Conversion Considerations for Alts Managers –

5 Reasons to Convert from a Private Fund to a ’40 Act Interval or Tender Offer Fund Today

By Dave Carson, President of Ultimus Managers Trust and Unified Series Trust and SVP, Client Strategies
Nick Darsch, SVP, Business Development, both with Ultimus Fund Solutions

In case you haven’t heard, the retail alternatives space is growing – faster than the hedge fund market, faster than the mutual fund market, faster than just about any other asset class.

In fact, according to Cerulli’s May 2020 monthly trends report, the interval fund space has seen several brand-name managers roll out interval funds in recent years, their numbers growing from 11 funds in 2013 to 55 in 2019[1]. And while the estimated $38.9 billion in interval fund assets still pale in comparison to the $3.24 trillion in global hedge fund assets[2]or the $21.16 trillion in the US mutual fund industry[3], the growth opportunity has many managers salivating.

The numbers are compelling, but many private fund managers aren’t fully convinced that they should or can make a move. Those on the fence are asking themselves:

Should I make the jump into the retail, high net worth market?
Do I have the resources to navigate the advisor and platform distribution network?
Can I convert my private fund into an interval or tender offer fund?

And while most of this conversion talk is being spurred by retail investor’s demand for yield through non-correlating asset classes, the decision to launch a 1940 Act (’40 Act) vehicle or convert a private fund into one is at the top of mind for alternative managers and institutional investment counseling firms alike. It comes down to what they want to accomplish, their target investors and whether the strategy is actually viable in an interval or tender offer fund construct.

To help private fund managers considering a conversion, below are some compelling reasons to make the move to an unlisted closed-end fund and some things to think about along the way.

1. **Tout Your Track Record** – The regulatory guidelines are clear. Managers can’t advertise a private fund track record except in one-on-one meetings with the appropriate disclosures. That’s a hard way to build broad awareness and to grow an investor base. An interval or tender offer fund (also mutual fund) structure allows managers to immediately begin building a public track record that they can leverage for marketing and fundraising. In some cases, the SEC will even allow a converted ’40 Act Fund to use the performance of the hedge fund in the prospectus as long as the manager can meet certain requirements such as show that there is no material change in the fund’s investment strategy. Converting to an interval, tender offer or mutual fund may allow managers to tout a track record and supports opportunities for growth[4].

[1] https://www.thinkadvisor.com/2020/06/01/mutual-fund-assets-bounced-back-in-april-but-outflows-continued-cerulli/
[2] https://www.marketwatch.com/story/hedge-fund-assets-hit-a-new-record-high-in-the-first-half-2019-07-19#:~:text=Hedge%20funds%20increased%20assets%20to,the%20following%20three%2Dmonth%20period.
[3] https://www.ici.org/research/stats/trends/trends_05_20
[4] The SEC has provided guidance that a fund should not be created solely for the purpose of establishing a performance record.

2. **Open the Door to New Investors** – There's no doubt that there are a lot of assets in private funds but there's also no getting around the fact that private funds are available only to accredited investors, qualified purchasers and limited in number of total investors (in the case of 3(c) funds, 100 investors). The Interval and Tender Offer fund structure eliminates those restrictions and opens the door to an unlimited number of investors. That creates access to new and much larger pools of assets that can help a manager scale their business and grow revenue beyond what may be possible in a private fund.

3. **Provide New Levels of Transparency** – For some managers who have a 'secret investing sauce,' this may not be seen as a positive, but for most investors in this day and age, transparency is a necessity. Significant transparency simply doesn't exist in a private fund structure, but registered funds demand higher levels of transparency, governance and oversight that provide investors more visibility into a fund's inner workings – and that often provides more clarity when it comes to their assets. It takes a change in mindset for managers to make this shift but providing new levels of transparency comes with the added benefit of providing access to new pools of capital and new distribution channels to potentially help a fund grow quickly.

4. **Access Retirement Market Assets** – ERISA plans are a huge untapped market for private fund managers. The reality is nearly half of all mutual fund assets are held in 401K or IRA plans, making the retirement space alone nearly three times as large as the entire hedge fund universe. Beyond that, most research shows that retirement plan participants are becoming more interested in alternative strategies all the time – including a recent push for access to Private Equity[5]. That makes the move to mutual funds that much more compelling for private fund managers. Two facts that all private fund managers need to know – there is the large opportunity in retirement plans and access is nearly unlimited.

5. **Compliance Requirements have Changed** – In the not so distant past very few private fund managers had to register with the SEC, but the Dodd-Frank legislation eliminated an oft-used exemption, immediately increasing the regulatory requirements and operational demands for most alternative investment managers. Given the steps that private fund managers now have to take to register, the reporting and regulatory requirements of a mutual fund may seem much less daunting, making the decision to convert a little easier. And many investors appreciate knowing that their investments are managed under the laws and regulations that apply to registered funds.

Things to Consider Along the Way

While there are clearly some attractive reasons for private fund managers to convert to an interval or tender offer fund structure, there are plenty of things to think about that will make the process more seamless for the fund and its current investors.

Strategy - The most important thing to consider is whether or not a strategy even lends itself to a more liquid structure. Many illiquid assets and complex investing strategies may need to be tweaked to accommodate the periodic liquidity and more frequent NAV calculations of interval or tender offer funds. Once a manager determines that the strategy is a fit for retail or mass affluent investors, they have to tailor the strategy to the structure and target investor base, including selecting between the interval and tender offer fund structure.

Investor Viewpoint - The reality is that current investors play a critical role in the conversion process. In fact, they can literally derail the process if they decide a registered fund structure is not what they want -- and managers should be prepared to lose some of their current investors. While there are liquidity, transparency and governance advantages in a registered fund, some accredited investors and qualified purchasers may want the exclusivity of being in a private fund and greater relative flexibility to hold illiquids in the private fund format.

Tax Factor - For those investors that do want to convert, managers need to ensure the process is as painless as possible – especially from a tax standpoint. Investors don't want to sell their private funds and realize a gain, so managers may have to take the necessary steps to convert them on a tax-free basis. That entails going through a detailed plan of reorganization and hitting certain targets. Such planning requires working with someone who has the experience and expertise to guide you through that process.

[5] https://www.barrons.com/articles/private-equity-could-be-coming-to-your-401-k-here-are-a-few-things-to-know-51592049601

And that's true of the conversion as a whole.

From reporting requirements and fund structures to distribution needs and conversion costs there are many other operational considerations that managers have to be aware of, prior to and during the process. The process is not insurmountable, but it takes a level of resources and expertise that most private fund managers aren't accustomed to.

Making the decision to convert from a private fund to an interval or tender offer fund is only the first step on the journey. Managers must be prepared to convert from an investing standpoint, from an operational standpoint and from a psychological standpoint. If they can do those things, the conversion conundrum becomes much clearer and it's much more likely that the process will go smoothly and that they will succeed in taking advantage of the tremendous opportunity in the retail and high-net-worth market.

ABOUT THE AUTHOR

***Dave Carson**, SVP and Director of Client Strategies & President of Ultimus Managers Trust and Unified Series Trust*

As Director of Client Strategies, Dave manages the series trust product line and provides expert assistance to investment managers considering starting a fund. He is a graduate of Kenyon College in Gambier, Ohio. Dave has been in the financial services industry since 1981, and has almost twenty years of fund and asset management experience. Dave has been Chief Compliance Officer for mutual fund families, registered investment advisors, and an ETF trust. He also served as Chief Operations Officer for a mutual fund family, and previously had senior management responsibility for fund and advisor marketing, fund wholesaling, transfer agency, shareholder servicing and advisor compliance. Dave is co-founder and president of Advancing Fund Governance, a forum for fund trustees and senior officers. He is also a former trustee and secretary of the Greater Cincinnati Mutual Funds Association.

ABOUT THE AUTHOR

***Nick Darsch**, SVP, Business Development*

Nickolaus Darsch joined Ultimus in July 2019 as Senior Vice President, Business Development. In this position, he focuses on building strategic relationships with investment advisers to help support product, operations and asset growth. Nick is also responsible for contributing to firm growth strategies, market analysis and reporting as well as cultivating partnerships with centers of influence.

Prior to Ultimus, Nick held multiple roles within SS&C Technologies (including predecessor firms DST Systems, ALPS and Boston Financial Data Services) in sales, strategic relationship management, product and research groups. In 2016, he was named a "Rising Star" in the Asset Management industry in by Fund Directions.

Nick received B.S. from Bentley University in Economics and Finance and an MBA from the McCallum Graduate School of Business at Bentley University.

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Ultimus Fund Solutions 225 Pictoria Drive, Suite 450 Cincinnati, Ohio 45246 513.587.3400 www.ultimusfundsolutions.com

2246-NLD-7/13/2020
8391-UFS-7/13/2020