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USA - NIXON PEABODY



Private equity access for retail investors

Several structures exist in the U.S. that alternative asset managers can use to offer retail investors access to private funds.

Private equity has traditionally focused on developing enduring relationships with a limited pool of large institutional investors. Due to this focus, the US private funds industry has largely shunned the infrastructure required to reach individuals through retail distribution and marketing. However, that is changing rapidly.

Fund structures under the Investment Company Act of 1940

The Investment Company Act of 1940 (1940 Act) allows alternative asset managers to use several structures to offer their strategies to both institutional and retail investors. These are business development corporations (BDCs), registered closed-end interval and tender offer funds (collectively, CEFs).

How do BDCs and CEFs work?

CEFs and BDCs give managers a way to invest money in a single fund on an ongoing basis, breaking the cycle of repeatedly needing to raise money for new fund “vintages.” These structures can also give managers more freedom in how they find, manage, and eventually sell their investments because they’re free from such things as being unable to recycle profits or having to close the fund at a set termination date.

BDCs are closed-end funds that follow some rules in the 1940 Act, even though they are not registered under that legislation. Most BDCs focus on lending money to or buying small and medium-sized private enterprises in the U.S.. They also typically have to assist with the running of their portfolio company. BDC shares can be sold privately or registered for public sale. Registered shares may be listed on an exchange. In this instance, the BDC may continuously offer its shares, creating constant liquidity for investors. An unlisted or private BDC may give investors liquidity by making periodic repurchase offers under the interval fund repurchase offer

rule or by making periodic tender offers under the Exchange Act tender offer regulations.

CEFs and BDCs can employ a wide range of investment strategies, especially less liquid ones. They also give sponsors more freedom than open-end mutual funds or exchange-traded funds (ETFs), which come with a particular set of regulatory challenges. These structures also act as a wrapper for alternative strategies that may be promoted to a wider range of investors using private wealth distribution channels, which private fund managers are increasingly developing either on a proprietary or collaborative basis. Because these 1940 Act structures are always available and mostly closed-end, managers may maintain a continuous fee income from management fees and, in certain cases, incentive payments. These fund formats give investors many of the same safeguards and transparency as mutual funds and ETFs, and provide have a level of liquidity that is likely to better accommodate the different investment horizons of individual investors.

What are Interval funds and Tender offer funds?

Interval funds are closed-end funds that are registered under the 1940 Act. They have to give shareholders periodic liquidity by making repurchase offers of 5% to 25% of outstanding shares at set “intervals” of every three, six, or twelve months. The fund’s current net asset value (NAV) must be used for any share buybacks. Investors can buy or sell shares of interval funds on an exchange or not. In this instance, the interval fund



may offer its shares on a regular basis. People generally think of interval funds as a mix between open-end mutual funds and regular closed-end funds that are listed.

Tender offer funds are closed-end funds registered under the 1940 Act. They may, but are not required to, give shareholders periodic liquidity, usually once every three months, through issuer tender offers that follow the requirements for tender offers in the Securities Exchange Act of 1934. Tender offer funds might have shares either listed on an exchange or not. In this circumstance, the tender offer fund may keep selling its shares.

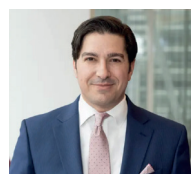
Regulatory oversight framework

The 1940 Act applies to CEFs and BDCs in the same way it does to other businesses. These rules control how funds work, including how they disclose their finances, how they distribute shares, how they make repurchase offers, how they use leverage, how they calculate NAV, and how they do

business with affiliates. These rules might make it harder for a sponsor to run a regulated fund the same way as its private funds. Still, individual investors and their financial advisors and intermediaries are likely to like this extra layer of regulation. They might be hesitant to invest in a private fund because they think it is illiquid, not transparent, has higher fees, and has longer investment horizons. Some institutional investors may also like this same regulatory overlay because it gives them more protections and makes things clearer, thanks to the 1940 Act.

Will interest in retail capital reshape growth strategies?

Some of the biggest funds in the business have made it a top priority to get more retail capital, and many of them have established clear goals for increasing the amount of money that individual investors have. The next level needs to decide if they want to do the same thing. Many companies are looking again at their plans for growth and raising money, both in terms of how much they want to grow and how much they want to raise. They are also wondering if individual capital should be a part of these plans. There is no one proper answer; it all depends on the company's goals and how it plans to raise money. However, as they sense a change in the competition, more and more companies are working on building the structures mentioned above.



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