SEC Proposes Rule Changes for Fund of Funds Arrangements

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SEC Proposes Rule Changes for Fund of Funds Arrangements

In a December 19, 2018 release (the "**Proposing Release**"), the Securities and Exchange Commission (the "**SEC**") proposed new rule 12d1-4 (the "**Proposed Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), to "streamline and enhance the regulatory framework applicable to funds that invest in other funds" (otherwise known as "fund of funds" arrangements). In connection with the Proposed Rule, the SEC proposed: (i) related amendments to Rule 12d1-1 under the Investment Company Act and to Form N-CEN; and (ii) to rescind Rule 12d1-2 under the Investment Company Act and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act.

The Proposed Rule would, under certain specified conditions, "permit a fund to acquire shares of another fund in excess of the limits of section 12(d)(1) of the Investment Company Act without obtaining an exemptive order" from the SEC. According to the Proposing Release, funds are increasingly investing in other funds for asset allocation, diversification, or other investment objectives, while "Main Street" investors also utilize fund of funds arrangements to achieve a desired allocation and diversification through a single, professionally managed portfolio.

According to the Proposing Release, the Proposed Rule "reflects decades of experience" with fund of funds and will protect investors by subjecting funds relying on the Proposed Rule "to a tailored set of conditions" and by providing a "comprehensive exemption for fund of funds to operate." The Proposing Release notes that the proposed rescission of Rule 12d1-2 under the Investment Company Act and individual exemptive orders for certain fund of funds arrangements will "create a consistent and efficient rules-based regime for the formation and oversight of funds of funds." Lastly, in connection with the proposed rescission of Rule 12d1-2, the SEC also proposed amendments to Rule 12d-1 under the Investment Company Act to "allow funds that rely on section 12(d)(1)(G) of the Investment Company Act to invest in money market funds that are not part of the same group of investment companies."

Overview of Section 12(d)(1) Limits

The Proposing Release notes that section 12(d)(1) of the Investment Company Act was enacted to guard against abuses historically related to control by acquiring fund shareholders, including "pyramiding," which is "a practice under which investors in the acquiring fund control the assets of the acquired fund and use those assets to enrich themselves at the expense of the acquired fund shareholders[,]" and to impose limits on fund of funds arrangements. According to the Proposing Release, Congress was

also concerned with the "potential for excessive fees when one fund invested in another, and the formation of overly complex structures that could be confusing to investors."

Under section 12(d)(1)(A) of the Investment Company Act generally, a registered fund (and companies or funds it controls) cannot: (i) acquire more than 3% of another registered fund's outstanding voting securities; (ii) invest more than 5% of its total assets in any one registered fund; or (iii) invest more than 10% of its total assets in registered funds generally. In addition, under section 12(d)(1)(A), neither a private fund nor a foreign fund generally can acquire more than 3% of a registered fund's outstanding voting securities. Under section 12(d)(1)(B) generally, a registered open-end fund cannot knowingly sell "securities to any other investment company [including private funds for purposes of clause (i)] if, after the sale, the acquiring fund would: (i) together with companies it controls, own more than 3% of the acquired fund's outstanding voting securities; or (ii) together with other funds (and companies they control), own more than 10% of the acquired fund's outstanding voting securities." Under section 12(d)(1)(C) generally, it is unlawful "for any investment company (the "acquiring company") and any company or companies controlled by the acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10[%] of the total outstanding voting stock of such closed-end company." According to the Proposing Release, in order to avoid overregulation of legitimate fund of funds arrangements, Congress enacted exceptions for three types of fund of funds arrangements: (i) conduit or master-feeder arrangements (section 12(d)(1)(E)), (ii) unaffiliated fund of funds arrangements (section 12(d)(1)(F)), and affiliated fund of funds arrangements (section 12(d)(1)(G)). Congress also empowered the SEC to provide exemptions for additional types of fund of funds arrangements, which the SEC exercised in 2006, when it adopted Rules 12d1-1, 12d1-2 and 12d1-3. The Proposing Release also notes that the SEC has issued numerous exemptive orders permitting fund of funds arrangements.

According to the Proposing Release, the combination of existing statutory exemptions, SEC rules and exemptive orders has created a regulatory regime where "substantially similar fund of funds arrangements are subject to different conditions." Thus, in order to create a "more consistent and efficient regulatory framework for fund of funds arrangements," the SEC has proposed to rescind Rule 12d1-2 and a majority of the exemptive orders that grant relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act. The Proposing Release notes that the SEC seeks to replace that relief with a "comprehensive fund of funds framework under new [R]ule 12d1-4" and to "reduce confusion and subject fund of funds arrangements to a tailored set of conditions that would enhance investor protection, while also providing funds with investment flexibility to meet their investment objectives in an efficient manner."

Scope of Proposed Rule 12d1-4 and Exemptions from Section 12(d)(1) of the Investment Company Act

Registered Funds and Business Development Companies ("**BDCs**"): According to the Proposing Release, the Proposed Rule would allow a registered investment company or BDC (collectively, "**Acquiring Funds**") to acquire the securities of any other registered investment company or BDC (collectively, "**Acquired Funds**") in excess of the limits described above, subject to conditions "that are designed to address historical abuses associated with fund of funds arrangements." The Proposing Release notes that registered open-end funds, unit investment trusts ("**UITs**"), closed-end funds (including BDCs), exchange-traded funds ("**ETFs**"), and exchange-traded managed funds ("**ETMFs**") could rely on the Proposed Rule as both Acquiring Funds and Acquired Funds.

In addition to fund of funds arrangements that are currently permitted under SEC exemptive orders, the Proposed Rule would:

- Allow open-end funds, UITs and ETFs to invest in unlisted closed-end funds and unlisted BDCs beyond the limits in section 12(d)(1);
- Increase permissible investments for closed-end funds beyond ETFs and ETMFs to allow them to invest in open-end funds, UITs, other closed-end funds, and BDCs beyond the limits in section 12(d)(1);
- Allow BDCs to invest in open-end funds, UITs, closed-end funds, other BDCs and ETMFs; and
- Allow ETMFs to invest in all registered funds and BDCs.

Thus, according to the Proposing Release, the Proposed Rule promotes a more consistent framework for all registered funds and BDCs by subjecting "fund of funds arrangements to conditions that are tailored to different Acquiring Fund structures, rather than assessing the merit of a particular fund of funds arrangement on an individual basis." According to the Proposing Release, the SEC believes the Proposed Rule will protect fund investors at both tiers of a fund of funds arrangement while also: (i) providing funds with the flexibility to meet their respective investment objectives "in an efficient manner"; (ii) eliminating "unnecessary and potentially confusing distinctions among permissible investments for different types of [A]cquiring [F]unds"; and (iii) leveling "the playing field among these entities."

Private Funds: According to the Proposing Release, private funds would not be within the Proposed Rule's scope of Acquiring Funds because private funds are not registered with the SEC and would not be subject to the reporting requirements that the SEC proposes on Form N-CEN regarding reliance on the Proposed Rule. Further, private funds would not report information regarding their Acquired Fund holdings on Form N-PORT and are not subject to the recordkeeping requirements under the Investment Company Act. Instead, according to the Proposing Release, the SEC deems it appropriate for private funds to request relief from sections 12(d)(1)(A) and (B) of the Investment Company Act through the individualized exemptive application process.

Unregistered Investment Companies: Unregistered investment companies (e.g., foreign funds) are also excluded from the scope of the Proposed Rule due to similar concerns as raised vis-à-vis private funds. Further, as in the case of private funds, the Proposing Release recommends unregistered investment companies request exemptive relief on a case-by-case basis.

Conditions of Proposed Rule

According to the Proposing Release, the conditions of the Proposed Rule are designed "to prevent the abuses that historically were associated with fund of funds arrangements," and are based on the conditions contained in exemptive orders granted by the SEC, but are intended to be streamlined in order to enhance compliance and "strengthen investor protections."

The below table sets forth a general overview of the differences between the conditions under current exemptive relief and the Proposed Rule:

Advisory Group

The Proposed Rule defines "advisory group" to mean "either: (1) an [A]cquiring [F]und's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or (2) an [A]cquiring [F]und's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser."

Control

The applicable condition in the Proposed Rule requires that "[t]he [A]cquiring [F]und and its advisory group [. . .] not control (individually or in the aggregate) an [A]cquired [F]und." The Investment Company Act defines control to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Further, the Investment Company Act "creates a rebuttable presumption that any person who directly or indirectly beneficially owns more than 25% of the voting securities of a company controls the company and that one who does not own that amount does not control it." It should also be noted that such "[a] determination of control depends on the facts and circumstances of the particular situation."

	Condition Under Existing Exemptive Orders	Condition Under the Proposed Rule
Control/Voting	Voting conditions (including the point at which the voting conditions is triggered) differ based on the type of Acquired Fund.	In order to prevent a fund from exerting undue influence over another fund, the Proposed Rule prohibits an Acquiring Fund and its advisory group from controlling, individually or in the aggregate, an Acquired Fund, except in the circumstances discussed below. The voting conditions do not differ based on the type of Acquired Fund. Instead, under the Proposed Rule, all Acquiring Funds that do not fall within the control exception discussed below would be subjected to the same voting condition: an Acquiring Fund and its advisory group must use pass-through (seek voting instructions from security holders and vote such proxies in accordance with their instructions) or mirror voting (vote the shares held by it in the same proportion as the vote of all other holders of the Acquired Fund) when they hold more than 3% of the Acquired Fund's outstanding voting securities. The Proposed Rule includes exceptions to this condition where: (i) an Acquiring Fund is within the same group of investment companies as an Acquired Fund; or (ii) the Acquiring Fund's investment sub-adviser or any person controlling, controlled by,

		or under common control with such investment sub-adviser acts as the Acquired Fund's investment adviser or depositor.
Redemptions	Fund boards must make certain findings and adopt procedures in order to prevent overreaching and undue influence by the Acquiring Fund and its affiliates. Existing exemptive relief requires a participation agreement between the Acquiring Fund and the Acquired Fund under which the parties are required to fulfill their responsibilities under.	To address concerns that an Acquiring Fund "could threaten large-scale redemptions as a means of exercising undue influence over an [A]cquired [F]und," the Proposed Rule would prohibit an Acquiring Fund that acquires more than 3% of an Acquired Fund's outstanding shares from redeeming or submitting for redemption, or tendering for repurchase, more than 3% of the Acquired Fund's total outstanding shares in any 30-day period.
Excessive & Duplicative Fees	In certain circumstances the existing exemptive relief: (i) requires an adviser to an Acquiring Fund to waive its advisory fees; or (ii) requires the board of the Acquiring Fund to find that the fees are not duplicative.	Where the Acquiring Fund is a management company, the Acquiring Fund's adviser must determine that it is in the best interest of the Acquiring Fund to invest in the Acquired Fund by evaluating: (i) the complexity of the fund of funds structure; and (ii) the aggregate fees associated with the investment. The adviser must make this determination before investing in the Acquired Fund, "and thereafter with such frequency as the board of directors of the [A]cquiring [F]und…deems reasonable and appropriate…but in any case, no less frequently than annually." The Proposed Rule also requires the adviser to report its findings to the board of the Acquiring Fund at the same frequency as the analysis. The Proposed Rule also includes recordkeeping requirements related to this determination. According to the Proposing Release, the adviser need not make these evaluations "in connection with every investment in an [A]cquired [F]und." For example, "an adviser to a fund that invests regularly in [A]cquired [F]unds as part of its strategy could consider establishing

Redemptions

Some view this proposed new limit on redemptions as favoring ETFs, because acquiring funds could sell in the secondary market without limit. Additionally, the 3% limit could raise issues for Acquiring Funds under the liquidity rule (Rule 22e-4 under the Investment Company Act).

Excessive & Duplicative Fees

The Proposing Release notes that, "In evaluating the complexity of a fund of funds structure, an adviser should consider the complexity of an [A]cquiring [F]und's investment in an [A]cquired [F]und versus direct investment in assets similar to the [A]cquired [F]und's holdings. The adviser should consider whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks. The adviser should consider whether an investment in an [A]cquired [F]und would circumvent the [A]cquiring [F]und's investment restrictions and limitations."

The Proposing Release notes that, "As part of this analysis, an adviser should consider whether the [A]cquired [F]und's advisory fees are for services that are in addition to, rather than duplicative of, the adviser's services to the [A]cquiring [F]und. The adviser should consider sales charges and other fees, including fees for recordkeeping, sub-transfer agency services, sub-accounting services, or other administrative services." The Proposing Release further notes that one way to mitigate the duplicative fee concerns would be the use of fee waivers.

		parameters for routine investments in [A]cquired [F]unds and review individual transactions that are outside of those parameters." Section 15 of the Investment Company Act already requires the board to evaluate any information reasonably necessary to evaluate the terms of an Acquiring Fund's advisory contracts (including the fees for services provided by the adviser). The Proposed Rule does not require the board to find that advisory fees are based on services that are in addition to, rather than duplicative of, services provided by the Acquired Fund's adviser and also does not require an Acquiring Fund's adviser to waive fees received from an Acquired Fund (as has been required in prior exemptive orders). The Proposed Rule also sets forth an alternative fee condition in the case of an Acquiring Fund that is a UIT. The Proposing Release notes that "on or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in [A]cquired [F]unds, and find that the fees of the UIT do not duplicate the fees of the [A]cquired [F]unds that the UIT holds or will hold at the date of deposit." Finally, with respect to separate accounts that fund variable insurance contracts that invest in an Acquiring Fund, the Proposed Rule "would require an [A]cquiring [F]und to obtain a certification from the insurance company issuing the separate account that it has determined that the fees borne by the separate account, [A]cquiring [F]und and [A]cquired [F]und, in the aggregate, are consistent with the standard set forth in section 26(f)(2)(A) of the [Investment Company] Act." The Proposing

		Release notes that, "The standard set forth in section 26(f)(2)(A) of the [Investment Company] Act provides that the fees must be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company."
Complex Structures	Existing exemptive relief "[l]imits the ability of an Acquired Fund to invest in underlying funds (that is, it limits structures with three or more tiers of funds)."	The Proposed Rule would include a condition that would "prohibit a fund that is relying on section 12(d)(1)(G) of the [Investment Company] Act or the [P]roposed [R]ule from acquiring, in excess of the limits in section 12(d)(1)(A), the outstanding voting securities of a fund that discloses in its most recent registration statement that it may be an [A]cquiring [F]und in reliance on proposed [R]ule 12d1-4." However, three-tier structures under a master-feeder arrangement where a fund invests all of its assets in an Acquiring Fund in reliance on Section 12(d)(1)(E) would be permitted. The Proposed Rule would also require a fund relying on the Proposed Rule (or a fund that "wants to preserve investment flexibility to rely on the rule") to disclose that it is an Acquiring Fund for purposes of the Proposed Rule in its registration statement. The Proposed Rule would also include a condition that would generally "prohibit arrangements where an [A]cquired [F]und invests in other investment companies or private funds in excess of the limits in section 12(d)(1)(A)[,]" but would also "allow arrangements where the [A]cquired [F]und invests in other funds in certain enumerated circumstances." According to the Proposing Release, these circumstances are consistent with those contained in prior exemptive orders. Under the Proposed Rule, an Acquired Fund would be allowed to (i) invest in another fund beyond the statutory limits "for short-term cash management purposes or in

Master-Feeder Arrangements

The Proposing Release notes that this condition "also would not prevent other funds from acquiring the voting securities of an [A]cquiring [F]und in amounts under 3%, effectively creating a type of three-tier structure."

		connection with interfund lending or borrowing transactions"; (ii) invest all of its assets in a master fund or invest in a wholly owned subsidiary; and (iii) receive fund shares as a dividend or as a result of a plan of reorganization.

Proposed Rescission of Rule 12d1-2 and Certain Exemptive Relief and Proposed Amendments to Rule 12d1-1

According to the Proposing Release, the SEC proposes to rescind Rule 12d1-2 in order to "create a more consistent and efficient regulatory framework for the regulation of fund of funds arrangements." According to the Proposing Release, Rule 12d1-2 permits funds that are relying on section 12(d)(1)(G) to: (i) "acquire the securities of other funds that are not part of the same group of investment companies, subject to the limits in section 12(d)(1)(A) or 12(d)(1)(F)"; (ii) "invest directly in stocks, bonds, and other securities"; and (iii) "acquire the securities of money market funds in reliance on [R]ule 12d1-1." The Proposing Release notes that this rescission would require funds previously relying on section 12(d)(1)(G) to comply with the conditions in the Proposed Rule to continue to invest in the above types of investments previously provided for in Rule 12d1-2. The SEC, however, is proposing an amendment to Rule 12d1-1 to "provide funds relying on section 12(d)(1)(G) with continued flexibility to invest in money market funds outside of the same group of investment companies if they rely on section 12(d)(1)(G)."

Further, according to the Proposing Release, the SEC is proposing to rescind exemptive orders permitting fund of fund arrangements, including all orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Act with one limited exception, as the SEC is not rescinding the exemptive relief granted from sections 12(d)(1)(A) and (B) in the case of certain interfund lending arrangements. The Proposing Release noted that the rescission of exemptive relief will apply to the 12(d)(1)(A) and (B) relief contained in ETF and ETMF exemptive orders.

In order to give funds time to adjust to the new requirements, the SEC is proposing that the rescission of Rule 12d1-2 and these exemptive orders not occur until one year after the effective date of the Proposed Rule.

Exemption from Prohibition on Certain Affiliated Transactions

The Proposed Rule would also provide an exemption from Section 17(a) of the Investment Company Act, which "generally prohibits an affiliated person of a fund, or any affiliated person of such person, from selling any security or other property to, or purchasing any security or other property from, the fund." The Proposing Release notes that, absent such relief, Section 17(a) would prohibit registered funds that hold "5% or more of the [A]cquired [F]und's securities from making any additional investments in the [A]cquired [F]und." Further, the Proposing Release notes that fund of funds arrangements that involve "funds that are part of the same group of investment companies or that have the same investment adviser (or affiliated investment advisers) also implicate the [Investment Company]

Act's protections against affiliated transactions, regardless of whether an [A]cquiring [F]und exceeds the 5% threshold." Additionally, with respect to ETFs, Section 17(a) would prohibit "the delivery or deposit of basket assets on an in-kind basis by an affiliated fund (that is, by exchanging certain assets from the ETF's portfolio, rather than in cash)."

Form Amendments

In addition, the Proposing Release notes that SEC has proposed to add a requirement to Form N-CEN, "a structured form that requires registered funds to provide census-type information to the [SEC] on an annual basis." According to the Proposing Release, the additional requirement would "require management companies [and UITs] to report if they relied on [R]ule 12d1-4 or the statutory exception in section 12(d)(1)(G) during the reporting period."

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The SEC has requested public comments on the Proposed Rule and amendments, to be received by the SEC on or before the 90th day after publication of the Proposing Release in the Federal Register.

- **See a copy of the Press Release announcing the Proposed Rule**
- **See a copy of the Proposing Release**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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