November 2022 Live Event-AICA Fall CEF/BDC/Interval Fund Bootcamp and Roundtable Panel #1; “Trends and Outlook for the CEF/BDC/ Interval Fund Marketplace”

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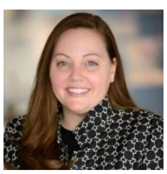
Kim Flynn, Managing Director for Alternative Investments with XA Investments, moderates the first panel of the AICA November 16th, 2022 live event; “Trends and Outlook for the CEF/BDC/Interval Fund Marketplace”. Read the transcript below to hear the discussion among Ms. Flynn and panelists Tom DeCapo, Partner at Skadden, Arps, Slate, Meagher & Flom, John Cole Scott, CIO at CEF Advisors and Founder of CEFData.com, and Steve Flantsbaum, Sr., Special Counsel Fellow, BDC-U.S. Securities and Exchange Commission.



Kim Flynn

Tom DeCapo

John Cole Scott

Steve Flantsbaum, Sr.

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Kim Flynn: Good morning, everybody. We’ve got a mix of industry folks and investors, so we’re going to focus on the trends, we’re going to cover or attempt to cover, the listed closed-end fund space, the growing interval fund space and also the BDC space. So thank you, John Cole Scott, Tom DeCapo, and Steve Flantsbaum. Did I say that correctly?

Steve Flantsbaum: You did.

Kim Flynn: Great. So Steve joins us from the SEC and Tom joins us from Skadden, and you know John Cole Scott. Amy Charles is sad to miss but we're going to have a good panel discussion. We're going to kick it off with listed closed-end funds. We're going to try to focus on trends or hopefully things that you're not yet thinking about.

We all know that the listed closed-end fund market has been dislocated. The IPO market has largely been open-shut but largely shut, so I think that a large reason that we're not seeing IPOs get done is the secondary market. So maybe, John, if we could go to you, can you talk about the impact of interest rates and inflation on the secondary market for closed-end funds?

John Cole Scott: Sure, happy to. So about a year ago inflation really wasn't a problem, interest rates were relatively low and the closed-end fund market was raising some of the largest funds that we'd seen since probably pre-Financial Crisis. And then of course this year we've had interest rates rising and the stock market in more of a downward trend, and some of those, we'll call them CEF 2.0s which had the manager paying the load and the term structure, I feel because many of the advisors that were buying those funds initially weren't as closed-end fund-centric, those funds actually were trading about 4.5-5% wider than their peer-group averages, the perpetual structures out there. So imagine a term structure, a 12-year window to get out, trading worse than the other funds in the neighborhood.

And when you think about it, a lot of the funds, because the manager had to pay the load, I would argue that the managers, fund sponsors had to be really thoughtful and bring great products to market. And so with the discounts widening over 7% this year peak to valley for peer groups not just individual funds, we found that it's a very good time to be a secondary buyer of closed-end funds. And it's harder to bring new funds to market when they're at double-digit discounts in the market, and we saw this similar after the Great Recession or even other times, 10 years or so ago where it took a while to get funds back up and running and the IPO market opened again. But closed-end funds have been around since 1860, US 1893, they will continue to evolve and I'm certain we'll get back to IPOs in the future.

Kim Flynn: With discounts we often see activist investors; 2021 we actually saw quite a bit of activism despite the fact that the market was trading pretty tight in terms of discounts. Tom, what are you seeing more recently with activists? How is the current environment impacting activist activity?

Tom DeCapo: We still see a fair amount of activist activity. I think it seems to be down a little bit this year as compared to last year. Some of the activists are involved in some large litigation that might change the face of activism as we go forward, and so I think they're a bit absorbed with that effort. We also obviously have higher interest rates right now, and so I think that it's very possible that the activists' war chest has pulled back a little bit as people have moved away from the returns that they're able to get in the activist activity as interest rates go up to move into other fields. But I think activism is here to stay and it will ebb and flow with general economic conditions, with discounts, with the regulatory field that surrounds it and the ease of being able to get in and actually achieve their objectives.

Kim Flynn: Any other thoughts on activism?

John Cole Scott: I would say that activism, I remember when I first joined my father's firm in '01, read about the Harvard Endowment was one of the first, at least recent history, activists. The one thing I have noticed is a lot of the activism is less about killing the fund, it's become far more common to have the tenders and also taking over the fund. Which I guess Bulldog did initially with a muni bond fund, which is now SPE. But it's been more common in recent time as a way of I guess not necessarily closing the discount but taking the investment advisor contract. That's been one newer development.

Kim Flynn: So you're seeing fewer takeovers but more tenders to force liquidity?

John Cole Scott: Well no, the takeovers are now more common and more I think of a concern for fund sponsors. The tenders, I'd say, the hard thing is tenders, yes, they're extra money for my clients when we do them but they really don't change discounts longer term. And for large funds, they're not really harmful to the fund, but smaller funds it does tend to generally raise the expense ratio and reduce liquidity. So I'd like to think there's other ways to improve the fund than just simply do tenders.

Tom DeCapo: If you can say, how do you feel as an investor, about the takeovers?

John Cole Scott: Well, it's interesting. I would say like all sectors there are some fund sponsors do a wonderful jobs with their funds and seem to have discount issues, there's some funds where we wish they can be taken over but they trade at weird levels and would not make sense. I would like to say that it's very dependent on the fund. Because when we build client portfolios we do pick sectors and managers and try to build tax-efficient after-tax yield-based income, and so if the fund's going to dramatically change, we'll often sell and wait.

Just like when a closed-end fund converts over to an interval fund, we'll often buy into that discount capture. And then when there's other direct listings and whatnot, there's a direct listing this week from, I think Wells Fargo bought a Franklin Square product direct listed $2 billion, we're going to wait and see how it trades to understand what's happening.

Kim Flynn: Can we talk about elevated leverage levels in the secondary market? I think there's some growing concern about muni funds, preferred funds, which are very popular categories of closed-end funds just given the ARB on leverage not being there. Are investors showing more concern about some of those more reliable income producing sectors like muni and preferreds given that leverage difference?

John Cole Scott: I would say the way we think about it is, yes, when the yield curve is flat there's less economic benefit of a levered income closed-end fund. However, I remind people that if you think the average fund is roughly a third levered, you have four parts investment to one part leverage, eventually the manager can pick up investments that will yield more to improve that. Yield curves tend to go back to normal eventually. Though I guess my undergrad degree's in psychology and I think in my abnormal psychology class they defined abnormal as just the absence of normal, and I'd say what is normal? There's no normal. What I've learned in 22 years, there's no normal.

But I'd say one thing we noticed during Covid, we'd added a datapoint to our spreadsheet, basically daily inferred leverage, basically the notional dollar amount of leverage and the current net asset value. And we saw some funds getting above their RIC levels, which we expected that their board and teams were selling some bonds to make that not a problem. There's only been two funds to my knowledge, fund sponsors, PIMCO had one fund pre-Crisis, November of '08, couldn't pay it's dividend until December. It did pay the dividend that year, but definitely that was a hairier time than even Covid. And I believe it's the Allianz, was it the Allianz Funds, NCZ? I think that did delay its dividend for two months.

I would be concerned about that, but what I've noticed with the '15, '16 energy, with Great Recession, with Covid, fund sponsors have gotten a lot more proactive on their leverage. And while there may be a delay to the pickup and benefit to investors, they're much more proactive on being careful and thoughtful on how they can not hit that RIC level and not be able to pay the dividend.

Tom DeCapo: I would concur with that. Managers really learned how to deal with the issue back going through the 2008 crisis. A lot of the types of leverage that are used now are more flexible, easier to take on and take off than was the case then. And so while obviously you'll have the normal economic impact of the market spreads, and the unfortunate situation of having to pay down that leverage by selling off assets when your assets are depressed, I think having the problems that we saw across the industry in 2008 is rather unlikely.

Kim Flynn: Is there anything else that fund sponsors are doing you think, to proactively support the secondary market? I know that underwriters, closed-end fund underwriters, there's a lot of people trying to get back into the IPO market and underwriters are telling fund sponsors to host quarterly webinars, to do the proactive secondary marketing, because right now it's challenging on the IPO side.

John Cole Scott: It is. At a basic level you can really only expect the fund sponsor to focus primarily on the net asset value performance, but you really can't ignore pervasive and substantial discounts. And so I'd say I was meeting with a fund sponsor, one of the larger ones, and chatting with how they may do their best to improve the advisor experience, the investor experience. I said, "In my opinion you should do a little bit of everything because you need, I would argue, a small-fee waiver until discounts go to maybe sub-10%. I would argue maybe buying in shares because while it's not exciting, it's a very good deal at a wide discount. And I would say you might even consider some small tenders on larger funds where you're not worried about the size being an issue. Because you need to say, 'It's not our fault.'

The market, obviously nobody planned this market, but we are in this business as institutions. One of the reasons we try to focus on making sure advisors and the clients they serve want to buy the next closed-end fund, want to stay in closed-end funds. I think you just need to be proactive and communicate that through your wholesalers to your clients.

Kim Flynn: So you mentioned some of the things that fund sponsors are trying in the secondary market, maybe we could pivot and talk about the IPO market. BlackRock did do a small municipal bond offering in October, they were able to price that. I think given the dislocations in the secondary market, it proved to be a very challenging calendar month. We do see the forward pipeline, PIMCO and Nuveen have also both filed for muni funds, but we don't see much else. So do you think that the closed-end fund IPO market requires some sort of structural change or some sort of inducement to bring advisors back into the IPO?

Tom DeCapo: I would argue that the closed-end product line needs some vast restructuring, and it's not as limited to what would get this particular IPO market going again. These are my personal views. Closed-end funds are able to provide to investors the ability to invest in less liquid assets as compared to anything else that retail investors can invest in. As we were just talking leverage, and to give retail investors access to professionally managed leverage. That's what closed-end funds can do for retail that they can't get in any other product. And I think the more that advisors focus on those two things, the more valuable the closed-end wrapper is to investors.

The funny dichotomy is that it's difficult to do those two things if you have to worry about discounts and worry about activists. And so that pushes the product to look more like an open-end product, or an interval product, or an ETF, which diminishes the value of the wrapper. And so I think there's this difficult dichotomy in what closed-end funds are, should be, or could be, and that obviously affects their ability to sold in the IPO market and how they trade in the secondary market.

Steve Flantsbaum: First thing, a disclaimer from the SEC. My views are my own and they do not necessarily represent those of the commissioners, their staff, or the Commission. And on that point, I think it kind of ties together with probably what we're going to talk about a bit later on interval funds and BDCs and the prevalence of the non-traded product, especially in the interval fund structure that's growing in the BDC space. The non-traded funds, and the private placement of BDCs are an increasingly a growing market segment compared to IPOs, and I think it is because of all the issues highlighted by this panel. So it is an interesting dynamic in that space, and it is interesting to see where the closed-end funds are going to go.

John Cole Scott: I'd say at a basic level the original BDC use was primarily equity, venture equity, and I can't tell you how they traded back in the eighties and nineties because I wasn't in the business. But when I got in the business a lot of those funds just had very wide discounts, and probably of note, Capital Southwest, which is the only BDC that's in my dad's 1991 book I brought because it's fun to pay homage to his career, converted to a debt-based BDC in a very successful process as an internally managed BDC.

So I would say that basic level, I always tell managers, "There's some funds that aren't levered," and I'd say, "You should at least do tactical leverage." Because as Tom said, you're able to use the leverage in the rapper, and prudent use of leverage at a good price to shareholders is something you can't do in an ETF and open-end fund. And ETFs and open-end funds are fine structures, but I'd say you got to maximize the closed-endedness of your product. And the illiquid, and the private, and the senior loans are very, very useful, but it's been so far hard with an 80% retail shareholder base to get them comfortable with private marks on the fair market values of a portfolio. Which I think is why there's been such success in the interval, I'm going to call it Share Post, I can't remember the new name of the fund, apologize. They're a speaker today, Christian, and their fund is a beautiful use of the interval fund wrapper.

Kim Flynn: Private Fund Shares.

John Cole Scott: Private Fund, thank you. I've known them too long, I know their previous name. And so beautiful use and a great product, and doing well and calculates its NAV daily. Again, a great use of the interval fund wrapper and you could not see that as a listed closed-end fund in my opinion, even though you should. In our current environment the way our investors treat the market, I just don't think you can.

Kim Flynn: So John and Tom, Randy and I were just talking about Angel Oak, and I always point out Angel Oak as being a good example of what the listed closed-end fund market needs to see more of, meaning alternative managers who are new entrants to the listed market. And I think as Tom was saying, we see so many mutual fund clones and that's not going to work in the secondary market.

So what do you think it's going to take for the US-listed market to be more like the London-listed market and feature more of these alternative credit managers, alternative as you were saying, private equity is of interest. What's it going to take to shift the market more in that direction?

Tom DeCapo: Again, my view, it's less of a focus on market discount, and some track record of those managers showing that over the long term, the returns of those strategies if they're allowed to pursue them on an undisrupted basis, are sufficient that they don't need to worry about the discount. Most investors get in in the secondary market and so that discount really shouldn't be an issue to them anyway, it's the IPO market where the discount is really a problem.

But I think the focus on the discount, in part because of the uncertainty about the mark on the valuation, and in part because that's simply what the retail investor has been trained to think about and focus on is the real issue, and the difficulty of bringing that kind of product in a listed format. The other thing that perhaps will happen over time is that there will be alternative liquidity sources for investors other than simply the stock exchanges. And there then maybe focus on that discount and focus on a more trading aspect by retail investors in closed-end funds over to a longer term investment focus might start to happen.

Kim Flynn: Tom, we were talking about blockchain and the recent applications in the registered fund space that you're seeing now. Obviously it's early days for the adoption of blockchain within a closed-end fund structure, but maybe if the audience is just hearing this now, as I was the first time when we talked, so share with us how it works and the benefit.

Tom DeCapo: Sure, I'm excited about it. There are very few funds that have done it, but there are a few funds out there that have basically created a share class, or if they're closed-end funds, their only share class, that are tokenized, so in essence their shares are a type of cryptocurrency. A crypto investor would probably look at it in the view of it being a stable coin. I think from a traditional fund investor point of view it is simply a different place to buy and trade your traditional investment product of funds. And so these funds have used blockchain as a way to establish their shareholder base and as a way to be able to buy and sell shares on an anytime basis, while at the same time having to maintain a traditional shareholdership record and transfer agency record that other funds have.

Kim Flynn: And custody, that's most important given the headlines in the news. So are the custody arrangements the same when you have the blockchain applied?

Tom DeCapo: Right, so from a funds point of view there's a couple of things on custody. There's custody of fund assets, and that doesn't change, the fund still holds its assets with a qualified custodian an the fund asset are completely and totally safe. Then there's the question of how the investor holds their shares, and the funds that have been done so far which really have not become active in peer to peer trading yet on blockchain but are looking to do that, those funds so far you can potentially trade them in two ways.

One is on a crypto exchange off the blockchain, in which case you would maintain them in a wallet like you would other digital assets, and those have the types of custody issues for your holdings that any crypto asset might have that you're holding in a wallet. Or you can trade them like you trade existing fund shares and not do it through the blockchain.

Kim Flynn: And are a lot of new fund sponsors considering this? Is it the novelty? Is it solving some problem that we don't have a solution for yet? Is it the transferability? What do you think the main benefit?

Tom DeCapo: I think it depends who you ask. Again, I think from a crypto perspective it's a form of stable coin, it's a coin that's actually backed by assets and so you've seen the crypto market moving a bit toward asset-backed tokens and some more stable asset alternatives. From a fund's point of view, or a fund distributor's point of view, I think is the potential for a new distribution market that they otherwise don't have access to.

And so if you are a crypto investor right now, and that market, there's some estimates of that market that are quite huge. There are estimates that the crypto market that the daily crypto volume is roughly a third of the New York Stock Exchange volume. Some people question whether that's real or not but it gives you at least an order of magnitude, it's a big market. So if you're in that market and you want to take your money out of crypto and move it into a more traditional investment, you need to get it off that exchange, you need to convert to cash, you need to get it into a brokerage account, and you need to buy what traditional investment you want to buy.

Having the ability to make that move on the crypto exchange without having to go through that process is a real efficiency, and I think from a fund sponsor point of view and a distribution point of view, it's access to a pool of capital for investment in the funds that otherwise has many steps in it. The blockchain also enables a different and more efficient method of reporting, and so funds can report out their holdings, their transactions, on a continuous basis through the blockchain in addition to their normal SEC reporting requirements that takes place through SEC filings. And so it's also a transparency of information on the operation of the fund that happens on a real-time basis, or that can happen on a real-time basis.

Kim Flynn: I think, Tom, you're touching on too, there's a push that we're seeing in the interval fund space on direct-to-consumer FinTech platforms, so maybe we'll circle back. I can understand why we'd be trying to broaden the buyer base for some of these listed closed-end funds, because it really is entirely wirehouse-focused at the present time.

Tom DeCapo: Right, and if you look down the road, and if it's the case that people begin to look at closed-end funds as really longer term investments that are designed to take advantage of those less liquid asset classes and professional leverage, not as a daily trading vehicle, then you can begin to look to something like being able to trade on a crypto exchange as a kind of backstop to a long-term investment. If you need to get out, even though you anticipated holding it for 10 or 15 years, you have that market there. It's not a liquid daily traded market, but it is there for a way to dispose of something that was meant to be a long-term investment. You're not stuck in it permanently, you might take a discount to get out but you have that option of another form of liquidity.

Kim Flynn: Maybe we'll transition to talk about interval closed-end funds. But before we do, Steve, are there any regulatory developments that investors and fund sponsors should be thinking about in the closed-end fund space? I know a lot of us are dealing with the new SEC marketing rule, what should we all be focused on?

Steve Flantsbaum: Yeah, I think it's no surprise to anybody here that the SEC has been very active in rule making. I think it's somewhat fortunate maybe for this audience that most of it is focused on private funds instead of registered funds. But there is a flurry of registered fund focused rules, the Names Rule I think is particularly important. The comment period ended for that so we're synthesizing the comments. The recent proxy on a shareholder proposal rule, that's something to focus on. 13D, 13G amendments, that's also an area of focus for us. And also just keeping abreast of all the rules that the SEC puts out, because that kind of gives you the idea of where the Commission's thinking is going and what the areas of focus will be, even if it's private funds.

And then the last thing I'll mention, and maybe this is not as particular to closed-end funds but it is for interval funds and BDCs, is co-investments. Right now we're seeing an incredible rise in negotiated investments as compared to liquid investments, and it wouldn't be a surprise to anyone here, you probably have co-investment exemptive relief or are thinking of applying for it. My words of advice would be find the right precedent, don't start from scratch. But also don't just pick any precedent you can find, that precedent has to be molded to your specific position, your specific business. And we have a process for processing these applications, so it would be very helpful for us if you start with the right precedent and accurately disclose how your business operates.

Kim Flynn: Great. So we've seen a ton of growth in the interval fund market. My firm uses the data that John's firm provides. We do a quarterly insight pack on the interval fund market and we're seeing a lot of new entrants, particularly in the area of private equity and venture capital where there's a lot of demand for alternatives. I think that the SEC frankly has been very helpful, constructive in the registration process. I think that we want to see alternatives packaged in the right structures, and the closed-end fund structure, be it listed or interval, is the right structure. So I think it's interesting we now have over 160 funds that are either interval or tender, about half the market is interval and half the market is tender fund.

So maybe I'll go to John, what do you attribute the growth in asset flows but also the rise of new entrants?

John Cole Scott: Yeah, so at a basic level, what we're seeing structurally in the US market is that a lot of people are self-directing their assets. There's less pension assets which would be a private fund general focus, and if you don't have accreditation or the desire to be in the LP or the non-registered fund space, there's a lot of demand for investments that are able to be a $5,000 in grandma's IRA, a $50,000 in your trust account. Really, really useful access. And so I think the demand is really the driver there.

And then when you think about it, there's a lot of people, and honestly when I first heard about interval funds I go, "That's a horrible idea. Who would not want to be able to trade and be stuck in the fund?" But as I dug in and watched product develop, and we find whether it's the BDC landscape or the interval fund landscape, or even the closed-end fund, over time competition is good. Competition amongst wrappers and having platforms require a good thesis for the investment is a positive thing for investors.

So the fact that you can have 80%+ illiquid guts and put it in a smaller account, and have a daily net asset value. And while no investment manager is perfect, the fact that these are registered products, where SEC is looking at them, FINRA's looking at them, there's an independent board, nothing's perfect, no fund is ever perfect, but much better than a murkier hedge fund or LP or private fund strategy. Like I said, we're seeing more growth there because there's demand. And while I think ETFs can do a great job for simple things, the best use of a closed-end fund, BDC wrapper is the more complex things.

Steve Flantsbaum: And if I may just add, this is where investor education becomes very critical. I recall a few years back, maybe interval funds were not as popular and maybe some of the feedback was, "What is this type of product?" Now we're seeing more and more demand for interval funds and I think it is because of the investor education. So managers, talk to the RIAs, the end-investors if you can, educate them on what an interval fund is, what purchase is, all the nuances of an interval fund. So I think that contributed to greater demand.

Tom DeCapo: Yeah, and I would add I think there's been an evolving view toward valuation on the regulatory front. If you go back 10-15 years, the view of the difficulty of valuing private illiquid holdings in a product that had in and out cash flows was such that it was very hard to get those products approved and many managers were simply very concerned about bringing them and taking on that responsibility and liability for pricing. Over time that view has loosened up a bit and people have gotten more comfortable with the valuations that are based on estimates of value as opposed to market quotes. And hopefully that will continue, but it's also the kind of thing that could in the event of a market crisis kind of reverse itself.

John Cole Scott: Yeah, I would say that really looking at simple things, like when I first got in this business closed-end funds were called stocks in every client statement. Some platforms have gotten better at putting them as ETFs, and some actually put them as closed-end funds. Interval funds are still, at least for our client statements, showing as mutual funds. And it is unfortunately remiss to that retail client when they try to sell it the next day and they go, “Well no, we have to wait 90 days because it’s not a mutual fund, it’s an interval fund.”

It’s hard to convince custodians to do that. I always chat with larger platforms, the larger fund sponsors because they have more weight than I do, to please encourage those custodians to properly bucket these in the client statement. Because that’s a basic, simple thing that does take some work but will make sure there’s understanding of the structure in their portfolio.

Kim Flynn: I mean, those two topics are connected, the daily NAV and being able to have your interval fund on the NSCC Fund/SERV platform which is used for mutual fund ticketing. Most of the private credit funds for example are daily NAV and can be sold to non-accredited investors for that reason, because there’s an ease of use with those.

Now Steve, you focus on the private credit space. What are you seeing? The private credit funds got an early start in terms of their growth, probably because they were paying current yield and people didn’t need to wait to see a track record develop. What are you seeing with private credit? And are you seeing crossover sponsors between the BDC space and the private credit space?

Steve Flantsbaum: Yeah. Yeah, we certainly do. We see a lot of concentration in the BDC industry and the interval fund industry that specifically focuses on private credit. I think just off the top of my head statistics, the top five or 10 BDCs or interval funds own more or issued more than 50% of their respective market shares, so it is incredible concentration there. And it is really interesting to see the dry capital that private equity managers that have credit affiliates are able to put into work. It’s also very interesting to see how the loan market responds to that, especially in the light of decreased issuances in the leveraged loan space and the increasing dry capital that private credit managers can provide.

Kim Flynn: Tom, in terms of funds that have been successful in the interval fund space, right now we’re seeing proof of concept in that part of the market with 20 funds north of a billion, 10 funds north of three billion. So I think we have a lot of fund sponsors looking at the success of some of those earlier interval funds and now they’re saying, “Well, I want to enter, what’s the best way to do that?”

What advice do you give clients, Tom, when they’re thinking of entering the interval fund space? I know you work with a lot of BDC and REIT clients as well.

Tom DeCapo: Obviously distribution. It’s one thing to be able to have the resources and ability to manage a particular type of fund, but when breaking into a new product type, the ability to have the distribution to raise that fund is obviously critical to success. And so that is the most important thing to talk about when a client comes and says, “We’d like to start doing a new product type,” of whatever it is, including interval funds.

Kim Flynn: It’s refreshing that you say that though, because we always advise people they’ve got to start with marketing a distribution because it takes the longest. There’s so many interval fund sponsors, they say, “We’re just going to get on file with the SEC. We’re going to get started that way,” and then many of the filings or the funds sit there without assets, they languish. Are you seeing anything that fund sponsors are doing to de-risk the launch or to get a jumpstart on the process?

Tom DeCapo: Some will start, in particular if it is an advisor that has an existing private client base, some will start by seeding those funds with their own small existing investor base so that the fund is at a critical size before it actually launches that public offering. And I think that’s very helpful because it brings the fund to an operational size and it allows other investors to come in without the concern of the weight of the expenses that the fund will bear. And obviously not unique to interval funds, but obviously the advisor being willing to wave management fees and to pick up some of the operating expenses until the fund gets to a critical size through fee caps, et cetera.

Steve Flantsbaum: Excellent points, and I would emphasize that disclosure here is very important. Tom, you mentioned seed investors, I think it is important to disclose anything material with respect to seed investors, any type of investment arrangements before a launch. Obviously very critical to start having the yield right away at fund launch, so if there are any arrangements, warehousing arrangements, investment arrangements have to be disclosed. Please talk to us. We have seen certain variations of these types of deals, so we really encourage you to talk to us, to the person who’s examining your registration statement.

And one more point of emphasis here is when something novel is done, please come to us with a legal analysis and not just ask the question, “Is this okay?” It would really help us, because then we can confirm the legal analysis with you.

Kim Flynn: Yeah, I think, Steve, this is really important what you’re saying because more and more fund sponsors are getting creative in the launch of these funds working with seed investors or lead investors to get capital. And a lot of these arrangements have been done off book and they haven’t been disclosed properly, and that’s not going to work going forward. But I do think we’re going to continue to see the trend of these type of arrangements, so disclosure is so very important.

Our firm, we work with Skadden, Tom’s firm, and I’ve always appreciated the advice that they give. But I think Tom and Steve are highlighting there’s a lot of bad advice I think that fund sponsors are given on launching interval funds. I heard from a client that they were told interval funds are cheap and quick to launch. And I was like, “Well, that’s really funny because I guess you could make the case that it doesn’t cost that much to pay the lawyer to launch it.” But as Tom was saying, it’s really expensive if you’ve got a fee waiver on for 18 months. And it can be quick to get on file with the SEC, but if you haven’t been thoughtful about getting seed capital or maybe potentially raising a private fund on the frontend, unfortunately once you’re on file some of those options are no longer available to help scale the fund. So I think these are really important points.

John Cole Scott: I would just chime in that the only cheap, easy wrapper I know is a UIT wrapper. If anyone has five million dollars you can get one done in three weeks.

Kim Flynn: So that's the only thing cheap and easy, is a UIT?

John Cole Scott: Well no, it's amazing, such a simple structure. We have a BDC UIT so I'm familiar with it since '14. And yeah, definitely the interval fund may seem easy versus a private fund but it's definitely different. I would love to make sure we have time for audience questions and I am looking at the clock.

Kim Flynn: Before we leave, anything that we need to cover on the BDC space? Any trends worth noting or regulation in development?

Steve Flantsbaum: Yeah, I think without mentioning any specific entrants by name, but there was one in 2021, it was a non-traded BDC that is changing the market a bit. So the trend, at least that we're looking at the SEC, if there's a fee compression on the BDC side, and how again the dry powder of the private credit market is affecting the leveraged loan space.

And also one thing to highlight between interval funds and BDCs, it's important for the investment manager to choose the right product for them. And for that, at least from the regulatory side not necessarily from the distribution side, be aware what regulations are applicable to the funds. What are you required to comply with? So for BDCs, managerial assistance obviously very important, 70% qualifying asset test is obviously crucial so you invest in US businesses. And the repurchases, interval funds are required a certain level of repurchases, BDCs you can change it a bit somewhat. So see what your investors want, what the regulatory requirements are, and choose the right product.

And also leverage, I know we talked about that in the beginning, that BDCs do allow more leverage. So see if that's something that's applicable to you.

Tom DeCapo: Yeah, and affiliated transactions.

Steve Flantsbaum: Absolutely.

Tom DeCapo: Right, yep. So if you're a shop that has a lot of involvement already, not through registered funds, in that asset class that you're going to, BDCs might be a little more friendly.

John Cole Scott: And I would just add, we actually dabbled in BDCs probably before they were really well known. My dad used them occasionally for clients. I love the fact that we have much larger, experienced credit managers. Yes, there's nice nichey funds like Capital Southwest or Hercules and others that are just in the sector, but the resources to deal with issues which we saw in 2020. I mean, 2020 was really, really scary for BDCs. They went down almost as bad as they did in '08 and '09, but they recovered because of the resources of the platforms and the commitment to the shareholders and to the NAV, and they all did it different ways.

And we kind of covered this in the BDC panel we did a year ago but it's nice to see that should the future storms come, the wrapper has proved durable, the managers have proved resilient, and shareholders. And while we can never take away volatility in a listed structure, I do try to tell our clients that volatility is not risk, it is opportunity. And if you want to be in a listed product, they're really pleased to see the success of going through the last big fire and the results that they were able to give shareholders.

Steve Flantsbaum: Yeah, an example of what came about from the Covid crisis was the follow-on exemptive relief, which was incredibly successful and it helped a lot of funds manage their portfolio companies through the crisis. And that relief was recently made permanent, you have to apply for it but that is I think a great example between the industry and the regulators where you highlighted a need to us and we worked with you to fulfill that need.

Kim Flynn: Dan, you've got a question?

Audience: Yeah. It's about AFFE. [inaudible] it certainly seems like everyone's asking for it. What are the scenarios [inaudible]?

John Cole Scott: So this is AFFE, yes.

Kim Flynn: What is the abbreviation?

John Cole Scott: Yeah, the acquired funds fee.

Steve Flantsbaum: Yeah, it's the Acquired Fund Fees and Expenses and disclosure of such fees and expenses. And unfortunately I can't talk about this, this is probably the first time I'm saying that as a regulator on a panel.

Kim Flynn: But Dan, what's the heart of the question? Are you concerned about the way acquired funds are disclosed?

Audience: Certainly with the BDC space right, that's an issue, [inaudible]. I think everyone's curious, well, is it [inaudible], but also what's the perspective of regulators? Is this a big priority? Is it just like, "Hey, we'll get to it whenever"? [inaudible 0:47:50].

Kim Flynn: Sounds like they're working on it.

John Cole Scott: What I can say is if you look at a BDCs expenses like an ETF, it ends up being around a 10% expense ratio. And in our UIT product it's not on the front of the fact card, it's in the prospectus. I think I've had three advisors comment on it. One thing we like to do at our firm is do gross non-leverage expense ratio, because BDCs have so much gross assets, usually about 20% more than the average taxable bond fund, and their leverage is more expensive, as it should be for venture loans. Even though there's a great success in their use, they're not as easy to lever as a muni bond.

So I think when you find a private fund that's gross non-leverage expense ratio in two and change, it's a good piece of information that challenges the way I understand the 40 Act. The only non-attorney I'm assuming on this panel, is that you have to show it the way the 40 Act is designed and that fund comes higher to the expense ratio of exchange traded products like ETFs. So it's harder to convince these funds to want to own these in BDCs, which I think happened in 2014 was the removal of BDCs from the S&P 500 and other indices.

So I would love to see it happen. Because in my opinion, if it's in the universe available for indices, it widens the investor base to other institutional investors. As you'll hear from Mitch and others later, more institutional investors in BDCs is really useful because we vote our proxies and we push on management. Retail does a great job but they're not generally speaking to these CFOs directly.

Kim Flynn: Another question.

Audience: For Tom and Steve, maybe they're related, but you mentioned the change to litigation about activist investors. And then Steve, is that related to the 13D and G changes you're making as well?

Tom DeCapo: The litigation I was referring to are challenges to some of the corporate governance options that are available to funds in part as a result of changes in state law. I would love to see the SEC take a stronger view on Ds and Gs as it relates to activists. I don't know if there's any such thing going on.

Steve Flantsbaum: Yeah, I think in the rule, one of the purposes is to modernize the timing. The timing is a big lag on disclosure, so that's really one of the purposes that the rule was released.

Audience: Question for Steve, slightly different subject perhaps. Is there any concern at the SEC regarding what I would call client boards of directors of both closed-end funds and mutual funds where it certainly can be questioned whether the board is acting in the interest of the fund managers or the shareholders?

Steve Flantsbaum: Right now I think I would have to refer to the exam priorities list, but it is something that we look at.

Kim Flynn: Great. Well, thanks everybody, we're going to I think move to the credit panel now.

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