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The Intersection of Private and Registered Funds: Interval Fund Investments in Private Open-End Real Estate Funds

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One of the growing areas where private funds and registered funds intersect is the investment of US registered interval funds into private open-end real estate funds. As defined benefit pension plans continue to give way to defined contribution plan structures and as other changes alter the institutional investor landscape, private managers of open-end real estate funds are looking for other sources of capital, including access to retail investors.

From the public fund manager perspective, there are a number of different factors leading managers to look for investments into alternative types of vehicles. First, there has been a fair amount of fee compression in the industry, placing downward pressure on the fees that managers can charge for more traditional retail asset classes. By contrast, if funds are investing in more sophisticated investment strategies, they can maintain a higher fee for the manager. At the same time, the retail investment market has witnessed the dramatic rise of passive investing. Index funds and exchange traded funds (ETFs) that pursue passive strategies are squeezing traditional fund managers outside of their historical competency in public markets. However, alternative investments such as private real estate are areas that are largely inaccessible to passive investing and where active managers can show their expertise. Lastly, registered funds have been trying to expand their investment offerings across different asset classes.

There are at least a few different structures for registered interval funds to invest in private real estate funds. The first one is a registered fund of funds that invests in a variety of unaffiliated private funds. Another structure is where a private fund manager is looking for a way to access retail investors and wants to set up, in essence, its own public fund structure that can invest in one or more private real estate funds managed by that manager. A hybrid of either one of these structures is a structure in which the registered fund is investing both in privately managed funds and public securities, such as listed real estate investment trusts (REITs) and commercial mortgage-backed securities (CMBS), which can provide more liquidity for the registered fund. This article explores, at a high level, some of the legal and regulatory considerations that should be of interest to managers of either registered funds or private funds as they approach this intersection between two traditionally distinct fund landscapes.

Interval Fund Regulatory Regime

The overall regulatory regime surrounding public interval funds focuses around the Investment

Company Act of 1940 (the 1940 Act), which specifically regulates interval funds. Rule 23c-3 under the 1940 Act lays out a number of the required characteristics for those funds. One of these is periodic redemptions. The interval fund will put out a redemption offer to allow its investors to take out somewhere between 5 percent and 25 percent of the outstanding shares of the fund on a periodic basis, such as quarterly, which is publicly disclosed. Also, interval funds are allowed to conduct an ongoing offer, so that on a daily basis they can take in subscriptions based on net asset value (NAV). While interval funds are technically closed-end funds for purposes of the 1940 Act, the ability to conduct ongoing offers, coupled with giving regular liquidity at NAV, gives them a strong family resemblance to open-end funds.[1] A critical requirement for the redemptions and the subscriptions as well is that the funds strike a net asset value, which is subject to extensive regulatory scrutiny. In light of these requirements, private open-end real estate funds are more attractive for an interval fund structure than might be the case for other types of alternative investments. Open-end real estate funds have quarterly deposits and redemptions, and they strike a quarterly NAV based on appraisals. In addition, appraisals of real estate are a much more robust form of valuation than other valuations of private equity.

Another requirement under the 1940 Act that is certainly novel for private fund managers is that interval funds have to maintain an evergreen public prospectus. Interval funds make public filings for a continuous offering of shares and keep updating their disclosures quite regularly to the extent that anything changes. Another key feature of the 1940 Act structure is governance and oversight by an independent board, which is the same for interval funds as for other kinds of registered funds. This requires a number of procedural elements, including annual renewal of contracts, enhanced disclosure and a lot of review by an independent board. Also key to the 1940 Act structure is the set of affiliation provisions discussed further below, as those really do get to the core of what the 1940 Act is trying to protect. Together, this range of regulation creates a number of complications for trying to operate a real estate fund management business and investment program in a way that might be more traditional for a private fund manager.

Affiliation Issues

A private fund manager looking to set up a registered fund structure that can make investments into a wide selection of its existing funds faces significant hurdles under the 1940 Act's affiliation requirements. Effectively, when a registered fund takes on an investment adviser, whether as the principal manager or as a subadviser, that advisory firm automatically becomes an affiliate for 1940 Act purposes.[2] If that fund is trying to invest into private funds that are managed by the same investment adviser, those underlying funds are also treated as affiliates. The registered fund will be prohibited from investing in those affiliated funds below. If the private fund manager is offering its funds to an interval fund managed by a third party that is unaffiliated, and the underlying manager is not in turn acting as an investment adviser to the registered fund, then those private funds can come into the registered fund portfolio.

The 1940 Act fund also technically becomes an affiliate of any private fund when it goes over 5 percent of the outstanding voting interest. A registered fund-of-funds needs to be aware of the 5 percent limitation, even if the underlying private fund was unaffiliated with the registered fund. However, the LP interests in private funds often can be structured so as not to qualify as voting securities for purposes of a 5 percent test. If the registered fund goes over 5 percent, this creates restrictions on interactions such as "joint transactions" (regulated under Section 17(d) of the 1940 Act) and other transactions with affiliates. Certainly, if a registered fund stays below 5 percent of the outstanding units of an underlying private fund, there is no way there can be an affiliation. However, there are ways to structure a registered fund's investment so as to not treat the interests

of private funds as voting securities. There are other triggers of affiliation, in particular when the registered fund is deemed to control an underlying fund, which raises questions as to large positions for registered funds coming into private funds.

A registered fund manager must determine a process for selecting underlying private funds for investment. The party that knows the most about the underlying private funds is the private fund manager. Oftentimes, the managers of interval funds may not have quite the same expertise in being able to select among different private fund options. The registered fund manager needs to determine who is going to fulfill a fiduciary obligation to make good investments and reallocate investments, and potentially make difficult choices to move away from one private underlying fund or into a different fund. The registered fund manager needs to be able to do that without relying entirely on the private fund manager. If an active manager of a registered fund has a group that does selection of investments in real estate, there might be sufficient expertise in-house to make investment decisions about underlying private real estate funds managed by unaffiliated investment firms. Alternatively, the interval fund manager can engage a consultant or a subadviser. There are a number of different options to be able to have the expertise. That is a critical element to trying to think through what structure works for an interval fund purchasing private open-end vehicles.

If the private fund manager is going to provide information to the named manager of an interval fund, it will be critical to conclude that the private fund manager is not deemed to be acting as an "investment adviser" to the interval fund.[3] In this regard, it is important to examine the types of information that can flow up and down from the private fund manager. There is certainly some flexibility to be able to transmit information to either the interval fund, or to the interval fund's subadviser or its consultant, that would allow them to make the appropriate decisions for which private funds to buy and how to allocate weightings across different private funds. The key is just staying clear of becoming an investment adviser to the registered fund. For 1940 Act purposes, the definition of "investment adviser" is quite broad and effectively rolls in subadvisers, sub-subadvisers, and so on, so one needs to be quite careful.

Registered Fund Tax Regime

Registered investment funds also have their own special tax regime. Most or nearly all registered funds seek to qualify as regulated investment companies (RIC) for tax purposes. A fund that qualifies as a RIC is not subject to a fund level tax, so long as it distributes all of its income, and it can pass through the character of that income, for example capital gains that are subject to favorable rates for individuals. In this way, RICs and real estate investment trusts (REITs) are similar. There are a number of qualification requirements for these purposes. One is a diversification requirement. A RIC cannot have more than 25 percent of its assets in a single issuer, and at least half of the fund's assets must be in securities of issuers that represent no more than 5 percent of the fund's assets and no more than ten percent of the voting stock of the issuer. In this bucket, for example, a fund needs at least 10 issuers that represent no more than 5 percent of the fund's total assets.

From a tax perspective, a RIC therefore needs to consider these diversification requirements when selecting private funds for investment. This issue often comes up when the private fund adviser has a limited number of private funds and the goal is to invest only in those private funds. For example, if there are only five or six (or anything under 12) private funds in which to invest and those are the only investments, the interval fund won't be able to meet the RIC diversification test. Private funds are often structured as partnerships, which own a number of underlying investments. Unfortunately, unlike REITs, there is no rule that says a RIC can look through private funds in that manner. For RIC diversification purposes, the RIC generally must look at each private fund. If a RIC does not have a

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large enough offering of private funds, the interval funds will have to look to obtain exposure through other means as well to meet the RIC diversification rules.

Unlike the 1940 Act, which has its own separate diversification requirements on an ongoing basis, the tax diversification requirements are measured at the end of each fiscal quarter. There are some cure periods; for example, a RIC has 30 days after quarter end to get into compliance with the test if it was not in compliance at quarter end. What is difficult with private funds is the way a RIC would cure noncompliance is to shift its asset mix and sell some investments and make other investments. This often does not work well with these private fund structures and the related business objectives. It is important upfront when a manager is contemplating setting up a fund to have an idea of what investments it will be able to use to meet the test.

In addition, there is a qualifying income requirement. At least 90 percent of the fund's income must consist of interest, dividends, income and gains from securities and other income and gain with respect to the fund's investments in securities. Notably, for this purpose, rents and other income from real estate investments do not qualify. Helpfully, many open-end real estate funds make all of their investments through REITs. REIT dividends are qualifying income for the RIC purposes, so REIT investments provide a good way to make sure that the fund is receiving qualifying income to qualify as a RIC. A RIC would want to confirm that the real estate fund invests only through REITs, and thus has only qualifying income. If a real estate fund invests directly in real estate or through other structures, the RIC would need to make sure it would meet the qualifying income requirements based on all of the RIC's investments.

Finally, there are distribution requirements for RICs, again similar to REITs. A RIC must distribute at least 90 percent of its income (other than net long-term capital gain) to qualify as a RIC and must distribute all of its income and capital gain to avoid a fund-level tax. If a private real estate fund allocates income to the interval fund from a private fund, the RIC must ensure that it has sufficient cash to make the necessary distributions for RIC purposes. Again, investing through REITs is a helpful point because REITs are also required to pay regular dividends.

Operational Issues

The differences between interval funds and private open-end real estate funds lead to a number of operational issues. The first is valuation. As mentioned above, private open-end real estate funds do appraisals on a quarterly basis. Usually, these appraisals are sometime during the quarter, not right at the end of the quarter. These appraisals are used to report a quarterly value for the fund, which is reported to investors at some point after the end of the quarter. In contrast, interval funds are being sold daily, at a daily net asset value. There are operating procedures for share valuation that a 1940 Act fund board will adopt, which will have to find ways to adjust the NAV in order to come up with a fair price to sell the shares at on a daily basis. There is a fair amount of conjecture over the course of a quarter, which could be second-guessed if the markets are moving around too much and the fund's NAV is not moving with them. A registered fund can address that to some degree by disclosure, but in the end, there has to be a fair value process. A bedrock of the 1940 Act structure for funds that accept daily subscriptions is to avoid diluting the interests of existing investors or charging too much for new investors coming in.

Another critical time for NAV calculations is for the periodic redemption, because there typically is going to be a significant outflow of capital and the fund is going to have to be striking a NAV on which to base that outflow. An interval fund generally does have the flexibility to set the period and the timing for its periodic redemptions so it can go out with an offer of redemption, coming up with the period of notice and then a date on which the fund can actually pay out the redemption. Ideally an interval

fund would coordinate all of the periodic valuations for its private fund so that they arrive immediately before the date on which it strikes the NAV used for its periodic redemption offer. There will always be a small lag in timing, but it is helpful that, on the date when a particularly large amount of the fund is going out for the periodic redemption, the fund is coming up with as firm a calculation as possible of the current value of the private funds in this investment portfolio.

Another common operational issue is contributions or investments. Contributions to open-end real estate funds are made on a quarterly basis, but sometimes, depending on the new investments that the open-end private fund is going to make, there might be a deposit queue or a line to get into the open-end funds. There are times when an investor may have to wait a couple of quarters before it is able to deploy its capital. However, interval funds are raising capital on a constant basis. As a result, the interval fund is looking for investments in private funds that are going to be able to invest their capital as quickly as possible, rather than ones where the interval fund is going to have to wait in a deposit queue for a few months.

Where an interval fund is raising money on a daily basis, but can only make investments into private funds on a periodic basis, the interval fund's performance record would suffer significantly from "cash drag" if it were to hold large amounts of cash while waiting for opportunities to put the cash to use in private funds. This is why many interval funds invest in a mixture of private funds and public securities. A critical element to structuring an interval fund is to have some way to put cash to work in an appropriate manner, both in order to hold onto that cash and make it move with the markets over time while waiting to make investments into private funds that might have a queue, and also in order to have liquidity on hand to meet redemptions. Both on the way in and on the way out, having a mix of types of investments is one of the ways interval funds try to manage this disconnect between the retail product and the private or institutional product.

When trying to fit together interval funds and private funds, it is worth focusing on the inherent differences between the redemption processes followed by the two fund types. In normal times, a private open-end fund will be accepting new contributions and processing redemptions in the ordinary course, but in times where a fund is liquidity-constrained, they may set up a redemption queue. Usually, private funds are not obligated to sell assets or to borrow cash in order to process redemptions. Interval funds, by contrast, are required to set their periodic redemptions at a publicly disclosed level and have at least 5 percent of the portfolio value going out, or at least available to go out, in cash with each periodic redemption offer. Consequently, there are going to be periods where an interval fund may need to have more liquidity on hand than it might be able to get from its private fund investments. The board of an interval fund does have the ability, on a quarterly basis, to change the amount of the fund that is being redeemed from between 5 and 25 percent. However, lowering the redemption percentage may run the risk of causing some investors to panic and overinflate the size of their redemption requests in efforts not to get pro-rated below the level of cash they specifically need in a given quarter. An interval fund should be aware of the risk of triggering a "run on the bank" if it tries to restrain those percentages too much on the quarterly redemption periods. This kind of run on the bank scenario also can occur in the private funds.

A final tension worth highlighting between the public and private funds is portfolio transparency. There are a number of public disclosure requirements that are probably even broader than those of the governmental pension plans that have historically invested in private funds. Mutual funds are required to have quarterly disclosure of all of their holdings. These disclosures, which are publicly reviewable on the Securities Exchange Commission's (SEC) EDGAR Website, show exactly what position each interval fund has in each private fund. The interval

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fund is not necessarily publishing a lot of disclosure about the underlying funds, but it does have an obligation to talk about its performance. Presumably, the 1940 Act fund is going to have to say something in its public documents about what happened in the course of a quarter and which underlying investments did well and which ones did not. Our experience has been that private managers have gotten comfortable with that disclosure, both in the public pension plan as well as the registered fund context. If there were not legal requirements to disclose the investments, there might be questions as to whether that creates any securities law issues, given that the private funds are privately offered and need to rely on private placement exemptions. However, it seems like the legal obligations of registered funds to make disclosures to their shareholders should trump the private placement requirements. In addition, the 1940 Act fund is a separate entity, and the adviser of the 1940 Act fund is not affiliated with the private fund manager. Nevertheless, it is important for the private fund manager to make sure that it is not tripping over any of the private placement requirements so that it does not appear to be trying to advertise its funds through a different wrapper.

Advantages of Accessing Capital through Registered Funds

This discussion started out by talking about how private funds liked the idea of getting capital from registered funds because it was a way for them to access the retail investor market. But interval funds, at least currently, are not truly retail. There is and has been for some time an informal SEC Staff position that prohibits any registered fund from investing more than 15 percent of its assets into private funds, unless that registered fund, and the interval fund in this case, restricts its investor base to accredited investors, which is the same standard that applies to private 3(c)(1) funds placed through Regulation D. It is essentially a high net worth individual type of test. While one can make public offerings of this kind of an interval fund, it is not going to be available to every person on the street who wants to buy a mutual fund, so there is a limitation on just how retail this type of interval fund product actually can be. Importantly, the term "private fund" has certainly been interpreted by a number of practitioners as meaning only 3(c)(1) or 3(c)(7) funds under the 1940 Act. If an interval fund is buying private funds that are relying on a different exemption, such as an exemption or exclusion on the basis that the underlying private funds are investing only in real estate, there may be some flexibility under current interpretations. Even still, for the standard private open-end real estate funds, there is going to be a limit to the types of investors that can actually buy the interval fund. Chair Clayton of the SEC has been making an effort to give more access for retail investors into slightly more private type investments. Again, we will have to see once rulemaking starts emerging out of Chair Clayton's initiatives and what comes out of recent SEC requests for comment, and to see what the industry does and how the SEC and its Staff are willing to open things up going forward.

Nonetheless, from the perspective of the private fund manager, a great advantage is the distribution channel—that those interval funds can be marketed on a very similar basis to an open-end registered public fund. If a private fund manager is getting a number of its funds exposed to a broader investing public through an interval fund structure created by a third party, it stands to benefit from whatever distribution channels that third-party sponsor has set up to sell its own funds. As we have seen these markets developing, there are a number of relatively retail-themed platforms in operation that firmly restrict investors to accredited investors. In addition, a registered fund is not limited by the private fund limitation on general solicitation. While an interval fund does not have the ability to be sold to everyday investors, this marketing freedom provides much broader exposure on the distribution side that starts to approximate retail.

There is a helpful difference from a tax perspective between an accredited investor investing directly in a private fund or a private feeder versus investing in a registered fund. Private feeders that are partnerships for tax purposes give K-1s to their investors. RICs, again like REITs, give Form 1099s, which the retail investor, including accredited investors that one might consider retail investors, would prefer 1099s. 1099s are simpler and come earlier in the year. This makes tax reporting easier for the investors. In addition, 1099 dividend income can be reported on the investor's resident state tax return without having to file returns in other states.

Summary

While there are a number of operational complications and regulatory issues to consider, interval funds are a good way for retail investors or at least some retail investors to get exposure to private real estate, and on the other side, for private real estate managers to gain access to another growing source of capital.

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NOTES

1 There are other variations that look like interval funds, such as so-called tender offer funds, which do not have the same prescriptive set of requirements as to periodic redemption, but the discussion in this article focuses on ordinary interval funds.

2 Technically, the 1940 Act builds its affiliation analysis on the defined term "affiliated person." Most 1940 Act prohibitions extend to what are often referenced as second-tier affiliates, namely "affiliated persons" of "affiliated persons." Under section 2(a)(3), an "affiliated person" of another person is defined as: "(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

3 Section 2(a)(20) defines "investment adviser" of an investment company quite broadly to mean "(A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) of this paragraph regularly performs substantially all of the duties undertaken by such person described in said clause (A); but does not include (i) a person whose advice is furnished solely through uniform publications distributed to subscribers thereto, (ii) a person who furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities, (iii) a company furnishing such services at cost to one or more investment companies,

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insurance companies, or other financial institutions, (iv) any person the character and amount of whose compensation for such services must be approved by a court, or (v) such other persons as the [SEC] may by rules and regulations or order determine not to be within the intent of this definition."

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