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Securities Services

The Rapid Growth of *Interval Funds*

What are Interval Funds?

First developed in the 1990s, interval funds have seen a resurgence in popularity as their unique structure complements current market conditions characterized by volatility, liquidity concerns, fee compression, and regulatory restrictions. While interval funds have regulatory and operational considerations that are similar to other registered funds, a few key differences are raising their appeal to investors and asset managers alike.

Interval funds are closed-end funds with set selling and redemption periods, making them a popular structure to house less liquid alternative investments including real estate, asset and mortgage-backed securities, corporate debt or other types of structured credit.

Due to illiquid holding limitations imposed by the Investment Company Act of 1940 (1940 Act), these investments are challenging to hold in open-end fund structures. Unlike traditional closed-end funds, which frequently trade at a discount on the secondary market making them susceptible to price arbitrage and shareholder activism, interval funds trade at the fund's net asset value (NAV) at predetermined intervals.

Popularity Growing with Investors and Managers

Though a relatively small overall market of $75.3 billion in assets under management (AUM)[1] in North America, interval funds have experienced rapid growth over the last several years. Since 2018, AUM has increased nearly 300% and the number of funds has grown from 60 to 93. Since the beginning of 2024, 16 new interval funds have filed registration statements with the Securities and Exchange Commission (SEC). In an August 2023 article, FUSE Research[2] predicted interval funds would continue to grow at a pace of 16% on average per year and to surpass $100 billion in assets before 2026. Assets continue to be concentrated within the five largest interval funds, which account for 48.1% of net assets. Credit remains the most popular strategy and constituted 54.1% of interval fund assets as of the end of September 2023, followed by real estate at 24.4% and equity at 14.4%, highlighting how managers are using this structure to make traditionally less liquid investments more accessible to retail investors.

Interval funds represent an opportunity for traditional U.S. asset managers to offer investors an avenue to pursue higher yielding, less liquid alternative investment strategies. Where open-end mutual funds are prohibited from investing more than 15% of their net assets in illiquid investments under the 1940 Act, the closed-end fund wrapper provides managers the flexibility to invest in a larger concentration of less liquid asset classes. In fact, during periods when there is no repurchase offer in effect, interval funds have no limits on illiquid asset concentration at all. This can make these funds more attractive to sophisticated or institutional investors who are looking for longer-term liability management and the potential for higher absolute returns. These investors are also probably better-positioned to adapt to the restricted, structured redemptions that are a key feature of interval funds.

There are various market factors driving interval funds' popularity. Interval funds are able to provide retail investors an opportunity to invest in asset classes typically available to only institutional investors. These asset classes tend to have lower market correlation than traditional asset classes and can hedge against swings in the stock market, which investors find appealing. In this regard, interval funds are similar to private funds, which many retail investors are unable to access. Retail investors also find interval funds appealing because of the stability in the value of their shares, due, in large part, to the lack of a secondary market for their shares, controlled redemptions, and their periodic repurchase feature, which promotes confidence in the product and encourages a long-term investment outlook.

In addition, this structure allows managers better control over redemption flow, which can be highly valuable in periods of volatility. This provides managers with the flexibility to invest in less liquid assets due to reduced concern over redemptions and permits them to invest in a wider range of assets, increasing portfolio diversification. The underlying alternative assets typically found in interval funds also warrant a higher fee structure, potentially making it an appealing addition to a firm's product line up in an environment characterized by ongoing fee compression. Lastly, no single provider has taken hold of the market. As mentioned above, AUM is currently concentrated among the larger asset managers, presenting an opportunity

[1] Interval Fund Tracker
[2] https://fuse-research.com/rapid-growth-in-interval-funds-to-continue

for firms at a range of AUM bands to consider launching an interval fund. Furthermore, private fund managers, who typically have a limited investor base due to "accredited investor" and "qualified purchaser" restrictions under the 1940 Act, can broaden their investor base by offering similar strategies through interval funds.

Regulations recently adopted by the SEC, including regulations pertaining to liquidity risk management under Rule 22e-4 of the 1940 Act, have created an increased amount of administrative and regulatory obligations for registered investment companies, leading managers to seek alternative investment options. Furthermore, recently adopted amendments to the reporting requirements on Forms N-Port and N-CEN, as well as the SEC's continued focus on liquidity, which could lead to additional proposed amendments to the SEC's Rule 22e-4 on liquidity could make managing certain portfolios and strategies more challenging in an open-end mutual fund structure. This may lead more managers to turn to interval funds as an investment option for their clients because they are not subject to the 1940 Act liquidity rules.

Derivatives may also be utilized by interval funds to increase the portfolio's overall leverage. Rule 18f-4 under the 1940 Act, which the SEC adopted in 2020, provides certain exemptions from the leverage and senior securities limits prescribed by Section 18 of the 1940 Act. Under Rule 18f-4, mutual funds, including interval funds, can enter into derivatives transactions that exceed Section 18 limits, subject to certain conditions. These conditions include the adoption of a derivatives risk management program, compliance with an outer limit on fund leverage based on value-at-risk or "VaR" and certain recordkeeping requirements.

Regulating Interval Funds

Although interval funds are organized as closed-end funds registered under the 1940 Act, intervals funds are hybrids with characteristics of both open and closed-end funds. While open-end funds continuously offer their shares and provide daily liquidity, traditional closed-end funds typically issue shares in an initial public offering, do not continuously offer their shares thereafter, and publicly list their shares for trading on a stock exchange. Interval funds, however, rely on Rule 23c-3 of the 1940 Act to periodically offer to repurchase shares from shareholders at pre-determined intervals – typically, every three, six or twelve months. In addition to pre-determined intervals, which can only be changed by shareholder approval, interval funds are able to make one discretionary repurchase offer every two years. Unlike traditional closed-end funds, interval funds are not typically traded on the secondary market and therefore are less susceptible to price arbitrage and activist investor pressures. Like in open-end funds, interval fund shareholders who redeem shares during a periodic repurchase do so at the fund's per share NAV.

From a liquidity standpoint, interval funds offer less investor liquidity than open-end funds, but greater liquidity as compared to traditional closed-end funds. Open-end funds are limited under 1940 Act rules in the amount of illiquid investments they can hold to no more than 15% of a fund's total assets. Closed- end funds on the other hand, have no such limitations and can theoretically hold an uncapped

amount of illiquid investments in a given portfolio. Interval funds land somewhere in the middle of these two extremes. While they are not subject to open-end liquidity requirements, they are however, required by Rule 23c-3 during a repurchase offer period to maintain 100% of the repurchase offer in liquid assets, which may include a line of credit. Therefore, during predetermined intervals, interval funds are required to remain in, or convert, assets into liquid positions in order for the fund to easily convert to cash to meet redemption obligations associated with the periodic share repurchases.

Similar to both open-end funds and traditional closed-end funds, interval funds may also elect to be treated as a Regulated Investment Company (RIC) under Subchapter M of the IRS code. Managers will want to ensure their investment strategy aligns with the IRS rules that support a RIC's favorable tax treatment. These requirements include deriving 90% of gross income from investments like stocks or securities, meeting quarterly diversification requirements and annually distributing all of the fund's investment income to shareholders.

Operational Considerations and Servicing

Interval funds require the typical service provider lineup, including legal counsel, an independent auditor and transfer agency, custodial and fund accounting/ administration support.

From a governance perspective, interval funds operate similarly to other registered funds. In line with open-end funds, interval funds must have a board of directors, a majority of which cannot be interested persons of the fund or the adviser, and a corresponding audit committee, with at least one committee member who meets the definition of a financial expert. Annual audited financial statements of the funds are also required.

From a valuation perspective, an interval fund's alternative assets may come with additional complexities. Any investments with limited trading may create a valuation challenge and firms will want to ensure they have a good understanding of the accounting and regulatory considerations around calculating a fair value for these investments. While a NAV is generally only required weekly, in practice most interval funds strike a daily NAV. Under Rule 2a-5 of the 1940 Act, the board of directors of an interval fund will typically appoint the adviser as the "valuation designee" to evaluate and make good faith fair value determinations with respect to hard-to-value positions. Rule 2a-5 also requires board oversight and certain reporting to the board.

The success of any interval fund will depend, in large part, on the distribution of the product. Prior to launching an interval fund, it is important to understand the investor landscape and to target the appropriate distribution channels. Working with appropriate service providers, with knowledge of interval funds and how they operate, will also help establish operational efficiencies and allow managers to focus on managing the product and its distribution.

Adding an Interval Fund to the Lineup

Interval funds should be evaluated in the context of a firm's overall product mix and could serve as a useful complement to a traditional open- and closed-end fund product lineup. To avoid cannibalizing other products, firms with other alternative offerings could consider narrowing the investment strategy of the new interval fund. Ideally, firms should be looking to attract a different pool of investors that have not yet been served by existing offerings.

Following exemptive relief by the SEC, interval funds can offer multiple share classes, which could allow managers to tailor distribution across different channels. The ability to offer multiple share classes with different fees for various fund services allows interval funds to better compete with open-end funds. Relatively low investment minimums also function as a differentiating feature from many other alternative fund structures, as do opportunities for streamlined tax reporting through 1099 forms as opposed to K-1s.

As firms consider distribution opportunities, they will want to prepare for what could be a lengthier process. Due to the complexity of the operational due diligence surrounding the fund's underlying assets, it may take longer for managers to access distribution platforms. Further, asset managers will need to put additional effort into explaining the benefits and limitations of this structure and ensure they have considered five key questions around launching an interval fund. Though unlikely to ever take hold of a dominant registered fund market share, interval funds may continue to grow in popularity provided asset managers can demonstrate enhanced returns for investors.

Five Questions to Consider Before Adding an Interval Fund

1. Who are the target investors that could be best served by the illiquidity premium of this product?
2. How can an interval fund complement my existing fund lineup?
3. Which partners will need to be aligned to address the unique operational, regulatory reporting and administrative challenge around this fund structure?
4. Which, if any, enhancements will we need to make to our existing fund governance framework?
5. At what frequency should the redemption period intervals be set?

Comparing Fund Structures

	Closed-End	Interval	Open-End
1940 Act Applies	Yes		
Illiquid Investments	Uncapped amount of illiquid investments	Uncapped but must have liquid assets to cover periodic repurchases	Illiquid investments cannot exceed 15% of total assets
Pricing	Exchange traded, market price	Fixed once per day at NAV	
Offering/Formation	One time IPO Registration on Form N-2	Continuous offering Registration on Form N-2	Continuous offering Registration on Form N-1A
Valuation	Daily		
Redemptions	Depending on trading volume, can continuously buy or sell	Set 3-, 6-, or 12-month intervals at NAV	Daily redemption available at NAV

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