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Consider This: Interval Fund Operational Practices

ICI Broker/Dealer Advisory Committee
Interval Funds Task Force

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Introduction

Interval funds are continuously offered closed-end funds that redeem shares by making periodic repurchase offers ("tenders" or "redemptions") at net asset value (NAV) in compliance with Securities and Exchange Commission (SEC) Rule 23c-3 under the 1940 Act, as amended in 1993. They differ from other closed-end funds that do not offer regularly scheduled liquidity (shares are generally sold on a secondary market at a price that could be at a premium or discount to the NAV). Interval fund purchases resemble open-end mutual funds in that their shares typically are continuously offered and priced daily.[1]

Interval fund offerings are growing rapidly in the mainstream market, placing stress on current industry capabilities to efficiently and effectively support interval fund operations. These headwinds are felt across the servicing environment, arising from interval funds' unique combination of operating characteristics that do not fully align with prevailing technologies and related service models used for either closed- or open-end funds. Disjointed processes, manual strategies to compensate for lack of automation, and inefficient processing models are a direct result of these factors.

In June 2019, the Investment Company Institute (ICI) published *Interval Funds: Operational Challenges and the Industry's Way Forward*.[2] The white paper, authored by a task force of ICI's Broker/Dealer Advisory Committee (BDAC), summarized operational challenges in supporting interval funds and provided a call to action for the industry to develop recommended practices regarding common interval fund activities.

Consider This: Interval Fund Operational Practices is the task force's response to this call to action. It expands on topics raised in the original publication, outlining general considerations for interval fund counterparties (e.g., fund managers, intermediaries, and their respective service providers) to efficiently and effectively support interval funds and fund shareholders. Each of the seven major subject areas are briefly introduced and then discussed from both an intermediary and fund perspective to highlight the importance of how counterparties must work together to achieve optimal operational efficiencies in interval fund operations.

Methods of Trading

> Consider this: A fund's decision on how to receive interval fund trades may affect product distribution and the features its interval funds offer to the marketplace.

Intermediaries and funds often use a combination of trading methods in support of interval funds. Three of the most common methods include the following:

- **DTCC Alternative Investment Product (AIP):** Launched in 2008, the AIP is offered by Depository Trust & Clearing Corporation (DTCC) Wealth Management Services. AIP is designed primarily for use by unregistered alternative investment products and other registered products that have limited liquidity or are not continuously offered.

1 See SEC Rule 23c-3 for information on the structure and characteristics of interval funds.

2 Available at www.ici.org/pdf/19_ppr_interval_funds.pdf.

- **NSCC Fund/SERV®:** Created in 1986, National Securities Clearing Corporation (NSCC) Fund/SERV is the industry utility for processing open-end 1940 Act–registered funds, UCITS, and insurance product transactions. Fund/SERV facilitates high-volume, efficient processing, and automatic net money settlement for fund companies, broker-dealers, banks, trust companies, third-party administrators, and insurance companies.
- **"Check and Application":** This method involves paperwork submitted directly to the fund's transfer agent, the primary recordkeeper of shareholder accounts. Activity is delivered by mail, fax, or phone and processed by transfer agent staff, including the opening of new accounts and all transaction processing.

Each alternative has strengths and weaknesses when supporting interval fund operations. When deciding which trading methods to support, funds should consider the following:

- opportunity for straight-through processing of trades,
- level of integration of related technology into the intermediary or fund back-office operations,
- ability to support unique product features, and
- compatibility of product features with other mutual fund products alongside which interval funds are often sold.

Straight-Through Processing

The AIP and Fund/SERV platforms are the most commonly used platforms to trade interval funds. Each has been designed to deliver efficiencies in straight-through processing of new accounts and trades, including clearance and settlement activities.

- **New accounts:** Both AIP and Fund/SERV support the creation of new accounts.
- **Subscriptions:** Both AIP and Fund/SERV support the submission of subscription records. AIP allows current- or future-dated trades to be submitted by the intermediary and warehoused by the fund, if necessary. Fund/SERV supports current-dated interval fund trade submission.
- **Repurchases:** AIP supports future-dated repurchase functionality. Fund/SERV supports current-dated interval fund trade submission.
- **Settlement:** AIP offers trade settlement through each counterparty's banks and settles debits separately from credits. Fund/SERV is included in net settlement obligations along with other DTCC products.
- **Reconciliation:** Both AIP and Fund/SERV, via its companion service, Networking, support investor-level reporting of activity and position data. AIP supports electronic document delivery along with trades.

The check and application model is the most broadly supported but least-efficient option of the three. Manual processing by the transfer agent is sometimes necessary with complex products and requests, or in handling trade exceptions or corrections. For some interval funds, check and application is the only way investors can purchase and transact an interval fund.

Integration into Back-Office Operations

Many shareholder accounting systems offered by funds and intermediaries integrate either with AIP or, more commonly, Fund/SERV.[3] As a result, interval funds traded through Fund/SERV may not be able to be easily distributed by intermediaries that are only integrated with AIP for interval funds, and vice versa.

To bridge the potential gap in distribution, some fund companies have taken operational steps to support interval funds on both platforms. This requires all fund-level activities to be duplicated, including the declaration and payment of dividend and capital gain distributions. Additionally, funds must merge the trading and reporting activities from both platforms within their own operation. While Fund/SERV trades are part of DTCC's combined net settlement process, AIP trades are not; therefore, using both requires dual settlement processes on different time schedules. Accommodating for these differences is costly and time-consuming—but necessary if pursuing a dual-distribution strategy.

Funds and intermediaries use the manual check and application model daily to handle requests that cannot otherwise be managed in an automated fashion. While not operationally efficient, the check and application model is not dependent upon integrating with a platform such as AIP or Fund/SERV and is readily available. However, some organizations may find robust quality control measures are necessary to ensure processing accuracy.

Product Features

Asset managers often strive to differentiate their interval fund products by offering distinct product features. Most notable is the use of subscription intervals, used by a small number of interval funds to receive subscriptions at certain times. Presently, AIP can support subscription intervals, while Fund/SERV requires all funds to be continuously offered (i.e., priced and available for daily subscription). Some interval funds are offered under a traditional sales load schedule, where a front-end commission is paid when acquiring shares. Fund/SERV has very robust support for multiple commission models; AIP has more modest capabilities in that regard.

Fund Family Features Compatibility

Often, interval funds are offered as part of a comprehensive portfolio of fund products sponsored by the asset manager. In some instances, it is important for the interval fund's recordkeeping platform to be closely aligned with the fund family's other products to derive any eligible commission discounts or to facilitate exchanges between products within the fund family. These needs may dictate which trading method(s) may be required or are unable to be supported.

In the case of product and fund family features, funds will select attributes that can be supported by their shareholder accounting systems, and, by extension, their check and application trading method. Because intermediaries are not recordkeeping the shareholder position in a check and application model, they have fewer system demands placed on them. Regardless, it is important for both funds and intermediaries to understand the product features of an interval fund to make sure they align with the capabilities of the trading methods supported by the asset manager and offered to intermediaries and shareholders.

[3] In limited instances, both platforms are supported.

Trading Methodology Comparison Table

The following table summarizes the three primary trading methods, highlighting general characteristics and considerations of each.

	AIP	Fund/SERV®	Check and Application
Account opening	» Intermediary submits 025 registration record for automated setup. » No paperwork required.	» Intermediary submits NSCC Networking B50 or Fund/SERV 400/401 for automated setup. » No paperwork required.	» Paperwork submitted by intermediary or shareholder to transfer agent (TA) for manual setup.
Subscription	» Intermediary submits AIP 001 purchase order. » Paperwork may be required.	» Intermediary submits Fund/SERV 001 purchase order. » No paperwork required.	» Intermediary or shareholder submits paperwork to TA. » May be required to separately arrange electronic payment. » Activity manually processed.
Repurchase	» Intermediary submits AIP 001 redemption order. » Trades could be submitted throughout the repurchase period. » Paperwork may be required.	» Intermediary submits Fund/SERV 001 redemption order. » Trades must be submitted on repurchase NAV date. » No paperwork required.	» Intermediary or shareholder submits paperwork to TA. » Fund may be required to separately arrange check or electronic payment. » Activity manually processed.
Settlement	» Automated stand-alone settlement occurs via AIP, according to fund settings (e.g., T+2, T+3[4]).	» Automated net settlement occurs with other DTCC products, according to fund settings (e.g., T+1, T+2, T+3[5]).	» Settlement occurs by check, wire, or Automated Clearing House (ACH) according to fund settings (e.g., T+1, T+2, T+3).
Trade confirmations and sales data	» AIP files are shared between intermediaries and fund managers.	» NSCC Fund/SERV and Networking files are shared between intermediaries and fund managers.	» Confirmations and statements are mailed or provided electronically, based on shareholder election.
NAV frequency	» May vary by product.	» Must be daily.	» May vary by product.

[4] Settlement on trade date + three days (i.e., T+3) is the most common AIP platform settlement cycle.

[5] Settlement through Fund/SERV typically occurs after one or two days (i.e., T+1 or T+2).

Scheduling Repurchase (and Subscription) Periods

Consider this: A fund's decision on when and how long to permit repurchases is critically important to managing operational risk and could directly affect the overall demand for the interval fund. The same considerations apply to subscription periods,[6] which are available but not commonly used.

A fundamental characteristic of interval funds is the use of repurchase periods when the fund will buy back shares held by shareholders—set by number or percentage of outstanding shares. Less commonly used, but also available, are subscription periods when shareholders can purchase shares from the fund. The end of each interval period coincides with a repurchase processing date or the periodic subscription processing date, respectively, when shares are transacted, and shareholder accounts updated.

Fund managers select repurchase and subscription frequency, dates, and duration based on product needs and other factors, such as managing portfolio liquidity. When selecting periodic subscription and repurchase periods for an interval fund, consider the special handling required operationally by all counterparties (funds, intermediaries, and service providers) to support each period. Some of those issues include the following:

» Enabling system processing of certain types of transactions when a period begins and systematically blocking them when the period ends. These changes may be required on the shareholder recordkeeping system (e.g., transfer agent system; broker-dealer subaccounting system) as well as for trading methods used by the interval fund and are designed to avoid incorrectly accepting transaction activity outside a repurchase or subscription period.

» Updating personnel that they could accept trades during an open period, including updated phone scripts, and changes to voice response recordings and shareholder self-service trading options through online (internet-based) trading.

» Ensuring all trading deadlines are understood throughout the operation regarding order delivery to the fund, order processing by the fund, and any need by the fund for proration.[7]

Operations teams will be challenged by the level of time-sensitive interval fund activity on subscription or repurchase processing dates. Funds should consider scheduling these dates away from other operationally burdensome days to reduce risk of errors or delays. In addition, funds should consider the following when determining frequency, dates, and duration of interval fund subscription and repurchase periods:

» **Month-/quarter-/year-end:** These are high-volume processing periods for transactions, dividends, statements, and commissions. Managing a subscription or repurchase period-end at this time is especially difficult and introduces additional operational risk that may not otherwise be necessary.

[6] Most interval funds are continuously offered, meaning they have open-ended subscription periods. For these interval funds, subscription period comments largely do not pertain.

[7] In some instances, shareholders' requests in response to a subscription or repurchase offer may exceed the allotted number of shares permitted by the offer. In those instances, shareholder instructions in good order will be subject to proration. All requests will be proportionally adjusted so they, in total, equal the total maximum shares the fund offers during the subscription or repurchase period. Corresponding shareholder transactions are processed for the adjusted amounts.

» **Other possible overlapping activities within the fund complex:** Activities such as fund distributions (e.g., dividend and capital gains) and corporate actions (e.g., fund closures/mergers, returns of capital, reverse stock split) that fall on subscription or repurchase dates introduce additional processing complexity and risk.

» **Adjacent holidays:** Consider that shareholders, financial representatives, and intermediary back-office representatives often take vacation time around holidays; in addition to fewer staff members, many firms (often) have less-tenured staff available for support during times with heightened out-of-office activity. Scheduling subscription or repurchase dates so they are not adjacent to holidays may reduce the risk of counterparties missing these dates, and the operational risk associated with holiday staffing.

» **Duration:** Consider how long the subscription or repurchase period should be. Regulations permit periods of up to 42 days; this may be sufficient or considered too long based on the number of intervals offered during the year. Duration may also influence or be influenced by the trading method(s) used by the interval fund, where automation may allow for shorter intervals.

Communication

Consider this: The combination of greater operational complexity and less operational standardization than the typical open-end mutual fund product makes effective communication about interval fund operational activities extremely important. Thankfully, there are new tools to help funds communicate vital operational details with efficiency and consistency.

Attributes of interval funds are unique and almost always vary from fund to fund. Clear and concise communication of these details to the appropriate stakeholders is key. While funds and intermediaries often communicate about complex operational practices such as corporate actions (e.g., fund closures, mergers, or stock splits), the operational complexities of interval funds highlight additional considerations when it comes to ongoing communication between fund managers, intermediaries, and service providers—all on behalf of interval fund shareholders.

Consider Communicating

» **An annual calendar:** With a recommended practice to send in October or November for the upcoming year, the calendar should include repurchase and subscription periods, as applicable. Funds may want to investigate using the Interval Fund Transaction Schedule from DTCC's MF Info Xchange[8] solutions, or automated notifications provided by third parties, as standardized methods to communicate dates and other interval fund details (e.g., proration factors) to counterparties.

[8] DTCC's MF Info Xchange facilitates, standardizes, and centralizes the delivery and receipt of timely operational notifications between firms and funds. The service includes an event calendar for receivers to view date-critical events, including event details. See www.dtcc.com/wealth-management-services/mutual-fund-services/mf-info-xchange for additional details.

- **Upcoming repurchase dates:** Notify stakeholders on or around the repurchase or subscription filing date, or the date in which the period opens. Funds may also consider sending reminders a week before and the day before the repurchase or subscription processing date. There are also attributes within the DTCC Mutual Fund Profile II: Security Issue database that help define key characteristics of interval fund repurchase periods.[9]

- **Proration events:** Communicate with operational counterparties as early as possible when the fund is aware that proration is most likely required. In many instances, communication may not be possible until early in the morning following the repurchase process date; however, funds that require binding notification of trading, or that receive courtesy prenotice regarding trades, may know sooner.[10]

- **Corporate actions:** Depending on the complexity of the change, consider 60 to 90 days' notice. Funds and intermediaries often use system controls to tightly restrict interval fund–related activities outside of repurchase or subscription periods and must take additional steps to enable processing of a corporate action (e.g., stock or reverse stock split, return of capital, fund merger or closure).

- **Unexpected market closure (UMC):** Fund managers should determine and communicate how a UMC will affect interval fund operations (e.g., trading deadlines, extensions). The ICI *Mutual Fund Operations Planning Guide for an Unexpected Market Close*[11] may be used as a guide for discussions.

- **Contact information:** Because interval fund communication with the fund is especially important, intermediaries should ensure contact information is periodically reviewed and updated with the fund.[12]

  - Consider providing the fund with a distribution list, as opposed to individual email addresses, to receive electronic communications.

  - Consider providing a common customer service telephone line and, if possible, secondary number(s) for funds to use.

  - Intermediaries and service providers should engage proactively to confirm the correct distribution list(s) are identified prior to executing the communications.

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9 DTCC's Mutual Fund Profile II: Security Issue database is a central data source of comprehensive fund prospectus and operational rules. See www.dtcc.com/wealth-management-services/mutual-fund-services/mutual-fund-profile-service-ii for additional details.

10 The asset manager must await receipt of all trading activity before the need to prorate is confirmed. This often includes intermediary requests for price protection due to delays in their processing that are typically not received until early in the morning following a repurchase process date.

11 Available at www.ici.org/pdf/19_ppr_marketclose.pdf.

12 Funds should provide updated contact information with each interval fund repurchase or subscription period, as described in the "Repurchase/Subscription Period Communication" section on page 8.

Repurchase/Subscription Period Communication

The task force recommends incorporating the following attributes into a robust communication regarding repurchase or subscription periods, as applicable:

- Fund identifiers:
  - Fund name
  - Fund identification number at the transfer agent
  - CUSIP
  - Ticker symbol
  - Share class
- Repurchase/subscription period start and end date.
- Repurchase/subscription trade date, NAV date, expected settlement date.
- Pre-notification requested (Y/N), pre-notification required (Y/N), pre-notification due date.
- Repurchase/subscription offer limits, pro rata percentage filled, and repurchase/subscription NAV.
- Fund manager contact information for pre-notifications, inquiries, trade, and other general requests.

Repurchase/Subscription Period Communication Methods

- Website: Often, intermediaries and other stakeholders will attempt to answer questions themselves by accessing the fund's website for information. Funds should ensure the interval fund's repurchase/subscription period calendar is available, visible, and accessible by shareholders and advisers.
- Email: Fund managers should communicate interval fund repurchase/subscription period details with consistent information across their common distribution channels and to their daily contacts. Fund managers often have back-office operational contacts they regularly communicate with and may not be aware of the second- and third-tier intermediaries and advisers that place trades through the intermediaries' back offices.
  - In some cases, fund managers work closely with introducing broker-dealers (IBDs), approve each IBD for trading, and communicate directly with the IBD.
  - In other cases, fund managers do not require the approval of each IBD for trading and may not have visibility to adviser-level contact information at IBDs.

  These model distinctions must be understood by the fund and intermediaries, including underlying roles and responsibilities regarding who owns the communication by "tier."
- Industry tools: Solutions such as MF Info Xchange should be considered when communicating interval fund subscription and repurchase periods, as they offer widely accepted standardization and should contribute to clearer communication and greater understanding across fund managers, intermediaries, and service providers.

» **Platform-specific tools:** Certain servicing platforms have developed interval fund communication templates, and their use may also be requested by certain intermediaries. Fund managers and intermediaries are best served by aligning on communication expectations and workflows prior to the important deadlines of repurchase or subscription periods so each party can implement a successful communication strategy.

» **Third-party vendor tools:** Vendor-supported capabilities may also assist with communication needs across stakeholders. For instance, there are certain aggregation platforms[13] that are leveraged as communication hubs for intermediaries; funds may want to investigate whether including one or more of these platforms as part of their communication plan will reach an underserved stakeholder population.

Trade Corrections

Consider this: Interval fund trade corrections[14] identified outside a repurchase or periodic subscription process date may have significant legal, operational, and portfolio ramifications for related transactions. As a result, those corrections may be restricted, limited, or denied. This leaves the intermediary and its related shareholder(s) subject to market risk and a less-than-ideal client experience.

Continuously offered interval fund subscriptions often follow similar rules to open-end mutual funds, where corrections submitted in good order are often permitted at any time. However, because periodic subscription and repurchase corrections are tied to an interval period with a designated allotment of shares specified in their SEC Form N-23c-3 notice, funds may be required to restrict or deny certain corrections. For instance, a trade that was processed incorrectly may be readily corrected, especially if due to fund processing error. However, there are other instances where trade correction may be less feasible.

An example of a trade correction request where additional scrutiny may be required is when an intermediary fails to deliver repurchase instructions to the fund by the repurchase deadline. If an intermediary misses a repurchase date, the repurchase request may not be able to be processed until the next repurchase date, which could be anywhere between one month and one year in the future. The same would apply for missed periodic subscriptions.[15] Funds are required to have policies and procedures for their trade corrections (often called “as-of” transaction policies) that are reviewed and approved by the fund’s senior management and board of directors.

Because interval fund trade corrections are typically more restrictive, by necessity, than those of open-end mutual funds, intermediaries and funds should consider these steps to minimize the operational, financial, and—most importantly—reputational risk with shareholders that may arise.

[13] Aggregation platforms provide consolidated views to financial representatives about their shareholder accounts across multiple fund complexes. They are sometimes used for other purposes, such as to consolidate and disseminate information about fund products. Other third-party solutions support intermediary back-office communications.

[14] Like all mutual funds, interval funds are subject to rules of constructive receipt, and instructions received in good order are processed at the next available NAV. An interval fund trade correction may be necessary to correct a processing error, to accommodate for delayed delivery by the intermediary, or for other legitimate reasons. Corrections typically require supporting documentation and/or indemnification from the submitting party that justifies the correction.

[15] Generally, interval funds are set up in fund transfer agent systems to accept periodic transactions (repurchases or periodic subscriptions) after market close on the day prior to the end of period processing date. After all processing is completed on the processing date, systems revert to restrict periodic transactions until the end of the next period.

Intermediaries

- Have procedures including a calendar in place to manage repurchase dates, and consider making the calendar available to advisers. For example, solutions such as the DTCC's MF Info Xchange incorporate a calendar feature to display all interval fund transaction schedules that funds provide through the service.
- Establish controls to mitigate trade transmission issues. Common practices include active monitoring for transmission errors, receipt of records confirming transmission receipt from receiving parties (e.g., DTCC, fund), as available, and notifications if certain transmissions have not been sent.
- Understand and communicate typical trade correction procedures and expectations to appropriate associates. Procedures typically are similar in either an omnibus[16] or individual account network Level 3 or trust networked Level 0[17] environment:
  - All trade corrections are processed manually.
  - Corrected trades may remain open two to three business days on average, and sometimes up to two weeks, awaiting trade confirmation from the fund.
  - If an intermediary/adviser fails to deliver repurchase instructions:
    - error positions representing the shares that should have been repurchased are transferred from the client account to an intermediary error account,
    - the underlying shareholder is made whole by the intermediary (e.g., cash proceeds remitted to the shareholder, based on the NAV for the repurchase process date),
    - should subsequent repurchase(s) be subject to proration, an asset may remain in the error account and liquidated over multiple repurchase periods, and
    - all valuation risk associated with price changes, between payment to the shareholder and final sale of share proceeds, are assumed by the intermediary.

[16] Omnibus accounts hold mutual fund shares that are registered with the mutual fund's transfer agent in the name of the financial intermediary. The intermediary maintains the underlying shareholder account information on its own recordkeeping systems—a process known as subaccounting—and typically reports share transactions to the funds on an aggregate basis. The intermediary or its agent handles all communications and servicing of its customer accounts.

[17] Most individual accounts opened on fund transfer agent systems through the NSCC by broker-dealers are Network Level 3 accounts, and those opened by trust companies are Network Level 0 "trust networked" accounts. Accounts are typically opened in the name of the broker-dealer or trust, respectively, on behalf of its customer. The intermediary handles all communications and servicing of its customer accounts.

Fund Managers

- Discuss with your product, portfolio management, and legal teams the types of activity that may negatively affect the fund and shareholders.
- Review current policies governing corrective activity for applicability to interval funds—including any areas that may require clarification and/or update.
- Using policies and activity review as inputs, take the following actions:
  - Set procedures for offering price protection, defining acceptable as-of trade windows, and managing gains/losses experienced as a result.
  - Define what are acceptable requests for requesting trade correction. (e.g., missing the repurchase date, incorrect trade account or amount).
- If there are scenarios where a trade correction cannot be accepted or vary from an open-end mutual fund, be prepared to help the intermediary understand why the correction cannot be accepted. For example, a correction may not be accepted if it:
  - crosses a dividend or financial reporting period (e.g., year-end),
  - causes the fund to cross a materiality threshold, such as creating a NAV error or material gain/loss for the fund/existing shareholders, or
  - would push the interval fund over the level where proration of repurchase or periodic transactions would be required, while such activity has already been paid out.

Share Class Conversions

Consider this: Interval funds are increasingly introducing multiple share class structures to accommodate various distribution models. Unlike open-end funds, however, interval funds may have unique operational constraints and requirements to accommodate cross-class conversions.

Share class conversions are becoming an increasingly popular way for intermediaries to more closely align a shareholder's investments with what is in their overall best interest concerning product features and fees. This is also the case for interval funds. Like open-end mutual funds, intermediaries may elect to offer certain interval fund share classes, and not others, based on their business model.

A share class conversion exchanges the value of shares held in one share class of a portfolio for shares held in another share class of the same portfolio. ICI's BDAC developed *Mutual Fund Share Class Conversions: A Matrix of Possibilities*[18] to describe various approaches to completing a share class conversion. The paper serves as a good resource on how to operationally affect a share class conversion—including both event-driven and ad hoc conversions. However, funds and intermediaries should consider that interval funds may have restrictions on the methods and timing for these transactions, such as:

- Funds may not support exchange transactions through NSCC Fund/SERV for interval funds in general, which means the exchange-based cross-class conversion process described in the share class conversion white paper may not be available for use.
- Funds may vary on the timing of share class conversions involving an interval fund. For instance, the interval fund may restrict share class conversions to the end of a repurchase period, processing all activity on a repurchase processing date. Conversely, the fund may determine that, although the conversion involves a repurchase of shares in one share class of a portfolio, it will permit an "off-period" share class conversion because the overall portfolio value (across all share classes) is not changing.
- Like all share class offerings, both the intermediary and the shareholder must be eligible to use the destination share class. For intermediaries, that may require updated selling agreements with the fund. Shareholder eligibility requirements, as outlined in the prospectus, must also be met.

[18] Available at www.ici.org/pdf/20_ppr_share_class_exchanges.pdf.

Both intermediaries and fund managers should consider the following when determining how they could complete or support a share class conversion on behalf of fund shareholders:

Intermediaries

- Be aware that funds may have varying policies on if/when share class conversions may occur. Policies should be compiled, reviewed with the fund for accuracy, and socialized within the operations and client-facing areas of the organization to provide the best shareholder support possible.
- Establish controls to mitigate trade transmission issues. Common practices include active monitoring for transmission errors, receipt of records confirming transmission receipt from receiving parties (e.g., DTCC, fund), as available, and notifications if certain transmissions have not been sent.
- Have internal policies for share class conversions (fees, suitability, supportability, etc.).
    - How/when are share classes evaluated for suitability?
    - What is necessary to support a new interval fund share class? Are those processes and controls in place?
    - When does the intermediary prefer to complete interval fund share class conversions? On a set schedule? In conjunction with other share class conversions?
    - What is the intermediary’s preferred method for completing the share class conversion?

Fund Managers

- Discuss with your product and portfolio management teams whether share class conversions may negatively affect the fund and shareholders. Is the negative impact mitigated by timing the share class conversion with a repurchase processing date?
- Determine what information related to the share class conversion should be disclosed in the prospectus, as applicable.
- Establish share class conversion procedures:
    - What causes a shareholder to be eligible for share class conversion?
    - What is the minimum amount required for conversion?
    - Is the share class restricted to certain intermediary account programs (e.g., advisory)?
    - Do share class conversions occur at NAV, or are they subject to some form of sales charge or commission schedule?
    - Are there any tax implications for the shareholder from the share class conversion (e.g., is the transaction a nontaxable event)?
    - May shareholders request a partial conversion of their account balance, or must all shares convert from one class to another?
    - What are the timing considerations for executing the share class conversion?
        - Do class conversions occur only on the repurchase date of the “from” fund?
        - If so, how are shares counted toward the repurchase offer amount for proration considerations?
- If there are scenarios where a share class conversion cannot be accepted or vary from an open-end mutual fund, be prepared to help the intermediary understand the parameters governing an interval fund share class conversion.

Fund Exchanges

Consider this: With timing differences between continuously offered subscriptions in some funds and interval fund repurchase periods, many funds have disabled the exchange transaction type involving interval funds. However, exchanges can be an effective tool to facilitate aspects of interval fund transaction processing.

Interval funds may offer shareholders the option of exchanging their ownership from one interval fund to another fund within the same "fund family." In some instances, the exchange may only be permitted between interval funds, while other instances may permit exchanges to/from the entire fund family. Typically, exchanges occur within the same share class, or they may occur between "compatible" share classes (e.g., a money market fund share class that is used as an exchange vehicle for multiple share classes). Interval funds have a distinct challenge in that, while they may be part of a fund family, interval funds are sometimes serviced by separate transfer agents, or by the same transfer agent but on different recordkeeping and/or trading platforms.[19]

Exchange transactions are some of the most complex transactions processed by a mutual fund or intermediary. Exchanges link the sale of shares in one fund with the purchase of shares in another. In a perfect operational context, they are preferred over separate sell and buy transactions to move shareholders between portfolios within the fund family because the exchange will only be affected when both sides of the transaction complete successfully. With sell and buy transactions, one side could process while the other fails, creating cash management issues for either the intermediary or fund.[20] Because of this risk, some funds have disabled exchanges involving interval funds, since the requirement becomes confusing to manage with interval funds for these reasons:

- Exchanges out of an interval fund must coincide with the fund's repurchase processing date, or the transaction will be rejected. Proceeds will not be available to pay for the exchange into the receiving fund.
- Periodic subscription interval funds would have their exchanges-in subject to the fund's periodic subscription processing date, or else the transaction would be rejected. Proceeds from the exchange-out fund would be uninvested and create shareholder servicing challenges.
- In a continuously offered interval fund, exchanges into the interval fund would not require restriction, since subscriptions can be accepted daily.

The variability in how interval funds interact with exchanges causes many funds and intermediaries to avoid using exchanges with them. If managed well, however, the use of exchanges can be quite beneficial to interval funds.

- Exchanges typically track when shares have already been subject to commission or sales charge, allowing processing at NAV or only assessing a differential sale charge or commission, as appropriate.
- Exchanges typically bundle the capability to automatically establish a "like-registration" account in the receiving fund, if it does not already exist.

[19] See "Method of Trading" section of this paper on page 1 for discussion of the common platforms supporting interval funds.

[20] If a sell transaction completes but the buy transaction does not, the fund is paying the intermediary without a corresponding transaction to keep the shareholder invested in the market. Conversely, if a buy transaction completes but the sell transaction does not, the intermediary must pay the fund for the buy transaction without the corresponding proceeds available from the sell.

- Proceeds from exchanges processed through NSCC Fund/SERV are part of net settlement, meaning that the exchange-out and exchange-in amounts will offset each other and only require internal money movement at the fund between the two portfolios involved for reconciliation and funding purposes.

With these facts in mind, intermediaries and funds should consider these points when evaluating how to use exchange transactions in support of interval funds:

Intermediaries

- Be aware that fund managers may have varying policies on if/when fund exchanges may occur. Policies should be compiled, reviewed with the fund for accuracy, and socialized within the operations and client-facing areas of the organization to provide the best shareholder support possible.
- Establish controls to mitigate trade transmission issues. Common practices include active monitoring for transmission errors, receipt of records confirming transmission receipt from receiving parties (e.g., DTCC, fund), as available, and notifications if certain transmissions have not been sent.
- Have internal policies and procedures for exchanges.
    - When is an interval fund exchange the preferred transaction to use?
    - Under what circumstances will the fund process exchanges involving interval funds?
        - Fund support for interval fund exchanges
        - Transaction will not be encumbered by interval fund repurchase or periodic subscription period
    - What system changes may be necessary to support interval fund exchanges?

Fund Managers

- Determine the eligible funds for exchange with interval funds.
    - What funds are considered part of the same “fund family?”
    - Are there limitations to exchanges based on the same intermediary governed by the same selling agreement?
    - Do interval funds eligible for exchange need to be supported by the same administrator and transfer agent?
- Discuss with your product and portfolio management teams whether fund exchanges may negatively affect the fund and shareholders.
- Determine what should be disclosed in the prospectus, as applicable.
    - Compatible funds within the fund family
    - Timing considerations
    - Other limitations, as applicable

- Set procedures based on prospectus filing/disclosures.
  - What causes a shareholder to be eligible for exchange?
  - What is the minimum amount required for exchange?
  - Do exchanges occur at NAV, or are they subject to some form of sales charge or commission schedule?
  - Are there any tax implications to the shareholder?
    - Typically, the relinquished fund will trigger a 1099-B and related cost basis reporting.
  - Can shareholders request a partial exchange of their account balance, or must all shares be exchanged?
  - What are the timing considerations for executing the exchange?
    - Do exchanges-out occur only on the repurchase processing date of the "from" fund?
    - Do exchanges-in for funds with periodic subscriptions occur only on the periodic subscription processing date of the "to" fund?
    - If either scenario applies, how are shares counted toward the repurchase or periodic subscription offer amount for proration considerations?
  - Are there any 22C-2 (e.g., short-term redemption fee or purchase block) implications or early withdrawal charges to consider?
- If there are scenarios where a fund exchange cannot be accepted or vary from an open-end mutual fund, be prepared to help the intermediary understand the parameters governing the use of exchange transactions with interval funds.

Distribution Processing

Consider this: Interval fund distributions (e.g., dividends and capital gains) introduce operational complexity to broker-dealer intermediaries using the omnibus model for shareholder accounting. There are alternatives, however, for funds and intermediaries to work around the challenges and successfully support payment of distributions to fund shareholders.

Interval funds have choices when scheduling their fund distributions. On the one hand, distributions may be scheduled for payment to coincide with a repurchase (or periodic subscription) processing date. This decision, however, introduces operational processing risks and potential latency to processing due to the many other interval fund activities occurring on the same day (e.g., repurchase evaluation for possible proration, processing higher volumes of transactions). On the other hand, distributions may be scheduled off-period, which is beneficial from a transaction management perspective but still does not address a significant operational challenge for omnibus broker-dealers.

Regardless of the date funds select for distribution processing, omnibus broker-dealers cannot leverage their standard open-end fund procedures to fully manage interval fund distributions. As described in ICI's white paper *Estimating Omnibus Dividend and Capital Gains Disbursements,*[21] those procedures typically involve setting the omnibus

[21] The white paper (available at www.ici.org/pdf/20_ppr_omnibus_distributions.pdf) presents how omnibus intermediaries typically manage open-end mutual fund distribution payments, and how funds may use data supplied by the intermediary to more accurately estimate the breakdown between cash and reinvested distributions.

account held at the fund to reinvest all distributions, and then submitting an as-of repurchase transaction early the next morning to generate the proceeds to make cash distribution payments to shareholders electing that option. Unfortunately, fund policies often prohibit interval fund repurchase transactions on any date except the repurchase processing date,[22] so the early morning repurchase transaction is rejected by the fund. This means the omnibus broker-dealer is faced with two challenges: (1) an out-of-balance situation, with fewer shares held, in aggregate, by beneficial owners than indicated by the omnibus account balance at the fund, and (2) a shortage of cash to remit cash distribution payments to shareholders electing that option.

This dilemma typically forces alternative models to support distribution processing, with intermediary and fund often working together to manage the challenges. Alternatives could include the following:

- Following the ICI white paper guidelines on estimating fund distribution disbursements, the fund may elect to estimate the intermediary's cash distribution needs, request the intermediary send a manually submitted trade the next morning, and manually settle and pay proceeds.
- The fund may elect to relax automated trading edits that would allow the intermediary to submit an as-of trade through a trading method that follows typical open-end mutual fund procedures for distributions.
  - Depending on the trading network used, this may require the authorization of additional features to support submission of as-of trades.
  - Funds run the risk that other trades in addition to the expected broker-dealer omnibus intermediary-related distribution transactions could be submitted.
  - Funds would need to ensure such practice(s) are permissible under their approved interval fund as-of trading policies.
- Broker-dealer omnibus intermediaries may determine that most of their interval funds are continuously offered from a subscription perspective, so executing the reverse of their open-end mutual fund process may be more workable for interval funds:
  - Instead of setting the omnibus account at the fund to reinvest all distributions, the intermediary sets the omnibus account to pay all distributions in cash.
  - The intermediary sends the fund an as-of subscription transaction, back-dated to the distribution payable date, to buy back shares for the reinvested shareholders.
    - The majority of interval fund shareholders are believed to reinvest their distribution payments; the buyback approach significantly increases operational risk through the much-larger amount of cash that could *potentially* need to move between fund and intermediary.[23]
    - The buyback strategy works around repurchase restrictions that are typically imposed immediately after the repurchase processing date.

[22] See the "Trade Corrections" section of this paper on page 9.

[23] For distributions processed through NSCC, the net settlement process *should* minimize the cash that must move between counterparties. However, should the intermediary fail to remit its as-of subscription, the fund will be sending a significantly larger cash payment to the intermediary than under the typical open-end mutual fund procedure that relies on as-of redemptions (akin to interval fund repurchase).

With these approaches in mind, broker-dealer omnibus intermediaries and funds should consider the following when addressing the unique challenges surrounding interval fund distributions:

Intermediaries

- Based upon the parameters imposed by repurchase periods, fund policies regarding as-of activity, and the broker-dealer omnibus intermediary's routine dividend processing model, intermediaries must evaluate whether routine distribution processing can take place for interval funds or whether other approaches need to be considered.
- Broker-dealer omnibus intermediaries should ensure that interval fund distribution processing—especially the key differences from open-end mutual funds supported by the intermediary—is well understood, with training provided across operational teams and underlying staff.
- Broker-dealer omnibus intermediaries may engage with fund managers to ensure understanding of the interval fund's processing model. For example, the intermediary may want to confirm whether a repurchase to raise cash for shareholders electing cash payment of distributions could be supported by the fund if placed outside of a repurchase processing date.
- By analyzing the various interval fund managers they support, broker-dealer omnibus intermediaries may determine that it is more consistent and straightforward to set their omnibus accounts to pay distributions in "cash" and submit a subscription to acquire shares for shareholders who requested reinvested distributions. This strategy may work especially well if the interval funds are continuously offered (e.g., support daily subscriptions).

Fund Managers

- Funds may consider reviewing their approved interval fund as-of trading policies and procedures to determine whether they can accept an as-of repurchase transaction on the morning following a distribution, to support a broker-dealer omnibus intermediary's cash payment to shareholders electing that option.
- Using the recommended process in ICI's white paper to estimate cash distribution disbursements, funds may consider whether the estimate is sufficiently accurate to allow broker-dealer omnibus intermediaries to submit an as-of repurchase transaction the following morning—either manually or by trading platform—to support cash payment to shareholders electing that option.
- Funds may consider discussing with their service provider the flexibility that exists to permit certain types of automated transactions while suppressing others. For instance, automated transactions through a trading platform with certain codes or indicators may be permissible, while other transactions would be rejected.[24] Such flexibility would allow funds to manage operational and trading risk while allowing firms to continue to follow common fund distribution processing steps.

[24] Ultimately, funds or their transfer agents would still need to ensure that unauthorized repurchase transactions are not inadvertently posted to accounts.

Conclusion

As both the original ICI interval funds white paper and this paper illustrate, interval fund operations have many unique operational challenges when compared to a typical open-end mutual fund. Intermediaries and funds require frequent and clear communication regarding methods of trading, repurchase period scheduling, and the processing of trade corrections, exchanges, share class conversions, and distributions in the unique context of interval fund operations.

This paper illustrates that each of the operational challenges has multiple potential solutions, and most have some well-defined pathways toward greater operational standardization, efficiencies, and automation. It is the hope of the task force that through the continued growth and expansion of interval fund offerings, the future introduction of new or updated automation, and the ongoing maturation of operational practices, the industry will recognize additional efficiencies in interval fund operations—and that the millions of investors who have grown to rely on interval funds as part of a diversified portfolio will also experience the benefits that come through efficient, effective, lower-risk operations.