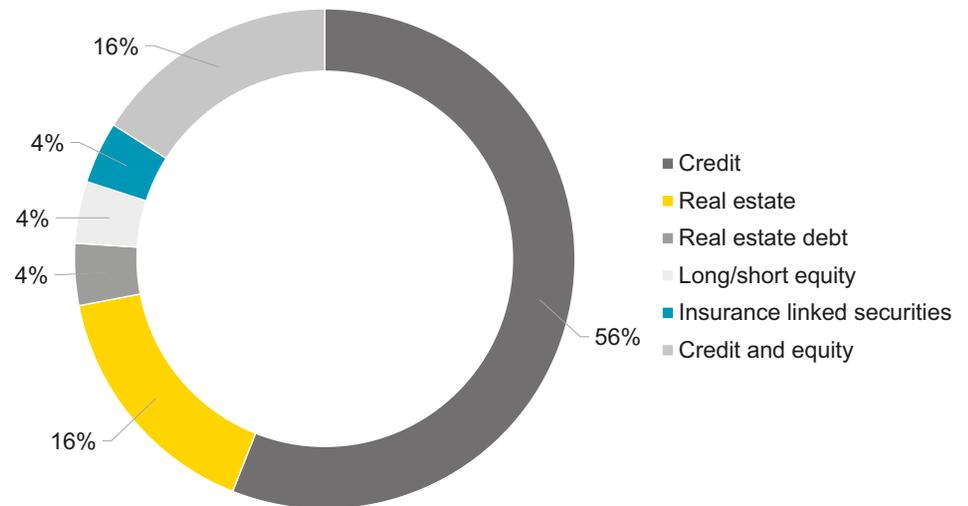
⁵ Investment Company Act of 1940, 1940, Section 270.23c3

An interval fund database, Interval Fund Tracker (IFT), noted 43⁶ interval funds that were registered with the SEC and had active investment portfolios. The AUM of these funds range from \$2.1m to \$5.0b⁶. These stats show not only how sparse the current interval fund landscape is, but also how managers, both large and small are offering them. Despite the small numbers, interval funds are undoubtedly gaining in popularity. In 2017, 10 new funds were approved by the SEC⁶.

IFT: Active funds⁶



IFT: Pending registration⁶



⁶ "Tools and Data", Interval Fund Tracker website, <https://www.intervalfundtracker.com/data/>, accessed 1 May 2018.

There are also 26 other funds currently waiting for registration approval by the SEC⁷. If a majority of those funds are granted approval and begin trading, combined with the 10 funds that were approved in 2017, the number of active interval funds could significantly increase. As noted in the previous charts, there is good diversity in both the funds currently showing activity and also funds pending SEC approval, giving investors an opportunity to pick from a variety of strategies.

IFT includes a list of recent interval fund launches by well-known credit managers. This list shows where managers differ in terms of fees and investment requirements, but every one of the managers has the same redemption offer of 5% per quarter, indicating that the industry consensus is to offer the bare minimum redemption capability to investors. This list is included for reference below⁸.

Fund	FS Energy Total Return Fund-A	FS Energy Total Return Fund-I	Griffin Institutional Access Credit Fund-A	Griffin Institutional Access Credit Fund-C	Griffin Institutional Access Credit Fund-I	Sierra Total Return Fund
Ticker	XFEAX	XFEYX	CRDTX	CGCCX	CRDIX	SRNTX
Advisor	FS Energy Advisor LLC	FS Energy Advisor LLC	Griffin Capital Credit Advisor, LLC	Griffin Capital Credit Advisor, LLC	Griffin Capital Credit Advisor, LLC	STRF Advisor, LLC (Medley Management)
Subadvisor	Magnetar Asset Management LLC	Magnetar Asset Management LLC	BCSF Advisor, LP	BCSF Advisor, LP	BCSF Advisor, LP	N/A
Minimum initial investment	\$2,500	\$1m	\$2,500	\$2,500	\$1m	\$2,500
Strategy	Equity and debt securities of natural resources companies	Equity and debt securities of natural resources companies	High-yield debt securities	High-yield debt securities	High-yield debt securities	Debt and equity
Target capital raise	Up to \$2b	Up to \$2b	Up to \$1b	Up to \$1b	Up to \$1b	Up to \$1b
Redemption program	5% per quarter	5% per quarter	5% per quarter	5% per quarter	5% per quarter	5% per quarter
Offering costs						
Maximum total sales load	5.75%	None	5.75%	None	None	2.00%
Maximum commission	5.00%	None	5.00%	None	None	0.75%
Dealer manager fee	0.75%	None	0.75%	None	None	1.25%
Distribution Fee	None	None	None	0.75%	None	0.75% average daily
Shareholder servicing expenses	0.25% average daily net assets	None	0.25% average daily net assets	0.25% average daily net assets	None	0.25% average daily net assets
Operating fees and costs						
Management fee	1.75% of total assets	1.75% of total assets	1.85% of net assets	1.85% of net assets	1.85% of net assets	1.5% of total assets
Contingent deferred sales charge	None	None	None	1.0% during first year	None	1.0% during first year
Incentive fee	None	None	None	None	None	15.0% of net investment income over 6.0% hurdle, with catch-up provision

⁷ "Tools and Data", Interval Fund Tracker website, <https://www.intervalfundtracker.com/data/>, accessed 1 May 2018.

⁸ "Research", Interval Fund Tracker website, <https://www.intervalfundtracker.com/research/>, accessed 1 May 2018.

There are a number of incentives for fund managers to create an interval fund, including the inherent benefits of being early adopters of new investment products (first to market). Knowing the repurchase offer schedule in advance allows managers to better plan for fund outflows and invest in less liquid, and potentially higher risk, investments. Fund managers can offer interval funds as an “alternative-asset” choice. We note that despite the current market trend toward passive investing, interval funds present an attractive opportunity for active managers to provide investors with a vehicle that can potentially generate higher returns. For many investors requiring liquidity, interval funds provide a nice balance between fully liquid open-end funds and less liquid closed-end funds. Even though shares of interval funds do not typically trade in the secondary market, periodic repurchases at the NAV and the ability to continuously offer shares at the NAV make entry and exit more appealing for investors who would rather not deal with the uncertainties associated with discounts and premiums of the NAV. Interval funds are experiencing a rightful rebirth, and their popularity is expected to continue to increase.

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Score No. 03801-181US
1805-2675390
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