CLIENT ALERT

SEC Proposes New Rule for Fund-of-Funds Arrangements

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AUTHORS

Margery K. Neale | Benjamin J. Haskin | Jay Spinola | Elliot J. Gluck
Anne C. Choe

On December 19, 2018, the Securities and Exchange Commission (the "SEC") voted to propose a new rule and a related rule amendment that would permit an investment company registered under the Investment Company Act of 1940 (the "1940 Act") to acquire the shares of another registered investment company in excess of the limits of Sections 12(d)(1)(A) and (B) (the "12(d)(1) Limits") of the 1940 Act.[1] In connection with this proposal, the SEC also proposes to rescind almost all of the exemptive orders on which many existing fund-of-funds arrangements rely, as well as Rule 12d1-2 under the 1940 Act (on which many affiliated fund-of-funds arrangements rely), in what is described as an effort to "create a consistent and efficient rules-based regime" for fund-of-funds arrangements.[2] Proposed Rule 12d1-4 ("Proposed Rule 12d1-4" or the "Proposed Rule") seeks to standardize and codify certain conditions of existing exemptive orders and to address the current regulatory framework in which substantially similar fund-of-funds arrangements may be subject to different conditions.[3] If enacted, however, the Proposed Rule may significantly change, and potentially curtail, the operation of certain existing fund-of-funds arrangements (especially those involving affiliated funds), as discussed below.

1 *Fund of Funds Arrangements*, Investment Company Act Release No. 33329 (Dec. 19, 2018) ("Proposing Release"), available at https://www.sec.gov/rules/proposed/2018/33-10590.pdf.

2 *See* Proposing Release at 6.

3 *See* SEC Commissioner Kara M. Stein, *Statement at Open Meeting on Proposed Rule 12d1-4 under the Investment Company Act of 1940 Governing Fund of Funds Arrangements* (Dec. 19, 2018), available at https://www.sec.gov/news/public-statement/statement-stein-2018-12-19-fund-funds.

Aspects of the Proposed Rule are accompanied by extensive requests for comment. Comments on the Proposed Rule are due on or before 90 days after publication of the proposal in the Federal Register, which, as of the date of this alert, has not occurred.

I. Section 12(d)(1) Limits

Section 12(d)(1) of the 1940 Act limits the ability of an investment company to invest above certain thresholds in the shares of another investment company. Generally speaking, Section 12(d)(1)(A) limits the acquisition by an investment company (an "acquiring fund") of shares of another investment company (an "acquired fund"),[4] and Section 12(d)(1)(B) limits a registered investment company's sales of its securities to other investment companies.[5] Section 12(d)(1) was enacted to prevent "pyramiding" schemes that gave investors in acquiring funds the ability to control and exert undue influence on acquired funds to benefit themselves.[6] There are three existing statutory exemptions from the 12(d)(1) Limits that permit fund-of-funds arrangements. First, master-feeder structures (in which the securities of the acquired fund are the only investment securities owned by the acquiring fund) that meet certain conditions are exempt from the 12(d)(1) Limits.[7] Second, subject to certain conditions, a registered investment company may acquire up to 3% of an unlimited number of other investment companies' securities.[8] Third, subject to certain conditions, registered open-end funds or unit investment trusts ("UITs") may invest without limitation in other registered open-end funds and UITs that are in the same group of investment companies ("affiliated funds").[9]

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4 Section 12(d)(1)(A) prohibits, in relevant part, an acquiring fund that is a registered investment company (and any company controlled by such acquiring fund) from purchasing or otherwise acquiring any security issued by an acquired fund if, immediately after such acquisition, the acquiring fund (and any company controlled by it) would own (i) more than 3% of the total outstanding voting stock of the acquired fund; (ii) securities issued by the acquired fund with a value exceeding 5% of the acquiring fund's total assets; or (iii) securities issued by the acquired fund and all other investment companies having an aggregate value in excess of 10% of the acquiring fund's total assets.

5 Section 12(d)(1)(B) prohibits an acquired fund that is a registered open-end investment company (and any principal underwriter of the acquired fund or broker-dealer registered under the Securities Exchange Act of 1934) from knowingly selling or otherwise disposing of any security issued by the acquired fund to an acquiring fund (or any company controlled by such acquiring fund) if, immediately after such sale or disposition, the acquiring fund (and any company controlled by such acquiring fund) would (i) own more than 3% of the total outstanding voting stock of the acquired fund; or (ii) together with all other investment companies (and companies controlled by them), own more than 10% of the total outstanding voting stock of the acquired fund.

6 *See* Proposing Release at 9-10; *see also Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 311-24 (1966) (describing the SEC's concerns about the growth and abusive practices of fund-of-funds arrangements).

7 *See* Section 12(d)(1)(E).

8 *See* Section 12(d)(1)(F); *see also* Rule 12d1-3.

9 *See* Section 12(d)(1)(G). Subparagraph (ii) of Section 12(d)(1)(G) defines "group of investment companies" as "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." A fund that relies on this exemption to invest in affiliated funds may also invest in Government securities and short-term paper.

The SEC adopted Rules 12d1-1 and 12d1-2 in 2006 to broaden the ability of acquiring funds to invest in acquired funds outside the 12(d)(1) Limits.[10] Rule 12d1-1 allows acquiring funds to invest in shares of money market funds in excess of the 12(d)(1) Limits. Rule 12d1-2 permits acquiring funds that rely on Section 12(d)(1)(G) to invest without limit in affiliated funds also to invest in (i) unaffiliated funds, (ii) stocks, bonds and other securities[11] and (iii) unaffiliated money market funds in reliance on Rule 12d1-1.

Under the current regime, to invest in acquired funds in excess of the 12(d)(1) Limits, registered investment companies must either rely on the existing statutory and regulatory exemptions or obtain individualized SEC exemptive relief. The Proposed Rule seeks to do away with most of the exemptive relief process and rescind relief previously granted.

II. Summary of the Proposed Rule

A. Scope of the Proposed Rule

The Proposed Rule would permit registered open-end funds, UITs, closed-end funds (including business development companies), exchange-traded funds ("ETFs") and exchange-traded management funds ("ETFMs") to rely on the Proposed Rule as both acquiring funds and acquired funds, subject to compliance with certain conditions. The Proposed Rule would not permit private funds or non-U.S. funds to invest in acquired funds in excess of the applicable 12(d)(1) Limits.[12]

B. Conditions for Reliance on the Proposed Rule

To rely on the Proposed Rule, eligible acquiring funds will need to comply with the following conditions:

- Control and Voting: An acquiring fund's ability to exercise direct or indirect control over an unaffiliated acquired fund would be subject to certain proposed limits.

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[10] *See Fund of Funds Investments*, Investment Company Act Release No. 27399 (June 20, 2006), available at https://www.sec.gov/rules/final/2006/33-8713.pdf.

[11] The SEC has provided exemptive relief, and the SEC staff has provided no-action relief, to permit an affiliated fund-of-funds relying on Section 12(d)(1)(G) and Rule 12d1-2 also to invest its assets in instruments that may not be securities. *See* Proposing Release at 88 n.208; 93 n.228.

[12] *See* Proposing Release at 20-21. Although private funds that rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act are excluded from the definition of "investment company" under the 1940 Act, they are deemed to be investment companies for purposes of Sections 12(d)(1)(A)(i) and (B)(i) and thus are subject to the limit on acquiring no more than 3% of the outstanding voting stock of a registered investment company. *See* Sections 3(c)(1) and 3(c)(7)(D). In addition, a non-U.S. fund that meets the definition of an "investment company" under Section 3(a)(1)(A) of the 1940 Act is generally subject to the applicable 12(d)(1) Limits. A non-U.S. fund that uses U.S. jurisdictional means in the offering of the securities it issues and that relies on Section 3(c)(1) or 3(c)(7) is a private fund that is subject to Section 12(d)(1) to the same extent as a U.S. private fund. *See* Proposing Release at 20-21.

1. An acquiring fund and its advisory group[13] would be prohibited from "controlling" (as such term is defined under the 1940 Act), individually or in the aggregate, an acquired fund, except under the circumstances discussed in paragraph 3 below.[14]

2. If an acquiring fund and its advisory group (in the aggregate) hold more than 3% of the outstanding voting securities of an acquired fund, each of the holders will vote its securities in the acquired fund using either pass-through or mirror voting.[15]

3. The control and voting conditions would not apply when (i) the 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 an acquired fund's investment adviser or depositor.[16]

- Limited Redemptions: Under the Proposed Rule, an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares would be prohibited from redeeming, submitting for redemption or tendering for repurchase more than 3% of an acquired fund's total outstanding shares in any 30-day period.[17]

- Fees: Under the Proposed Rule, the fund-of-funds arrangement's fee structure must be evaluated. The evaluation of the fee structure varies depending on the structural characteristics of the acquiring fund.[18]

    1. *Management Investment Company as Acquiring Fund*: The investment adviser of a management investment company would be required to (A) evaluate (i) the complexity of the structure and (ii) the aggregate fees associated with the acquiring fund's investment in the acquired fund; and (B) find that it is in the best interest of the acquiring fund to invest in the acquired fund. The acquiring fund's investment adviser would need to report to the acquiring fund's board its finding and the basis for the finding before investing in any acquired fund.[19]

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[13] Proposed Rule 12d1-4(d) defines "advisory group" as either "(1) [a]n acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or (2) [a]n acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser."

[14] *See* Proposed Rule 12d1-4(b)(1)(i).

[15] *See* Proposed Rule 12d1-4(b)(1)(ii).

[16] *See* Proposed Rule 12d1-4(b)(1)(iii).

[17] *See* Proposed Rule 12d1-4(b)(2).

[18] *See* Proposed Rule 12d1-4(c).

[19] *See* Proposed Rule 12d1-4(b)(3)(i).

2. *UIT as Acquiring Fund*: On or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor would be required to evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds and find that the fees of the UIT do not duplicate the fees of the acquired funds that the UIT holds or will hold.[20]

3. *Separate Account Funding Variable Insurance Contracts as Acquiring Fund*: An acquiring fund would be required to obtain a certification from the insurance company issuing the separate account that it has determined that the fees borne by the separate account, the acquiring fund and the acquired fund, in the aggregate, meet the reasonableness standard in Section 26(f)(2)(A) of the 1940 Act (*i.e.*, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company).[21]

- Complex Structures: Other than in specified limited circumstances, the Proposed Rule is designed to limit fund-of-funds arrangements to two tiers of funds.

1. A fund that intends to rely on the Proposed Rule must disclose in its registration statement that it is, or at times may be, an acquiring fund.[22]

2. A fund may not rely on Section 12(d)(1)(G) of the 1940 Act or the Proposed Rule to acquire, in excess of the 12(d)(1) Limits, shares of a fund that discloses in its most recent registration statement that it may be an acquiring fund in reliance on the Proposed Rule.[23]

3. The Proposed Rule also generally would prohibit fund-of-fund arrangements where the acquired fund invests in other investment companies or private funds in excess of the 12(d)(1) Limits unless the investment is (A) part of a master-feeder arrangement in reliance on Section 12(d)(1)(E) of the 1940 Act; (B) for short-term cash management purposes pursuant to Rule 12d1-1 or other exemptive relief;[24] (C) in a subsidiary that is wholly owned and controlled by the acquired fund; (D) the receipt of securities as a dividend or as a result of a plan of reorganization of a company; or (E) the acquisition of securities of

[20] *See* Proposed Rule 12d1-4(b)(3)(ii).

[21] *See* Proposed Rule 12d1-4(b)(3)(iii).

[22] *See* Proposed Rule 12d1-4(b)(4)(i).

[23] *See* Proposed Rule 12d1-4(b)(4)(ii).

[24] It is not clear from this reference to "other exemptive relief" whether acquired funds in a fund-of-funds structure that make investments in non-money market funds for short-term cash management purposes would be able to continue to rely on individualized exemptive relief.

another investment company pursuant to an exemptive order to engage in interfund borrowing and lending transactions.[25]

C. Rescission of Rule 12d1-2, Amendment to Rule 12d1-1 and Rescission of Existing Exemptive Relief

The Proposed Rule would preserve an acquiring fund's ability to invest in unaffiliated money market funds in reliance on Rule 12d1-1 by amending Rule 12d1-1, but would rescind Rule 12d1-2 (and thus the expanded relief that the rule provides to an affiliated fund-of-funds arrangement relying on Section 12(d)(1)(G)).[26] Rule 12d1-2 under the 1940 Act was adopted, in part, to provide relief for fund-of-funds arrangements that do not conform to the limits in Section 12(d)(1)(G) of the 1940 Act because the acquiring fund invests not only in other affiliated funds but also in unaffiliated funds (including money market funds) and stocks, bonds and other securities.[27]

The SEC is also proposing to rescind the exemptive orders permitting fund-of-funds arrangements, including all orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the 1940 Act, as well as ETF and ETFM exemptive orders providing relief from Sections 12(d)(1)(A) and (B).[28] The SEC is not, however, proposing to rescind interfund lending exemptive orders that permit certain funds within the same complex to borrow and lend money to each other for temporary purposes and subject to certain conditions.[29]

III. Key Observations about the Proposed Rule

A. 3% Limit on Redemptions

Under the Proposed Rule, once an acquiring fund holds in excess of 3% of an acquired fund's outstanding shares, it would not be permitted to redeem more than 3% of the acquired fund's shares in any 30-day period. This limit on redemption could have a significant effect on fund-of-funds arrangements and render certain of such arrangements nonviable. The 3% limit on redemptions from an acquired fund could restrict an acquiring fund's ability to respond to large shareholder redemptions and constrain an acquiring fund from reallocating its assets among various underlying acquired funds or other investments. In addition, it could make it difficult for an acquiring fund with a significant investment in an acquired fund to replace that acquired fund in a reasonable time period following a decision to make such an investment change, which could be problematic where the acquiring fund's investment adviser perceives the need to act quickly. In that regard, the Proposing Release notes that, assuming an acquiring fund holds up to 25% of the outstanding shares of

[25] *See* Proposed Rule 12d1-4(b)(4)(iii).

[26] *See* Proposing Release at 88-90.

[27] *See id.* at 87-88.

[28] *See id.* at 95.

[29] *See id.* at 96.

an acquired fund and is subject to the Proposed Rule's 3% limit on redemptions, it could take an acquiring fund ten months to fully unwind its investment in an acquired fund.[30] An acquiring fund could seek to address this challenge under the Proposed Rule by holding a larger percentage of its assets in cash and/or limiting its investments in acquired funds to 3% or less of the acquired fund's outstanding shares (making investments in smaller, niche acquired funds or newly launched acquired funds less attractive investments). Either of such options, however, could have an adverse effect on the acquiring fund's performance and hamper the development of certain investment strategies. Another option for an acquiring fund would be to invest in acquired funds that are ETFs or listed closed-end funds, where the acquiring fund could dispose of its holdings through a sale on an exchange, rather than by redemption from the fund, and thus not be subject to the 3% limit on redemptions.[31] An acquiring fund that employs this alternative, however, might find itself with a narrower universe of potential acquired funds.

In the context of affiliated funds-of-funds, the 3% limit on redemptions would apply under the Proposed Rule, despite the ability of the investment adviser and its portfolio managers in certain contexts to coordinate investing activities to address redemptions at the level of both the acquiring and acquired funds. Acquiring funds that invest in affiliated funds would not be restricted by the 3% limit on redemptions under the Proposed Rule if they were to rely solely on Section 12(d)(1)(G) of the 1940 Act. Prior to the adoption of Rule 12d1-2 in 2006, affiliated funds-of-funds were, absent exemptive relief, limited to investing in affiliated funds, government securities and short-term paper.[32] Since then, however, affiliated funds-of-funds have been able to rely on Rule 12d1-2 also to invest in unaffiliated funds (subject to limits in Section 12(d)(1)(A) or (F) of the 1940 Act), stocks, bonds and other securities[33] and in unaffiliated money market funds in reliance on Rule 12d1-1. In proposing Rule 12d1-2, the SEC noted that Congress encouraged it to "provide exemptions from [the Section 12(d)(1)] limitations 'in a progressive way,' taking into account factors that related to the protection of investors."[34] At the time, the SEC indicated that there did not appear to be any additional concerns or risks in allowing an affiliated fund-of-funds to invest in unaffiliated funds subject to the limits of Section 12(d)(1)(A) or (F) or directly in other types of investments.[35] If Rule 12d1-2 were rescinded and the Proposed Rule were adopted as proposed, an affiliated fund-of-

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30 *See* id. at 119 n. 260.

31 The SEC requested comment, however, on whether there are instances where acquiring funds transact in ETFs in the primary market through an authorized participant and whether the 3% redemption limit would affect the efficiency of the ETF arbitrage mechanism. *See* Proposing Release at 54-55. There is no current limit on an authorized participant acquiring ETF shares from a fund-of-funds and then subsequently redeeming those shares.

32 Section 12(d)(1)(G)(i)(II).

33 *See supra* note 11.

34 *Fund of Funds Investments; Proposed Rule*, Investment Company Act Release No. 26198 (Oct. 1, 2003) (citing H.R. Rep. No. 622, 104th Cong., 2d Sess., at 43-44 (1996)).

35 *See* Proposing Release at 88.

funds that instead relied on Section 12(d)(1)(G) to avoid being subject to the Proposed Rule's 3% limit on redemptions would lose its current flexibility in the types of investments it could make.

Acquiring funds that seek to invest in acquired funds that are not affiliated funds would not be able to rely on Section 12(d)(1)(G) to avoid the constraint of the Proposed Rule's 3% limit on redemptions. These funds would have limited options—operate subject to the 3% redemption limit, restructure to an affiliated fund-of-funds arrangement (which could potentially adversely affect acquired funds in unaffiliated fund-of-funds arrangements), or liquidate. In addition, these unaffiliated funds-of-funds might face certain challenges in seeking to comply with the 3% limit on redemptions, as they would not necessarily have real-time daily knowledge of the size of any unaffiliated acquired fund.

The redemption limitations of the Proposed Rule may have certain unintended consequences related to the recently adopted liquidity risk management rule (Rule 22e-4 under the 1940 Act). Under the rule, registered open-end funds must treat securities that cannot be sold or disposed of in seven calendar days or less as "illiquid."[36] As the Proposed Rule would restrict the redemption of holdings above 3% of the acquired fund's shares within a 30-day period, it appears that those holdings would be rendered illiquid. Any such holdings must, in the aggregate, comprise 15% or less of the fund-of-funds' net assets under Rule 22e-4. This limitation may make it difficult to manage a fund-of-funds that cannot rely on Section 12(d)(1)(G). It should be noted that an open-end acquired fund is itself subject to the liquidity risk management provisions of Rule 22e-4, and thus, there is a question as to the utility of a 3% limit on redemptions from such acquired fund.[37] In that regard, Rule 22e-4 was adopted, in part, to "reduce the risk that a fund will be unable to meet its redemption obligations[.]"[38]

B. Limited Three-Tier Fund-of-Funds Structures

The Proposed Rule would curtail three-tier fund-of-funds structures, which might require certain types of existing three-tier arrangements to restructure. For example, certain current three-tier structures may involve an acquiring fund that relies on Section 12(d)(1)(G) and Rule 12d1-2 to invest in affiliated and unaffiliated acquired funds that, in turn, in reliance on exemptive orders, may invest in excess of the 12(d)(1) Limits in shares of ETFs, short-term fixed income funds for cash management purposes, or other "central funds" to centralize the portfolio management of floating rate or other instruments.[39] In certain of these affiliated fund-of-funds structures, the investment adviser to the acquiring fund charges

[36] Rule 22e-4 defines an "illiquid investment" as "any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment . . . ."

[37] Also, the policy rationale behind the 3% redemption limit may not have fully taken account of the ability of acquired mutual funds to redeem in-kind (*see, e.g.*, Signature Financial Group, SEC Staff No-Action Letter (Dec. 22, 1999)), subject to board-adopted procedures to avoid disruption from large-scale redemptions. Similarly, most ETFs have the ability to redeem in-kind and avoid similar disruption.

[38] *See Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Jan. 17, 2017) at 8.

[39] *See* Proposing Release at 86-87; *id.* at 95-97.

only a relatively low advisory fee or no advisory fee for its services, and the acquired fund fees and expenses of both underlying tiers of the fund-of-funds structure are fully disclosed in the expense ratio of the acquiring fund, mitigating the concerns of layering of fees and overly complex structures. With the Proposed Rule, all exemptive orders that facilitate these arrangements would be rescinded,[40] and any acquired fund relying on the Proposed Rule would not be permitted to invest in an acquired fund that discloses in its registration statement that it too may rely on the Proposed Rule. As a result, these types of existing three-tier arrangements may need to be restructured.[41]

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Although the Proposed Rule reflects an effort to simplify and standardize the current regulatory framework applicable to fund-of-funds arrangements, the Proposed Rule would impose new conditions that are not applicable under the current regime and could require changes to the operation of certain existing fund-of-funds arrangements. Investment advisers that currently rely on exemptive orders to operate fund-of-funds structures should review their orders to assess the differences between their relief and the Proposed Rule to determine whether any changes in operation would be required under the Proposed Rule and the potential impact of any such changes.

[40] *See supra* note 24.

[41] The Proposing Release acknowledges that the acquired funds could be required to reallocate or reduce their investments in ETFs. *See* Proposing Release at 96-97.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Margery K. Neale
212 728 8297
mneale@willkie.com

Benjamin J. Haskin
202 303 1124
bhaskin@willkie.com

Jay Spinola
212 728 8970
jspinola@willkie.com

Elliot J. Gluck
212 728 8138
egluck@willkie.com

Anne C. Choe
202 303 1285
achoe@willkie.com