CLOSED-END FUNDS

A closed-end fund is a type of investment company that raises a fixed amount of capital through an initial public offering and then typically lists its common stock on a national stock exchange. After its initial public offering, the fund's shares are bought and sold in the open market instead of being purchased or redeemed directly by the fund. Therefore, the market price of closed-end fund shares fluctuate like that of other publicly traded companies. Closed-end funds maintain a fixed number of shares, and no new money will flow into the fund.

Traditionally, investors in closed-end funds "redeem" their shares differently than investors in open-end funds, or mutual funds. Unlike mutual fund shares, closed-end fund shares are not typically redeemable by the closed-end fund at net asset value (NAV) or otherwise. Most resales of closed-end fund shares are made through secondary markets, either on national securities exchanges for listed shares or over the counter. The market price of listed closed-end shares may be greater than the shares' NAV, but closed-end shares can often be purchased at a significant discount from a closed-end fund's NAV due to market volatility. Because closed-end funds are not required to buy back shares from shareholders, closed-end fund managers do not have the same concerns about constant redemptions as mutual fund managers, and they do not have to manage their funds to account for the possibility of those redemptions. Furthermore, traditional closed-end funds are not subject to the liquidity requirements that apply to mutual funds. As a result, closed-end fund managers often have more flexibility to invest in more illiquid assets, such as in the securities of private companies, derivatives, or certain debt instruments. Closed-end funds may also use more debt or other leverage as compared to other types of investment companies in order to purchase their investments.

There are many different types of closed-end funds, categorized based on asset class and fund structure. This article explores different types of closed-end funds that diverge in structure: interval funds, tender offer funds, and Business Development Companies (BDCs). Additionally, as a direct contrast to closed-end funds, this article discusses target date funds, which are a type of open-end fund. In the subsequent section, we will discuss in further detail the different characteristics of these funds.

Interval Funds

In 1993, the Securities and Exchange Commission (SEC) adopted Rule 23c-3 under the Investment Company Act of 1940, as amended (the "1940 Act"), providing exemptive relief to allow certain closed-end funds to make periodic repurchases of their shares. Closed-end funds that rely on Rule 23c-3 under the 1940 Act to repurchase shares are known as "interval" funds. An interval fund is a registered hybrid type of closed-end investment company that engages in continuous offerings of its shares and periodic offers to repurchase its shares from shareholders. Interval funds conduct their repurchase offers pursuant to policies adopted by their boards in accordance with Rule 23c-3 under the 1940 Act, and the frequency, amount and timing of such repurchases are set pursuant to Rule 23c-3.

Investors in closed-end funds redeem their shares differently than investors in open-end funds (or mutual funds) in that closed-end funds are not obligated to repurchase their shares from investors. Interval funds, however, must offer to buy back a stated portion of their shares (between 5% and 25% of outstanding shares) from their shareholders every three, six or 12 months (or monthly with exemptive relief). Shareholders, on the other hand, are not required to accept these offers to sell their shares back to the funds. Shareholders are free to hold out for a better price, but they may not exit a fund until the next designated interval described in the fund's prospectus. As opposed to other closed-end funds, interval funds are permitted to (and oftentimes do) continuously offer their shares at a price based on a fund's NAV.

One key advantage of interval funds is that they may use Rule 486 under the Securities Act of 1933, as amended (the "Securities Act"), which provides for automatic effectiveness of post-effective amendments to registration statements. Additionally, repurchase offers are not subject to SEC filing fees and are usually cheaper to conduct than tender offers under Rule 13e-4. They come with no required FINRA filing fees, and they are subject only to FINRA Rule 2341, which imposes varying caps on sales compensation/distribution fee levels.

Interval funds also provide an opportunity for investors to access private credit, which is often a closed-off market, by offering structures that allow for exposure to illiquid investments even while maintaining a degree of liquidity through periodic share repurchases. In fact, interval funds are better positioned to anticipate investors' liquidity needs than open-end funds, because they do not need to accommodate daily liquidity requests. Instead, interval funds have the flexibility to limit the size and timing of repurchase offers, and shareholders are required to give the funds advance notice of their redemptions. Moreover, exposure to private credit, among other asset classes, offers diversification, and periodic repurchases effectively reduce the spread between the market trading price of a fund's shares and the fund's NAV, which helps facilitate additional capital raising following the initial fundraising round.

Tender Offer Funds

Similar to an interval fund, a tender offer fund is a type of continuously offered closed-end fund registered under the 1940 Act. The main difference between these two types of funds is that—as opposed to repurchasing investors' shares at set intervals—tender offer funds conduct periodic tender offers, most often quarterly, at the discretion of a fund's board pursuant to Rule 13e-4 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Thus, tender offer funds offer investors increased liquidity by allowing them to sell their shares back to the fund at a predetermined price rather than selling them on the open market. Tender offers also provide more flexibility for fund managers in terms of frequency, amount and timing of share repurchases than do interval funds, and these funds have no liquidity requirements. The price of a given tender offer fund is typically near or at NAV, but it can be set at a negotiated discount. Tender offer funds are able to repurchase at their discretion and even have the flexibility to value their assets periodically (*e.g.*, daily, weekly, monthly). This discretion allows companies to provide controlled liquidity to investors, but the drawback is that investors may not have that desired liquidity when they most want it.

Since tender offers are discretionary, a fund may be inclined to make a tender offer to increase the fund's share price when shares are trading at a significant discount to the fund's NAV. Indeed, a fund can seek to reduce the NAV discount by offering to buy back shares, thereby allowing investors to earn fair value returns on the shares. In turn, these purchases are likely to simultaneously improve the market price of the fund's shares by restricting the market's supply of such shares. Tender offers also provide investors with the opportunity to exit the fund by selling their shares somewhere other than the secondary market.

Tender offer funds also have more flexibility than interval funds in the timing of repurchase offers. While interval funds must conduct periodic repurchase offers every three, six or 12 months (or monthly with exemptive relief), the boards of tender offer funds have discretion to make such offers in accordance with Rule 13e-4 of the 1940 Act, which sets forth the parameters for commencing, terminating, filing, disseminating and generally conducting tender offers. At the commencement of a tender offer, the tender offer fund will notify shareholders of the repurchase offer, complete Schedule TO (the tender offer statement of the fund, which includes, typically by exhibit, the Offer to Purchase), deliver the Letter of Transmittal to shareholders and file all repurchase offer documents with the SEC.

While the process for conducting a tender offer is typically more burdensome than conducting an interval offer, Rule 13e-4 of the 1940 Act is less limiting than Rule 23c-3 of the 1940 Act in a few key respects: (i) the board of directors has the flexibility to skip a tender offer (although commercial considerations may limit its ability to do so), (ii) the amount of the tender offer is not prescribed, (iii) the deadline by which shareholders must receive the proceeds from their tendered shares is not prescribed and (iv) the rule does not prescribe the amount of liquid assets required to be held by the fund in connection with the tender offer.

Tender offer funds have wide latitude in establishing their share repurchase practices. There is no minimum number or frequency of tender offers that must be completed. The predetermined repurchase price for shares is set by Rule 14D-10 (the "best-price rule"). It stipulates that consideration offered to one shareholder must be equal to the highest consideration paid to any other shareholder. The purpose is to provide equal treatment to all shareholders. The fund sets the repurchase price, typically set at a premium to the fund's current market price, in order to incentivize shareholders to sell their shares to the fund.

Business Development Companies

BDCs are closed-end investment management companies that are specially regulated by the 1940 Act. BDCs are primarily designed to invest in small- and middle-market US companies. As a result of their special status under the 1940 Act, BDCs are exempt from many regulatory requirements imposed by the 1940 Act on traditional investment companies. BDCs generally benefit from pass-through tax treatment (*i.e.*, the BDC is not taxed, and income and expenses are passed through to the owners of the BDC).

Given the limited access to, and availability of, financing from traditional bank lenders, BDCs have played an important and increasing role as a crucial source of capital and liquidity for small and mid-sized companies that may not be able to otherwise obtain financing. Most BDCs raise capital by selling their securities to the public in offerings registered under the Securities Act and list a class of their equity securities on a national securities exchange (*e.g.*, the New York Stock Exchange). Many BDCs, though, are privately held after selling their securities to accredited investors in offerings exempt from registration under the Securities Act. Private BDCs are usually sponsored or formed by private equity firms or financial institutions that have the requisite pre-existing relationships with their investors to successfully raise sufficient capital.

All BDCs, whether public or private, must register a class of securities under the Exchange Act, and must generally comply with the Exchange Act reporting requirements applicable to publicly held operating companies.

OPEN-END FUNDS

An open-end fund, in contrast to the different types of closed-end funds discussed above, is a type of investment company that continually raises capital by issuing and redeeming shares. Investors can buy and sell shares of an open-end fund (not on an exchange) at any time, and the shares trade at NAV. As such, the size of such funds fluctuates based on investor activity, growing as investors invest and shrinking as investors divest.

Unlike closed-end funds, open-end funds are subject to liquidity requirements pursuant to Rule 22-e4 of the 1940 Act. Under that rule, open-end funds may not invest more than 15% of their assets in illiquid investments. This benefits shareholders by ensuring that the fund will remain liquid enough to cover any shareholder redemptions, but it has the drawback of reducing potential diversification by limiting the assets to which investors are exposed.

Another advantage to open-end funds, especially as compared to closed-end funds, is how flexible their share redemption process is in all respects. As mentioned above, investors can sell their shares back to the fund at any time at NAV. They do not have to wait for the proper interval to arise or for a tender offer to be issued at the fund's discretion. Moreover, investors are not limited to selling a designated number of shares when the fund buys them back. Rather, open-end fund investors can redeem their shares as they please and in any quantity. However, open-end funds carry the risk that high demand for redemptions will cause a fund to sell assets to cover that demand, thereby hindering the fund's performance. These are drawbacks that controlled liquidity funds, such as tender offer funds, do not encounter.

Target Date Funds

Target date funds are a specific type of open-end fund typically composed of relatively risky assets (often high-cap growth stocks) at inception and continuously de-risked over time by gradually modifying its asset composition (for example, selling stocks and buying bonds) until the fund reaches its most conservative point at the target date, whatever that date may be. Theoretically, a target date fund could also begin at its most conservative point and become riskier over time, or its asset allocation could change in some other way, such as shifting investments from the energy sector to the technology sector over time, but the risky-to-safe format is by far the most common structure.

Target date funds have all of the same general benefits and drawbacks of open-end funds, but they have the added benefit of a built-in mechanism for an investor to reach a goal over time. The conventional example is the retirement date fund: the fund's target date is the year in which the investor wants to retire, and the fund's exposure to risk decreases over time as the investor's retirement date approaches, thereby optimizing the investor's assets for growth in the early years and ensuring that the investor's assets will be safer when it is time to withdraw in retirement. Depending on the fund, this principle could be applied to help almost any manner of investor reach almost any goal. The downside is that, after a fund has decreased its risk exposure, investors may not receive returns as high as they otherwise could from a riskier portfolio or, more generally, that the fund's composition simply doesn't reflect the investor's desires or best interests at a given point in time.

Ultimately, which fund an investor chooses to invest in depends on the specific investor and its goals at a given point in time. Any of the above funds could be appropriate under the right circumstances.

See our comparison of the main characteristics of each type of fund discussed in this article. Visit our Permanent Capital Vehicles Resource page.

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