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Securities and Exchange Commission Adopts Final Fund of Funds Rule

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The Securities and Exchange Commission (SEC) adopted on October 7, 2020 Rule 12d1-4 (final rule) and other amendments under the Investment Company Act of 1940, as amended (1940 Act), which streamline and enhance the regulatory requirements for registered investment companies and business development companies (together, funds) to acquire shares of other funds in excess of the limits in Section 12(d)(1) of the 1940 Act (fund of funds arrangements).[1],[2] Fund of funds arrangements have historically been permitted through statutory exemptions in the 1940 Act, SEC rules under the 1940 Act and SEC exemptive orders. The final rule generally codifies existing conditions in the SEC exemptive orders, removing the need for SEC exemptive relief for many fund of funds arrangements. The SEC adopted requirements under the final rule, generally as proposed by the SEC (proposed rule)[3], except for certain differences that are discussed below.

The SEC approved the following as part of the October 7, 2020 rule-making:

- Adoption of new Rule 12d1-4 under the 1940 Act (with certain differences from the proposed rule);
- Rescission of Rule 12d1-2 under the 1940 Act;
- Rescission of most SEC orders granting exemptions from 12(d)(1)(A), (B), (C) and (G) of the 1940 Act;
- Amendments to Rule 12d1-1 under the 1940 Act; and
- Amendments to Form N-CEN

These are described below.

New Rule 12d1-4

Rule 12d1-4 allows funds (acquiring funds) subject to certain conditions to acquire shares of other funds[4] (acquired funds) without obtaining a fund of funds exemptive order from the SEC. The final rule builds upon the fund of funds exemptive orders that have historically been issued by the SEC and permits additional types of fund of funds arrangements. In addition to mutual funds and exchange-traded funds (ETFs), exchange-traded managed funds (ETMFs), listed and unlisted closed-end funds, unit investment trusts (UITs), and listed and unlisted business development companies can be acquiring and acquired funds under the final rule. Private funds and unregistered investment companies, such as foreign investment companies, are excluded from the final rule.

Conditions. The final rule subjects fund of funds arrangements to a tailored set of conditions designed to address the historical abuses associated with fund of funds arrangements. The proposed rule would have imposed redemption limits if an acquiring fund held more than 3% of an acquired fund and required disclosure if a fund was or could be an acquiring fund. The SEC determined not to adopt the redemption limit or the disclosure requirement. Instead, the final rule includes a combination of conditions regarding: (i) required evaluations and findings by investment advisers, and (ii) fund of funds investment agreements. These conditions are based on the conditions contained in SEC exemptive orders with some differences as shown in the chart below. The following chart summarizes certain of the conditions under the final rule, and shows the differences from current regulatory requirements and the proposed rule.

Conditions	Existing Fund of Funds Exemptive Relief	Proposed Rule	Final Rule
Control and Voting	Differing voting conditions and procedures to prevent undue influence.	If an acquiring fund and its advisory group in the aggregate hold more than 3% 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.	Voting conditions differ based on the type of acquired fund. Voting conditions require an acquiring fund and its advisory group to use mirror voting when they hold more than: (i) 25% of the outstanding voting securities of an open-end fund due to a decrease in the outstanding securities of the acquired fund, or otherwise control the acquired fund (within the meaning of the 1940 Act); or (ii) 10% of the outstanding voting securities of a closed-end fund. In circumstances where an acquiring fund is the only shareholder of an acquired fund, however, pass-through voting may be used.

			The final rule does not impose a limit on redemptions.
Required Findings: Layering of Fees	Requires the investment adviser to an acquiring fund to waive advisory fees in certain circumstances or the board of the acquiring fund to make certain findings regarding the advisory fees (e.g., that they are not duplicative). Sets limits on sales charges and service fees.	Advisers to management companies would be required to evaluate the complexity of the fund of funds arrangement and the associated aggregate fees associated with investment in the acquired fund and determine that it is in the best interest of the acquiring fund to invest in the acquired fund. The adviser would be required to report such determination and the basis for the determination to the board of the acquiring fund before investing and at least annually. This evaluation would not be required for each individual investment. Section 15 of the 1940 Act requires the board of the acquiring fund to evaluate any information reasonably necessary to evaluate the terms of the acquiring fund's advisory contract (including fees for services provided by the acquiring fund's adviser). The proposed rule did not require that the board of the acquiring fund find that the advisory fees are based on services provided that are in addition to, rather than duplicative of,	Generally, the same as proposed. In addition, an acquiring fund's investment adviser must find that the acquiring fund's fees and expenses are not duplicative of the fees and expenses of the acquired fund. Investment advisers to acquired funds that are management companies must make a finding that any undue influence concerns related to an acquiring fund's investments in the acquired fund are reasonably addressed, including the consideration of the (i) scale of investment, (ii) anticipated timing of redemption requests, (iii) advance notification of investments or redemptions and (iv) policies related to in-kind redemptions. A fund's investment adviser must also report its findings to its board of directors at the board's next scheduled board meeting.

		services provided by the acquired fund's adviser and did require an acquiring fund's adviser to waive fees received from an acquired fund. No sales charge or service fees limits because certain fund of funds arrangements are otherwise subject to limits by the Financial Industry Regulatory Authority (FINRA) Rule 2341.	
Fund of Funds Investment Agreement	Fund of funds participation agreements/board procedures and findings to prevent undue influence.	Proposed redemption restrictions to replace the requirements for certain board procedures and findings and fund of funds participation agreements.	The final rule requires funds that do not have the same investment adviser to enter into a fund of funds investment agreement. Although the agreements can generally be negotiated between the parties, the final rule requires that each such agreement also include three specific conditions, including (i) any material terms necessary to make fund findings specified above, (ii) a termination provision allowing either party to terminate with advance notice no longer than 60 days, and (iii) a provision requiring an acquired fund to provide the acquiring fund with any reasonably requested fee and expense information.
Complex Structures	Limits the ability of acquired fund to invest in underlying funds (three-tier fund of funds arrangements), subject to certain exceptions.	Prohibits a fund relying on Section 12(d)(1)(G) or proposed rule 12d1-4 from investing in an acquiring fund and limits acquired funds from investing in underlying	Prohibits a fund relying on Section 12(d)(1)(G) or the final rule from investing in an acquiring fund and limits acquired funds from investing in underlying funds (three-

	funds (three-tier structures), subject to certain exceptions. Requires an evaluation of the complexity of the fund of funds structure. (e.g., comparison to direct investment in similar assets held by an acquired fund). (see above) An acquiring fund would be required to disclose that it is or may at times be an acquiring fund in its registration statement.	tier structures), subject to certain exceptions. Allows an acquired fund to invest up to an additional 10% of its assets in other funds and private funds.

Limits on Control and Voting

As proposed, the final rule prohibits an acquiring fund and its advisory group from controlling an acquired fund (as control is defined in the 1940 Act) and establishes voting limitations noted above in order to reduce the amount of influence that an acquiring fund and its advisory group may have over an acquired fund. The limitations on control and voting conditions do not apply to fund of funds arrangements involving only funds within the same group of investment companies[5].

Required Findings

Pursuant to the final rule, advisers of acquired funds and acquiring funds must make certain evaluations and findings described above related to the potential exertion of undue influence over an acquired fund or the potential charging of duplicative fees and expenses. These findings differ depending upon the type of entity and whether a fund is the acquiring fund or the acquired fund.

Required Fund of Funds Investment Agreement

The final rule establishes a new requirement that was not included in the proposed rule. A fund of funds investment agreement, similar to participation agreements under current exemptive orders, must be entered into by acquiring and acquired funds that do not share the same investment adviser. Although the SEC expects such agreements to be individually negotiated, three specific conditions must be included as summarized in the chart above. The fund of funds investment agreement provides acquired funds with additional protection from potential undue influence from acquiring funds by providing acquired funds greater control over the timing and type of redemptions and the timing and scale of investments.

Complex Structure Limitations

The SEC addressed its concern over the potential to create overly complex fund of funds arrangements structures by also generally prohibiting an acquiring fund from investing in an acquired fund that in turn invests in another fund (three-tier structures), except in certain circumstances.

Permitting acquired funds to invest up to 10% of their total assets in other funds and private funds without restriction allows for flexibility in such acquired funds' investment strategies. However, many nontraded closed-end funds, which are now permitted acquired funds under the final rule, themselves invest in private funds. This provision in the final rule will limit the ability of acquiring funds to invest in such funds.

Exemptions from Section 17(a) of the Act. As proposed, the final rule provides an exemption from Section 17(a) of the 1940 Act with respect to fund of fund arrangements. Section 17(a) of the 1940 Act 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. The 1940 Act generally defines an "affiliated person" as someone owning, controlling or having the power to vote, 5% or more of a fund's outstanding securities. Absent an exemption, Section 17(a) would prohibit an acquiring fund that holds 5% or more of an acquired fund's securities from making any additional investments in the acquired fund, thereby limiting the scope of the final rule. In addition, the SEC adopted a modified exemption from Section 17(a) to provide relief for the in-kind purchase and redemption of shares in creation units directly by an acquiring fund that is an affiliated person of an acquired fund ETF solely by reason of the acquired fund holding with the power to vote 5% or more of the acquired fund ETF's shares.

Rescission of Rule 12d1-2 and Amendment to Rule 12d1-1 and Form N-CEN; Disclosures

In connection with the final rule, the SEC is rescinding Rule 12d1-2 under the 1940 Act, which permits a fund relying on Section 12(d)(1)(G) of the 1940 Act to (i) acquire securities of other funds that are not part of the same group of investment companies, (ii) invest directly in stocks, bonds and other types of securities and (iii) acquire the securities of money market funds. The SEC noted in the final rule release that as a result of the rescission, funds relying on Section 12(d)(1)(G) would not be able to acquire assets other than funds that are within the same group of investment companies, government securities and short-term paper. Funds currently relying on Section 12(d)(1)(G) will be required to rely on the final rule to make those other direct investments.

The SEC also adopted amendments to Rule 12d1-1 under the 1940 Act to allow funds relying on Section 12(d)(1)(G) to continue to invest in unaffiliated money market funds (i.e., cash sweep arrangements).

Additionally, the SEC adopted amendments to Form N-CEN, which require that a fund report if it relied on the final rule or the statutory exception from Section 12(d)(1)(G) to operate as a fund of funds during the reporting period.

An acquiring fund is currently required to disclose the fees and expenses it incurs indirectly from investing in an acquired fund. The SEC's release regarding the proposed rule requested comment on the impact of this disclosure on certain acquired funds, such as business development companies. The SEC is not addressing disclosure of acquired fund fees and expenses (AFFE) as part of the current rule-making. In the final rule release, the SEC referred to its recent broader review of fund disclosures and request for comment.[6]

Rescission of Exemptive Relief and Withdrawal of Staff No-Action Letters

The SEC is rescinding previously granted exemptive relief permitting fund of funds arrangements that

fall within the scope of the final rule. Fund of funds exemptive relief or portions of relief from provisions of the 1940 Act that are outside the scope of the final rule will not be rescinded. For example, the exemptive relief from Section 17(a) and 17(d) of the 1940 Act and Rule 17d-1 under the 1940 Act included in orders to permit a registered fund to invest in private funds would stay in place.

The fund of funds exemptive relief that is within the scope of the final rule and will be rescinded include:

- Standard fund of funds orders granting relief from Section 12(a)(1)(A), (B) and (C) and Section 17(a)(1) and (2);
- Relief from Section 12(d)(1)(A) and (B) included in the ETF exemptive orders. In connection with adopting Rule 6c-11, the SEC rescinded most ETF orders but had not at that time rescinded the relief provided to ETFs from section 12(d)(1) and sections 17(a)(1) and (a)(2) under the Act related to fund of funds arrangements involving ETFs.
- ETFs relying on Rule 6c-11 under the 1940 Act that do not have fund of funds orders may enter into fund of funds arrangements by satisfying the representations and conditions contained in recent ETF fund of funds orders. The SEC's release adopting Rule 6c-11 stated that the SEC's position was effective until a final fund of funds rule was adopted; however, the SEC in the final rule release has extended the termination date for its position to one year from the effective date of the final rule.
- Fund of funds relief provided to nontransparent ETFs and ETMFs;
- Fund of funds relief granted to funds relying on Section 12(d)(1)(G) to make direct investments in assets other than funds within the same group of investment companies, government securities and short-term paper;
- Fund of funds relief provided to open-end funds or UITs to invest in affiliated open-end or closed-end funds; and
- Relief granted in connection with fund of funds arrangements that are captive to an affiliated managed account program.

The following exemptive relief is considered by the SEC to be outside the scope of the final rule and is not being rescinded:

- Interfund lending;
- Affiliated insurance fund relief;
- Transaction-specific relief;
- Grantor trusts; and
- Fund of funds arrangements with managed risk provision and relief related to Section 12(d)(1)(E).

Over the years, the SEC staff has also provided no-action relief with respect to certain fund of funds arrangements. Certain no-action letters that fall within the scope of the final rule will be withdrawn one year from the effective date of the final rule. Information regarding the no-action letters that are withdrawn is posted on the SEC's website.[7]

Compliance and Transition Dates

The final rule will become effective 60 days after publication in the *Federal Register*.[8]

The rescission of Rule 12d1-2 will become effective one year after the effective date of the final rule. The compliance date for the amendment to Form N-CEN is 425 days after publication in the *Federal Register*. The SEC also adopted a one-year period after the effective date of the final rule before rescission of the SEC exemptive orders and no-action letters that are within the scope of the final rule.

Practice Points and Tips

The final rule and related rule-making attempt to create a harmonized fund of funds regulatory regime. It lessens many of the financial and time burdens on investment advisers who would have needed exemptive relief to enter into fund of funds arrangements that are within the scope of the final rule, but will require those advisers with existing fund of funds arrangements to review those arrangements and make procedural and operational changes as needed. In some cases, the permitted scope of acquired funds will have expanded. Advisers with existing fund of funds orders and those currently relying on Section 12(d)(1)(G) and/or Rule 12d1-2 will need to determine whether they will be able to continue to rely on their fund of funds orders and/or whether they will want to rely on the final rule or Section 12(d)(1)(G) to continue their fund of funds operations. This will require a careful review of their existing fund of funds operations, scope of current fund of funds relief and the conditions under the final rule. Investment advisers of both acquired funds and acquiring funds must review their policies, procedures and controls, and make changes necessary to implement the conditions required under the final rule to the extent they will be relying on the final rule. Those with existing fund of funds participation agreements should amend those agreements as necessary to comply with the conditions. Pursuant to Rule 38a-1 under the 1940 Act, acquiring and acquired funds would be required to adopt policies and procedures reasonably designed to prevent a violation of rule 12d1-4. Fund boards and chief compliance officers should also review the funds' current compliance policies and procedures, as well as develop appropriate board reporting and oversight.

Footnotes:

1. Section 12(d)(1)(A) generally provides that it is unlawful for any registered fund (the acquiring company) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the acquired company), and for any investment company (the acquiring company) and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the acquired company), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate: (i) more than 3% of the total outstanding voting stock of the acquired company, (ii) securities issued by the acquired company having an aggregate value in excess of 5% per centum of the value of the total assets of the acquiring company, or (iii) securities issued by the acquired company and all other investment

companies having an aggregate value in excess of 10% of the value of the total assets of the acquiring company.

2. Section 12(d)(1)(B) generally provides that it is unlawful for any registered open-end fund (the acquired company), any principal underwriter therefor, or any broker or dealer registered under the Exchange Act, knowingly to sell or otherwise dispose of any security issued by the acquired company to any other investment company (the acquiring company) or any company or companies controlled by the acquiring company, if immediately after such sale or disposition: (i) more than 3% of the total outstanding voting stock of the acquired company is owned by the acquiring company and any company or companies controlled by it, or (ii) more than 10% of the total outstanding voting stock of the acquired company is owned by the acquiring company and other investment companies and companies controlled by them. Private funds that rely on the Sections 3(c)(1) and 3(c)(7) are subject to the 3% limitation on investments in a registered fund in Section 12(d)(1)(A)(i) and Section 12(d)(1)(B)(i).

3. *See* 2018 Fund of Funds Proposing Release, Investment Company Act Release No. 33329 (Dec. 19, 2018).

4. Issuers excepted from the definition of investment company pursuant to Section 3(c)(1) or 3(c)(7) (private funds) are not investment companies for this purpose. Private funds are, however, investment companies for purposes of the 3% limitation in Section 12(d)(1)(A) with respect to their investment in funds. The final rule, as noted above, does not exempt such a transaction from that limit.

5. Group of investment companies means any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for purposes of investment and investor services.

6. *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, Investment Company Act Release No. 33963 (Aug. 5, 2020) (“Investor Experience Proposal”). The SEC, in proposing the AFFE disclosure modifications in the Investor Experience Proposal, considered comments received in connection with the 2018 Fund of Funds Proposing Release.

7. https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements

8. As of the date of this alert, the final rule has not been published in the *Federal Register*.

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