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Improving Operational Efficiency for Interval Funds

By Jeff Naylor

Fund firms that offer interval funds—a type of closed-end fund that periodically offers to repurchase a portion of its shares—face unique operational challenges. To address these, ICI's Broker-Dealer Advisory Committee recently launched the Working Group on Interval Funds. The working group plans to publish a comprehensive white paper that will consider new approaches to boosting the operational cohesiveness and efficiency of trade processing for these funds. The paper will include pertinent recommendations that should greatly benefit interval fund investors.

What Is an Interval Fund?

An interval fund is a closed-end fund that periodically offers to repurchase a limited percentage of outstanding shares, as defined by its prospectus, from shareholders. An investor seeking to "redeem" fund shares submits a fund repurchase request to participate in the interval fund's next scheduled repurchase offer. The fund transacts repurchases at periodic intervals on preset dates—typically, every one, three, six, or 12 months—at the fund's net asset value (NAV) on the transaction date.

Unlike many other closed-end funds, interval funds typically are not listed or traded on an exchange and have no secondary market. Investors may buy shares in an interval fund on any business day at a purchase price based on the fund's NAV that day. Interval funds always price their shares at NAV, an important difference from traditional exchange-traded closed-end funds that may be priced at a premium or discount determined by market trading. An investor can transact in interval fund shares—buying or placing a repurchase order—through an intermediary, such as a broker-dealer, or directly from the fund.

Interval funds tend to invest in income-producing products and strategies. They also tend to offer investors periodic distributions from the fund, in the form of income, capital gains, return of capital, or some combination of the three. A typical interval fund provides investors exposure to less-liquid asset classes such as real estate.

Asset managers' interest in offering interval funds picked up after the Securities and Exchange Commission (SEC) issued its October 2016 release for the liquidity risk management program rule. That rule included language that alleviated some potential regulatory concerns about the liquidity of these funds. Today, there are around 60 active SEC-registered interval funds, with $29 billion in total assets. Nearly 40 percent of these funds were launched after the October 2016 SEC release.

Unique Characteristics of Interval Funds Complicate Order Processing

The working group is examining timing issues and other factors that complicate order processing due to the fact that interval funds repurchase investors' shares only periodically, not daily.

When an investor submits a request for the fund sponsor to repurchase a portion or all of the investor's shares of an interval fund, the transaction isn't processed at the end of that day, as it would be with an open-end mutual fund. The related order is typically held—or "warehoused"—until the predesignated transaction date for the fund repurchases, which could be days, weeks, or even months after submission.

The working group is also delving into ways to achieve greater automation for execution, clearance, and settlement. Currently, many industry platforms lack the ability to effectively handle orders to buy or repurchase interval fund shares. Some must warehouse orders outside a broker-dealer or fund company's usual order management system, adding complexity and introducing operational risk. So trading in interval funds in some cases still relies on means of communications—phone calls, faxes, and letters—that are largely outmoded in transactions for open-end funds and that require extensive manual work.

Panel at ICI Closed-End Fund Conference Will Discuss Interval Funds

At the Institute's Closed-End Fund Conference on November 14 in New York City, Jay Jackson of Thrivent Investment Management, Inc. will moderate a panel on interval funds and discuss some of the issues that the working group is considering. Its white paper will be a significant and welcome first step toward improving industry operations for these funds to the benefit of their investors.

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