January 3, 2019

SEC Proposes Changes for Fund of Funds Arrangements

On December 19, 2018, the SEC issued a release (the "Release") proposing new Rule 12d1-4 and related amendments under the 1940 Act intended to enhance and streamline the regulation of funds that invest in other funds ("fund of funds arrangements"). The Release noted that the current combination of statutory exemptions, SEC rules and exemptive orders has created a regime in which substantially similar fund of funds arrangements are subject to different conditions. The Release's proposals are intended to replace the existing regime in order "to create a more consistent and efficient regulatory framework for fund of funds arrangements." Nonetheless, if Rule 12d1-4 is adopted as proposed, we expect that many existing fund of funds arrangements would need to be restructured.

- Rule 12d1-4 (the "Proposed Rule") is intended to be a comprehensive exemptive rule and, therefore, the SEC has proposed to rescind Rule 12d1-2, as well as most exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the 1940 Act.
- In light of the proposed rescission of Rule 12d1-2, the Release would amend Rule 12d1-1 to permit funds that rely on Section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies.
- The Release would add a requirement to Form N-CEN to require open-end funds, closed-end funds and unit investment trusts ("UITs") to report whether they relied on Proposed Rule 12d1-4 or, instead, the statutory exception in Section 12(d)(1)(G) during the reporting period.
- The Release would have no effect on the ability of private funds to invest in registered investment companies, including business development companies ("BDCs").

The Release is discussed in detail below. Comments on the Proposed Rule must be received by the SEC no later than 90 days after publication in the Federal Register.[1]

Background

In general, Section 12(d)(1)(A) contains the so-called "3-5-10%" limits governing a registered fund's investments in other funds.[2] Section 12(d)(1)(B) addresses the sell-side of such investments by limiting a registered open-end fund's sales of its securities to other investment companies.[3] Section 12(d)(1)(C) contains limitations on fund investments in registered closed-end funds.

[1] As of the date of this Alert, the Release has not been published in the Federal Register.

[2] 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.

[3] 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

Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of Section 12(d)(1), and Rule 12d1-2 permits funds that rely on Section 12(d)(1)(G)[4] with flexibility to invest in securities of funds that are not part of the same group of investment companies, as well as stocks, bonds and other securities.

Investments Permitted by Proposed Rule 12d1-4

Subject to specific conditions (described below), and notwithstanding the prohibitions in Sections 12(d)(1)(A), (B) and (C), 17(a) and 57 of the 1940 Act, the Proposed Rule would allow:

- A registered investment company or BDC (collectively, "acquiring funds") to acquire the securities of any other registered investment company or BDC (collectively, "acquired funds").
- An acquired fund, its principal underwriter and any broker-dealer to sell the acquired fund's securities to any acquiring fund.
- An acquired fund to redeem or repurchase its securities issued to an acquiring fund.

Currently, permitted fund of funds arrangements vary significantly based on the type of acquiring fund. The Proposed Rule would generally expand the types of permitted fund of funds arrangements. For example, the Proposed Rule would permit open-end funds to invest in unlisted closed-end funds (including unlisted BDCs) in amounts that exceed the limits specified in Section 12(d)(1). The following chart, which appears in the Release, summarizes the types of fund of funds arrangements that would be permitted if the Proposed Rule is adopted.

Acquiring Fund Under Proposed Rule 12d1-4	Acquired Funds Under Proposed Rule 12d1-4
Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs Exchange-traded managed funds ("ETMFs")	Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs ETMFs

Proposed Rule 12d1-4 Conditions

To rely on the Proposed Rule, a fund of funds arrangement would be required to satisfy various conditions intended to protect investors from the same harms that Congress sought to prevent by enacting Section 12(d)(1) of the 1940 Act: (i) shareholders of an acquiring fund controlling – through the voting power of a controlling interest or the threat of large-scale redemptions – the assets of an acquired fund to benefit themselves at the expense of the acquired fund's other shareholders, (ii) excessive, duplicative fees that may result when one fund invests in another and (iii) overly complex

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).

[4] Section 12(d)(1)(G) allows a registered open-end fund or UIT to invest without regard to the limits in Section 12(d)(1)(A)(i) and Section 12(d)(1)(B)(i), provided that securities of other registered open-end investment companies and registered UITs that are part of the same "group of investment companies," government securities and short-term paper are the only investments held by the acquiring open-end fund or UIT.

structures leading to confusion among investors about who controls their fund and the value of their investments. The Proposed Rule's conditions fall into four categories:

1. **Control**

   a. An acquiring fund and its "advisory group"[5] would not be permitted to control an acquired fund. Control would be determined using Section 2(a)(9)'s definition, including the definition's rebuttable presumption of control. Thus, up to 25% of an acquired fund's shares normally could be acquired by an acquiring fund and its "advisory group."[6]

   b. If an acquiring fund and its advisory group, in the aggregate, hold more than 3% of the outstanding voting securities of an acquired fund, each of the holders must vote the securities in the manner prescribed by Section 12(d)(1)(E)(iii)(aa) (*i.e.*, either by seeking instructions from security holders regarding voting the acquired fund's shares or by echo/mirror voting the shares).[7]

   c. Conditions a. and b. above would not apply if (i) the acquiring fund is in the same "group of investment companies"[8] as an acquired fund or (ii) the acquiring fund's investment sub-adviser or any control affiliate of the sub-adviser is the adviser or depositor of the acquired fund.

2. **Redemption Limits**

   a. An acquiring fund that holds more than 3% of an acquired fund's outstanding voting shares would not be permitted to redeem or tender for repurchase more than 3% of the acquired fund's outstanding shares during any thirty-day period in which the acquiring fund holds the acquired fund's shares in excess of the 3% limit.[9]

   b. The Release notes that an acquiring fund relying on Section 12(d)(1)(G)'s statutory exemption to Section 12(d)(1)(A) (as opposed to the Proposed Rule) may acquire more than 3% of an acquired fund's shares without being subject to any redemption limits, provided the acquired fund is in the same group of investment companies and is structured as an open-end fund or UIT.

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[5] The Proposed Rule defines "advisory group" as either (i) 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 (ii) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser.

[6] If an acquiring fund and its advisory group become a holder of more than 25% of the outstanding voting securities of an acquired fund "passively" – due to a decrease in the outstanding voting securities of the acquired fund (*i.e.*, as a result of redemptions by other shareholders of the acquired fund) – the Proposed Rule would not require an acquiring fund to divest itself of the acquired fund's shares. Instead, the acquiring fund and its advisory group would not be permitted to rely on the Proposed Rule to acquire additional securities of the acquired fund. This condition exists in many existing exemptive orders with the added condition that, if an acquiring fund and its advisory group exceed 25% of the outstanding voting securities of an acquired fund passively, they must vote shares of the acquired fund in the same proportion as the vote of all other holders of the acquired fund's shares.

[7] This condition is more restrictive than many exemptive orders, which impose the voting requirements of Section 12(d)(1)(E) if an acquiring fund and its advisory group become a holder of more than 25% of the outstanding voting securities of an acquired open-end fund passively. Therefore, we expect this condition will attract significant comment from the industry.

[8] The term "group of investment companies" is defined as "any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services." This definition is broader than the term defined in Section 12(d)(1)(G)(ii) because it includes BDCs.

[9] In 2008, the SEC proposed that an acquiring fund that acquired more than 3% of an ETF's outstanding shares would be prohibited from redeeming any of those shares. *See* Exchange-Traded Funds, Rel. No. IC-28193 (Mar. 11, 2008). While not as onerous as the 2008 proposal, the Proposed Rule's proposed redemption limit is an additional requirement that goes further than the conditions in existing exemptive orders.

3. **Fees and Other Considerations**

   a. If an acquiring fund is an open-end fund or closed-end fund (including a BDC), the acquiring fund's investment adviser must evaluate the complexity of the structure and aggregate fees associated with the acquiring fund's investment in the acquired fund, and find that it is in the best interest of the acquiring fund to invest in the acquired fund. The acquiring fund's investment adviser must report its finding and the basis for the finding to the acquiring fund's board of directors/trustees before investing in an acquired fund for the first time and at least annually thereafter.[10]

   b. If the acquiring fund is a UIT, the UIT's principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees associated with the UIT's investment in acquired funds and, on or before the date of initial deposit of portfolio securities into the UIT, find that the UIT's fees do not duplicate the fees of the acquired funds that the UIT holds or will hold at the date of deposit.

4. **Avoiding Complex Fund Structures**

   a. An investment company intending to rely on the Proposed Rule must disclose in its registration statement if it is, or at times may be, an acquiring fund relying on the Proposed Rule.

   b. No investment company may rely on Section 12(d)(1)(G) or the Proposed Rule to acquire, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of another investment company that disclosed in its most recent registration statement that it may be an acquiring fund under the Proposed Rule. The purpose of this provision is to prevent funds relying on Section 12(d)(1)(G) and funds relying on the Proposed Rule from acquiring the securities of acquiring funds, thereby limiting the creation of multi-tier arrangements.[11]

   c. An acquired fund may not acquire the securities of another investment company, or companies that would be investment companies but for the exclusions in Section 3(c)(1) or Section 3(c)(7), in excess of the limits in Section 12(d)(1)(A), unless the acquired fund's investment is:

      i. Made in reliance on Section 12(d)(1)(E) of the 1940 Act (*i.e.*, a master-feeder relationship);

      ii. For short-term cash management purposes under Rule 12d1-1 or exemptive relief from the SEC;

      iii. In a subsidiary that is wholly owned and controlled by the acquired fund;

      iv. The receipt of securities as a dividend or as a result of a plan of reorganization of a company; or

      v. Made in reliance on SEC exemptive relief to engage in interfund borrowing and lending transactions.

Amended Rule 12d1-1

With the rescission of Rule 12d1-2, fund of funds arrangements that rely on Section 12(d)(1)(G) would lose the flexibility to invest in unaffiliated money market fund securities in reliance on Rule 12d1-1. To provide funds relying on Section 12(d)(1)(G) with continuing flexibility to invest in money market funds outside of their "group of investment companies," the Release would amend Rule 12d1-1 to permit such investments.

[10] This condition is similar to the conditions proposed with respect to custom baskets in the June 2018 ETF rule proposal (described in a prior Ropes & Gray Alert).

[11] Note that Section 12(d)(1)(G)(i)(v) grants the SEC authority to prescribe rules or regulations with respect to acquisitions under Section 12(d)(1)(G) as necessary and appropriate for the protection of investors.

Amended Form N-CEN

At present, Item C.7 of Form N-CEN requires funds to report if they relied on certain 1940 Act rules during the reporting period, including if they relied on Rule 12d1-1. The Release would amend Form N-CEN to require funds to report if they relied on the Proposed Rule or the statutory exception in Section 12(d)(1)(G) during the reporting period.

Observations

The Proposed Rule would expand the types of permissible investments for various fund of funds arrangements. In that vein, it may present opportunities to develop new fund of funds arrangements with exposure to a broader array of underlying fund types, including less-liquid vehicles such as interval funds, non-interval closed-end funds and BDCs.[12]

However, the Proposed Rule also imposes new conditions that raise some questions and concerns on which we expect there to be industry comment, including the following:

1. ***Impact of Redemption Limits on Existing Fund of Funds Arrangements.*** The Proposed Rule's redemption limits would make many current fund of funds arrangements unworkable. As noted above, the Proposed Rule would prohibit acquiring funds relying on the Proposed Rule from redeeming more than 3% of an acquired fund's total outstanding shares during any 30-day period in which the acquiring fund owns more than 3% of the acquired fund's shares. Currently, many acquiring funds own well in excess of 3% of one or more acquired funds.[13] Redemptions in excess of 3% of the acquired fund's shares are common for some acquiring funds, often in connection with reallocations among asset classes. For many other acquiring funds, redemptions in excess of 3% of an acquired fund's shares are infrequent, but the flexibility to redeem is nonetheless essential (*e.g.*, in the case of large redemptions from the acquiring fund or rapidly changing market conditions triggering the need to reallocate among acquired funds).[14]
2. ***Impact of Redemption Limits on Liquidity Risk Management Programs***. The Proposed Rule's redemption limits also would have important implications for the acquiring fund's liquidity risk management program adopted under Rule 22e-4 under the 1940 Act ("LRM Program"). Even if an acquiring fund were comfortable with the 3% redemption limit from an investment perspective, any portion of the acquiring fund's investment in an acquired fund that could not be redeemed within seven calendar days may need to be deemed an "illiquid investment" under the acquiring fund's LRM Program.[15] Acquiring funds also may face some practical challenges monitoring compliance with this requirement with respect to unaffiliated acquired funds, as the acquiring fund may not know how many acquired fund shares are outstanding on a given day.

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[12] The Proposed Rule also addresses a gap in the June 2018 ETF rule proposal (described in a prior Ropes & Gray Alert); namely, that many existing ETFs have exemptive orders that permit other registered investment companies to make investments in them in excess of the Section 12(d)(1) limits.

[13] The current regulatory framework addresses these situations for unaffiliated fund of funds arrangements by requiring "participation agreements" between the acquired fund and the acquiring fund, a structure that has become commonplace and operationally workable in the industry. For affiliated fund of funds arrangements (*i.e.*, within the same group of investment companies) the industry has generally addressed the concerns over significant ownership positions and related conflicts of interest through the implementation of compliance policies and procedures that are tailored to circumstances of the particular fund complex.

[14] This observation would not apply where the acquired funds are ETFs and/or closed-end funds because the relevant transactions would occur on the secondary market instead of through redemptions.

[15] Footnote 128 of the Release provides that "[a]n acquiring fund that holds more than 3% of an acquired fund's total outstanding shares should take this [redemption] limitation into account when classifying this portfolio investment as part of its liquidity risk management program under [Rule 22e-4 under the 1940 Act]."

3. ***Impact on In-Kind ETFs***. ETF sponsors, in particular, may want to comment on the Proposed Rule's proposed redemption limits. As the SEC acknowledged in connection with LRM Programs, "In-Kind ETFs"[16] do not face the same types of redemption risks as some other types of funds because of their in-kind creation/redemption mechanisms. Accordingly, some of the risks that the SEC relied on in the Release to justify the Proposed Rule's control and voting provisions are less of a concern for In-Kind ETFs, which suggests that In-Kind ETFs should not be subject to the stringent redemption provisions under the Proposed Rule.

4. ***Impact on Three-Tier Fund of Funds Arrangements***. The Proposed Rule would prohibit most three-tier fund structures, subject to the limited exceptions described above. Some fund complexes currently employ a three-tier structure by relying on a combination of Section 12(d)(1)(G) (and Rule 12d1-2 thereunder) and either an ETF or fund of funds exemptive order. If these orders are rescinded as proposed, many of these complexes would need to restructure their investments. The SEC "acknowledge[d] that three-tier structures may, in certain circumstances, provide efficient and cost-effective exposure to certain market segments," but stated that it "continue[s] to believe that three-tier structures can obfuscate the fund's investments, fees, and related risks." On this topic, the SEC seeks public comment on the following question, among others: "Should the proposed rule permit acquired funds relying on section 12(d)(1)(G) to invest in a third-tier 'central fund' in order to centralize the portfolio management of floating rate or other instruments?"

5. ***Possible Reversion to "Plain Vanilla" Section 12(d)(1)(G) Fund of Funds Arrangements***. Some funds may find the Proposed Rule's conditions to be unworkable (for the reasons listed above) and, instead, seek to structure their affiliated fund of funds arrangements by relying on Section 12(d)(1)(G). However, assuming 12d1-2's rescission, funds relying on Section 12(d)(1)(G) would be limited to investing in funds that are in the same group of investment companies, unaffiliated money market funds (under amended Rule 12d1-1), government securities and short-term paper. While some affiliated funds of funds could operate with such a limited range of permitted investments, many could not (or would require significant restructuring).[17]

6. ***Private/Foreign Acquiring Funds***. Many in the industry will be disappointed that the Proposed Rule has no effect on the ability of private funds and foreign funds to invest in registered investment companies, including BDCs, beyond the existing limits of Section 12(d)(1).

7. ***Board/Procedural Issues***. If the Proposed Rule is adopted as proposed, investment advisers would have to establish new procedures for making and documenting "best interest" findings and presenting the findings to the acquiring fund's board of directors/trustees.

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Please contact your regular Ropes & Gray attorney for additional information or any questions about how the issues described in this Alert may impact your operations.

[16] An In-Kind ETF is an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and that publishes its portfolio holdings daily.

[17] The SEC recognized the difficulties that rescission of Rule 12d1-2 would present and, therefore, the Release proposes a one-year grace period after the Proposed Rule's effective date before Rule 12d1-2 is rescinded.