



John Hunt is a partner at Sullivan & Worcester, LLP. He can be contacted on +1 (617) 338 2961 or by email: jhunt@sullivanlaw.com.

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■ SPECIAL REPORT ARTICLE REPRINT October 2023

Private equity strategies using interval funds, tender-offer funds and ELTIFs 2.0

BY JOHN HUNT

Private equity (PE) funds generally provide liquidity to their investors only when there is a capital transaction, such as a sale of a portfolio investment, and the funds' investment managers receive carried interest to remunerate them when the funds make a profit on a sale. However, because of funds' lack of liquidity (given that fund terms range from eight years and longer, investors cannot otherwise sell their interests except under limited conditions, and most funds apply high fees and have complex terms) most securities regulators limit investments in PE funds to institutional and professional

investors. To broaden distribution channels, fund sponsors are rethinking fund structures. Enter interval funds and tender-offer funds in the US and European long-term investment funds (ELTIFs) in Europe.

US PE funds, interval funds and tender-offer funds, generally

In the US, most PE funds are organised as Delaware limited partnerships, are not 'investment companies', and thus are not subject to direct regulation. Regulation of traditional PE funds, however, is generally indirect through the regulation of the funds' investment

managers. Investment managers generally must be registered with the US Securities and Exchange Commission (SEC) as 'investment advisers', or they must file notices with the SEC as 'exempt reporting advisers'. Those laws and regulations applicable to registered investment advisers and exempt reporting advisers also impose restrictions on the registered investment advisers' and exempt reporting advisers' client accounts, which includes the funds managed by the investment managers. Thus, funds are typically treated as affiliates of their investment advisers, subjecting fund transactions to the same

limitations applicable to transactions by the investment advisers themselves.

Unlike most traditional PE funds, interval funds and tender-offer funds are ‘investment companies’, and thus are subject to direct regulation by the SEC, including SEC registration. Moreover, they are closed-end funds. However, unlike most closed-end funds, which offer investors liquidity through the sale of their fund shares on an exchange, interval fund and tender-offer fund shares are not exchange-traded. Instead, interval funds and tender-offer funds periodically make tender-offers for outstanding fund shares and may continuously offer and sell shares, thus permitting the funds to grow, even as the funds repurchase shares. More importantly, because they offer limited liquidity at the discretion of the fund, they may invest predominantly in illiquid portfolio investments, such as those types of investments which traditional PE funds make. In addition, because the funds are investment companies, fund shares may be offered to classes of investors that would not otherwise be eligible to invest in many traditional PE funds.

ELTIFs

In Luxembourg and Ireland, most PE funds also are organised as limited partnerships. When organised by US managers, fund terms, especially the use of partner capital accounts, typically are similar to terms US investment managers use for US PE funds. Non-European investment managers typically use other fund terms, such as representing client interests with shares rather than capital accounts. As with US regulation, European regulation is typically indirect through the regulation of the alternative investment fund manager (AFIM), under the EU Alternative Investment Funds Managers Directive (AIFMD). Unlike the US, many types of European PE funds require some degree of regulator submission.

ELTIFs are collective investment funds that allow investors to invest in companies and projects that require long-term capital, and they are intended to increase the amount of available non-bank financing of ‘real assets’, especially infrastructure projects. Prior to the adoption of the initial ELTIF rules in 2015, infrastructure and similar funds could not, among other things, take advantage of any EU cross-border marketing passport, and thus, were effectively limited in size. After adoption, however, ELTIFs struggled for acceptance.

The European Parliament and the Council of the European Union recently approved amendments to the rules applicable to ELTIFs (the amended rules are commonly referred to as ELTIF 2.0), to make ELTIFs more accessible to retail investors and more flexible for fund sponsors. Those amended rules are expected to apply from 10 January 2024. Among other things, the amended rules will: (i) permit master-feeder and fund-of-funds structures; (ii) broaden the scope of eligible assets by removing the €10m floor; (iii) broaden the definition of ‘real assets’ and no longer distinguish between infrastructure assets and other asset types; (iv) increase the maximum market capitalisation of listed portfolio investments to €1.5bn from €500m, and make the time of determination the time of initial investment instead of ongoing; and (v) increase the portfolio diversification limit from 10 percent to 20 percent, and the concentration limit to 30 percent from 25 percent.

More importantly, the new amendments have abolished the 10 percent cap and €10,000 minimum investment amount on investments by retail investors whose investment portfolios are less than €500,000. Also, under the amended rules, the limit on the amount that an ELTIF may borrow in cash is increased to 50 percent of the ELTIF’s net assets from 30 percent if the ELTIF is marketed to any retail investors, and to 100

percent if the ELTIF is marketed only to professional investors. Finally, the new amended rules abolish the previous obligation of an ELTIF to wind down and liquidate in the event the ELTIF fails to satisfy investor redemption requests within one year from the date they were made.

Considerations for using alternatives to a traditional PE fund

Below are some considerations that sponsors of PE funds should consider in offering a PE investment strategy through an interval fund, tender-offer fund or an ELTIF.

Shareholder liquidity. Traditional PE funds typically do not permit any redemptions of funds shares. Under the 1940 Act, interval funds are required to hold a certain percentage of assets in liquid securities to satisfy repurchases of fund shares tendered by investors. Tender-offer funds are not required to make tender offers or satisfy redemption requests, respectively, unless they have separately agreed to do so. ELTIFs are expected to satisfy redemption requests although they no longer are required to wind down if they fail to do so.

Borrowing. Traditional PE funds typically are limited in their borrowings policies only to what is disclosed to investors. The 1940 Act imposes strict limits on how much a registered investment company may borrow. ELTIF 2.0 also limits how much an ELTIF may borrow.

Calculation of performance and incentive fees. Traditional PE funds typically provide for the fund’s general partner or an affiliate to receive carried interest distributions, that is, a share of distributions paid to limited partners in excess of certain thresholds. Carried interest distribution calculations do not work easily with any fund that is continuously offered and which permits periodic redemptions or withdrawals. Instead, it would be less complex if the fund calculated performance fees

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and allocations based on the realised and unrealised value of the fund's assets determined any time there is a subscription to or a redemption or withdrawal from the fund, the timing of which may or may not occur concurrently with a portfolio capital transaction.

PE funds are popular with institutional investors because they have, or are perceived to have, provided their investors with outsized investment returns, notwithstanding the application

of high management fees and carried interest. PE funds, however, have been largely unavailable to retail investors, primarily because of regulations intended to protect retail investors for their purported lack of sophistication. That attitude toward at least some retail investors, however, is changing. Interval funds, tender-offer funds and ELTIFs will not soon replace traditional PE funds, especially for institutional investors. However, those types of funds permit

investment managers with strong retail client investor bases an opportunity to offer their clients products that invest in PE and other illiquid asset classes that were previously unavailable to them. ■



John Hunt is a partner at Sullivan & Worcester, LLP. He can be contacted on +1 (617) 338 2961 or by email: jhunt@sullivanlaw.com.

John Hunt's practice is focused on representing asset managers and their affiliates on regulatory, compliance and transactional matters. He represents US and non-US investment advisers as well as mutual funds, hedge funds, real estate funds, bank-managed collective investment funds, private equity funds and venture capital funds. He also represents the independent directors to mutual funds. Mr Hunt regularly interfaces with US regulators on a broad range of matters, including exemptive order applications, no-action letters, registration statements and examination inquiries. He also assists asset managers and fund sponsors in organising and operating US and non-US collective investment vehicles.

This article first appeared in the October 2023 issue of
Financier Worldwide magazine. Permission to use this reprint
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