New SEC Liquidity Rules Could Spawn A Boom In Interval Funds

Friday, July 14, 2023

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Kenneth Burdon, an attorney in the investment management group at Skadden, Arps, Slate, Meagher and Flom. Read the Q&A below as Kenneth says that rules proposed by the Securities and Exchange Commission that would dramatically change liquidity requirements on traditional mutual funds could result in a boom for interval funds. While noting that the proposals still have a ways to go before approval, Burdon says that they would, if passed, make it so that many bank loans and other 'less liquid securities,' couldn't be held in traditional funds. Some funds may convert to closed-end status, he says, while other firms will plan more interval offerings if the rule passes.

Kenneth Burdon

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CEFAdvisors will be holding their 46th consecutive closed-end fund, business-development company, and interval fund research call for the second quarter of 2023 on July 19th at 2PM Eastern Standard Time. Register to attend live or for the replay at CEFAdvisors.com/quarterly. The session is approved for 1.5 hours continuing education credit.

CHUCK JAFFE: Attorney Kenneth Burdon from Skadden Arps is here and we're talking about how a proposed SEC rules change might be altering the future of closed-end and interval funds, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators, and if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're diving into an SEC rules change proposed last year that appears ready to have a big impact on the closed-end fund and interval fund space. We're doing that with Kenneth Burdon, he's an attorney in the investment management group at Skadden, Arps, Slate, Meagher and Flom, and you can learn more about him and the firm at Skadden.com, but we also have a link to more information about the rules that we're talking about in our show notes. And to learn more about closed-end funds, interval funds, and business-development companies generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Kenneth Burdon, welcome back to The NAVigator.

KENNETH BURDON: Yeah, thanks Chuck. I appreciate you all having me on again.

CHUCK JAFFE: So let's dive in, because we don't want to get bogged down in jargon and all the rest, but there was a proposal that's going to change liquidity rules to traditional open-end mutual funds and there's likely to be some fallout if this rule goes through that's going to change some things for closed-end funds and interval funds. So explain what the rule is and why the fallout is so likely.

KENNETH BURDON: Yeah, so Chuck, there's a big regulatory focus from the SEC right now on liquidity in open-end mutual funds, so this is a part of a broader thematic focus on resiliency and transparency in the markets that the SEC's been focused on recently. For example, listeners may be aware that the SEC just yesterday adopted new rules to govern money market funds, and these rules were by and large designed to make money market fund holdings more liquid. Well, what the SEC is coming to next is a proposal that it floated in November that is now going to be designed to try and make regular traditional mutual fund holdings more liquid. So what does that mean for closed-end funds? I won't get too into the weeds on the mutual fund liquidity risk management kind of tick-tock, but the basic effect of this SEC proposal, if it's adopted as proposed, is to make entire asset classes, such as bank loans, largely unavailable in any meaningful way to mutual funds, and to also penalize larger funds and those with more concentrated portfolios by requiring assumptions and evaluating liquidity that can make even highly liquid large-cap equity holdings illiquid for this purpose. So the whole end result of this could be a decline in the mutual fund wrapper for certain asset classes strategies that investors would continue to want exposure to. I'm talking about bank loans, I'm talking about funds with more concentrated portfolios, and strategies to close funds more than you might have seen before to keep their size manageable within this new liquidity framework. So what I think you can see, and what managers should be thinking about, is how to keep investment options available to retail investors in a way that provides a similar investment experience for the investor and a similar distribution structure for the manager. I think that's where closed-end and interval funds can come in.

CHUCK JAFFE: Does that mean that what you're expecting is that, if this rule goes through, we're going to wind up seeing a wave of conversions? In other words, we'll see the traditional mutual fund or ETF, in which we've got some bank loans and senior notes or whatever it might be, saying, "We want to change structures"? And then specifically will they go to a closed-end structure or will they go to an interval fund structure, which is a closed-end structure but also that, hey, we're going to have a liquidity gate because the issue here is liquidity?

KENNETH BURDON: Right, so I think you might see some people looking at a strategy to convert existing open-end funds to closed-end funds, not listed closed-end funds but the interval version of the closed-end fund, and I'll get into that in a minute but I think we know that historically has not been something that people have seen. But I do think that as you look at the costs and benefits of what the fallout of this rule might be, boards and managers might be able to make compelling cases to shareholders, who would have to vote on any such conversion or change, to kind of trade off the daily liquidity that mutual funds offer for the more periodic liquidity that interval funds would offer while being able to keep exposure to the strategies that they would lose in the mutual fund wrapper. We've seen a lot of growth in interval funds, I think the statistics that I most recently saw was a 237% increase in assets between 2017 and 2022, and over $80 billion in AUM across about 79 funds as of the end of 2022. So it's a growing class and it's something that I think that managers could be looking at in order to preserve those investment options for investors and then also preserve the investment experience. So to tick through a couple features of interval funds that can make them attractive to managers in light of potentially more stringent liquidity requirements in mutual funds, there's investor liquidity, so interval funds, as you alluded to, are required to offer to buy back at NAV a certain percentage of their shares on a periodic basis, which can be as frequently as quarterly. And while that's not daily NAV liquidity, the types of investment programs that we're talking about here are meant for longer term investment, so quarterly NAV liquidity could be modulated, an amount based on the band, the max would be 25% of the fund, and that could be a reasonable tradeoff to retain access to desired asset classes and strategies.

CHUCK JAFFE: If we're going to see this rule happen, what is the resolution of the rule's timeframe and then how quickly do you expect folks to react? Because obviously you're looking at this now, which means that your clients are looking at the changes that they're going to have to make pretty much the minute it gets passed, if it gets passed.

KENNETH BURDON: So the SEC puts out this very cryptic chart called the Regulatory Flexibility Agenda, they have this proposal in the quote "final rule stage". That doesn't really tell us much in terms of exact timing but I would imagine that the chair of the SEC would want to start pushing these rules through over the course of this year and into next year, especially with the presidential election coming up next year. Once that rule is finalized, in whatever form it is finalized in, I expect there would be a significant period for people to come into compliance with that rule. So it wouldn't be an immediate thing, managers would have the opportunity to look at the rule, evaluate it, and determine how to move forward before a compliance date.

CHUCK JAFFE: And here we are talking about it, that doesn't mean it's going to happen, but given that the SEC has put a lot of focus on liquidity lately does this feel to you like something that this is going to happen?

KENNETH BURDON: This feels to me like something that the SEC wants to do. I'm not sure in what form it will ultimately come to pass. I think I alluded to the fact that there's been quite a bit of pushback on these rules and how they've been proposed and what their impacts would be. It's unclear how the SEC might react to that. They did listen to the industry with the money market fund proposal, which had originally contained a requirement for what's called 'swing pricing', that was a very big operational burden for the industry and it was pushed back on hard and the SEC ended up dropping it. But in exchange for that, the SEC is requiring a mandatory redemption fee when net redemptions equal 5% or more of net assets. So for example, you could see some other tradeoffs in terms of how to manage liquidity that the SEC might come up with after considering the industry's input there. But bottom line is that the proposal is just a proposal, and while we would expect it to be adopted in some form, it's not necessarily going to be the exact form that it was proposed.

CHUCK JAFFE: Ken, thank you so much for joining me to talk about it. We'll watch how it plays, and assuming it plays out as expected, I'm sure we'll be talking with you again down the line.

KENNETH BURDON: Great, thank you very much for having me again.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, and you can check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies check out AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Kenneth Burdon, an attorney in the investment management group at Skadden, Arps, Slate, Meagher and Flom. You can learn more about him and the firm at Skadden.com, and we have a link to some more information from the firm about the rules we're talking about in our show notes. The NAVigator podcast is new every Friday, follow along on your favorite podcast app to make sure you don't miss an episode. We will be back next week, until then, happy investing everybody.

Recorded on July 13, 2023

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