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SEC Staff Issues Interpretive Letter Confirming that Certain Registered Funds of Funds May Invest in Affiliated Closed-End Funds

[30568] February 7, 2017 TO: ICI Members
Chief Compliance Officer Committee
Closed-End Investment Company Committee
SEC Rules Committee
Small Funds Committee SUBJECTS: Closed-End Funds
Compliance RE: SEC Staff Issues Interpretive Letter Confirming that Certain Registered Funds of Funds May Invest in Affiliated Closed-End Funds

The staff of the Securities and Exchange Commission's Division of Investment Management recently issued an interpretive letter confirming that certain registered funds that invest in affiliated open-end funds and unit investment trusts ("UITs") under a statutory exemption also may invest in affiliated closed-end funds, up to certain limits.[1] The letter clarifies regulatory text that otherwise seems to suggest that those funds could not invest in affiliated closed-end funds and provides those funds with another investment option.

Background

Many funds rely on the exemption in Section 12(d)(1)(G) of the Investment Company Act of 1940 to invest in affiliated funds in amounts that exceed the statutory limits on investments in other funds.[2] Section 12(d)(1)(G) permits funds to exceed the statutory limits, so long as the fund, among other things, invests only in open-end funds and UITs that are part of the same "group of investment companies," government securities and short-term paper.[3] Rule 12d1-2 under the 1940 Act permits funds to acquire an expanded list of assets while relying on Section 12(d)(1)(G), including other funds' securities that are not issued by another registered fund that is in the same group of investment companies, subject to certain limitations.[4] The restriction in this provision limiting investments in other funds to those outside of the same group of investment companies raised interpretive questions as to whether funds relying on the section and rule could invest in affiliated closed-end funds. The incoming letter, therefore, requested that the SEC staff concur with its interpretation that the restriction does not include closed-end funds in the same group of investment companies. In other words, this interpretation would permit funds relying on Section 12(d)(1)(G) and Rule 12d1-2 also to invest in affiliated closed-end funds.

Relief

The SEC staff concurred with the incoming letter's conclusion based on the analysis in the letter. As more fully described in the request letter, the requestors contended that the Commission did not intend Rule 12d1-2 to prevent an open-end fund from investing in affiliated closed-end funds. Rather, they reasoned that the rule was intended to broaden the scope of investments for an investing open-end fund relying on Section 12(d)(1)(G) and that there was no policy reason that would justify excluding investments in affiliated closed-end funds. The requestors also asserted their belief that the legislative and regulatory history behind the enactment of Section 12(d)(1)(G) supported the interpretation that closed-end funds should not be treated differently from other affiliated funds for these purposes.

The SEC staff's interpretation now provides funds relying on the relief in Section 12(d)(1)(G) and Rule 12d1-2 with a sound basis to invest in affiliated closed-end funds, up to the limits set forth in Rule 12d1-2.[5]

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endnotes

[1] *See* Dechert LLP (pub. avail. Jan. 25, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/dechert-012517-12d1.htm.

[2] Section 12(d)(1)(A) prohibits a registered fund ("acquiring fund") from acquiring the securities of any other registered fund ("acquired fund") if, after the acquisition, the acquiring fund owns: (a) more than 3 percent of the acquired company's voting stock; (b) securities of the acquired company with a value exceeding 5 percent of the acquiring fund's total assets; and (c) the aggregate value of the securities of all funds owned by the acquiring fund exceeds 10% of its net assets (the "3/5/10 limits").

[3] Section 12(d)(1)(G) permits funds to invest in other open-end funds and UITs that are part of the same "group of investment companies" in amounts greater than the 3/5/10 limits when:

- The acquiring fund and acquired fund are part of the same "group of investment companies;"
- The fund only holds open-end funds and UITs that are part of the same "group of investment companies," government securities, and short-term paper;
- The acquiring fund does not pay sales loads or distribution fees on the acquired fund's shares unless the acquiring fund does not charge a sales load or distribution fee, or, if imposed at both levels, the sales loads and distribution fees are not excessive under SEC or FINRA rules;
- The acquired company has a policy prohibiting it from acquiring securities of registered open-end funds and UITs; and
- The acquisition does not contravene any SEC rules and regulations.

"Group of investment companies" means any 2 or more registered funds that hold themselves out to investors as related companies for purposes of investment and investor

services. See Section 12(d)(1)(G) of the 1940 Act.

[4] Rule 12d1-2 under the 1940 Act permits funds relying on Section 12(d)(1)(G) of the 1940 Act to acquire:

- Securities issued by a fund, other than securities issued by another registered investment company that is in the same group of investment companies, when the acquisition is in reliance on [Section 12(d)(1)(A) (subject to the 3/5/10 limits) or Section 12(d)(1)(F) (an exemption for funds to invest in unaffiliated funds)];
- Securities (other than fund securities); and
- Money market fund securities.

See Rule 12d1-2 under the 1940 Act.

[5] The acquiring fund may acquire shares of the closed-end fund up to 3/5/10 limits or, when the acquiring fund is acting in compliance with Section 12(d)(1)(F) of the 1940 Act, up to 3 percent of the total outstanding stock of the acquired fund's total outstanding stock when combined with the interests of other affiliated persons of the acquiring fund. *See id.* Section 12(d)(1)(F) permits funds and their affiliated persons to exceed the 5 percent and 10 percent limits of the 3/5/10 limits and acquire up to 3 percent of the total outstanding stock of an acquired fund when:

- The acquiring fund charges a sales load of 1.5 percent or less; and
- The acquiring fund seeks instructions from security holders or votes shares in proportion as the other votes cast ("mirror votes") and the acquired fund is not obligated to redeem more than 1 percent of its total outstanding securities during any period less than 30 days.

See Section 12(d)(1)(F) under the 1940 Act.
