The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC Adopts Fund of Funds Rule

[32821]

October 9, 2020 TO: ICI Members
Investment Company Directors
CCO Advisory Issues Subcommittee
Chief Compliance Officer Committee
Closed-End Investment Company Committee
Compliance Advisory Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
ICI Securities Regulation Advisory Group
Independent Directors Council
Money Market Funds Advisory Committee
SEC Rules Committee
Small Funds Committee
Variable Insurance Products Advisory Committee SUBJECTS: Closed-End Funds
Compliance
Exchange-Traded Funds (ETFs)
Money Market Funds
Variable Insurance Products RE: SEC Adopts Fund of Funds Rule

Earlier this week, the SEC adopted a new rule (Rule 12d1-4) and amendments under the Investment Company Act of 1940 designed to streamline and enhance the regulatory framework for funds that invest in other funds ("fund of funds" arrangements).[1] The SEC also is rescinding 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 Act. Finally, the SEC is adopting related amendments to Rule 12d1-1 under the Act and Form N-CEN.

New Rule 12d1-4

Rule 12d1-4 will permit a registered investment company or business development company (BDC) ("acquiring funds") to acquire the securities of any other registered investment company or BDC ("acquired funds") in excess of the limits in Section 12(d)(1) of the Investment Company Act. The rule will create a consistent framework for fund of funds arrangements to replace the existing approach, which depends on the SEC's exemptive orders and varies based on an acquiring fund's type. Mutual funds, UITs, closed-end funds (including BDCs), ETFs, and ETMFs will be able to rely on Rule 12d1-4 as both acquiring and acquired funds.

Rule 12d1-4 includes conditions that are based on the conditions in prior fund of funds exemptive orders and commenters' suggestions (including ICI). A table on pages 34-35 of the SEC's release provides a general overview of the differences among the conditions under its current exemptive relief, proposed Rule 12d1-4, and the final rule. The final conditions include the following:

- ***Limits on Control and Voting*.** Rule 12d1-4 will prohibit an acquiring fund from controlling an acquired fund and will require an acquiring fund and its advisory group to use mirror voting when they hold more than: (i) 25 percent of the outstanding voting securities of an open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund (consistent with prior exemptive orders and as suggested by ICI); or (ii) 10 percent of the outstanding voting securities of a closed-end fund. An acquiring fund that is part of the same fund group as the acquired fund and an acquiring fund that has a sub-adviser that acts as adviser to the acquired fund will not be subject to the control and voting conditions. As proposed, the rule, which did not differ based on the type of acquired fund, would have required an acquiring fund and its advisory group to use pass-through or mirror voting when they hold more than 3 percent of the acquired fund's outstanding voting securities.
- ***Required Evaluations and Findings*.** To address concerns that an acquiring fund could exert undue influence over an acquired fund or charge duplicative fees and expenses, the rule will require (i) an acquired management company's adviser to make certain findings focused on addressing undue influence concerns by considering specific enumerated factors, including timing of redemptions;[2] (ii) an acquiring fund's adviser, principal underwriter, or depositor to conduct an evaluation of the complexity of the fund of funds structure and its aggregate fees and expenses and make a finding that the fees and expenses are not duplicative. UITs and separate accounts funding variable insurance contracts are subject to different findings. Notably, with respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the rule will require an acquiring fund to obtain a certification from the insurance company issuing the separate account that it has determined that the fees and expenses borne by the separate account, acquiring fund, and acquired fund, in the aggregate, are consistent with Section 26(f)(2)(A) of the Investment Company Act. This requirement generally is the same as proposed.
- ***Required Fund of Funds Investment Agreements*.** The rule will require funds that do not share the same investment adviser to enter into a fund of funds investment agreement memorializing the terms of the arrangement. In negotiating the fund of funds investment agreement, funds can set the terms of the agreement to support the findings' condition discussed above. The agreement also must include a termination provision that allows either party to terminate the agreement with advance written notice within a period no longer than 60 days. Lastly, the agreement must include a provision requiring an acquired fund to provide the acquiring fund with fee and expense information to the extent reasonably requested.

  This and the evaluation and findings' condition replace the most disruptive aspect of the proposed rule (and the least consistent with prior regulation of fund of funds arrangements), a proposed requirement that would have prohibited an acquiring fund that acquires more than 3 percent of an acquired fund's outstanding shares from redeeming more than 3 percent of the acquired fund's total outstanding shares in any 30-day period. The release notes that the requirement to enter into a fund of funds investment agreement, coupled with the expanded findings' condition, are collectively

a more effective approach than the proposed redemption limit to address undue influence concerns from redemptions.

- ***Limits on Complex Structures*.** To limit funds' ability to use fund of funds arrangements to create overly complex structures, Rule 12d1-4 generally will prohibit funds from creating three-tier fund of funds structures, except in certain circumstances, including an exception recommended by ICI that will permit an acquired fund to invest up to 10 percent of its total assets in other funds (including private funds) without restriction (the "10 percent bucket").[3] Accordingly, Rule 12d1-4 provides flexibility for acquired funds to invest in private funds, structured finance vehicles, central funds, ETFs, and other investment funds up to a 10 percent limit. This condition, however, is generally more comprehensive and, therefore, limiting, than the conditions in the SEC's exemptive orders, and addresses certain multi-tier arrangements that have emerged.[4]

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

To help create a consistent and streamlined regulatory framework for fund of funds arrangements, the SEC also is taking several related actions:

- ***Rescission of Rule 12d1-2 and Certain Exemptive Relief.*** The SEC is rescinding Rule 12d1-2, which permits funds that primarily invest in funds within the same fund group to invest in unaffiliated funds and non-fund assets. The SEC also is rescinding its exemptive orders permitting fund of funds arrangements, with limited exceptions.[5] Similarly, the SEC is withdrawing no-action letters stating that the staff would not recommend an enforcement action under specific circumstances related to Section 12(d)(1).[6] As a result, funds wishing to create certain types of fund of funds arrangements that exceed the statutory limitations will be required to rely on Rule 12d1-4 and comply with its associated conditions.
- ***Amendments to Rule 12d1-1*.** The SEC is amending Rule 12d1-1 to allow funds that primarily invest in funds within the same fund group to continue to invest in unaffiliated money market funds.

Acquired Fund Fees and Expenses

An acquiring fund is currently required to disclose the fees and expenses it incurs indirectly from investing in shares of one or more acquired funds. In Form N-1A, for example, an open-end fund investing in another fund is required to include in its prospectus fee table an additional line item titled "Acquired Fund Fees and Expenses" (AFFE). Since the SEC adopted the AFFE disclosure requirement, some, including ICI, have expressed concerns about the impact of this disclosure on certain acquired funds, including BDCs. The release notes that the SEC is not addressing AFFE disclosure requirements as part of this rulemaking. Instead, the release notes that the SEC is considering modifications to AFFE disclosure as part of a broader review of how funds disclose fees in their prospectuses.[7]

Amendments to Form N-CEN

The SEC also is amending Form N-CEN to require funds to report whether they relied on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G) of the Investment Company Act during the applicable reporting period.

Effective and Compliance Dates

The rule will be effective 60 days after publication in the *Federal Register*. To facilitate a

transition period, the compliance date for the amendments to Form N-CEN will be 425 days after publication in the *Federal Register*. Further, the rescission of Rule 12d1-2 and the SEC's exemptive orders will be effective one year from the effective date of the rule.

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endnotes

[1] *See* Fund of Funds, SEC Release No. IC-34045 (October 7, 2020) ("release").

[2] These factors are (1) the scale of contemplated investments by the acquiring fund and any maximum investment limits; (2) the anticipated timing of redemption requests by the acquiring fund; (3) whether, and under what circumstances, the acquiring fund will provide advance notification of investment and redemptions; and (4) the circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any redemptions in kind.

[3] Exceptions to the 10 percent bucket requirement include securities of another investment company that is: (i) acquired in reliance on Section 12(d)(1)(E) of the Investment Company Act (*i.e.*, master-feeder arrangements); (ii) acquired pursuant to Rule 12d1-1; (iii) a subsidiary wholly owned and controlled by the acquired fund; (iv) received as a dividend or as a result of a plan of reorganization of a company; or (v) acquired pursuant to SEC exemptive relief to engage in interfund borrowing and lending transactions.

[4] The release notes that some existing multi-tier structures may be required to modify their investments to ensure compliance with Rule 12d1-4. For example, as of June 2018, the SEC identified 231 three-tier structure for which both the first- and second-tier funds invested in other funds beyond the limits in Section 12(d)(1). These multi-tier arrangements may need to restructure their holdings over time to continue to maintain the same investment, to the extent that the acquired funds in such structures invest more than 10 percent of their assets in underlying funds, exclusive of investments in underlying funds made pursuant to the exceptions noted in note 3.

[5] Fund of funds exemptive relief that falls outside the scope of Rule 12d1-4, as well as the relevant portions of fund of funds exemptive orders that grant relief for provisions in the Act outside of the scope of this rulemaking, will remain in place. The major topical areas of fund of funds exemptive relief that are within the scope of Rule 12d1-4 are listed on pages 140-145. The major topical areas that are outside the scope of Rule 12d1-4 are listed on pages 146-149.

[6] Release at 149-151.

[7] *See* Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Release No. IC-33963 (August 5, 2020).