

# ALLEN & OVERY

## 1940 Act Funds:

*Commercial and Operational Issues for Non-U.S. and  
U.S. Alternative Investment Managers*

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# Introduction

*Non-U.S. and U.S. alternative investment managers looking to increase and diversify their assets under management (AUM), add new revenue streams, and, for non-U.S. managers, globalize their businesses may find a “1940 Act Fund” an attractive option (a 1940 Act Fund is a fund registered with the U.S. Securities and Exchange Commission under the U.S. Investment Company Act of 1940) an attractive option. A 1940 Act Fund is the only securities fund permitted to raise capital from U.S. retail investors, particularly defined contribution retirement plans, and it provides a transparent, tax-efficient structure for U.S. investors. Any investment manager seeking to launch a 1940 Act Fund must appreciate the particular 1940 Act restrictions and prohibitions that apply to launching and operating such a product, but perhaps more importantly must appreciate the broader effect that the 1940 Act will have on its business and operations.*

*This briefing discusses, through a commercial and operational lens, the material issues managers likely will face when organizing and managing a 1940 Act Fund. Future briefings will discuss specific 1940 Act Fund structures, including permanent capital vehicles such as 1940 Act funds-of-hedge funds and funds-of private equity funds, business development companies, and “liquid alternative” 1940 Act funds, and how to bring a 1940 Act Fund to market.*



# Why 1940 Act Funds?

The U.S. retail investor market is the largest single investor base in the world.

Any manager seeking additional streams of AUM must consider the depth and breadth of the U.S. retail market, which is estimated to have more than USD 33 trillion in investible assets.<sup>2</sup> 1940 Act Funds are the only variety of U.S. securities fund in which U.S. retail investors may invest<sup>3</sup> and, as a result, have become the dominant vehicle in U.S. retirement plans. 1940 Act Funds hold over USD 18 trillion in assets, over 40% of U.S. households own interests in at least one 1940 Act Fund and 64% of investors made their first 1940 Act Fund purchase through an employee-sponsored retirement plan.<sup>4</sup>

1940 Act Funds 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 1940 Act Funds, which do not typically require net worth or similar minimums.<sup>5</sup> 1940 Act Funds also do not require subscription documents, which makes the investing process more streamlined than traditional hedge or private equity funds.

And regardless of whether a manager is seeking U.S. retail or institutional investors, 1940 Act 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 ERISA money into a 1940 Act Fund, regardless of whether the fund is offered to U.S. retail investors, rather than capping ERISA investment or complying with QPAM or more stringent ERISA requirements.

The 1940 Act allows for three primary fund types, generally according to the frequency of offerings and liquidity:

- **Open-end funds** (also known as “mutual funds”), which continuously offer their shares, invest in liquid portfolios and allow for daily redemptions;
- **Closed-end funds** (including business development companies, or “BDCs”), that are permanent capital vehicles that may continually offer their shares, invest in less liquid portfolios, and offer liquidity through exchange listing or periodic tender offers; and
- **Interval funds**, which are closed-end funds that offer periodic, scheduled liquidity through redemptions of shares at set levels.<sup>1</sup>

<sup>1</sup> We will not discuss exchange-traded funds, or “ETFs”, in this briefing. ETFs generally are hybrid 1940 Act funds that combine elements of open-end funds with the ability to trade ETF shares on a national stock exchange.

<sup>2</sup> Cerulli Associates, U.S. Retail Investor Advice Relationships 2014: Evolving Roles in Client Relationships.

<sup>3</sup> Of course, a commodity trading advisor or an equity real estate manager could raise U.S. retail capital through a vehicle registered under the U.S. Securities Act of 1933 that avoids holding securities, such as a commodity pool or an equity REIT; also, certain specific asset classes that qualify for 1940 Act exemptions (such as mortgage pools and oil and gas funds) may be publicly offered to U.S. retail investors. An investment manager could also look to publicly market and advertise a private fund to U.S. investors under the more relaxed JOBS Act private offering exemption, but the ultimate investors must still meet certain investor sophistication standards, thus eliminating much of the true U.S. retail investor market.

<sup>4</sup> Investment Company Institute Factbook 2015.

<sup>5</sup> Notable exceptions are 1940 Act funds-of-hedge funds and funds-of-private equity funds, which typically are privately-offered to accredited investors and require investment minimums and some manner of subscription process.

## 1940 Act Funds have a competitive advantage over private funds in attracting U.S. bank capital.

1940 Act Funds are not “covered funds” for purposes of the Volcker Rule, and thus may attract investments from bank entities that are now prohibited from acquiring “ownership interests” in covered funds. With banks and bank affiliates considering alternatives to private fund investments, 1940 Act Funds offered by traditional private fund managers alongside those managers’ private funds provide an attractive alternative.

# Commercial and Operational Considerations

All 1940 Act 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 into other funds, and specific board governance requirements. Managers should consider the following benefits of launching or advising a 1940 Act Fund, regardless of fund type.

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

**Any manager advising a 1940 Act Fund must register with the SEC as an investment adviser.**

The Investment Advisers Act of 1940 requires managers of 1940 Act Funds – including sub-advisers to 1940 Act Funds – to be registered with the Securities and Exchange Commission, regardless of their amount of AUM, the number of U.S. investors or clients, and the location of the manager's principal place of business. Non-U.S. managers and alternative managers relying on "exempt reporting adviser" or "foreign private fund adviser" exemptions 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 imposed by the 1940 Act on a manager of a 1940 Act Fund, particularly because exempt managers at all times remain subject to the Advisers Act's broad antifraud, recordkeeping and insider trading requirements.

**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 1940 Act funds-of-hedge funds or funds-of private equity funds (which would eliminate many retail investors). Additionally, investors will scrutinize management fees and a fund's overall expense ratio, and managers willing to sacrifice some economics by setting a lower AUM fee must pay close attention to the fund's all-in expense ratio that includes administrative, trading and operational costs.

**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 1940 Act Funds is developed through proactive retail sales efforts, and 1940 Act 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.

## Managers must ensure that their strategies can perform as expected in a 1940 Act Fund wrapper, and not all performance is portable.

A manager seeking to market its 1940 Act Fund with the performance of other funds or accounts must conform to strict SEC guidelines that generally require uniformity of strategy and personnel. Moreover, managers should conduct thorough pre-testing of their strategies within the liquidity, leverage and co-investing limitations of the 1940 Act to condition their expectations and the expectations of investors. Open-end 1940 Act 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, while closed-end and interval 1940 Act Funds may have more flexibility to incorporate illiquid fixed income and other strategies into their portfolios since they are each not subject to the same liquidity requirements. A manager determining whether to launch a 1940 Act Fund should consider a “test run” of its 1940 Act Fund strategy in a model portfolio sleeve, private fund, or seed-only vehicle prior to marketing a 1940 Act Fund.

## Managers must be cautious not to cannibalize their existing product offerings.

Not all of a manager’s clients will find it optimal to invest in a 1940 Act Fund, and managers should be mindful about offering products that may replace existing offerings at a lower cost. Managers whose strategies already conform in material part to the 1940 Act should consider steps to distinguish a potential 1940 Act Fund offering from existing offerings.

## Retail investors can be reactive.

Retail money is not “sticky” – investors in open-end funds may make large redemptions when markets decline, reducing overall assets, and investors in closed-end fund and interval funds may attempt to sell or redeem shares and lower the share trading price. To wit, a number of “alternative” 1940 Act Funds saw lower sales and net outflows in 2015.<sup>6</sup> While the 1940 Act permits some use of redemption fees in the case of an open-end fund, managers cannot ensure that investors will stay invested with 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 the 1940 Act Fund is intended to play as a means to prevent large-scale redemptions.

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<sup>6</sup> See Ignites, “Liquid Alts Sales Fizzle in 2015” (Dec. 24, 2015).

This briefing is intended only as a general discussion of U.S. legal issues that asset managers face and should not be regarded as legal advice. If you require advice on any of the matters raised in this note, please contact **Marc Ponchione** at +1 202 683 3882 or [marc.ponchione@allenoverly.com](mailto:marc.ponchione@allenoverly.com), or your usual contact at Allen & Overy.

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