SEC Adopts Changes to Regulatory Framework of Fund of Funds Arrangements

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The Securities and Exchange Commission voted on October 7, 2020, to adopt new Rule 12d1-4 under the Investment Company Act of 1940 to govern most arrangements where registered funds invest in other registered funds ("fund of funds" arrangements), as well as related amendments to the existing regulatory framework governing such arrangements.[1] As part of this new regulatory framework, the SEC also is rescinding Rule 12d1-2 under the 1940 Act and most exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the 1940 Act, as well as withdrawing certain staff no-action letters relating to Section 12(d)(1) of the 1940 Act. In addition, the SEC is making related amendments to Rule 12d1-1 and Form N-CEN.

Rule 12d1-4 (Rule) will allow a registered investment company or a business development company (each referred to as an "acquiring fund" under the Rule) to acquire shares of any other registered investment company or BDC (each referred to as an "acquired fund" under the Rule) in excess of the limitations currently imposed by the 1940 Act without obtaining individual exemptive relief from the SEC, subject to applicable conditions. The Rule imposes conditions designed specifically for acquiring funds and other conditions applicable to acquired funds.

Rule 12d1-4 will be effective 60 days after publication in the Federal Register, and the compliance date for the amendments to Form N-CEN will be 425 days after publication in the Federal Register.[2] The rescission of Rule 12d1-2 and the applicable existing exemptive orders, along with the withdrawal of relevant staff no-action letters, will be effective one year after the effective date of Rule 12d1-4.

The changes initially were proposed on December 19, 2018 (proposed rule).[3] The final rulemaking package reflects several important modifications from the proposed rule (most notably, the Rule will not include the proposed limitation on redemptions by an acquiring fund, which was strongly opposed by many commenters). The SEC characterized these modifications as "designed to increase the workability of the [R]ule's requirements, while enhancing protections for investors in fund of funds arrangements."[4]

The following provides an overview of fund of funds arrangements and the components of the SEC's final rulemaking package, which likely will require adjustments to many existing fund of funds arrangements, as well as related compliance, reporting and other processes.

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1 Fund of Funds Arrangements, Release No. IC-34045 (Oct. 7, 2020) (Adopting Release).

2 As of the date of this OnPoint, the Adopting Release and Rule 12d1-4 had not yet been published in the Federal Register.

3 Fund of Funds Arrangements, Release No. IC-33329 (Dec. 19, 2018) (Proposing Release). For further information regarding the proposed rulemaking, please refer to *Dechert OnPoint*, SEC Proposes Changes to Regulatory Framework of Fund of Funds Arrangements and Requests Comments on Potential Changes to AFFE Disclosure Requirements.

4 Adopting Release at 6.

Fund of Funds Arrangements and Existing Regulatory Framework

Registered investment companies, such as mutual funds, exchange-traded funds, and closed-end funds, and BDCs, have increasingly invested in other funds for a variety of reasons (*e.g.*, to achieve asset allocation or diversification or target exposure to a particular market).[5]

Section 12(d)(1) of the 1940 Act places limits on the investments that funds may make in other funds, as described below.

- Section 12(d)(1)(A) prohibits a registered fund or BDC from: (i) acquiring more than 3% of the outstanding voting securities of another fund or BDC; (ii) investing more than 5% of its total assets in any one fund or BDC; or (iii) investing more than 10% of its total assets in funds or BDCs generally (so-called 3%/5%/10% limits).[6]

- Section 12(d)(1)(A) prohibits a "private fund" from acquiring more than 3% of the outstanding voting securities of a registered fund or BDC.[7]

- Section 12(d)(1)(B) imposes corresponding restrictions and limits the ability of registered open-end funds to knowingly sell their shares to an acquiring fund in violation of the applicable limits in this section.[8]

- Section 12(d)(1)(C) limits the ability of any fund or BDC to acquire shares issued by a registered closed-end fund or BDC if the acquiring fund, together with other investment companies that have the same investment adviser, owns more than 10% of the total outstanding voting securities of the closed-end fund or BDC.

These limits were designed to address concerns regarding undue influence by the acquiring fund and its affiliates over the acquired fund and its affiliates, the pyramiding of control, the layering of fees and overly complex fund structures.[9]

Over the years, various statutory exceptions, SEC rules, related exemptive orders and staff no-action relief have collectively permitted the development of different types of fund of funds arrangements, subject to certain conditions.[10] For example, in 1996, Congress added Section 12(d)(1)(G) to the 1940 Act, which allows a registered open-end fund or unit investment trust (UIT) to invest – *without limit* – in other open-end funds and UITs that are in

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5 In the Adopting Release, the SEC staff estimated that approximately 40% of all registered funds hold an investment in at least one fund. *See* Adopting Release at 3.

6 Section 60 of the 1940 Act makes these limits applicable to a BDC to the same extent as if it were a registered closed-end fund. In addition, both registered and unregistered investment companies are subject to these limits with respect to their investments in a registered investment company. Registered investment companies are also subject to these same limits with respect to their investment in an unregistered investment company.

7 A "private fund" is an issuer that would be an "investment company," as defined in Section 3 of the 1940 Act, but for the exclusions from that definition provided for in Section 3(c)(1) or 3(c)(7) of the 1940 Act. A company relying on Section 3(c)(1) or 3(c)(7) is therefore not an "investment company" under the 1940 Act and not directly subject to the limits of Section 12(d)(1)(A). However, Sections 3(c)(1) and 3(c)(7) provide that such a company is nonetheless an "investment company" for purposes of the 3% limitation described in Section 12(d)(1)(A) and (B), but only with respect to the company's purchase of shares issued by any registered fund or BDC.

8 Section 12(d)(1)(B) also applies to such sales by (i) a principal underwriter to the acquired fund or (ii) a broker-dealer registered under the Securities Exchange Act of 1934. The 3% limit under Section 12(d)(1)(B)(i) also applies to sales to private funds with respect to a registered open-end fund. *See* Sections 3(c)(1) and 3(c)(7).

9 *See* Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Report No. 2337, 89th Cong., 2d Sess., at 311-324 (1966).

10 However, the process of obtaining exemptive or no-action relief can be costly and time consuming, and the conditions of such exemptive relief differed from those imposed on other fund of funds arrangements, including fund of funds arrangements that rely on Section 12(d)(1)(G) and Rule 12d1-2.

the same "group of investment companies," subject to certain conditions. Under this section, however, an acquiring fund's investments are limited *solely* to: (i) other funds and UITs that are in the same "group of investment companies;" (ii) government securities; and (iii) short-term paper.[11]

The SEC subsequently adopted Rule 12d1-2, which widened this universe of potential investments by permitting a fund that relies on Section 12(d)(1)(G) to also invest in: (i) other funds that are *not* in the same "group of investment companies" in reliance on Section 12(d)(1)(A) or (F); (ii) non-fund assets (*e.g.,* stocks, bonds and other securities); and (iii) money market funds in reliance on Rule 12d1-1.[12] The adoption of Rule 12d1-2 greatly expanded the utility of the Section 12(d)(1)(G) exemption from the 3%/5%/10% limits.

According to the SEC, the myriad of statutory exceptions, exemptive rules and individual exemptive orders has resulted in a regulatory regime whereby similarly managed fund of funds arrangements are operated subject to differing conditions.[13]

Currently, a fund's ability to invest in another fund in excess of the 3%/5%/10% limits varies greatly depending upon the type of funds involved. For example, the following table (which was included in the Proposing Release) illustrates the types of fund of funds arrangements that have been permitted under SEC exemptive orders:

Acquiring Fund under Exemptive Orders	Acquired Fund under Exemptive Orders
Open-end funds	Open-end funds UITs ETFs Exchange traded managed funds (ETMFs) Listed closed-end funds Listed BDCs
UITs	Open-end funds UITs ETFs ETMFs Listed closed-end funds
Closed-end funds (listed and unlisted)	ETFs ETMFs
BDCs (listed and unlisted)	ETFs
ETFs	Open-end funds UITs ETFs Listed closed-end funds Listed BDCs

[11] *See also* Sections 12(d)(1)(E) (permitting master-feeder arrangements) and (F) (permitting smaller positions without limit on the number of acquired funds) of the 1940 Act.

[12] Rule 12d1-1 provides exemptions from statutory limits for investments in money market funds. The SEC staff further widened the universe of potential investments, based on certain facts and circumstances, to include investments that may not be securities. *See* *Northern Lights Fund Trust*, SEC Staff No-Action Letter (pub. avail. June 29, 2015).

[13] Adopting Release at 6.

Rule 12d1-4

The SEC stated that Rule 12d1-4, together with the remainder of the overall rulemaking package (namely the rescission of Rule 12d1-2 and most fund of funds exemptive orders), is designed to create a "consistent and efficient rules-based regime for the formation, operation, and oversight of fund of funds arrangements."[14] The following table (which was included in the Proposing Release) illustrates the types of fund of funds arrangements that will be permitted under Rule 12d1-4:

Acquiring Fund under Rule 12d1-4	Acquired Fund under Rule 12d1-4
Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs ETMFs	Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs ETMFs

As shown above, in addition to the fund of fund arrangements allowed by the SEC's current exemptive orders, Rule 12d1-4 (subject to its applicable conditions) will allow registered open-end funds, UITs and ETFs to invest in *unlisted* closed-end funds and *unlisted* BDCs beyond the 3%/5%/10% limits. The Rule also will increase permissible investments for registered closed-end funds beyond ETFs and ETMFs[15] to allow such closed-end funds to invest in open-end funds, UITs, other closed-end funds and BDCs in excess of the 3%/5%/10% limits. BDCs also will be allowed to invest in open-end funds, UITs, closed-end funds, other BDCs and ETMFs in excess of the 3%/5%/10% limits. However, the SEC did not permit private funds or unregistered investment companies (*e.g.*, foreign funds) to rely on Rule 12d1-4 as acquiring funds.

Fund of funds arrangements relying on Rule 12d1-4 will be subject to several conditions, certain of which are specific to a fund's position in the arrangement (*i.e.*, as acquiring or acquired fund). Overall, the conditions address matters relating to: (i) control and voting; (ii) certain required findings relating to fees and undue influence (among other things); (iii) fund of funds investment agreements; and (iv) limitations on complex structures. As discussed below, Rule 12d1-4 also provides an express exemption from Section 17(a) of the 1940 Act, as well as a limited exemption for in-kind transactions for certain affiliated persons of ETFs.[16]

Control and Voting

Consistent with the historical concern of acquiring funds exercising undue influence over acquired funds, Rule 12d1-4 will impose certain control and voting requirements on acquiring funds and their advisory groups.

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[14] *See* Adopting Release at 3.

[15] In addition, the Rule will allow ETMFs to invest in open-end funds, UITs, BDCs and closed-end funds in excess of the statutory limits.

[16] In addition, in the Adopting Release, the SEC stated that ETFs may want to consider adopting and implementing policies and procedures to determine whether persons who identify themselves as potential purchasers of an ETF's shares as or through an authorized participant intend to purchase the ETF's shares for investment companies. *See* Adopting Release at 17.

Control

Rule 12d1-4 will prohibit an acquiring fund and its advisory group[17] from controlling, individually or in the aggregate, an acquired fund, subject to certain limited exceptions. In the event that certain predetermined ownership thresholds are exceeded, the Rule generally imposes mirror voting requirements, as described below.

A determination of control under the 1940 Act depends on the facts and circumstances of the particular situation, and does not turn solely on ownership of voting securities of a company. Under the 1940 Act, a person that has not exceeded any particular ownership limit nevertheless may control a fund where it has the power to exercise a controlling influence over management, or the policies, of the fund (unless such power is solely the result of an "official position" with such fund).[18] The 1940 Act also creates a rebuttable presumption that any person that, directly or indirectly, beneficially owns more than 25% of the voting securities of a company controls that company.[19] As a result, an acquiring fund and its advisory group will be permitted under the Rule to beneficially own, individually or in the aggregate, up to 25% of the voting securities of another fund without being presumed to control the acquired fund.[20]

Voting

In addition, Rule 12d1-4 will require an acquiring fund and its advisory group to use mirror voting in certain cases. Mirror voting will be required when the acquiring fund and its advisory group, in the aggregate, hold more than: (i) 25% of the outstanding voting securities of an acquired open-end fund or UIT, due to a decrease in the outstanding voting securities of the acquired fund; or (ii) 10% of the outstanding voting securities of an acquired closed-end fund or BDC. The Rule does not impose a lower investment limit with respect to closed-end funds as suggested by some commenters, but does impose a lower trigger for mirror voting requirements in the context of acquired closed-end funds.[21]

Exceptions to Control and Voting Requirements

There are two exceptions to the control and voting conditions of Rule 12d1-4. Notably, these requirements do not apply where (i) an acquiring fund is within the same "group of investment companies" as an acquired fund, or (ii) the acquiring fund's investment sub-adviser, or any person controlling, controlled by, or under common control with that sub-adviser, acts as the acquired fund's investment adviser or depositor.[22]

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[17] Under Rule 12d1-4(d), an "advisory group" means either: (1) an 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) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser. Consistent with past exemptive orders, Rule 12d1-4 will not require an acquiring fund to aggregate the ownership of the acquiring fund advisory group with that of any acquiring fund sub-advisory group, instead allowing these entities to consider their ownership separately (and each of these groups will be subject to the voting provisions). *See* Adopting Release at 41-42.

[18] 15 U.S.C. 80a-2(a)(9).

[19] *Id*. The application of control under Rule 12d1-4 reflects the long-held view of the SEC that "no person may rely on the presumption that less than 25% ownership is not control when, in fact, a control relationship exists under all the facts and circumstances." Exemption of Transactions by Investment Companies with Certain Affiliated Persons, Release No. IC-10698 (May 16, 1979) 44 FR 29908 (May 23, 1979), at n.2.

[20] The SEC noted in the Adopting Release that "[l]ike the limits under section 12(d)(1) of the [1940] Act, Rule 12d1-4's control limitation is an acquisition test." Adopting Release at fn. 103. The SEC also noted that BDCs are subject to other limitations on investments in other funds under the 1940 Act. *See* Adopting Release at fn. 39 (citing 15 U.S.C. 80a-54(a)).

[21] The SEC stated in the Adopting Release that, because private funds will not be permitted to rely on the Rule as acquiring funds, the SEC did not adopt any specific provisions relating to private fund investments in closed-end funds under the Rule. Adopting Release at 46.

[22] Under Rule 12d1-4(d), a "group of investment companies" means 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.

In addition, in situations where Rule 12d1-4 or Section 12(d)(1) require acquired fund shareholders to employ mirror voting, and it would not be possible for an acquiring fund of the acquired fund to engage in mirror voting (*e.g.*, where an acquired fund is held only by acquiring funds that are subject to the mirror voting requirement), an acquiring fund and its advisory group must use pass-through voting.[23]

Certain Potential Implications

The SEC recognized that the Rule's definition of "advisory group" may capture many affiliates of an acquiring fund and its investment adviser in a complex financial services firm, and will result in monitoring and compliance burdens that are greater than if the definition only looked to the holdings of an acquiring fund and its adviser.[24] The SEC also noted that this condition could necessitate other internal modifications, including the potential need for an advisory group to restructure information barriers to permit entities within the advisory group to share the necessary information to comply with the Rule.[25]

Further, acquiring funds under Rule 12d1-4 may be required to revise their proxy voting policies to reflect that they are potentially subject to the Rule's provisions with respect to voting securities of other funds.[26] In addition, investment advisers may be required to revise their existing proxy voting policies and procedures, including those of other members of the advisory group and with respect to their respective clients, to reflect that the client accounts may be subject to the Rule's voting provisions.[27]

Fund Findings

Rule 12d1-4 will require certain evaluations and/or findings by advisers to both acquiring funds as well as acquired funds with respect to investments or arrangements made or structured in reliance on the Rule, subject to an adviser's fiduciary duties to each fund it advises.[28] The particular conditions vary depending on the particular fund or structure involved, as explained below, and apply whether or not the acquiring and acquired funds have the same investment adviser (or are in the same group of investment companies).

Notably, following strong opposition from many commenters, the SEC did not adopt the provisions in the proposed rule that would have prohibited an acquiring fund that holds more than 3% of an acquired fund's total outstanding shares from redeeming (or tendering for repurchase) more than 3% of the acquired fund's total outstanding shares in any 30-day period (or to require that funds disclose whether they are or may at times be an acquiring fund). Instead, Rule 12d1-4 requires investment advisers to management companies to make certain findings (Fund Findings) that are intended to address considerations such as the complexity and fees associated with fund of funds arrangements and certain undue influence concerns. With respect to management companies (which include BDCs), there is *not* an exception from the Fund Findings requirement for funds that are part of the same group of investment companies or that share the same investment adviser. In addition, the investment adviser is subject to certain board reporting requirements relating to the Fund Findings.

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23 *See* Rule 12d1-4(b)(1)(ii).

24 *See* Adopting Release at 40.

25 *Id.*

26 *See* Adopting Release at 191.

27 In the Adopting Release, the SEC noted that, as is the case with many current exemptive orders, the SEC believes that an "adviser would need to consider these voting requirements as a component of its fiduciary duty when determining whether and how much an acquiring fund should invest in an acquired fund under the rule." Adopting Release at 55.

28 This represents a change from the proposed rule, which would have applied similar determinations only to acquiring funds (and not acquired funds).

The Rule also will impose different conditions designed for UITs and separate accounts funding variable insurance contracts.

Required Findings for Management Companies

If an *acquiring fund* is a management company,[29] the management company's investment adviser must – *prior to* the initial acquisition in excess of the 3% limit in Section 12(d)(1)(A)(i) – "evaluate the complexity of the structure and fees and expenses associated with the acquiring fund's investment in the acquired fund, and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund[.]"[30] The SEC noted that when evaluating the complexity of an acquiring fund's investment in an acquired fund, the acquiring fund's adviser should consider, among other factors, the fund's investment in an acquired fund against similar assets (*e.g.,* direct investments) and whether the acquired fund invests in other funds.[31] The SEC also noted that when evaluating the fees and expenses associated with an acquiring fund's investment in an acquired fund, the acquiring fund's adviser should consider whether the advisory fees are duplicative and evaluate the other fees and expenses associated with the investment, among other considerations.[32] Examples of other fees and expenses that an adviser should consider as identified by the SEC in the Adopting Release are sales charges, recordkeeping fees, sub-transfer agency services and fees for other administrative services.

The final rulemaking includes a corresponding requirement for acquired funds. If an *acquired fund* is a management company, the management company's investment adviser will be required – *prior to* the initial acquisition in excess of the 3% limit in Section 12(d)(1)(A)(i) – to "find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund are reasonably addressed[.]"[33] Under the Rule, and as part of this finding, the investment adviser must consider the following specific factors:

- 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 redemptions in kind.[34]

The factors listed above are not exhaustive; they are the minimum factors to be considered when making this finding, as the SEC stated that "acquired fund advisers should consider anything else relevant under the circumstances when making their findings."[35] The SEC explained that this condition is designed to focus an acquired fund's adviser on

29 The term "management company" means an open-end fund or closed-end fund (including a BDC). *See* Adopting Release at fn. 251.

30 Rule 12d1-4(b)(2)(i)(A).

31 In the Adopting Release, the SEC explained that the Fund Findings apply regardless of the type of acquiring or acquired fund involved, noting that "an adviser to an acquiring fund that is a management company would still need to make its finding with respect to the acquiring fund even if the acquired fund is, for example, a UIT (which will not need its own Fund Finding under the [R]ule)." Adopting Release at fn. 248.

32 Adopting Release at 88.

33 Rule 12d1-4(b)(2)(i)(B).

34 Adopting Release at 73.

35 *Id.* at 83.

possible measures to reduce the threat of undue influence, but the Rule does not dictate how advisers must weigh these factors.

In either scenario, the respective investment adviser to the acquired fund and the acquiring fund must report its evaluations or findings, and the basis therefor, to the relevant board of directors/trustees no later than its next regularly scheduled meeting.[36]

Required Findings for Unit Investment Trusts

The principal underwriter or depositor of an acquiring fund under Rule 12d1-4 that is a UIT similarly will be required to evaluate the complexity of the structure and make a finding as to the UIT's fees and expenses. Specifically, the principal underwriter or depositor must, 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."[37]

Separate Accounts Funding Variable Insurance Contract Certifications

Where a separate account funding variable insurance contracts invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company that the insurance company has determined that the fees and expenses borne by the separate account, acquiring fund, and acquired fund, in the aggregate, are consistent with the reasonableness standard set forth in Section 26(f)(2)(A) of the 1940 Act.[38]

Certain Potential Implications

Among other things, these conditions likely will cause many advisers to closely review existing processes, develop new, more formal investment and compliance protocols to account for the required findings and evaluations and implement new measures to meet related recordkeeping and board reporting requirements.[39]

Fund of Funds Investment Agreements

Rule 12d1-4 will require an acquiring fund and an acquired fund, unless they share the same adviser, to enter into a "fund of funds investment agreement" before the acquiring fund acquires securities of the acquired fund in excess of the limits of Section 12(d)(1) in reliance on the Rule.[40] A fund of funds investment agreement is necessary for funds in the same group of investment companies, unless they share the same adviser.

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[36] In the Adopting Release, the SEC stated that, although the Rule only requires an adviser to report the applicable Fund Finding to the board once (*i.e.*, no later than the next regularly scheduled meeting), board reporting will occur subsequently on at least an annual basis under the fund's compliance program. *See* Adopting Release at 78. This reflects a modification from the proposed rule, which would have required a board to determine the frequency of similar determinations by the adviser.

[37] *See* Adopting Release at 205, 245 and 265. This provision applies if the date of initial deposit of portfolio securities into the UIT occurs after the effective date of Rule 12d1-4.

[38] 15 U.S.C 80a–26(f)(2)(A) (requiring insurance companies sponsoring such accounts to determine that the "fees and charges deducted under the contract, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company").

[39] Rule 12d1-4(c) imposes various recordkeeping requirements relating to fund of funds investment agreements, required evaluations and findings and insurance company certifications mandated under the Rule.

[40] Specifically, Rule 12d1-4 does not impose the fund of funds investment agreement condition in cases when the acquiring fund's investment adviser acts as the acquired fund's investment adviser, and such adviser is not acting as the sub-adviser to either fund. In the Adopting Release, the SEC noted that it "believe[s] that fund of funds investment agreements are material contracts not made in the ordinary course of business … [and] must be filed as an exhibit to each fund's registration statement." Adopting Release at 102.

The Rule provides that such fund of funds investment agreement must be for the duration of the funds' reliance upon the Rule, and include the following: (i) any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the required Fund Findings; (ii) a termination provision that allows either the acquiring fund or acquired fund to terminate the agreement, subject to advance written notice no longer than 60 days; and (iii) a provision requiring that the acquired fund provide the acquiring fund with information regarding the fees and expenses of the acquired fund reasonably requested by the acquiring fund.[41]

Subject to the three requirements noted above, the Rule will permit funds to negotiate terms and tailor arrangements to reflect their particular circumstances.

Certain Potential Implications

Although substantially similar agreements (typically called participation agreements) are common in the context of fund of fund arrangements entered into under existing exemptive relief, investment advisers may need to consider entering into the agreements under the Rule sufficiently far in advance of an investment decision triggering reliance on the Rule to preserve investment flexibility. In addition, certain terms under these agreements, and possibly material variations in those terms, likely would call for particular attention in the compliance and investment onboarding process. For example, these agreements might include provisions related to redemptions (*e.g.*, requiring the acquiring fund to commit to submitting redemption requests over multiple days), which could present further considerations under acquiring and acquired funds' liquidity risk management programs pursuant to Rule 22e-4 under the 1940 Act.[42] In addition, although many funds already have participation agreements in place as required under existing fund of funds exemptive relief, it is likely that the new requirements for investment agreements under the Rule will cause most existing participation agreements to be replaced in their entirety by new investment agreements.

Complex Structures

Rule 12d1-4 generally restricts the use of fund of funds arrangements to establish three-tiered fund of funds structures by limiting the ability of an acquired fund to itself invest in other funds. The Rule provides a "10% Bucket" for acquired funds, which permits an acquired fund to invest in other funds (and private funds) up to 10% of the value of the total assets of the acquired fund, exclusive of certain carve-outs from the 10% Bucket, as explained below. These conditions, which are designed to limit unduly complex structures, will significantly limit the ability to structure a three-tiered fund of funds arrangement.

Rule 12d1-4 limits three-tiered fund of funds arrangements by imposing two general conditions. First, the Rule provides that an investment company may not rely on Section 12(d)(1)(G) or the Rule to invest in another investment company in excess of the limits in Section 12(d)(1)(A) if the second-tier fund relies on the Rule to invest in an acquired fund, unless the second-tier fund is subject to the 10% Bucket. In addition, the Rule provides that an acquired fund may not invest in another investment company or private fund if, immediately after such purchase or acquisition, the securities of investment companies and private funds owned by the acquired fund have an aggregate value in excess of 10% of the value of the total assets of the acquired fund, subject to certain exceptions from this 10% limit.

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41 The SEC explained, in the Adopting Release, that termination of such an agreement would "not, unless otherwise agreed to by the parties, require that the acquiring fund reduce its position in the acquired fund" but that such termination would "prevent the acquiring fund from purchasing additional shares of the acquired fund beyond the limits of section 12(d)(1)." Adopting Release at 101.

42 In the Adopting Release, the SEC affirmed that the terms of any such agreement that require advance notice of a redemption "would still have to comply with section 22(e) of the [1940] Act." Adopting Release at 86.

10% Bucket

Rule 12d1-4 permits an acquired fund to invest up to 10% of its total assets in other funds – without restriction on the purpose of the investment or types of underlying funds, and regardless of the size of the investment in any one fund.[43] The SEC characterized this feature of the Rule as permitting "innovation and efficient portfolio management while limiting the potential for confusing structures and duplicative fees."[44] Notably, if an acquired fund relies on the 10% Bucket to invest in an underlying fund over the 3% or 5% limits of Section 12(d)(1)(A), the acquired fund and underlying funds must comply with the conditions of Rule 12d1-4 as acquiring and acquired funds, respectively, or operate pursuant to another exemption.[45]

Exceptions to 10% Bucket

Rule 12d1-4 provides that the 10% Bucket will not include investments by an acquired fund in other funds made in:

- Reliance on Section 12(d)(1)(E) of the 1940 Act;
- Reliance on Rule 12d1-1 under the 1940 Act;
- A subsidiary that is wholly-owned and controlled by the acquired 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 SEC exemptive relief to engage in interfund borrowing and lending transactions.

In a change from the proposed rule, which would have limited the exception of investments made in reliance on Rule 12d1-1 only to those made for "short-term cash management purposes," the Rule will allow acquired funds to invest in money market funds in reliance on Rule 12d1-1 for any investment purpose.

Certain Potential Implications

A fund that does not satisfy the complex fund structure conditions set forth above may not be an acquired fund under *either* Section 12(d)(1)(G) *or* the Rule. Accordingly, fund groups will need to carefully scrutinize fund line-ups and investment strategies to determine funds that generally are able to operate as acquired funds subject to the 10% Bucket. Given the substantive conditions and possible downstream impacts, it may not be efficient for many funds to change course between operating as an acquiring or acquired fund under the Rule.

In addition, although the topic was subject to many comment letters, the SEC did not provide a further carve-out for structured finance vehicles that traditionally are not considered pooled investment vehicles but rely on Sections 3(c)(1) or 3(c)(7) of the 1940 Act. For example, many collateralized loan obligations (CLOs) rely on Sections 3(c)(1) or 3(c)(7), but some CLOs and many other structured finance vehicles may rely on another exception or exclusion from the 1940 Act.[46] As a result, investment advisers may need to scrutinize the viability of existing strategies and structures, as well as analyze carefully portfolios and processes. In addition, the sponsors of structured finance

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[43] The SEC noted in the Adopting Release that "[l]ike the limits under section 12(d)(1) of the [1940] Act, the 10% Bucket is an acquisition test." Adopting Release at fn. 416.

[44] Adopting Release at 105.

[45] Adopting Release at 119.

[46] *See*, *e.g.*, Section 3(c)(5)(C) (exclusion relied upon by many real estate investment trusts (among other issuers)) and Rule 3a-7 (exclusion relied upon by many issuers of asset-backed securities).

vehicles may choose to re-evaluate the exceptions on which they rely in light of these potential limitations on sources of investment capital.

Amendments to Existing Regulatory Regime[47]

Rescission of Rule 12d1-2 and Changes to Rule 12d1-1

The SEC is rescinding Rule 12d1-2, which permits funds that primarily invest in other funds within the same group of investment companies in reliance on Section 12(d)(1)(G) to invest in: (i) funds outside the same group of investment companies (up to the limits in Section 12(d)(1)(A) or (F)); and (ii) non-fund assets.[48] As a result, a fund relying on Section 12(d)(1)(G) generally will no longer be permitted to invest in funds outside the same group of investment companies or invest directly in stocks, bonds and other instruments, other than in compliance with the conditions of Rule 12d1-4.[49]

In addition, the SEC is amending Rule 12d1-1 to allow funds that rely on Section 12(d)(1)(G) to invest primarily in funds in the same group of investment companies the flexibility to continue to invest in money market funds that are *not* in the same group of investment companies despite the rescission of Rule 12d1-2.

Exemption from Section 17(a)

Rule 12d1-4 also will provide an express exemption from Section 17(a) of the 1940 Act, which generally prohibits affiliated persons of a fund from engaging in certain transactions with the fund in order to prevent affiliated persons from managing a fund for their own benefit.[50] The SEC stated that, absent such an exemption, the efficacy of the Rule would be limited. The SEC further stated that funds complying with Rule 12d1-4 may rely upon this exemption from Section 17(a), whether or not the funds are relying on the Rule for an exemption from Section 12(d)(1).[51]

Although the SEC clarified that it has historically implied Section 17(a) relief with respect to arrangements under Sections 12(d)(1)(E) and 12(d)(1)(G) "because, without this relief, these statutory provisions would be inoperable,"[52] the SEC declined to extend the exemption from Section 17(a) more broadly. In the Adopting Release, the SEC stated it was "not issuing an interpretation that there is an implied exemption from section 17(a) for fund of funds arrangements that involve affiliated persons but do not exceed the [3%/5%/10% limits]."[53] In addition, the SEC stated

[47] The proposed rule requested comments regarding disclosure requirements of acquired fund fees and expenses (AFFE). Currently, acquiring funds include a separate AFFE line item in the "Fees and Expenses" table contained in registration statements pursuant to Form N-1A requirements. The SEC in the Adopting Release indicated that it would not be addressing AFFE disclosure requirements as part of this rulemaking, but possibly might do so as part of another proposed rule on how open-end funds disclose fees in their prospectuses. For further information, please refer to *Dechert OnPoint,* SEC Proposes to Modernize Disclosure Framework for Mutual Funds and Exchange-Traded Funds, Modify Fee Information in Investment Company and Business Development Company Advertisements.

[48] Non-fund assets means stocks, bonds and other securities (including investments in items that may not be "securities," but which were deemed "securities" for purposes of Section 12(d)(1)(G) per exemptive relief), as well as investments in money market funds.

[49] *See* Rule 12d1-1 (as amended by this rulemaking) and Section 12(d)(1)(G) (permitting certain non-fund assets).

[50] *See* Rule 12d1-4(a). With respect to BDCs, the Rule also will provide an exemption from Sections 57(a)(1)-(2) and 57(d)(1)-(2) of the 1940 Act.

[51] *See* Adopting Release at 25 and 31

[52] *Id.* at 30.

[53] *Id.* (referring to investments that do not exceed the limits of Sections 12(d)(1)(A), (B), (C) or (F)).

that the Section 17(a) exemptions provided in Rule 12d1-4 are "limited in scope to those necessary for a fund of funds structure to operate under the rule[.]"[54]

Rule 12d1-4 also will provide a limited exemption from Section 17(a) for in-kind transactions by an acquiring fund that is an affiliated person of an ETF (or who is an affiliated person of such a fund) *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 any investment company that is an affiliated person of the ETF.[55] Under this exemption, ETF baskets may be created and redeemed by acquiring funds that are affiliated as a result of owning with the power to vote 5% or more of the acquired fund's shares.

Rescission of Exemptive Relief and Withdrawal of No-Action Letters

The SEC is rescinding (with some exceptions) exemptive relief that permits fund of funds arrangements now within the scope of Rule 12d1-4. In the Adopting Release, the SEC noted that it is not rescinding fund of funds exemptive relief that is outside the scope of Rule 12d1-4 or relevant portions of fund of funds exemptive orders that provide relief with respect to provisions of the 1940 Act outside the scope of Rule 12d1-4.[56]

In the Adopting Release, the SEC cited exemptive relief permitting fund of funds arrangements that fall outside the scope of the Rule and relevant portions of fund of funds exemptive orders that provide exemptive relief outside the scope of the rulemaking, stating that such relief will remain in place.

In addition, the SEC is withdrawing certain staff no-action letters. Similar to the rescission of fund of funds exemptive relief, the SEC is withdrawing staff no-action letters that permit fund of funds arrangements now falling within the scope of Rule 12d1-4. The list of withdrawn staff no-action letters was recently announced.[57] Importantly, two no-action letters received by Dechert LLP that provide flexibility with respect to foreign funds investing in U.S. registered funds are *not* being withdrawn.[58]

Changes to Form N-CEN

The Rule amends Form N-CEN to require funds and UITs to report whether they relied on Rule 12d1-4 or Section 12(d)(1)(G) during the applicable reporting period. All reports filed on Form N-CEN on or after 425 days following publication of the amendments in the Federal Register must comply with these amendments.

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54 *Id.* at 30-31.

55 Consistent with prior ETF exemptive orders, the Section 17(a) exemption will not be available where the ETF is an affiliated person of the acquiring fund, or an affiliated person of such person, for a reason other than such power to vote. *See* Adopting Release at 27-28.

56 As stated in the Adopting Release, this relief includes (1) exemptive orders that provide relief from Section 17(a), Section 17(d) and Rule 17d-1 under the 1940 Act for registered funds to invest in private funds; (2) exemptive orders that grant relief from Section 17(d) and Rule 17d-1 under the 1940 Act to enter into fee sharing agreements to avoid duplicative fees; (3) exemptive relief from Section 12(d)(1)(A) and (B) granted to allow certain interfund lending arrangements; (4) transaction-specific relief; (5) exemptive orders related to grantor trusts; and (6) exemptive relief from Sections 12(d)(1)(A) and (B) of the 1940 Act for portions that allow a feeder fund to rely on Section 12(d)(1)(E) without complying with certain aspects of Section 12(d)(1)(E) of the 1940 Act.

57 *See* Division of Investment Management Staff Statement Regarding Withdrawal of Staff Letters Related to Rulemaking on Fund of Funds Arrangements (IM-INFO-2020-05) (October 2020).

58 *See* Dechert LLP, SEC Staff No-Action Letter (pub. avail. Aug. 24, 2009) and Dechert LLP, SEC Staff No-Action Letter (pub. avail. Mar. 8, 2017).

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