CLIENT ALERT

SEC Adopts New Rule for Fund of Funds Arrangements

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On October 7, 2020, the Securities and Exchange Commission (the "SEC") adopted Rule 12d1-4 (the "Rule") under the Investment Company Act of 1940 (the "1940 Act") to permit investment companies registered under the 1940 Act and business development companies ("BDCs") to acquire shares of other registered investment companies and BDCs in excess of the limits of Sections 12(d)(1)(A), (B) and (C) of the 1940 Act (the "12(d)(1) Limits"), subject to certain conditions.[1] The Rule and related administrative actions (discussed below) are intended to "streamline and enhance the regulatory framework applicable to fund of funds arrangements" by creating "a consistent and efficient rules-based regime . . . ."[2]

Consistent with the SEC's rule proposal in December 2018,[3] the Rule does not expand the ability of private funds or non-U.S. funds to invest in registered funds and BDCs in excess of the applicable limits set out in Sections 12(d)(1)(A) and (B). In addition, the Rule restricts multi-tiered fund of funds structures, generally limiting fund of funds arrangements to two-tiered structures, with certain specified exceptions (discussed below). In a notable change from the SEC's 2018

1 *Fund of Funds Arrangements*, Investment Company Act Release No. 34045 (October 7, 2020) (the "Release"), *available* here.

2 Release at 3.

3 *See Fund of Funds Arrangements*, Investment Company Act Release No. 33329 (December 19, 2018) ("Proposing Release"). For more information on the proposed rule, please see our client alert entitled "SEC Proposes New Rule for Fund-of-Funds Arrangements" (January 29, 2019), available here.

proposal, the Rule does not contain the 3% limitation on redemptions by acquiring funds from underlying funds that faced criticism from the industry.[4]

In connection with the adoption of the Rule, the SEC adopted related amendments to Rule 12d1-1 under the 1940 Act and Form N-CEN. In addition, the SEC is rescinding Rule 12d1-2 along with almost all of the fund of funds exemptive orders that it has issued, in seeking to regulate those arrangements through a single rules-based regime. The SEC's Division of Investment Management has also announced the withdrawal of previously issued letters relating to fund of funds arrangements.[5]

The effective date of the Rule and the related amendment to Rule 12d1-1 will be 60 days following publication of the Rule in the *Federal Register*.[6] The compliance date for the amendment to Form N-CEN will be 425 days after publication in the *Federal Register*. The rescission of Rule 12d1-2 and the fund of funds exemptive orders will become effective one year from the effective date of the Rule.

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.[7] 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, and to address concerns regarding the potential for duplicative and excessive fees and the formation of overly complex structures that could be confusing to investors.[8]

The 12(d)(1) Limits are embodied in Sections 12(d)(1)(A), (B) and (C). Generally speaking, Section 12(d)(1)(A) limits the acquisition by an investment company (an "acquiring fund") of securities of another investment company (an "acquired

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4 *See* Proposing Release at 47-59 (discussing the proposed redemption limit).

5 See Division of Investment Management Staff Statement Regarding Withdrawal of Staff Letters Related to Rulemaking on Fund of Fund Arrangements, IM Information Update 2020-05 (October 2020) (available here), for a list of no-action letters that are being withdrawn.

6 As of the date of this client alert, the Rule has not been published in the *Federal Register*.

7 Section 60 of the 1940 Act makes Section 12 applicable to BDCs. In addition, 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 Section 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 its securities and that relies on Section 3(c)(1) or 3(c)(7) is subject to Section 12(d)(1) to the same extent as a U.S. domiciled private fund.

8 *See* Release at 7; *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).

fund"),[9] and Section 12(d)(1)(B) limits a registered open-end investment company's sales of its securities to other investment companies.[10] Section 12(d)(1)(C) limits the acquisition by an acquiring fund, together with other investment companies having the same investment adviser, of securities of a registered closed-end investment company.[11]

There are three statutory exemptions from the 12(d)(1) Limits that permit different types of fund of funds arrangements, each subject to its own conditions. First, under Section 12(d)(1)(E), the investment by a feeder fund in a master fund, where the securities of the master fund are the only investment securities owned by the feeder fund, is exempt from the 12(d)(1) Limits. Second, under Section 12(d)(1)(F), a registered investment company may acquire up to 3% of an unlimited number of other investment companies' securities. Third, under Section 12(d)(1)(G), registered open-end funds and 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").[12]

The SEC adopted Rules 12d1-1 and 12d1-2 in 2006 to broaden the ability of acquiring funds to invest in acquired funds outside of the 12(d)(1) Limits.[13] Rule 12d1-1 allows acquiring funds to invest in shares of (registered and unregistered) money market funds in excess of the 12(d)(1) Limits. Rule 12d1-2 permits acquiring funds that rely on Section

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9 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.

10 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 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.

11 Section 12(d)(1)(C) prohibits an investment company that is an acquiring fund (and any company or companies controlled by the acquiring fund) from purchasing or otherwise acquiring any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition the acquiring fund, 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 investment company.

12 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, but not in other types of investments. See *infra* note 17 and accompanying text for a discussion with respect to the condition in Section 12(d)(1)(G) that limits the ability of acquired funds in an affiliated fund of funds arrangement to invest in other funds.

13 *See Fund of Funds Investments*, Investment Company Act Release No. 27399 (June 20, 2006), *available* here. In connection with the same rulemaking, the SEC also adopted Rule 12d1-3, which generally allows funds relying on Section 12(d)(1)(F) to charge sales loads greater than 1.5%, provided that the aggregate sales load an investor pays (*i.e.*, the combined distribution expenses of both the acquiring and acquired funds) does not exceed the limits on sales loads established by the Financial Industry Regulatory Authority, Inc. for funds of funds.

12(d)(1)(G) to invest without limit in affiliated acquired funds also to invest in (i) unaffiliated funds, where the acquisition is made in reliance on Section 12(d)(1)(A) or (F), (ii) other securities,[14] and (iii) unaffiliated money market funds in reliance on Rule 12d1-1.

Over the years, the SEC has also used its authority under Section 12(d)(1)(J) of the 1940 Act to issue exemptive orders permitting various types of fund of funds arrangements that would otherwise be prohibited by the 12(d)(1) Limits. For example, relief from Sections 12(d)(1)(A) and (B) was included in exemptive orders permitting exchange-traded funds ("ETFs") to operate so that acquiring funds could invest in ETFs in excess of the 12(d)(1) Limits.

The adoption of the Rule and the rescission of Rule 12d1-2 and most exemptive orders permitting fund of funds arrangements will narrow the available relief from the 12(d)(1) Limits for funds that currently participate in fund of funds arrangements, while expanding the ability of other types of funds (such as unlisted closed-end funds and BDCs) to participate in fund of funds arrangements in reliance on the Rule.

II. Summary of the Rule

A. Scope of the Rule

The Rule permits registered open-end funds, UITs, listed and unlisted closed-end funds, BDCs, ETFs and exchange-traded management funds ("ETMFs") to rely on the Rule as both acquiring funds and acquired funds, subject to compliance with certain conditions. Notably, the Rule does not permit private funds or non-U.S. funds to rely on the Rule. As a result, private funds and non-U.S. funds may acquire no more than 3% of the outstanding voting stock of a U.S. registered investment company or BDC.[15]

[14] The SEC has provided exemptive relief, and the SEC staff has issued no-action relief, to permit an affiliated fund of funds arrangement relying on Section 12(d)(1)(G) and Rule 12d1-2 also to invest its assets in instruments that may not be securities. *See* Release at 142 n.504. The exemptive relief is being rescinded and the no-action relief is being withdrawn in connection with the current rulemaking. *See supra* note 5 and accompanying text.

[15] See *supra* note 7 for a discussion of the applicability of Section 12(d)(1) to private funds and non-U.S. funds. The Release notes that unregistered investment companies may seek exemptive relief to invest in excess of the 12(d)(1) Limits, as the exemptive application process provides an opportunity for the SEC to consider tailored conditions and limitations for a specific applicant. *See* Release at 20.

B. Limitations on Complex Structures

The Rule restricts fund of funds arrangements to two tiers, except in certain limited circumstances that the Release describes as not implicating the regulatory concerns underlying the Rule.[16] Specifically, under the Rule:

(a) No investment company may rely on Section 12(d)(1)(G)[17] or the Rule to purchase or otherwise acquire, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of an investment company (a "second-tier fund") that relies on the Rule to acquire securities of an acquired fund, unless the second-tier fund makes investments as described in the next paragraph;[18] and

(b) No second-tier fund may purchase or otherwise acquire the securities of an investment company or private fund if, immediately after such purchase or acquisition, the securities of investment companies and private funds owned by the second-tier fund have an aggregate value in excess of 10% of the value of the total assets of the second-tier fund (the "10% Bucket"). The following investments by the second-tier fund are not counted towards the 10% Bucket:

- investments as a feeder fund in a master-feeder arrangement in reliance on Section 12(d)(1)(E) of the 1940 Act;
- shares of registered or unregistered money market funds acquired in reliance on Rule 12d1-1;
- investment in a subsidiary that is wholly-owned and controlled by the second-tier fund;
- securities received as a dividend or as a result of a plan of reorganization of a company; or
- securities of another investment company received pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.[19]

[16] *See* Release at 112.

[17] Section 12(d)(1)(G)(i)(IV) limits the ability of an acquired (i.e., second-tier) fund in an affiliated fund of funds structure to invest in other registered open-end funds or UITs. Specifically, any such second-tier fund must have a policy that prohibits it from investing in other registered open-end funds or UITs in reliance on Section 12(d)(1)(F) or (G).

[18] Rule 12d1-4(b)(3)(i).

[19] Rule 12d1-4(b)(3)(ii).

The ability of a second-tier fund to invest in reliance on the 10% Bucket is without restriction on the purpose of the investment or types of underlying funds or the size of investment in a particular underlying fund.[20]

C. Exemptions from the Prohibition on Certain Affiliated Transactions

Absent an exemption, the prohibition in Section 17(a) of the 1940 Act on principal transactions between an affiliated person of a registered fund and the fund could inhibit fund of funds arrangements where an acquiring fund that is an affiliated person of the acquired fund (such as by virtue of holding 5% or more of the acquired fund's voting securities) seeks to make additional investments in the acquired fund.[21] The Rule provides an exemption from Section 17(a) to the extent necessary to permit fund of funds arrangements under the Rule.[22]

For in-kind transactions involving an acquired fund that is an ETF, the Rule provides an exemption from Section 17(a) with regard to the deposit and receipt of baskets of assets by an acquiring fund that is an affiliated person of the acquired ETF (or an affiliated person of such a person) solely by reason of holding with the power to vote 5% or more of the ETF's shares or holding with the power to vote 5% or more of the shares of any investment company that is an affiliated person of the ETF.[23] This exemption is not available where the ETF is an affiliated person of the acquiring fund, or an affiliated person of such a person, for a reason other than such power to vote.[24]

The Release acknowledges the implied exemption from Section 17(a) that exists with respect to fund investment transactions permitted by Sections 12(d)(1)(E) (the exemption from 12(d)(1) Limits for master-feeder structures) and 12(d)(1)(G) (the exemption from 12(d)(1) Limits for affiliated funds of funds).[25] The Release states, however, that the SEC

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[20] *See* Release at 118-19. To the extent an acquired fund relies on the 10% Bucket to invest in an underlying fund in excess of the 12(d)(1) Limits, the acquired fund and the underlying fund would be required to comply with the conditions of the Rule as acquiring and acquired funds, respectively, or seek to rely on another available exemption. *See id.*

[21] Section 17(a) 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. Section 2(a)(3) defines an "affiliated person" of another person to include, among others, any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person, any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person, and any person directly or indirectly controlling, controlled by, or under common control with such other person. *See* Section 2(a)(3)(A), (B) and (C) of the 1940 Act.

[22] *See* Rule 12d1-4(a). With respect to BDCs, the Rule provides an exemption from Section 57(a)(1)-(2) of the 1940 Act for arrangements that comply with the Rule. *See id.* Sections 57(a)(1) and 57(a)(2) generally prohibit certain persons who are close affiliates of a BDC (as set forth in Section 57(b)), acting as principal, from knowingly selling any security or other property to such BDC (or any company controlled by such) or from knowingly purchasing from such BDC (or any company controlled by such BDC) any security or other property (except securities of which the seller is the issuer), in each case subject to certain limited exceptions.

[23] Rule 12d1-4(a)(3).

[24] Release at 28.

[25] *See id.* at 30.

is not issuing an interpretation that there is also an implied exemption from Section 17(a) for fund of funds arrangements that involve affiliated persons but that do not exceed the 12(d)(1) Limits or that meet the statutory exemption in Section 12(d)(1)(F).[26] However, the Release states that funds that comply with the conditions in the Rule may rely upon the exemption from Section 17(a) provided by the Rule even if they are not relying upon the Rule for an exemption from the 12(d)(1) Limits.[27] Thus, a second-tier fund in an affiliated fund of funds arrangement under Section 12(d)(1)(G) could rely on the Rule to invest in an affiliated fund, even if such investment were not in excess of the 12(d)(1) Limits.[28]

D. Conditions for Reliance on the Rule

To rely on the Rule, an acquiring fund (and, with respect to certain identified conditions, an acquired fund) must satisfy the following:

1. *Control and Voting*

To address the concern that an acquiring fund might have the ability to exert undue influence over an acquired fund by reason of ownership of the acquired fund's voting securities in excess of the 12(d)(1) Limits, the Rule places restrictions on an acquiring fund's (and certain of its affiliates') ownership and voting of securities of the acquired fund. The control and voting conditions described below do not apply when (i) the acquiring fund is in the same "group of investment companies" as an acquired fund,[29] 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 (collectively, "adviser and sub-adviser affiliated arrangements").[30]

[26] Id.

[27] *Id.* at 31.

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

[29] The Rule defines "group of investment companies" as any two or more registered investment companies or BDCs that hold themselves out to investors as related companies for purposes of investment and investor services.

[30] Rule 12d1-4(b)(1)(iii).

The Rule imposes the following control and voting provisions other than with respect to adviser and sub-adviser affiliated arrangements:

(a) An acquiring fund and its advisory group[31] are prohibited from "controlling" (as such term is defined in the 1940 Act), individually or in the aggregate, an acquired fund;[32] and

(b) If an acquiring fund and its advisory group (in the aggregate) hold (a) more than 25% of the outstanding voting securities of an acquired fund that is a registered open-end fund or UIT as a result of a decrease in the outstanding voting securities of the acquired fund, or (b) more than 10% of the outstanding voting securities of an acquired fund that is a registered closed-end fund or BDC, the acquiring fund and its advisory group must vote its securities of the acquired fund using mirror voting (or, in circumstances where all of the outstanding voting securities of the acquired fund are held by acquiring funds that are otherwise required to use mirror voting, pass-through voting).[33]

The imposition of the mirror voting requirement when an acquiring fund and its advisory group hold more than 10% of a closed-end fund's outstanding voting securities applies even if such threshold is exceeded as a result of a decrease in the outstanding voting securities of the closed-end fund and not through acquisition. The Release states that the purpose of

[31] 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." The Release acknowledges that the definition of "advisory group" may capture many affiliates of an acquiring fund and its investment adviser in a complex financial services firm. It notes, however, that the conditions in the Rule relating to control and voting are similar to those in existing exemptive orders, and funds relying on those orders likely already have established policies and procedures to monitor compliance with the aggregation requirement embedded in the definition of "advisory group." The Release further states that, to the extent a particular advisory group has not already established policies and procedures pursuant to an exemptive order, it may need to restructure information barriers to permit entities within the advisory group to share the necessary information to comply with the Rule. *See* Release at 40.

[32] Rule 12d1-4(b)(1)(i). Because Section 2(a)(9) of the 1940 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, this condition will effectively preclude an acquiring fund and its advisory group from *acquiring*, in the aggregate, more than 25% of the outstanding voting securities of an acquired fund. Dispositions of acquired fund shares would not be required if the 25% ownership threshold were crossed by virtue of a reduction in the number of outstanding shares of the acquired fund.

[33] Rule 12d1-4(b)(1)(ii). Mirror voting generally requires that an acquiring fund vote the shares held by it in the same proportion as the vote of all other holders of shares of the underlying fund. Pass-through voting generally requires that an acquiring fund seek voting instructions from its security holders and vote such proxies in accordance with their instructions.

the 10% threshold for closed-end funds is to reduce undue influence concerns associated with shareholder votes, which are greater for closed-end funds than for other types of acquired funds given the more frequent shareholder meetings.[34]

As noted above, the Rule does not permit a private fund to rely on the Rule to invest in an acquired fund in excess of the limits in Section 12(d)(1)(A). The Release discusses concerns expressed by commenters regarding investments in registered closed-end funds by private funds. For example, some commenters noted that an investment adviser to multiple private funds that each invests in a registered closed-end fund below the 12(d)(1) Limits could, in the aggregate, acquire a significant interest in the closed-end fund that would not be subject to the conditions imposed by the Rule, as proposed, and thereby seek to exert undue influence on the acquired closed-end fund to the detriment of long-term shareholders.[35] Notwithstanding these concerns, the SEC declined to adopt any further limitations on the acquisition of closed-end fund shares by private funds in connection with the adoption of the Rule, stating, "After considering comments, we believe commenters' additional recommendations with respect to investments in closed-end funds that are within the statutory limitations of section 12(d)(1) are beyond the scope of this rulemaking."[36]

In one notable change from the proposed version of the Rule, the SEC determined, in response to strong opposition from commenters, not to include in the Rule the proposed limitation on redemptions by an acquiring fund of its holdings in an acquired fund.[37] As originally proposed, the Rule would have prohibited an acquiring fund that acquired shares of an acquired fund in excess of the 12(d)(1) Limits 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. In lieu of the proposed redemption limit, the Rule instead requires findings in respect of the acquiring fund and acquired fund, and, in certain cases, an agreement between the acquiring fund and acquired fund, which are intended to protect investors in fund of funds arrangements from the concerns the proposed redemption limit sought to address.[38] These requirements are discussed below.

2. *Required Findings*

The investment adviser to an acquired fund, and the investment adviser, principal underwriter, or depositor (as applicable) to an acquiring fund, respectively, in a fund of funds arrangement must make certain findings in connection with an acquisition of the acquired fund's shares in reliance on the Rule. The requirement that the findings be made applies to

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[34] Release at 52 ("We are concerned that a higher threshold for acquiring fund investments in closed-end funds, such as 15% or 25%, could give an acquiring fund's advisory group the ability to dictate certain fund actions and unduly influence the acquired closed-end fund.").

[35] *Id.* at 46.

[36] *Id.* at 48 (note omitted).

[37] *See supra* note 4 and accompanying text.

[38] As adopted, the Rule also does not require funds to disclose in their registration statements whether they are, or at times may be, an acquiring fund, which was another component of the proposal. *See* Release at 71.

adviser and sub-adviser affiliated arrangements (which, as discussed above, are carved out from the control and voting conditions).

Specifically, under the Rule:

(a) If the acquired fund is a management investment company (that is, not a UIT), the investment adviser to the acquired fund must find, prior to the initial acquisition of shares of the acquired fund by an acquiring fund in excess of the 3% limit in Section 12(d)(1)(A), that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed and, as part of this finding, the investment adviser must consider at a minimum the following items:[39]

- the scale of contemplated investments by the acquiring fund and any maximum investment limits;
- the anticipated timing of redemption requests by the acquiring fund;
- whether and under what circumstances the acquiring fund will provide advance notification of investments and redemptions; and
- the circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any such redemptions in kind.[40]

(b) If the acquiring fund is a management investment company (that is, not a UIT), the investment adviser of the acquiring fund must evaluate, prior to the initial acquisition of shares of an acquired fund in excess of the 3% limit in Section 12(d)(1)(A):

- the complexity of the structure;[41] and

[39] The Release states that an acquired fund's investment adviser should take into account, in addition to the items specified in the Rule and listed in the text above, any other relevant regulatory considerations in connection with making the requisite findings. For example, an acquired fund's investment adviser should take into account the acquired fund's liquidity and its liquidity risk management program under Rule 22e-4 when determining whether a fund of funds arrangement poses a risk of undue influence. *Id.* at 86.

[40] Rule 12d1-4(b)(2)(i)(B).

[41] The Release states that an acquiring fund's investment adviser, when evaluating the complexity of a fund of funds structure, should compare the complexity of the acquiring fund's investment in an acquired fund with a direct investment in assets similar to the acquired fund's holdings, and determine "whether the resulting structure would make it difficult for shareholders to appreciate the fund's exposures and risks or circumvent the acquiring fund's investment restrictions and limitations." Release at 87.

- the fees and expenses associated with the acquiring fund's investment in the acquired fund. The adviser must find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund.[42]

(c) If the acquiring fund is a UIT and the date of initial deposit of portfolio securities into the UIT occurs after the effective date of the Rule, the UIT's principal underwriter or depositor must evaluate the complexity of the structure associated with the UIT's investment in acquired funds and, on or before the date of initial deposit, find that the UIT's fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit.[43]

(d) In the case of a separate account funding variable insurance contracts that invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company offering the separate account that the insurance company has determined that the fees and expenses borne by the separate account, the acquiring fund, and the acquired fund, in the aggregate, are consistent with the standards set forth in Section 26(f)(2)(A) of the 1940 Act.[44]

In the case of the findings described in paragraphs (a) and (b) above, the investment adviser to each of the acquiring fund and the acquired fund must report its evaluation or findings, and the basis for its evaluation or findings, as applicable, to the relevant fund's board of directors no later than the next regularly scheduled board of directors meeting.[45] Following the initial investment by the acquiring fund in reliance on the Rule, an investment adviser is not required to make a separate evaluation or finding, as applicable, in connection with each additional investment by the acquiring fund in the acquired fund. However, continued evaluation and board reporting would be conducted as part of the fund's overall compliance program pursuant to Rule 38a-1 under the 1940 Act.[46]

Notably, as originally proposed, the Rule would have required the investment adviser of an acquiring fund to determine that the investment in an acquired fund was "in the best interest" of the acquiring fund, in connection with its evaluation of the complexity of the structure and aggregate fees and expenses associated with the acquiring fund's investment in the acquired fund.[47] After consideration of comments received on the proposal, the SEC did not include a "best interest"

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[42] Rule 12d1-4(b)(1)(A). As part of the assessment by an acquiring fund's investment adviser regarding the duplication of fees and expenses, the Release states that the adviser should consider factors such as whether the acquired fund's advisory fees are for services that are in addition to, rather than duplicative of, the services provided by the adviser to the acquiring fund, taking into account all relevant fees and expenses, such as sales charges, recordkeeping fees, sub-transfer agency services, and fees for other administrative services. Release at 88.

[43] Rule 12d1-4(b)(2)(ii).

[44] Rule 12d1-4(b)(2)(iii).

[45] Rule 12d1-4(b)(2)(i)(C).

[46] *See* Release at 78.

[47] *See id.* at 75.

determination in the Rule, opting instead to require that the investment adviser to the acquiring fund determine that the fees and expenses are not duplicative of the fees and expenses of the acquired fund, as described above.[48] In addition, the Release notes that, in the case of the required analysis and findings described in paragraphs (a) and (b) above, the investment adviser to each of the acquiring fund and the acquired fund will be subject to its fiduciary duty to act in the best interests of each fund it advises.[49]

3. *Fund of Funds Investment Agreement*

Except where the acquiring fund and the acquired fund share the same investment adviser (and such adviser is not acting as the sub-adviser to either fund), an acquiring fund must enter into an agreement with the acquired fund that will be effective for the duration of each fund's reliance on the Rule (an "investment agreement").[50] The Release states that the investment agreement will empower funds relying on the Rule to negotiate and tailor appropriate terms to protect their respective interests in a fund of funds arrangement. The investment agreement must be entered into before the acquiring fund invests in the acquired fund in reliance on the Rule and must include the following terms:

(a) any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the required findings under the Rule;

(b) a termination provision whereby either the acquiring fund or the acquired fund may terminate the agreement subject to advance written notice no longer than 60 days; and

(c) a requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund.[51]

Termination of the investment agreement does not, unless otherwise agreed to by the parties, require that the acquiring fund reduce its position in the acquired fund, but will prevent the acquiring fund from purchasing additional shares of the acquired fund beyond the 12(d)(1) Limits.[52]

The Release notes that, in negotiating the investment agreement, the investment adviser to each of the acquiring fund and acquired fund, respectively, "can set the terms of the agreement to support" the findings required by the Rule, such as by including a term requiring that "the acquiring fund agree to submit redemptions over a certain amount for a given period

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[48] *See id.* at 76.

[49] *See id.* at 74.

[50] Funds with same investment adviser would not enter into an agreement but the fund must memorialize the arrangements that enabled the adviser to make the required findings for each fund under the Rule. *See* Rule 12d1-4(c)(2).

[51] Rule 12d1-4(b)(2)(iv).

[52] Release at 101.

as a condition" to the acquired fund entering into the agreement.[53] The Release further states that the investment adviser to each of the acquiring fund and the acquired fund "should address all matters to the extent necessary to allow the fund to comply with legal and regulatory requirements under the Federal securities laws."[54]

The Release makes clear that investment agreements are material contracts not made in the ordinary course of business and, as such, must be filed as an exhibit to a fund's registration statement.[55]

III. Rescission of Rule 12d1-2 and Existing Exemptive Relief and Amendment of Rule 12d1-1

The SEC is rescinding Rule 12d1-2 under the 1940 Act "to harmonize the overall regulatory structure and create a consistent and efficient regulatory framework for the regulation of fund of funds investments."[56] As described above, Rule 12d1-2 generally permits a fund that is relying on Section 12(d)(1)(G) to acquire the securities of acquired funds that are not part of the same group of investment companies, subject to the 12(d)(1) Limits, to invest directly in other securities, and to acquire the securities of money market funds in reliance on Rule 12d1-1.[57] The rescission of Rule 12d1-2 will eliminate the ability of funds relying on Section 12(d)(1)(G) to acquire the securities of underlying funds that are not part of the same group of investment companies and to invest directly in other securities (or other financial instruments) other than Government securities and short-term paper; to do so, these affiliated fund of funds arrangements will instead need to rely on the Rule. An affiliated fund of funds arrangement that seeks to continue to rely on Section 12(d)(1)(G) will, however, be able to continue to invest in unaffiliated money market funds in reliance on Rule 12d1-1, as amended in connection with the adoption of the Rule.

The SEC is also rescinding 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 ETMF exemptive orders providing relief from Sections 12(d)(1)(A) and (B).[58] The SEC is not, however, rescinding exemptive orders granting relief from Sections 12(d)(1)(A) and (B) that allow certain interfund lending arrangements, subject to certain conditions, or exemptive

[53] *See id.* at 98.

[54] *Id.* at 88.

[55] *Id.* at 102.

[56] *See id.* at 129.

[57] *See supra* note 14.

[58] *See Release* at 139.

orders (or portions thereof) granting relief that fall outside the scope of the Rule.[59] The SEC staff is also withdrawing certain no-action letters relating to the 12(d)(1) Limits, effective one year from the effective date of the Rule.[60]

The adoption of the Rule and the rescission of Rule 12d1-2 and the exemptive orders permitting fund of funds arrangements may require changes to, or otherwise curtail the operation of, certain existing fund of funds arrangements, such as multi-tier fund of funds arrangements. In order to limit the potential hardship that the rescission of Rule 12d1-2 and the fund of funds exemptive orders could have on existing fund of funds arrangements, the SEC is delaying the effective date of the rescission of Rule 12d1-2 and the exemptive orders until one year following the effective date of the Rule.

IV. Recordkeeping and Reporting

Funds that enter into fund of funds arrangements in reliance on the Rule are required to maintain and preserve certain written records for a period of not less than five years, the first two years in an easily accessible place, including copies of any investment agreements and a written record of the evaluations and findings required to be made under the Rule and the basis for those findings.

In connection with its adoption of the Rule, the SEC is also amending Form N-CEN to require a reporting fund to disclose on Form N-CEN whether it relied on the Rule or the statutory exception in Section 12(d)(1)(G) during the reporting period.

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The Rule reflects an effort to simplify and standardize the current regulatory framework applicable to fund of funds arrangements, and eliminates "unnecessary and potentially confusing distinctions among permissible investments for different types of acquiring funds" by, for example, expanding the types of funds that may be acquired by closed-end funds and BDCs above the statutory limits to create parity with open-end funds and ETFs.[61] At the same time, the Rule imposes new conditions that are not applicable under the current regime and could require changes to the operation of certain existing fund of funds arrangements, particularly those involving multiple tiers of funds. 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 conditions imposed by the Rule to determine whether any changes in operation will be required under the Rule and the potential impact of those changes.

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[59] For example, the SEC is not rescinding exemptive orders or portions of exemptive orders, as the case may be, that provide relief from Sections 17(a) and/or 17(d) of the 1940 Act and Rule 17d-1 thereunder that allow a registered fund to invest in private funds or that permit fee sharing agreements to avoid duplicative fees. *See id.* at 139-40.

[60] *See id.* at 149-51. *See supra* note 5.

[61] *See* Release at 12-13.

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

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