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MUTUAL FUNDS

Untapped Opportunities in the Registered Alternative Closed-End Fund Space

BY PAMELA POLAND CHEN

An increasing number of private fund managers are turning to alternative products registered under the Investment Company Act of 1940 ("1940 Act") as a means of growing their assets under management and diversifying their product offerings and revenue streams. These products include open-end funds, or mutual funds, that offer daily liquidity (liquid alternative funds) as well as closed-end funds that offer periodic liquidity. The demand for registered funds that pursue alternative strategies has grown exponentially in recent years and is predicted to increase further in coming years as noted.

Benefits of 1940 Act Registration

The ability to access a broader investor market and new distribution channels, coupled with the desire of financial intermediaries to allocate client assets to alternative products, has driven this trend. Registration of a fund under the 1940 Act allows it to have more than 100 investors without any constraint on the types of investors that may invest. A registered fund can also register its shares under the Securities Act of 1933 and make a public offering of its shares, engage in advertising and offer its securities to retail investors. This makes registered funds better suited to broad offerings by brokerage firms and financial advisory firms that have large numbers of clients who may not meet investor qualification standards that apply in the case of private funds. Additionally, registered fund assets are not "plan assets" under the Employee Retirement Income Security Act of 1974 ("ERISA"). Therefore, regardless of the extent of ownership of a registered fund by employee benefit plans, the fund's assets will not be plan assets and ERISA constraints will not apply to the management of the fund.

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Registered Fund Structures

Registered alternative funds are generally organized as either open-end funds or closed-end funds. Open-end funds issue shares that are redeemable at the option of the investor on a daily basis at their net asset value per share and are publicly offered. New Rule 22e-4 under the 1940 Act, recently adopted by the Securities and Exchange Commission ("SEC"), will soon require open-end funds to adopt liquidity risk management programs designed to minimize the risk that the funds will be unable to meet redemption requests and to mitigate the risk of redemptions diluting the interests of remaining shareholders. This rule also codifies, with some modification, the SEC's longstanding position that open-end funds may not acquire an illiquid investment if, as a result of the acquisition, more than 15 percent of their net assets would be invested in illiquid investments.

Closed-end funds, on the other hand, do not issue redeemable securities, are not subject to Rule 22e-4, and have no regulatory limitation on making illiquid investments. These features of closed-end funds enable a manager to have greater flexibility concerning the nature of the fund's investment strategy and greater control over the timing of cash flows in and out of the fund. A closed-end fund may also pay performance-based compensation to its adviser, so long as all investors in the fund are qualified clients.

Benefits of the Closed-End Fund Structure

Although mutual funds provide a way to reach the broadest investor market, the requirement of daily liquidity and the limitation on illiquid investments may present stumbling blocks to some managers who are seeking to offer alternative strategies in a 1940 Act-registered fund. Using a registered closed-end fund avoids these issues. A registered closed-end fund can have the look and feel of a hedge fund. It can use the same investment program as a manager's hedge fund, use the hedge fund's track record in its offering materials, pay a performance fee and provide roughly the same liquidity terms as a manager's hedge fund. A closed-end fund structure may also be beneficial because it eliminates the need to deal with daily cash flows, which may adversely affect fund investment performance. By offering liquidity and fee terms in a registered closed-end fund that are similar to those offered in a manager's existing hedge fund, a manager can avoid its investors viewing the registered fund as more attractive than the hedge fund.

Considerations in Product Design

In designing a closed-end fund, managers must consider the capabilities and needs of the financial intermediaries that will be distributing the fund as well as the types of investors they are trying to reach. Questions to be asked include: What liquidity terms will the distribution channels demand (e.g., quarterly, semi-annual or annual)? How should the fund's fees be structured to accommodate the compensation demanded by financial intermediaries that will distribute the fund? Would the target investors meet a $2.1 million ″qualified client″ standard required for funds that pay a performance fee? Generally, financial intermediaries have shown a preference for products that are publicly offered and provide quarterly liquidity and Form 1099 tax reporting (such simplified tax reporting is possible for funds that elect to be treated as ″regulated investment companies″ under Subchapter M of the Internal Revenue Code of 1986).

1940 Act Investment Limitations

While registration under the 1940 Act involves certain investment and compliance considerations, managing a registered fund may not require significant changes to a hedge fund manager's existing infrastructure. Although most alternative strategies can meet the 1940 Act's investment and leverage limitations, managers should recognize the asset coverage restrictions that apply. Most importantly, there are 1940 Act limitations on borrowings (a registered fund must have $3 in total assets for every $1 of borrowing) and the use of certain types of transactions, including derivatives, that create a potential future payment or delivery obligation on the part of the fund. These transactions include short sales, futures, writing options, swaps and forwards. However, a fund's transactions of this type will not be treated as subject to the asset coverage limitations if the fund segregates cash and liquid securities with a value at least equal to the amount of the potential payment or settlement obligation.

Conclusion

A registered closed-end fund with the look and feel of a hedge fund can allow managers to access a broader investor base and to diversify their income stream – it may represent an untapped opportunity that deserves a closer look.

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