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Why More Alternative Asset Managers Should Embrace the 1940 Act

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Private equity sponsors and other alternative asset managers have historically focused on developing and managing investment strategies and products geared towards institutional investors such as state and local government pension plans, corporate pension plans, sovereign wealth funds, ultra-high net worth individuals, and family offices. Individual investors have often been overlooked in these efforts on account of the regulatory requirements associated with offering fund products to such investors—particularly those who do not satisfy the "accredited investor" standard—and related operational and compliance considerations. Individual investors nonetheless represent a potentially significant investor universe for alternative asset managers looking to expand their platforms and tap into new sources of capital. By one recent estimate, individual investable assets are targeted to reach $106 trillion by 2025.[1] At the same time, private markets are projected to continue to grow substantially, along with the demand for alternative products among individual investors.[2]

Fortunately, the Investment Company Act of 1940 (the 1940 Act), the federal statute enacted to protect the investing public against self-dealing, conflicts of interest, and overreaching by sponsors of pooled investment vehicles, contemplates several well-suited alternatives to the private fund structure that alternative asset managers can utilize to offer their strategies to both institutional and individual investors. This article focuses on three closed-end fund structures in particular and their potential benefits to alternative asset managers seeking to reach both institutional and individual investors: registered closed-end interval funds and tender offer funds (together, CEFs) and business development companies (BDCs).[3]

CEFs and BDCs provide managers a means to deploy capital on an evergreen basis in a single fund and escape the cycle of repeated capital raising for new private fund "vintages." These structures can also provide managers with greater flexibility in the sourcing, management, and, ultimately, harvesting of their investments because they are not constrained by, for example, a limited ability to recycle proceeds or a requirement to wind down the fund after a set period of time. CEFs and BDCs can accommodate a range of investment strategies, particularly those that are less liquid, while affording sponsors fewer restraints relative to open-end mutual funds or exchange-traded funds (ETFs). These structures also provide a wrapper for alternative strategies that can be widely marketed to a broader investor base through multiple distribution channels. Due to the

continuously offered, largely closed-end nature of these 1940 Act products, managers are able to maintain a potentially continuous stream of revenue from management fees and, in some cases, incentive fees. For investors, these fund structures offer many of the same protections and transparency that are features of mutual funds and ETFs, as well as a degree of liquidity that, particularly in the case of individual investors, is likely to better match their diverse target investment horizons.

Overview of Fund Types

The 1940 Act classifies management companies as either "open-end" or "closed-end" companies. Generally speaking, open-end investment companies, such as mutual funds, issue "redeemable securities" and are required to permit shareholders to redeem their shares daily at the then-current net asset value (NAV) per share. Because those funds provide daily liquidity, they are also required to maintain the bulk of their assets in liquid investments. In contrast, closed-end funds, such as interval funds, tender offer funds and BDCs, do not issue "redeemable securities" and do not provide investors with the right to redeem their shares at the option of the shareholder.[4] Because they are not required to provide liquidity to shareholders (with the exception of interval funds, which are required to conduct periodic repurchase offers at NAV, as discussed below), closed-end funds can invest a greater percentage of their assets in less liquid or illiquid investments and, as a result, are generally a more suitable vehicle for pursuing alternative strategies.

Interval Funds

Interval funds are closed-end funds registered under the 1940 Act that must provide periodic liquidity to shareholders by making repurchase offers of between 5 percent and 25 percent of outstanding shares at pre-established "intervals" of every three, six or twelve months. All share repurchases must be made at the fund's then-current NAV. Shares of interval funds may be listed on an exchange or unlisted. In the latter case, the interval fund may engage in a continuous offering of its shares. Interval funds are often viewed as a hybrid between open-end mutual funds and traditional (listed) closed-end funds.

Tender Offer Funds

Tender offer funds are closed-end funds registered under the 1940 Act that may, but are not obligated to, provide periodic liquidity (typically quarterly) to shareholders through issuer tender offers conducted pursuant to the tender offer rules under the Securities Exchange Act of 1934 (the Exchange Act). Shares of tender offer funds may be listed on an exchange or unlisted. In the latter case, the tender offer fund may engage in a continuous offering of its shares.

Business Development Companies

BDCs are closed-end funds that are not registered under the 1940 Act, but that elect to be subject to regulation under certain provisions of the 1940 Act. Most BDCs focus on making loans to, or acquiring minority equity stakes in, small and medium-sized private companies in the United States, and generally are required to offer managerial assistance to their portfolio companies. Shares of BDCs may be privately offered or registered for public offering. If registered, the shares may be listed on an exchange or unlisted. In the latter case, the BDC may engage in a continuous offering of its shares. A BDC may provide liquidity to investors either by conducting periodic repurchase offers pursuant to the interval fund repurchase offer rule or by conducting periodic tender offers under the Exchange Act tender offer rules.

Exhibit 1 outlines certain key comparisons of interval funds, tender offer funds and BDCs. CEFs and BDCs are subject to the applicable requirements of the 1940 Act. These requirements govern fund operations such as financial reporting, distribution of shares, repurchase offers, fund leverage, NAV calculations, and transactions with affiliates. While these regulatory guardrails may impose certain constraints on a sponsor's ability to operate a regulated fund in the same

Exhibit 1—Key Comparisons

	Interval Funds	Tender Offer Funds	BDCs
May engage in continuous offerings	Yes	Yes	Yes
Exchange listed	Possible	Possible	Possible
May be offered to retail investors	Yes	Yes	Yes
Portfolio liquidity requirement	Partial (Only during periodic repurchase offers)	No	No
Daily NAV calculations	Yes (During periodic repurchase offers)[i]	No[ii]	No[ii]
Periodic redemptions	Yes	Discretionary	Possible
Performance fees	Possible depending on investor base[iii]	Possible depending on investor base[iii]	Yes

[i] An interval fund also generally must calculate NAV on a daily basis during any period when the interval fund is offering its common stock.

[ii] Closed-end tender offer funds and BDCs that are continuously offered typically calculate NAV monthly or quarterly in connection with investor subscriptions, and at certain other times (for example, in connection with share repurchases).

[iii] CEFs are able to pay incentive fees on realized capital gains only if all investors are "qualified clients" as defined under the Investment Advisers Act of 1940 (currently, $2.2 million net worth/$1.1 million assets under management). The same limitation does not apply in the case of an incentive fee on dividend and interest income.

manner as its private funds, this regulatory overlay is likely to be viewed more favorably by individual investors and their financial advisors and intermediaries that might otherwise be wary of investing in a private fund due to perceived illiquidity, lack of transparency, higher fees, and longer investment horizons. This same regulatory overlay also may be viewed favorably by certain institutional investors who may prefer the additional protections and transparency afforded by the 1940 Act.

Structural Advantages and Other Considerations

Investment Strategy, Leverage, and Valuations

As noted above, CEFs and BDCs are not required to provide daily liquidity to shareholders and, therefore, are not subject to the same limit on illiquid investments applicable to registered open-end funds. In fact, CEFs and BDCs are not subject to any requirements with respect to portfolio liquidity, other than in the limited case of an interval fund that must hold liquid assets from the time that notice of a repurchase offer is sent to investors until the repurchase pricing date equal to at least 100 percent of the repurchase offer amount. However, because an interval fund is required to offer to repurchase, in any specific offer, a minimum of only 5 percent of the fund's outstanding shares, this means that the bulk of the fund's assets can continue to be invested in less liquid or illiquid investments during the repurchase offer period.

Interval funds and tender offer funds are able to pursue a range of illiquid and non-traditional strategies, including private equity, venture capital, infrastructure, high-yield and distressed credit, real estate credit, and convertible credit strategies, without being subject to the volatility of daily inflows and outflows. A CEF can pursue these strategies through direct investments, by operating as a fund of funds that invests in underlying funds that pursue such strategies, or through a combination of direct and indirect investments. BDCs, on the other hand, focus primarily on direct lending to, or acquiring minority equity stakes in, small and medium-sized private companies in the United States, and are

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required to invest at least 70 percent of their total assets in "qualifying assets," which generally are limited to eligible portfolio companies,[5] cash and government securities. A BDC may use the remaining 30 percent "bucket" to invest in non-US companies or other non-qualifying assets.

The 1940 Act imposes certain limitations on funds' use of leverage, primarily through the restrictions on the issuance of "senior securities" imposed by Section 18 of the 1940 Act. CEFs and BDCs, however, are permitted under the 1940 Act to incur leverage to a greater degree than mutual funds and ETFs. Interval funds and tender offer funds may issue preferred stock and debt securities and can borrow money from both bank and non-bank lenders, subject to a 200 percent asset coverage ratio in the case of preferred stock and a 300 percent asset coverage ratio in the case of debt.[6] BDCs are generally subject to a 200 percent asset coverage ratio for debt and preferred stock, but have flexibility under the 1940 Act to elect to be subject to a 150 percent asset coverage ratio, subject to certain conditions. In addition, unlike interval funds and tender offer funds, which are limited to one class of senior security representing indebtedness, BDCs can issue multiple classes of senior securities representing indebtedness. For example, a BDC could issue notes that have a higher priority to its bank credit facility.[7] All three types of funds may use derivatives and other instruments that have the effect of creating economic leverage, subject to Rule 18f-4 under the 1940 Act, which imposes certain limitations and requirements with respect to the use of derivatives transactions, reverse repurchase transactions, and unfunded commitments.

Depending on a fund's underlying strategy, the frequency of NAV calculations may be a significant consideration, as less frequent NAV calculations may present an advantage for funds pursuing illiquid and non-traditional strategies. Interval funds are required to calculate NAV: (1) no less frequently than weekly, and more frequently in connection with sales and repurchases of shares; and (2) in connection with repurchase offers, on the repurchase pricing date and on each of the five business days prior to the repurchase request deadline. Tender offer funds and BDCs have greater flexibility in terms of the timing of NAV calculations; often, NAV calculations are tied to the timing of acceptance of investor subscriptions (for example, daily, monthly, or quarterly).

The board of a CEF or BDC is responsible for the fair valuation of the fund's assets, but can delegate such responsibilities to the fund's investment adviser (subject to the board retaining a significant oversight function) pursuant to Rule 2a-5 under the 1940 Act.[8] Generally speaking, funds must value their investments using the market value of their portfolio securities when market quotations are "readily available," and fair value when a market quotation for a portfolio security is not readily available (or unreliable) or if the investment is not a security.

Distribution of Shares

CEFs and BDCs may choose to register the sale of their securities under the Securities Act of 1933 (the 1933 Act), allowing fund sponsors to distribute and sell fund shares to investors without regard to whether the investors are qualified purchasers, as defined in the 1940 Act, or accredited investors, as defined in Regulation D under the 1933 Act. Sales efforts may include entering into arrangements with financial intermediaries to access different fund "supermarkets" or other retail investor distribution channels.[9] Non-traded BDCs that engage in a public offering of their shares also are subject to certain state blue sky requirements that govern, among other things, investor suitability (including minimum net worth requirements and concentration limits).

CEFs and non-traded BDCs are able to obtain exemptive relief to offer multiple share classes with differing fee structures to tailor distribution opportunities. Share classes may be created, for example, with differing sales loads and distribution and service fees. The process of obtaining multi-share class exemptive relief from the SEC has become standardized, albeit requiring additional cost and expense. A

fund may seek exemptive relief to permit the fund, an affiliate or a principal underwriter to enter into arrangements whereby payments are made by the fund to finance the distribution of fund shares. Obtaining exemptive relief permits fund sponsors to take advantage of many of the same diverse distribution channels available to publicly offered mutual funds.

CEFs and non-traded BDCs that register shares under the 1933 Act typically engage in a continuous offering of shares and may admit new investors as desired (for example, daily, monthly, or quarterly). These continuous offerings enable a fund to replenish cash that is used to satisfy periodic repurchase offers or tender offers and can alleviate the need to sell existing portfolio holdings to generate cash for new investments. Subscriptions are often fully funded, eliminating the need for capital calls and the "J-curve" returns typical of private funds with a drawdown structure.

Each of these fund types also can be privately offered, either on a continuous basis or as a limited term fund with a traditional private equity drawdown structure. The private offering is typically made in reliance on Section 4(a)(2) of the 1933 Act and Regulation D thereunder, and investors in the fund must all be accredited investors. Notably, a registered fund or BDC engaged in a private offering to accredited investors is not limited to only 100 holders, as would be the case for a fund relying on the 3(c)(1) private fund exclusion from 1940 Act regulation.

Plan Assets

Registration under the 1940 Act also provides greater flexibility for offers and sales to investors subject to the Employee Retirement Income Security Act of 1974 (ERISA), such as corporate pension plans, and to individuals purchasing shares through their individual retirement accounts (IRAs). Importantly (and unlike interests in private, unregistered funds), the acquisition of CEF shares by ERISA plans and IRAs will *not* cause the underlying assets of a CEF to be treated as "plan assets" under ERISA and the parallel provisions of Section 4975 of the Internal Revenue Code (the Code). This is because ERISA and the Code provide that the underlying assets of 1940 Act-registered funds are not, by definition, "plan assets." This characterization allows sponsors of CEFs to attract potentially large amounts of capital from ERISA plans and IRAs without concern that the funds could become subject to ERISA or Section 4975 of the Code.[10]

Unlike CEFs, the underlying assets of BDCs may or may not be treated as "plan assets" under ERISA and Section 4975 of the Code, depending on how the BDCs are structured. Consequently, the "plan assets" status of BDCs often must be analyzed like the "plan assets" status of private funds, such as private equity funds and hedge funds. As with private funds, if a BDC is treated as holding "plan assets" for purposes of ERISA or Section 4975 of the Code, several legal and regulatory requirements will apply to the BDC. These may include, as applicable, heightened standards of care on the part of BDC managers, substantial restrictions on transactions involving the BDC, limitations on the manner in which BDC managers may be compensated, certain disclosure obligations, and other limitations. Fortunately, BDC sponsors can, if they wish, take certain actions to avoid having their BDCs treated as holding "plan assets." For example, BDC sponsors could prevent ERISA plans and IRAs from owning 25 percent or more of any class of equity interest in a BDC. Alternatively, BDC sponsors could consider operating a BDC as a "venture capital operating company" (by making investments in underlying operating companies with respect to which the BDC obtains and exercises certain management rights). In addition to these strategies, certain BDCs may avoid holding "plan assets" by issuing shares that are publicly offered, widely held, and freely transferable. Each of these foregoing strategies has important technical requirements and limitations that need to be considered carefully with ERISA counsel.

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Liquidity

Closed-end funds, by definition, do not issue redeemable securities. As such, sponsors can raise capital that tends to be "sticky" and do not have to liquidate investments at an inconvenient time or during down markets to meet redemption requests. At the same time, CEFs and BDCs normally offer periodic liquidity that is not typically available to investors in many private funds. Interval funds offer to repurchase a specified percentage of their outstanding shares (between 5 percent and 25 percent) at NAV on a periodic basis (quarterly, semi-annually, or annually) pursuant to a fundamental policy adopted by the fund that may not be modified or eliminated without shareholder approval. Tender offer funds and BDCs may, but are not required to, repurchase shares by conducting periodic tender offers. Accordingly, a tender offer fund's/BDC's board has greater flexibility to make a determination each period as to whether it is in the fund's interest to conduct a tender offer—and set the amount of the offer—in light of prevailing market conditions and other relevant factors. In the case of both an interval fund and a tender offer fund/BDC, if shareholders submit shares in an amount exceeding the repurchase or tender offer amount, the fund is required to repurchase shares on a pro rata basis, subject to certain limited exceptions.

Repurchase/tender offers are subject to certain specific requirements under Rule 23c-3 under the 1940 Act (for interval funds and BDCs) and Rule 13e-4 under the Exchange Act (for tender offer funds and BDCs). These rules govern filing, shareholder notification, and disclosure requirements and requirements with respect to pricing of repurchased shares and payment of repurchase/tender offer proceeds. As noted above, an interval fund must hold liquid assets equal to at least 100 percent of the repurchase offer amount from the time that notice of a repurchase offer is sent to investors until the repurchase pricing date. Tender offer funds are not subject to the same portfolio liquidity requirements. Nonetheless, the tender offer rules are seen by some as more burdensome than Rule 23c-3, particularly as the disclosure requirements applicable to tender offers under the Exchange Act are not as streamlined as those that apply to interval funds under Rule 23c-3.

Management and Incentive Fees

Like many private funds, CEFs and BDCs typically charge an asset-based management fee, which can vary greatly by fund. Interval funds and tender offer funds, like other funds managed by US registered investment advisers, may not charge a performance fee based on capital gains or capital appreciation, unless they limit sales of shares to persons who are "qualified clients," as defined under the Investment Advisers Act of 1940. BDCs, however, may charge a performance fee based on capital gains or appreciation, subject to certain limitations, even if fund investors are not limited to qualified clients. In addition, each type of fund may charge a performance fee based on dividend and interest income. This fee on investment income is often (but not always) subject to a hurdle rate.[11] An adviser can obtain exemptive relief from the SEC to receive all or a portion of its management or incentive fees in fund shares, subject to certain conditions. In this way, an adviser can demonstrate an alignment of interest with fund shareholders by having "skin in the game."[12]

In contrast to certain private funds, which may offer multiple share classes with different advisory fees, CEFs and BDCs cannot vary advisory fees by share class. In addition, registered funds and BDCs are limited by Section 18 of the 1940 Act from entering into side letters or other contractual arrangements that have the effect of varying certain economic terms (including management fees) or other terms of investment for specific investors.

Affiliated Transactions and Co-Investment Relief

One of the significant differences between private funds, on the one hand, and registered funds

and BDCs, on the other hand, that may impact a manager's ability to deploy its existing strategies in a CEF or BDC arises from the 1940 Act's unique restrictions on principal and joint transactions with affiliates. These restrictions may have a potential impact on an adviser's current practices with respect to, among other things, the sourcing and allocation of investment opportunities. However, as discussed below, many advisers have obtained standardized exemptive relief from the SEC that permits them to invest the capital of their CEF or BDC clients alongside their private funds—and in some cases the adviser's proprietary capital—in privately negotiated co-investment deals. This relief may help to mitigate any potential impact on an adviser's business, while also enabling investors to benefit from the adviser's deal sourcing capabilities and the greater bargaining power and control over deal terms that results from participating alongside other clients of the adviser.

Section 17(a) of the 1940 Act makes it unlawful for any affiliate of a CEF (or an affiliate of such an affiliate (a second-tier affiliate)), acting as principal, to knowingly purchase securities or other property from, or sell such assets to, a CEF, subject to certain limited exceptions. Section 57 of the 1940 Act contains similar prohibitions applicable to certain "close" and "remote" affiliates of BDCs. As a result of these restrictions, among other things:

- A CEF or BDC may not invest in a private fund controlled by the adviser to the CEF or BDC (or an affiliate of the adviser);
- A private fund controlled by the adviser to the CEF or BDC (or an affiliate of the adviser) generally may not sell securities or other property to, or purchase a security or other property from, the CEF or BDC; and
- An affiliate or second-tier affiliate of a CEF or BDC, such as the fund's adviser or a private fund controlled by the adviser (or an affiliate of the adviser), may not borrow from the CEF or BDC.

It is important to note that, unlike private funds where conflicts can often be addressed through disclosure and/or consent, certain transactions between a CEF or BDC and an affiliate (for example, principal transactions) may be prohibited under the 1940 Act, absent exemptive relief from the SEC. It also should be noted that BDCs have increased flexibility to enter into principal transactions (and joint transactions, described below) with certain affiliates without needing to obtain exemptive relief.

Section 17(d) of the 1940 Act and Rule 17d-1 thereunder make it unlawful for any affiliate (or a second-tier affiliate) of a CEF, acting as principal, to participate in or effect any transaction in connection with a "joint enterprise or other joint arrangement" in which the CEF is a participant. Section 57 of the 1940 Act contains similar prohibitions applicable to certain "close" and "remote" affiliates of BDCs. These restrictions could limit a CEF's or BDC's ability to participate with, or make investments or enter into other transactions alongside, other clients of the adviser, including joint exits or restructurings with respect to an investment. As noted above, however, many advisers have obtained an exemptive order from the SEC that permits the adviser's CEF or BDC clients to co-invest alongside affiliated private funds and, in some cases, proprietary accounts of the adviser, subject to compliance with certain conditions. Among other things, these conditions ensure that a CEF's and BDC's board of directors is involved in reviewing and approving co-investment transactions and receiving information periodically regarding the co-investment program, that investment opportunities that are appropriate for CEF and BDC clients are being shared with those clients and that all clients of the adviser participate in deals on the same terms and conditions. As with the multi-class relief discussed above, the process of obtaining co-investment relief requires additional cost and expense, but has become fairly standardized.[13]

Like the 1940 Act, ERISA, and Section 4975 of the Code impose significant restrictions on transactions with affiliates. These restrictions typically

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would *not* apply to CEFs because they are registered under the 1940 Act. However, since BDCs *may* be treated as "plan assets" vehicles (as discussed above) for purposes of ERISA and Section 4975 of the Code, BDC sponsors should pay careful attention to such restrictions.

Tax Considerations

Like mutual funds and ETFs, CEFs and BDCs generally seek to qualify as "regulated investment companies" (RICs) for US federal income tax purposes. By qualifying for treatment as a RIC, a fund avoids corporate-level federal income tax on ordinary income and capital gains that it distributes to its shareholders. A RIC is also able to pass through to shareholders the character of income, such as long-term capital gains, that may be subject to preferential tax treatment in the hands of shareholders, and to block the receipt of income that could have adverse tax consequences to tax-exempt and non-US shareholders. RIC treatment allows shareholders to receive tax information about the fund on the relatively simple Form 1099, rather than on the investor-disfavored Schedule K-1 that would be issued to a direct investor in an underlying private fund treated as a partnership.

To qualify as a RIC, a fund must meet an annual gross income test and quarterly asset diversification tests and must distribute at least 90 percent of its ordinary income to its shareholders each year. The gross income test requires at least 90 percent of the fund's gross income each year to be derived from dividends, interest, payments with respect to certain loans of securities, gains from the sale of stock or other securities, or other income with respect to the fund's business of investing in such stock or securities. A fund may still qualify as a RIC if up to 10 percent of its gross income consists of "bad" income such as income and gain from physical commodities, virtual currencies, or related derivatives.

Two asset diversification requirements must be met at the end of each quarter. First, at least 50 percent of the fund's assets must consist of cash and cash items (including receivables), government securities, securities of other RICs, and the securities of any other issuer to the extent they do not represent more than 5 percent of the value of the fund's assets or more than 10 percent of the outstanding voting securities of the issuer. Second, no more than 25 percent of the fund's assets may be invested in the securities of a single issuer, two or more issuers which the fund controls and which are engaged in similar or related businesses, or one or more qualified publicly traded partnerships (such as an oil and gas master limited partnership).

Finally, to qualify for treatment as a RIC, a fund must distribute at least 90 percent of its investment company taxable income (consisting of ordinary income and short-term capital gains) to its shareholders each year. In practice, a RIC typically distributes all of its investment company taxable income and long-term capital gain each year so that it avoids any entity-level tax on its income. A RIC must pay corporate tax on any long-term capital gains that it retains within the fund, and then passes through a credit for such tax to its shareholders.

A CEF or BDC may have difficulty qualifying as a RIC during a ramp-up period if, for example, it does not have enough investments during that period to meet the asset diversification tests. The fund generally would be treated as a taxable C corporation during such an initial period, although certain funds may seek to be treated as partnerships.

A CEF or BDC can face practical difficulties in obtaining, from underlying partnerships, the information it needs to determine whether it has satisfied the RIC requirements. For example, a fund would need quarterly information from a private fund partnership to determine its compliance with the asset diversification tests and annual information to determine its compliance with the gross income test. A fund might consider investing in a particular partnership through a domestic or offshore blocker corporation in order to ensure its qualification as a RIC if it cannot timely obtain information from the underlying partnership.

A RIC is able to pass through to its shareholders the character of income, such as long-term capital gains and qualified dividend income, on which non-corporate investors are taxed at preferential rates, or income qualifying for the dividends received deduction, which benefits corporate shareholders. Non-US shareholders can avoid US withholding tax on dividends paid from a RIC's long-term capital gains, short-term capital gains, and qualifying interest income (generally, interest the RIC receives from US borrowers).

Certain investors can avoid the adverse tax consequences that would arise from a direct investment in an underlying partnership by investing through a RIC. A partnership that directly or indirectly engages in active business operations generally will be in receipt of, and in turn generate, unrelated business taxable income (UBTI) for certain of its US tax-exempt investors and effectively connected income (ECI) for non-US investors. Investments acquired with borrowings also generate UBTI. These adverse tax consequences generally can be avoided if such an investor invests through a RIC rather than directly in the underlying fund; however, a RIC generally does not block ECI arising from investments in US real property interests.

Non-corporate shareholders may not be able to deduct their shares of a RIC's expenses, including the management fee, if the fund is not a "publicly offered RIC." These expenses are treated as miscellaneous itemized deductions and are disallowed entirely through 2025 and subject to limitation thereafter. These limitations increase the investor's effective tax rate on its income from the fund. A RIC is considered to be publicly offered if its shares are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by or for at least 500 persons.

Other Areas of Focus

Governance

Both state law and the 1940 Act impose on boards of directors significant responsibility for the oversight of the affairs of CEFs and BDCs. In particular, the board of a CEF or BDC must, among other things, approve the fund's advisory contract, approve any principal underwriting agreements and other service provider agreements, approve the compliance program, appoint the fund's chief compliance officer (and approve his or her compensation), and oversee the valuation of the fund's investments. Members of the board are subject to fiduciary duties in carrying out their responsibilities. The 1940 Act, and certain rules adopted under the 1940 Act, place limitations on the composition of a fund's board and generally require that the board be comprised of at least a majority of "independent" directors. In addition, in the case of "plan assets" BDCs, the managers of such vehicles have certain fiduciary duties arising under ERISA, if applicable.

Public Reporting

One significant difference between CEFs and BDCs, on the one hand, and private funds, on the other, is that CEFs and BDCs are required to publicly disclose their investment portfolios as of the most recent quarter end, and the values the funds ascribe to their investments, on a regular basis. CEFs are subject to the 1940 Act's periodic reporting requirements, which generally entail the filing with the SEC of, among other things, annual and semi-annual shareholder reports containing financial statements (which are audited, in the case of annual reports), schedules of investments, certain performance disclosures and other information, and quarterly schedules of investments on Form N-PORT. Annual and semiannual reports also must be delivered to shareholders. BDCs are required to have a class of equity securities registered under the Exchange Act and, like public operating companies, are required to file periodic reports on Forms 10-K and 10-Q and current reports on Form 8-K.

FINRA Requirements

Sponsors and distributors of CEFs relying on multi-class relief must comply with the requirements

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of FINRA Rule 2341 related to the prompt payment for transactions in investment company shares and limits on sales loads and service fees. Tender offer funds that do not conduct at least two repurchase offers in a calendar year are subject to FINRA's corporate financing rule and related limits on underwriting compensation. BDCs that are publicly offered are subject to FINRA rules governing direct participation programs, including related limits on underwriting compensation. Broker-dealers recommending CEFs or BDCs to retail customers are subject to FINRA's suitability rule and Regulation BI, which requires broker-dealers and registered representatives to (among other things) consider the risks, rewards, and costs of a recommended investment in light of a customer's investment profile and other investment options, and have a reasonable basis to believe that the recommendation is in the customer's best interest.

Conclusion

Interest in interval funds, tender offer funds, and BDCs continues to grow as individual investors look for exposure to alternative strategies that have historically been limited in availability. The unique features and potential benefits of these 1940 Act fund structures can make them attractive to alternative asset managers. While managers utilizing these fund structures will need to address certain requirements imposed by the 1940 Act that are not present in a typical private fund structure, these requirements need not be a source of apprehension.

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NOTES

1 Marissa Lee, "Future of Alternatives 2025: The 'Retailization' of Private Markets," *Prequin* (Nov. 10, 2020) (*citing* SEC study).

2 Harriet Agnew, "Traditional asset managers race to expand private investment alternatives," *Financial Times* (June 19, 2022).

3 This article is not, nor is it intended to be, a comprehensive summary of all statutory and regulatory requirements applicable to CEFs and BDCs. Rather, its purpose is to introduce alternative asset managers to these fund structures and highlight certain characteristics they should consider when evaluating how best to expand their platforms and attract a broader investor base.

4 Exchange-listed closed-end funds, which are not covered in this article, offer liquidity to investors through the listing of their shares publicly on a stock exchange. However, listed closed-end funds often trade at a discount to NAV, which affects the price an investor is able to receive for its shares when selling them on the exchange.

5 Eligible portfolio companies are generally defined as (1) US companies (2) with an equity market capitalization of less than $250 million (3) that are not investment companies or exempt from investment company registration pursuant to Section 3(c) of the 1940 Act, and (4) whose securities are acquired in private transactions.

6 "Asset coverage" generally means the ratio of total assets (including the proceeds of the issuance of preferred stock or debt securities or of the borrowing) of the fund to the aggregate amount of outstanding preferred stock and debt of the fund. For example, a CEF subject to a 300 percent asset coverage ratio could incur $1 of debt for every $2 of equity. Additional limitations apply to the incurrence of debt by interval funds.

7 Both CEFs and BDCs are limited to one class of senior security representing stock.

8 A BDC holding "plan assets" under the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code of 1986 (the Code) must have its investments valued independently, to avoid conflicts that might arise from having the fund's management do so, especially if asset valuation is tied to the BDC's management or performance fees.

[9] Under a historical, unpublished SEC Staff position, if a registered closed-end fund invests more than 15 percent of its assets in private funds, it must limit the offering and sale of its shares to accredited investors, even if the offering is registered under the 1933 Act, and impose at least a $25,000 initial investment minimum.

[10] Although, generally, IRAs are not subject to ERISA, IRAs *are* subject to the prohibited transaction rules in Section 4975 of the Code, which are substantially similar to the prohibited transaction rules in ERISA. Consequently, fund sponsors should consider the "plan assets" status of their funds when targeting IRAs in their capital-raising efforts, even in the absence of participation by ERISA plan investors.

[11] A CEF may also impose a "fulcrum fee," which adjusts the adviser's compensation both up and down based on the CEF's performance relative to that of a benchmark index; however, fulcrum fees are relatively uncommon.

[12] If a BDC holds "plan assets" for purposes of ERISA or Section 4975 of the Code, there are limits on the extent to which the BDC may charge performance fees. These limits are intended to prevent transactions that are otherwise prohibited due to the conflicts involved in such fee arrangements. Therefore, a "plan assets" BDC sponsor should consider carefully these limitations when designing fee structures.

[13] In addition to exemptive relief, under a line of SEC staff no-action letters, a CEF or BDC may co-invest alongside an affiliate in private transactions where all of the affiliated parties participate on the same terms, there are no terms negotiated other than those that are price-related, and allocations of opportunities are made fairly and pursuant to established policies.

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