

MEMO# 31540

January 2, 2019

SEC Proposes Rule Changes for Fund of Funds Arrangements

[31540]

January 2, 2019 TO: ICI Members
Investment Company Directors
Closed-End Investment Company Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
ICI Securities Regulation Advisory Group
SEC Rules Committee
Small Funds Committee
Unit Investment Trust Committee
Variable Insurance Products Advisory Committee SUBJECTS: Closed-End Funds
Disclosure
Exchange-Traded Funds (ETFs)
Unit Investment Trusts (UITs)
Variable Insurance Products RE: SEC Proposes Rule Changes for Fund of Funds
Arrangements

The Securities and Exchange Commission recently proposed a new rule and related amendments under the Investment Company Act of 1940 designed to streamline the regulatory framework for funds that invest in other funds (“fund of funds” arrangements).[\[1\]](#) The SEC also is proposing 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 Act. Finally, the SEC is proposing related amendments to Rule 12d1-1 under the Act and Form N-CEN.

Comments on the proposal are due 90 days after publication in the Federal Register.

Proposed Rule 12d1-4

Proposed Rule 12d1-4 would permit a registered investment company (including mutual funds, UITs, closed-end funds (listed and unlisted), ETFs and ETMFs) or BDCs (collectively referred to as “acquiring funds”) to acquire the securities of any other registered investment company or business development company (referred to as “acquired funds”) in excess of the limits in Section 12(d)(1) of the Investment Company Act of 1940.

Notably, proposed Rule 12d1-4 would not include private funds as acquiring funds because

private funds are not registered with the Commission and would not be subject to the reporting requirements that the SEC proposes on Form N-CEN regarding reliance on the proposed rule. For similar reasons, the proposed rule would not include foreign funds.

Proposed Rule 12d1-4 includes the following conditions:

- **Control and Voting.** Proposed Rule 12d1-4 would permit an acquiring fund to acquire up to 25 percent of an acquired fund, but an acquiring fund that holds more than 3 percent of an acquired fund's outstanding voting securities must use pass-through or mirror voting to minimize the influence that an acquiring fund may exercise over an acquired 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 would not be subject to the control and voting conditions.
- **Redemption Limits.** To address concerns that an acquiring fund could threaten large-scale redemptions as a means to exert undue influence over an acquired fund, the proposed rule would prohibit 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.[\[2\]](#) The release notes that acquiring funds that rely on the proposed rule to invest in funds that are listed on an exchange would be permitted to continue to sell shares in the secondary market without regards to the volume limit. This replaces the conditions under existing exemptive orders that require participation agreements and board findings/procedures.
- **Excessive Fees.** The proposed rule includes conditions designed to prevent duplicative and excessive fees in fund of funds arrangements by requiring an evaluation of aggregate fees associated with the investment in the acquired fund and the complexity of the fund of funds arrangement. Specifically, the conditions vary based on the structural characteristics of the acquiring fund (management companies, UITs, or separate account funding variable insurance contracts).
- **Complex Structures.** To limit funds' ability to use fund of funds arrangements to create overly complex structures, proposed Rule 12d1-4 generally would prohibit funds from creating three-tier fund of funds structures, except in certain limited circumstances.
 - Proposed Rule 12d1-4 would include a condition designed to prevent an acquiring fund from also being an acquired fund under the rule or under Section 12(d)(1)(G) of the Act. Specifically, the proposed rule would prohibit a fund that is relying on Section 12(d)(1)(G) of the Act or the proposed rule 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 acquiring fund in reliance on proposed Rule 12d1-4. This proposed provision would limit the ability of funds relying on Section 12(d)(1)(G) or Rule 12d1-4 to acquire the securities of acquiring funds, and, as a result, would significantly limit funds' ability to create multi-tier arrangements.
 - This condition would not prevent a master-feeder arrangement where a fund invests all of its assets in an acquiring fund in reliance on Section 12(d)(1)(E). Similarly, this condition would not prevent other funds from acquiring the voting securities of an acquiring fund in amounts under 3 percent.
 - Proposed Rule 12d1-4 would require a fund that relies on the rule (or wants to preserve investment flexibility to rely on the rule) to disclose in its registration statement that it is (or may be) an acquiring fund for purposes of Rule 12d1-4.

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

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

- **Proposed Rescission of Rule 12d1-2 and Certain Exemptive Relief.** The SEC is proposing to rescind 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. With the exception for orders for certain interfund lending arrangements, the SEC also is proposing to rescind the Commission's exemptive orders permitting fund of funds arrangements. As a result, funds wishing to create certain types of fund of funds arrangements that exceed the statutory limitations would be required to rely on proposed rule 12d1-4 and comply with its associated conditions.
- **Proposed Amendments to Rule 12d1-1.** The proposal also recommends 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.

Proposed Amendments to Form N-CEN

The proposal also includes amendments to 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.

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endnotes

[\[1\]](#) Fund of Funds Arrangements, Investment Company Act Release No. IC-33329 (December 19, 2018).

[\[2\]](#) It does not apply as a result of the fund exceeding the 5 percent limit on the total assets of an acquiring fund that may be invested in a single acquired fund under Section 12(d)(1)(A)(ii) of the Act or the 10 percent limit on the total assets of an acquiring fund that may be invested in all acquired funds under Section 12(d)(1)(A)(iii) of the Act.