

# Registered Investment Companies – Commercial Considerations for First Timers



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## I. Introduction to the Regulatory Framework

The Investment Company Act of 1940, as amended (the **Investment Company Act**) is the principal U.S. federal regulatory regime applicable to investment funds. The Investment Company Act broadly prohibits an entity that meets the definition of “investment company” from using means of U.S. commerce to issue securities unless it registers with the U.S. Securities and Exchange Commission (the **SEC**) or qualifies for an exemption from registration. This chapter considers the commercial implications of registering as an investment company with the SEC under the Investment Company Act. As discussed elsewhere in this publication, the SEC and other U.S. agencies are considering regulatory reforms to the regimes applicable to investment companies, and managers that are interested in entering the registered funds space must be mindful of key commercial considerations as well as the evolving regulatory landscape applicable to registered funds.

In this chapter, we provide a brief overview of the types of registered funds and the key commercial and operational considerations that could affect a manager sponsoring a registered fund for the first time, with a focus on issues applicable to a non-U.S. manager that is new to registered funds.

## II. Types of Registered Funds<sup>1</sup>

If an investment company cannot rely on an exemption from registration under the Investment Company Act, it generally must register itself with the SEC under the Investment Company Act and it must register securities offered to the public under the Securities Act of 1933, as amended (the **Securities Act**). The staff of the SEC reviews registration statements (which may be on Form N-1A, Form N-2, or other investment company forms) to seek to ensure compliance with form requirements and related regulations. The staff of the SEC may issue comments on the filing prior to declaring the registration statement “effective”. An open-end fund (discussed in more detail below), such as a mutual fund which offers its securities to the public, must maintain a current prospectus with the SEC by filing post-effective amendments to its Securities Act registration statement. A closed-end fund (discussed in more detail below) that offers securities to the public may register the securities at the time of offering or maintain a shelf registration statement that permits the fund to offer securities from time-to-time by, among other things, filing a prospectus supplement with the SEC at the time of the offering. A mutual fund and a closed-end fund respectively must provide shareholders with annual and semi-annual reports containing updated financial information and a list of the fund’s portfolio securities.

Funds registered under the Investment Company Act generally fall into one or more of the categories below:

### (a) *Open-end funds*

Open-end funds, some of which are commonly referred to as “mutual funds”, offer their shares to investors continuously. Open-end funds may be actively or passively managed, but must invest in at least 85% of their net assets in liquid securities.<sup>2</sup> Mutual funds offer the benefit of liquidity to investors and must allow investors to redeem their interests at least once daily at the mutual fund’s current net asset value. According to the Investment Company Institute, as of year-end 2016, mutual funds made up over 80% of all U.S. registered funds.

### (b) *Exchange-traded funds*

Exchange-traded funds (**ETFs**) are typically structured as open-end funds, but differ in that they specifically provide investors with exposure to an index or a pool of assets. Prior to launch, an ETF must generally obtain an exemptive order from the SEC for conditional relief from certain provisions of the Investment Company Act, which would otherwise be inconsistent with an ETF’s strategy. Instead of redeeming through the fund, most investors obtain liquidity by trading shares on an exchange at market-set prices. Only “authorised participants” (such as large broker-dealers) may buy and redeem ETF shares from the ETF, which occur through in-kind purchases and sales.

### (c) *Closed-end funds*

Closed-end funds are permanent capital vehicles that offer various forms of interests to investors, whether debt or equity (including convertible interests and warrants, in certain cases). Unlike open-end funds, closed-end funds do not offer their interests to investors on a continuous basis and they may be publicly or privately traded. In the public markets, closed-end funds function similarly to operating companies and typically conduct an initial public offering and subsequent follow-on offerings. A publicly traded closed-end fund thus generally offers liquidity to investors through secondary market trading, whereas liquidity for an investor in a privately traded closed-end fund is somewhat limited. A closed-end fund may, however, make periodic tender offers. Closed-end funds include business development companies (**BDCs**) and interval funds.

### (d) *Business development companies*

A BDC is a type of closed-end fund that must invest a significant portion of its assets in small and mid-sized U.S. privately held companies. In exchange, the Investment Company Act permits BDCs to have a higher leverage ratio than traditional closed-end funds. Most BDCs are lending vehicles that offer investors unique exposure to the floating-rate lending market and are often referred to as a part of the “shadow banking” industry in the U.S.

**(e) Interval funds**

An interval fund is a closed-end fund that offers its investors periodic liquidity events. Interval funds offer redemptions to investors consistent with a pre-determined schedule (generally every three months, six months or 12 months) pursuant to a fundamental policy of the fund.

**(f) Unit investment trusts**

Unit investment trusts (UITs) share some characteristics with mutual funds and closed-end funds. UITs are not generally actively managed funds, but instead buy and hold securities in a static pool. UITs have an established termination date and investors receive dividends or interest payments from the underlying portfolio.

### III. Registered Funds Could Open Up a New Investor Base for Fund Managers

According to the Investment Company Institute (the ICI), registered funds made up \$19.2 trillion in managed assets at year-end 2016, an increase of over \$1 trillion from the prior year. Retail investors (such as U.S. households) held over 85% of U.S. mutual fund investments and approximately 95% of long-term mutual fund investments. Mutual fund investments alone are spread across approximately 94 million investors, a substantial portion of which invest through employer-sponsored retirement plans. With such a high proportion of retail investors investing in mutual funds for varied financial goals, mutual funds continually tend to attract additional capital even in times of market uncertainty. ICI survey results also show that younger generations tend to start investing in mutual funds earlier than their older generation counterparts did, yet an additional factor suggesting that the market will continue to grow.

Any manager seeking additional streams of assets under management would thus be wise to consider the depth and breadth of the U.S. retail market, particularly because registered funds have become the dominant investment vehicle for U.S. retirement plans. The propensity of retail investors in the registered funds space is largely due to the fact that registered funds are the only variety of U.S. securities fund permitted to offer to U.S. retail investors without regard for regulatory sophistication standards typical to hedge funds and private equity funds, such as “accredited investor” or “qualified purchaser”.<sup>3</sup>

Registered funds are attractive to investors because they provide a transparent, efficient structure for investors to gain access to the securities markets. U.S. retail investors generally do not qualify to invest in traditional hedge funds or private equity funds due to the high-net-worth requirements and steep minimum investment amounts, and therefore must look to registered funds. From a practical standpoint, registered funds are easy to invest in; they do not require subscription documents or extensive verification procedures, making the investing process more streamlined than traditional hedge funds and private equity funds.

Regardless of whether a manager is seeking U.S. retail or institutional investors, registered funds provide transparency and can deliver a tax-efficient structure via pass-through tax treatment that can eliminate K-1 tax reporting and block certain U.S. state taxation at the fund level. Similarly, managers can raise an unlimited amount of capital subject to the Employee Retirement Income Security Act of 1974 (ERISA) in a registered fund without additional compliance burdens, compared to privately offered funds which typically limit ERISA investments or must comply with qualified professional asset manager (QPAM) and other ERISA requirements.

Registered funds are also not “covered funds” under the Volcker Rule, which generally prohibits banks and affiliated banking entities from acquiring “ownership interests” in or sponsoring

covered funds. By excluding registered funds from the definition of “covered fund”, the Volcker Rule has provided a competitive advantage to registered funds over private funds in attracting U.S. bank capital. Registered funds offered by traditional private fund managers alongside those managers’ private funds may provide an attractive alternative to banks and bank affiliates that are considering alternatives to private fund investments.

### IV. Commercial and Operational Considerations

All registered funds are subject to numerous substantive requirements and restrictions, such as periodic public reporting to the SEC and to investors, limits on the use of leverage and derivatives, prohibitions on principal and joint transactions with insiders and affiliates, limitations on investing in other funds, and specific board governance requirements. Managers must be familiar with these issues, and, more importantly, must understand how these issues translate into a number of broader commercial and operational issues, any of which may affect a manager’s core enterprise and strategy, including the following:

**(a) Any manager advising a registered fund must register with the SEC as an investment adviser**

The Investment Advisers Act of 1940, as amended (the **Advisers Act**) requires managers of registered funds – including sub-advisers to registered funds – to be registered with the SEC, regardless of their amount of assets under management, the number of U.S. investors or clients, or the location of the manager’s principal place of business. Non-U.S. managers and alternative managers that currently rely on the “exempt reporting adviser” or the “foreign private fund adviser” exemption must consider the implication of a full registration with the SEC. However, the additional Advisers Act requirements alone do not materially increase the compliance obligations that the Investment Company Act imposes on a manager of a registered fund, particularly because exempt managers at all times remain subject to the Advisers Act’s broad antifraud, recordkeeping and insider trading requirements.

**(b) Performance fees are generally prohibited, and investors pay close attention to fees and expense ratios**

Managers will not be able to charge performance fees unless they conduct limited offerings to certain classes of sophisticated investors, such as through the Investment Company Act’s funds of hedge funds or funds of private equity funds (which would eliminate many retail investors). In a rare exception, the Investment Company Act permits a manager of a BDC to charge a performance fee.

Investors will scrutinise management fees and a fund’s overall expense ratio, and managers willing to sacrifice some economics by setting a lower assets-under-management fee must pay close attention to the fund’s all-in expense ratio that includes administrative, trading and operational costs.

Registered funds in general tend to have higher expenses than traditional privately offered hedge funds and private equity funds. Mutual funds, in turn, tend to have higher management and administrative expenses than traditional closed-end funds. Many of these expenses arise from the fact that a registered fund typically engages a number of service providers, including for example, a distributor or principal underwriter, a transfer agent, a custodian, an independent auditor, an independent valuation firm, legal counsel for the fund, independent legal counsel for the board and a proxy firm. The SEC’s recently adopted liquidity management rules, pursuant to which open-end funds will be required to classify assets in six specific liquidity categories and conduct an ongoing review of the fund’s liquidity, is also likely to add to an open-end fund’s expenses.

**(c) Distribution of open-end fund shares, and offerings of closed-end fund shares, are each critical to success**

Somewhat different to the buyer-driven market of hedge and private equity funds, the market for registered funds is developed through proactive retail sales efforts, and registered funds must be heavily marketed to attract an investor base. This means that managers must seek out distribution partners, in the case of open-end funds, and carefully consider underwriting lead and syndicate options, in the case of a closed-end fund. Distribution partnership options for open-end funds take many forms, from traditional sub-advisory roles with multi-manager funds to series trusts sponsored by a manager with a strong distribution network. Similarly, underwriter selection for closed-end funds requires careful diligence.

**(d) Managers must ensure that their strategies can perform as expected in a registered fund wrapper, and not all performance is portable for marketing purposes**

Open-end fund strategies tend to focus on the most liquid of securities, including long/short equity, and some event-driven or credit strategies that do not rely on illiquid securities. Closed-end funds, on the other hand, are not subject to portfolio liquidity requirements, do not offer their shares continuously, and are not subject to daily redemption requests. Thus, a manager of a closed-end fund may pursue a more flexible investment strategy involving, by way of example, an illiquid portfolio that focuses on fixed income securities and borrowing through the issuance of senior securities. While a flexible investment strategy may be more attractive to certain managers, closed-end funds tend to attract a smaller portion of U.S. retail capital. Many closed-end funds also trade at a discount to net asset value per share and consequently struggle to offer interests that reflect the fund's assessed net asset value in follow-on offerings. A manager determining whether to launch a registered fund should consider a "test run" of its registered fund strategy in a model portfolio sleeve, private fund or seed-only vehicle prior to marketing a registered fund.

A manager seeking to market its registered fund by using the performance of other funds or accounts must conform to strict SEC guidelines that generally require uniformity of strategy and personnel for such performance information to be used in an offering. Moreover, managers should conduct thorough pre-testing of their strategies within the liquidity, leverage and co-investment limitations of the Investment Company Act to condition their expectations and the expectations of investors, and to establish appropriate internal procedures that seek to comply with these limitations.

Many fund managers have explored sponsoring registered funds that invest, at least in part, in cryptocurrencies and cryptocurrency-related products. The SEC continues to express concern over these investments and whether they are consistent with the requirements that apply to registered funds. For example, in the case of mutual funds, the staff of the SEC has questioned whether cryptocurrency-related products would comply with the liquidity requirements of the Investment Company Act. Consequently, managers exploring such a strategy should be cautious given the staff of the SEC's general uncertainty and the current lack of regulation.

**(e) Managers must be cautious not to cannibalise their existing product offerings**

Not all potential investors will find it optimal to invest in a registered fund, and managers should be mindful about offering products that may replace existing offerings at a lower cost, particularly given the risk that a manager could give up a performance fee on a non-registered product. Managers whose strategies already conform in material part to the Investment Company Act should consider steps to distinguish a potential registered fund offering from existing offerings.

**(f) Retail investors can be reactive and are a focus of SEC enforcement**

Retail money is not "sticky" – investors in open-end funds may make large redemptions when markets decline, which could quickly and drastically reduce assets under management for a manager of an open-end fund. Investors in closed-end funds and interval funds similarly may attempt to sell or redeem shares and lower the share trading price. While the Investment Company Act permits some use of redemption fees in the case of an open-end fund, managers cannot generally lock up investors in the fund. Managers may wish to choose an investment strategy that complements an investor's existing portfolio (such as a non-correlative strategy designed to reduce overall volatility and risk) and thoroughly educate selling brokers, advisers and investors about the specific role that the registered fund is intended to play in the manager's platform as a means to prevent large-scale redemptions.

The SEC continues to focus on protecting retail investors, given the potential lack of sophistication compared to typical hedge fund and private equity fund investors. In fact, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced in 2018 that it would prioritise examining advisers of mutual funds with poor performance to ensure that the funds are complying with applicable regulations and disclosing risks adequately. In particular, OCIE's priorities focus on never-before-examined investment advisers. Unregistered advisers that will be required to register as a result of advising a registered product should thus be conscious of compliance pitfalls at the outset and should engage appropriate compliance advisers.

**(g) Registered funds may avoid double taxation**

Registered investment companies may elect to be treated as a "regulated investment company" (RIC) under the U.S. Internal Revenue Code (the Code) in order to avoid double taxation. If a registered fund elects to be treated as a RIC and complies with the RIC requirements under the Code (including diversification requirements and the requirement to distribute 90% of the fund's net investment income to investors), the fund will not be subject to U.S. federal income tax on its income and capital gains.

**(h) A registered fund must generally be organised in the U.S.**

Section 7(d) of the Investment Company Act prohibits a non-U.S. fund from registering under the Investment Company Act unless it has received exemptive relief to do so from the SEC. The SEC has historically only granted such relief on very rare occasions, with the result of Section 7(d) being that it is practically impossible for a non-U.S. fund to register as an investment company. Since a fund pursuing a typical open-end fund or closed-end fund strategy would be required to register to offer securities in the U.S., a manager sponsoring a registered fund must be prepared to organise the fund in the U.S. and to address related considerations of having a U.S. organised client.<sup>4</sup> The fact that a registered fund must be organised in the U.S. does not necessarily require a manager to have a U.S. presence.

**Endnotes**

1. In this chapter, we focus on the commercial and operation considerations associated with typical open-end funds and closed-end funds. We do not specifically address in detail the commercial and operational nuances of other registered funds, such as UITs, money-market funds and business development companies.
2. At least 85% of a mutual fund's net assets must be held in "liquid securities", which are generally securities that can be disposed of within seven calendar days.

3. Of course, a commodity trading adviser or an equity real estate manager could raise U.S. retail capital through a vehicle registered under the Securities Act that avoids holding securities, such as a commodity pool or an equity REIT. Certain specific asset classes that qualify for Investment Company Act exemptions (such as mortgage pools and oil and gas funds) may also be publicly offered to U.S. retail investors.
4. Most open-end funds and some closed-end funds are organised in Delaware or Massachusetts due to favourable tax and corporate governance laws. Certain closed-end funds are incorporated in Maryland for similar reasons.

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Marc's practice focuses on the asset management industry, where he advises clients on a broad spectrum of regulatory and transactional issues. Marc is fluent in all aspects of regulation affecting money managers, funds and fund sponsors and he focuses particularly on issues under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Marc regularly advises asset managers, sponsors and issuers in structuring, documenting, and offering funds and other investment products inside and outside the U.S., including funds registered under the 1940 Act, private funds, specialty finance products such as securitisation vehicles, CLOs, REITs and other vehicles, and advises asset managers on regulatory and transactional issues under the Investment Advisers Act, including registration with the SEC and exemptions from registration. Marc also has considerable capital markets experience, having represented issuers and underwriters in creating and structuring hundreds of products and transactions to avoid 1940 Act "status" issues.

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Sheena is an associate in Allen & Overy's asset management group, where she advises clients on a broad range of regulatory and transactional issues, with a specific focus on fund formation and regulatory matters relating to investment funds in the U.S. Sheena is experienced in advising funds (including registered investment funds) and asset managers in connection with an array of transactional and regulatory matters, including those arising under the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Act of 1933.

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