October 14, 2020

SEC Adopts Changes for Fund of Funds Arrangements

On October 7, 2020, the SEC issued a release (the "Release") adopting new Rule 12d1-4 and making several related rule and form amendments under the 1940 Act intended to streamline and enhance the regulatory framework applicable to 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 is intended to replace the existing regime with "a consistent and efficient rules-based regime for the formation, operation, and oversight of fund of funds arrangements."

While Rule 12d1-4, as adopted, differs substantially from the version of the rule proposed by the SEC in 2018 (the "Proposed Rule," described in this Ropes & Gray Alert), and does not include the Proposed Rule's widely criticized redemption limits, many existing fund of funds arrangements may nonetheless require modifications.

EXECUTIVE SUMMARY

- Rule 12d1-4 (the "Rule") permits fund of funds arrangements subject to various conditions, including limits on control and voting, required evaluations and findings, required fund investment agreements and limits on complex (*i.e.*, more than two tier) fund of funds structures. The Rule is intended to be a comprehensive exemptive rule and, therefore, the SEC is rescinding 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 and related no-action letters.
    - Rule 12d1-2 currently provides funds that rely on Section 12(d)(1)(G) with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities. The rescission of Rule 12d1-2 will result in the loss of this flexibility.
    - Existing exemptive orders and no-action letters permit multi-tier fund of funds arrangements. The rescission of these orders and letters will result in the elimination of many of these arrangements, including "central funds" (three-tier affiliated fund-of-fund arrangements used to efficiently manage exposure to a specific asset class).
- In light of the rescission of Rule 12d1-2, the Release amends 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.
- In general, the Rule is designed to restrict multi-tier fund of funds arrangements, where an acquired fund's investments in other investment companies or private funds exceed the limits of Section 12(d)(1)(A) of the 1940 Act. The Rule permits some multi-tier structures.
    - The Rule prohibits an acquired fund in a fund of funds arrangement relying on either Section 12(d)(1)(G) or the Rule from investing in the securities of an investment company or private fund if, subject to limited exceptions, the value of the securities of investment companies and private funds owned by the acquired fund exceeds 10% of the acquired fund's total assets (the "10% Bucket").
- The Release adds 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 Rule 12d1-4 or, instead, the statutory exception in Section 12(d)(1)(G) during the reporting period.

- The Release does not provide additional flexibility for private funds to invest in registered investment companies, including business development companies ("BDCs").

Effective Date. The Release's effective date is 60 days after the Rule's publication in the *Federal Register*.[1] The rescission of Rule 12d1-2 is effective one year from that date, as is the rescission of various exemptive orders and no-action letters effected by the Release.

The Release is discussed in detail below. The Rule, marked to show changes from the Proposed Rule, appears in this Alert's Appendix.

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 and a private fund's[2] investments in registered funds.[3] 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.[4] Section 12(d)(1)(C) contains limitations on fund investments in registered closed-end funds.

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 currently provides funds that rely on Section 12(d)(1)(G)[5] with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities.

INVESTMENTS PERMITTED BY RULE 12d1-4

Subject to specific conditions (described below), and notwithstanding the prohibitions in Sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)-(2) and 57(d)(1)-(2) of the 1940 Act, the Rule allows:

- A registered investment company or BDC (each, an "acquiring fund") 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.

- An acquiring fund that is an affiliated person of an ETF (or an affiliated person of such an acquiring fund) ***solely by reason of holding with the power to vote 5% or more*** of the outstanding shares of (i) the ETF or (ii) any fund that is an affiliated person of the ETF, to deposit and receive the ETF's "baskets,"[6] provided that the acquired ETF is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund.[7] An acquiring fund that transacts with an ETF through an authorized participant ("AP") that holds 5% or more of the ETF is within this group.

Currently, permitted fund of funds arrangements vary significantly based on the type of acquiring fund. In some cases, the Rule generally expands the types of permitted fund of funds arrangements. For example, the Rule permits 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 appeared in the underlying 2018 SEC release (the "Proposing Release"), summarizes the types of fund of funds arrangements that the Rule permits.

Rule 12d1-4 Acquiring Funds	Rule 12d1-4 Acquired Funds
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

RULE 12d1-4 CONDITIONS

To rely on the Rule, a fund of funds arrangement is 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 voting power 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 structures leading to confusion among investors about who controls their fund and the value of their investments. The Rule's conditions fall into five categories:

1. Control

An acquiring fund and its "advisory group"[8] may not "control" an acquired fund. Control is determined using the definition set forth in Section 2(a)(9) of the 1940 Act, 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.

This condition does not apply if the acquiring fund is within the same "group of investment companies"[9] as an acquired fund, or 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. Voting

An acquiring fund and its advisory group must employ mirror voting[10] if they hold ***more than 25%*** of the voting securities of an acquired open-end fund or UIT due to a decrease in the number of those shares outstanding,[11] or ***more than 10%*** of the voting securities of an acquired closed-end fund or BDC.

There are two exceptions to these voting conditions:

i. In situations where all holders of the outstanding voting securities of an acquired fund are required by Rule 12d1-4 or Section 12(d)(1) of the 1940 Act to employ mirror voting, an acquiring fund and its advisory group are instead required to employ pass-through voting to vote securities of the acquired fund.[12] The Release cites as an example an acquired fund that is held only by acquiring funds that are relying on Rule 12d1-4 as a situation in which there may be no other investors to vote the acquired fund's shares, thereby requiring pass-through voting.

ii. As with the control condition, the voting conditions do not apply if the acquiring fund is within the same group of investment companies as an acquired fund, or the acquiring fund's investment sub-adviser or any control affiliate of the sub-adviser is the adviser or depositor of the acquired fund.

3. Required Findings

The Rule does not include the Proposed Rule's (i) limitations an acquiring fund's redemptions of an acquired fund and (ii) requirement that funds disclose whether they are or may be an acquiring fund. Instead, the Rule requires an investment

adviser to an open-end fund or closed-end fund (including a BDC) that relies on the Rule to evaluate and make certain findings regarding the arrangement ("Fund Findings")[13] discussed in this section, and also requires an acquiring fund and acquired fund to enter into a fund of funds investment agreement (discussed below). The underwriter or depositor of a UIT that is an acquiring fund, and any insurance company a separate account of which that funds variable insurance contracts and invests in acquiring fund must make similar findings and, in the latter case provide the acquiring fund with a related certification. The Fund Findings and related board-reporting requirements are as follows:

i. If the ***acquiring*** fund is an open-end fund or closed-end fund (including a BDC), prior to the initial acquisition of an acquired fund in excess of the 3% limit in Section 12(d)(1)(A)(i), the acquiring fund's investment adviser must evaluate the complexity of the structure and fees and expenses arising from the 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.

ii. If the ***acquired*** fund is an open-end fund or closed-end fund (including a BDC), before the initial acquisition of an acquired fund in excess of the limits in Section 12(d)(1)(A)(i), the acquired fund's investment adviser must find that any concerns regarding undue influence arising from the acquiring fund's investment in the acquired fund are reasonably addressed. At a minimum, as part of this finding, the investment adviser must consider the following items:

   - 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 such redemptions in kind.

iii. The investment adviser to each acquiring or acquired fund must report its evaluations and findings, including the adviser's underlying reasoning, for the required items in (i) and (ii), as applicable, to the fund's board of directors, no later than the next regularly scheduled board meeting.[14]

4. Fund of Funds Investment Agreement

Unless an acquiring fund and an acquired fund share the same investment adviser, the Rule requires the funds to enter into a fund of funds investment agreement before the acquiring fund acquires securities of the acquired fund that exceed Section 12(d)(1)'s limits. The Rule mandates that this fund of funds investment agreement must be effective for the duration of the funds' reliance on the Rule, and must 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 permitting either the acquiring fund or the acquired fund to terminate the agreement upon no more than 60 days' written notice.

iii. A requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund.

The Release stated that, in negotiating the fund of funds investment agreement, the funds could set the terms of the agreement that support the Fund Findings. For example, "an acquired fund could require the acquiring fund to agree to

submit redemptions over a certain amount for a given period as a condition to the fund of funds investment agreement."[15] The Release noted that termination of a fund of funds investment agreement would not, unless the parties agreed otherwise, require the acquiring fund to reduce its holdings of the acquired fund. However, the termination of the agreement will preclude the acquiring fund from purchasing additional shares of the acquired fund beyond the Section 12(d)(1) limits.

The Release also stated that "fund of funds investment agreements are material contracts not made in the ordinary course of business" and, therefore, "they ***must be filed as an exhibit*** to each fund's registration statement." (Emphasis added).

5. Complex Structures

In general, the Rule is designed to restrict fund of funds arrangements with more than two tiers, where an acquired fund's investments in other investment companies or private funds exceed the limits of Section 12(d)(1)(A) of the 1940 Act. The Rule permits some multi-tier structures.

The Rule prohibits an acquired fund in a fund of funds arrangement relying on either Section 12(d)(1)(G) or the Rule from purchasing or otherwise acquiring the securities of an investment company or private fund if, immediately after such purchase or acquisition, the value of the securities of investment companies and private funds owned by the acquired fund exceeds 10% of the acquired fund's total assets (the "10% Bucket").[16] The 10% Bucket does ***not*** include investments by the acquired fund in:

i. Reliance on Section 12(d)(1)(E) of the 1940 Act.

ii. Reliance on Rule 12d1-1 (as amended).

iii. A subsidiary that is wholly-owned and controlled by the acquired fund.

iv. Securities received as a dividend or as a result of a plan of reorganization of a company.

v. Securities of another investment company received pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.

In short, the Rule requires that an acquired fund's investments in other investment companies and private funds, other than investments excluded under (i) – (v) above, must not exceed its 10% Bucket. The Rule provides that no investment company may rely on the Rule or Section 12(d)(1)(G) to purchase or otherwise acquire, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of an investment company (a "second-tier fund") that relies on the Rule to acquire the securities of an acquired fund, unless the second-tier fund's investments in other investment companies and private funds are limited to its 10% Bucket and securities listed in (i) – (v), above. A fund that does not satisfy these conditions may not be an acquired fund under Section 12(d)(1)(G) or the Rule.[17]

RESCISSION OF RULE 12d1-2 AND AMENDED RULE 12d1-1

To limit the hardship that the rescission of Rule 12d1-2 could have on existing fund of funds arrangements, the Release provides for a one-year period after the effective date of the Rule before Rule 12d1-2 is rescinded. The Release states that this "one year is adequate time for funds relying on current rule 12d1-2 to bring their future operations into conformity with section 12(d)(1)(G) or rule 12d1-4."

With the rescission of Rule 12d1-2, fund of funds arrangements that rely on Section 12(d)(1)(G) lose the flexibility to invest in unaffiliated money market fund securities in reliance on Rule 12d1-2(a)(3).[18] 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 amends Rule 12d1-1 to permit such investments.

RESCISSION OF EXEMPTIVE ORDERS AND WITHDRAWAL OF NO-ACTION LETTERS

The Release rescinds exemptive relief under Section 12(d)(1)(G) that permits an affiliated fund of funds to invest in assets that are beyond the scope of that statutory provision, effective one year after the Rule's effective date. The Release also rescinds fund of funds exemptive orders that "fall within the scope of Rule 12d1-4," effective one year after the Rule's effective date.

The Release states that certain "[f]und of funds exemptive relief that falls outside the scope of rule 12d1-4, as well as the relevant portions of fund of funds exemptive orders that grant relief for provisions in the Act outside of the scope of this rulemaking, will remain in place." This includes (i) interfund lending orders, (ii) exemptive orders that provide relief from Sections 17(a) and 17(d) and Rule 17d-1 under the 1940 Act permitting a registered fund to invest in private funds and (iii) portions of fund of funds exemptive orders that provide relief from Section 17(d) and Rule 17d-1 permitting fee-sharing agreements to avoid duplicative fees.

The Release states that no-action letters applicable to specific circumstances related to Section 12(d)(1) will be withdrawn one year from the Rule's effective date, and that the withdrawn letters will include only those letters that fall within the scope of Rule 12d1-4.[19] The Release does not provide a list of the no-action letters that will be withdrawn but, instead, refers interested persons to the Division of Investment Management's website. As of the date of this Alert, the Division's list of Modified or Withdrawn Staff Statements has not been amended to identify withdrawn no-action letters.

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 amends Form N-CEN to require funds and UITs to report if they relied on the Rule or the statutory exception in Section 12(d)(1)(G) during the reporting period. The effective date for the amended Form N-CEN is 425 days after publication of the Release in the *Federal Register*.

OBSERVATIONS

1. ***No Redemption Limits.*** The Rule eliminates the most controversial and unpopular condition to reliance on the Proposed Rule, which would have capped redemptions by an acquiring fund in excess of 3% of an acquired fund's shares during any 30-day period. While the conditions included in lieu of the redemption limits impose potentially burdensome new obligations on advisers and boards, the Rule dropped a condition that would have been entirely unworkable for many fund of funds arrangements.

2. ***Impact on Three-Tier Fund of Funds Arrangements.*** The Rule prohibits most three-tier fund structures, subject to the limited exceptions described above. Some fund complexes currently employ a multi-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. The rescission of these orders may require these complexes to restructure their investments. The SEC stated that "[w]e agree with commenters that additional flexibility to enter into multi-tier arrangements could lead to efficiencies and cost savings for fund investors." However, the SEC ultimately concluded that the "10% Bucket, when combined with the enumerated exceptions discussed above, will provide flexibility for beneficial multi-tier arrangements while limiting the harms that Congress sought to prevent." Whether the SEC will provide future exemptive relief to permit other multi-tiered structures is unknown and is likely to be contingent on experience with the Rule. In particular, it remains to be seen whether the SEC's assertion that the Rule and related changes will provide sufficient flexibility for beneficial multi-tier arrangements will be borne out.

3. ***A Mixed Bag for ETFs.*** Many funds that are acquired funds in fund of funds arrangements operating under Section 12(d)(1)(G) or Rule 12d1-2 currently invest without limit in ETFs in reliance on the ETFs' exemptive orders. Under the Rule, acquired funds' investments in ETFs (and other investment companies and private funds) will be subject to the 10% Bucket. While this imposes a new limit with respect to funds investing in ETFs with exemptive orders, it also creates new flexibility to invest in excess of the limits of Section 12(d)(1)(A) in ETFs

without exemptive orders. Separately, the Rule addresses a gap in the ETF Rule (Rule 6c-11); namely, that ETF baskets may be contributed and redeemed by acquiring funds that are technically affiliated with an ETF by virtue of owning 5% or more of the acquired ETF's shares. However, the Commission also suggests that ETFs should question potential purchasers of the ETF's shares (including purchasers acting through an authorized participant) to determine whether those persons intend to purchase ETF shares for investment companies, and adds that the ETF may want to consider adopting and implementing policies and procedures to make these inquiries.[20]

4. ***Affiliated Fund of Funds Structures.*** The impact of the Rule on most two-tier affiliated fund of funds structures could be extensive. Advisers to funds relying on the Rule, rather than Section 12(d)(1)(G), will be required to make new findings and provide new reports to fund boards, but will be exempt from the control and investment agreement requirements. Affiliated fund of funds that can operate in compliance with Section 12(d)(1)(G) may opt to do so in order to avoid the Rule's findings and reporting requirements. Of course, the rescission of Rule 12d1-2 means that funds relying on Section 12(d)(1)(G) will lose the ability to acquire the securities of other funds that are outside of the fund's group of investment companies (except for money market funds) and invest directly in stocks, bonds and other securities, as now permitted by Rule 12d1-2, and derivatives and other financial instruments that are not securities under the 1940 Act (as now permitted under the Northern Lights Fund Trust no-action letter).

5. ***Efficacy of Fund of Funds Investment Agreements and Effects on Liquidity Risk Management Programs.*** The Release specifically contemplates that advance notice requirements and redemption limits might be included in fund of funds investment agreements, but does not indicate whether such limits would actually be enforceable. Even if an acquiring fund were to agree to provide advance notice to an acquired fund and to spread out large redemptions, it may retain the legal right to redeem open-end fund shares on any business day and to receive redemption proceeds within seven days.[21] The question of whether redemption limits in fund of funds investment agreements are enforceable also has implications for the acquiring fund and acquired fund's respective liquidity risk management programs adopted under Rule 22e-4 under the 1940 Act.

6. ***No New Protections for Closed-End Funds.*** Many closed-end fund sponsors and boards hoped that a final rule would provide additional protections from activist investors, particularly given the SEC's objective of protecting funds from undue influence exerted by other funds. Many closed-end fund activist investors acquire large positions in closed-end funds by using numerous private funds, each of which acquires up to 3% of a given closed-end fund's shares. While the Rule's "control" condition requires mirror voting when an acquiring fund and its advisory group hold more than 10% of a closed-end fund's outstanding voting securities, this condition would only apply where an activist holds at least some of its shares in a given closed-end fund through a registered fund. Mirror voting would not be required where an activist exclusively uses private funds (most activists' structure of choice in any case) to acquire large positions in closed-end funds.

7. ***Disclosure.*** While the Rule does not require a fund to disclose that it is an acquired fund subject to the Rule's limitations, the fund may want to consider whether the Rule's limits on an acquired fund (*e.g.*, complying with 10% Bucket requirements) limit its investment flexibility materially.

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For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.

1. As of the date of this Alert, the Release has not been published in the *Federal Register*.
2. A "private fund" is an issuer that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions from that definition in Section 3(c)(1) or Section 3(c)(7).
3. 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% 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.
4. 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).
5. 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.
6. The Rule defines "baskets" to have the same meaning as in Rule 6c-11(a)(1).
7. Section 17(a)(2) would prohibit an ETF from purchasing securities and other property (*i.e.*, securities and other property in the ETF's basket) from the affiliated acquiring fund in exchange for ETF shares. Section 17(a)(1) would prohibit an acquiring fund from selling any securities and other property (*i.e.*, securities and other property in the ETF's basket) to an affiliated ETF in exchange for the ETF's shares. The Rule codifies certain exemptive orders that provide relief from Section 17(a) to permit these transactions. Recently adopted Rule 6c-11 under the 1940 Act, as well as prior exemptive orders, provide relief from Section 17(a) for the acquisition or sale of an ETF's basket assets in connection with the creation or redemption of ETF creation units. However, that relief is insufficient to permit an ETF's in-kind transactions with another fund. The Rule thus additionally closes this gap in Rule 6c-11 and prior exemptive orders by permitting other registered funds to make investments in ETFs in excess of the Section 12(d)(1) limits through basket transactions.
8. The 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.
9. 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.
10. Mirror voting means that votes are cast in the same proportion as the votes of all other holders.
11. This condition applies in many existing exemptive orders where an acquiring fund and its advisory group exceed 25% of the outstanding voting securities of an acquired fund passively.
12. Pass-through voting means seeking instructions from the acquiring fund's security holders with regard to the voting of all proxies of an acquired fund.
13. The Rule separately requires tailored findings regarding acquiring UITs and a certification regarding separate accounts underlying variable insurance contracts (also, "Fund Findings").
14. While the Rule does not specify the frequency of subsequent reporting regarding the Fund Findings, the Release states that "subsequent reporting regarding these Fund Findings will be conducted at least annually under the fund's compliance program."

The Fund Findings and annual reporting conditions are similar to the conditions adopted with respect to custom baskets in the SEC's 2019 ETF rule, Rule 6c-11(discussed in this Ropes & Gray Alert).

15. Release at 98.
16. The Release noted that, if an acquired fund holds more than 10% of its assets in other underlying funds due to market movements, it cannot make additional investments in underlying funds, but the acquired fund will not be required to dispose of its existing investments in underlying funds.
17. An acquiring fund or an acquired fund that satisfies the conditions of the Rule can invest directly in stocks, bonds and other securities (including financial instruments that may not be "securities").
18. Rule 12d1-2 and related exemptive and no-action relief currently provides funds that rely on Section 12(d)(1)(G) with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities (including financial instruments that may not be "securities."). The rescission of Rule 12d1-2 and the related relief will result in the loss of this flexibility, except in compliance with Rules 12d1-4 and amended 12d1-1.
19. Among the no-action letters to be withdrawn, the Release identifies (i) Northern Lights Fund Trust (pub. avail, June 29, 2015) (permitting an affiliated fund of funds arrangement relying on Section 12(d)(1)(G) and Rule 12d1-2 to invest in financial instruments that are not securities under the 1940 Act) and (ii) Franklin Templeton Investments (pub. avail. April 3, 2015) (permitting an acquiring fund relying on Section 12(d)(1)(G) to acquire shares of an underlying fund that, in turn, purchases shares of a central fund).
20. The SEC added that an ETF that explains its obligations pursuant to Section 12(d)(1)(B) to potential purchasers, and documents that exchange with the potential purchaser, generally would satisfy its obligation not to knowingly sell or otherwise dispose of any of its securities in excess of 12(d)(1)(B) limits. Further, the SEC noted that if an ETF intends to rely on Rule 12d1-4 to exceed the Section 12(d)(1) limits, such ETF must comply with the conditions of the Rule, including entering into a fund of funds investment agreement with the acquiring investment company.
21. The Release states that advance-notice requirements applicable to an acquiring fund's planned large redemption may be included in a fund of funds investment agreement. However, the Release also states that any fund of funds investment agreement would still have to comply with Section 22(e) of the 1940 Act, which provides, in part, that a registered fund may not suspend the right of redemption, or postpone the date of payment upon redemption for more than seven days after tender of the security absent unusual circumstances.

October 14, 2020

Rule 12d1-4, as Adopted, Marked to Show Changes from the Proposing Release

Exemptions for investments in certain investment companies.

(a) Exemptions for acquisition and sale of acquired fund shares.

If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)-(2), and 57(d)(1)-(2) of the Act (15 U.S.C. 80~~a-~~a 12(d)(1)(A), 80a-12(d)(1)(C), 80~~a-~~a 17(a), 80a-56(a)(1)-(2), and 80a-56(d)(1)-(2)):

(1) A registered investment company (other than a face-amount certificate company) or business development company (an "acquiring fund") may purchase or otherwise acquire the securities issued by another registered investment company (other than a face-amount certificate company) or business development company (an "acquired fund");~~ and~~

(2) An acquired fund, any principal underwriter thereof, and any broker or dealer registered under the Securities Exchange Act of 1934 may sell or otherwise dispose of the securities issued by the acquired fund to any acquiring fund and any acquired fund may redeem or repurchase any securities issued by the acquired fund from any acquiring fund~~.~~; and

(3) An acquiring fund that is an affiliated person of an exchange-traded fund (or who is an affiliated person of such a fund) solely by reason of the circumstances described in § 270.6c-11(b)(3)(i) and (ii), may deposit and receive the exchange-traded fund's baskets, provided that the acquired exchange-traded fund is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund.

(b) Conditions.

(1) Control.

(i) The acquiring fund and its advisory group will not control (individually or in the aggregate) an acquired fund; ~~and~~

(ii) If the acquiring fund and its advisory group, in the aggregate, (A) hold more than ~~3~~25% of the outstanding voting securities of an acquired fund that is a registered open-end management investment company or registered unit investment trust as a result of a decrease in the outstanding voting securities of the acquired fund, or (B) hold more than 10% of the outstanding voting securities of an acquired fund that is a registered closed-end management investment company or business development company, each of those holders will vote its securities in the ~~manner prescribed by~~same proportion as the vote of all other holders of such securities; provided, however, that in circumstances where all holders of the outstanding voting securities of the acquired fund are required by this section or otherwise under section 12(d)(1)~~(E)(iii)(aa) of the Act (15 U.S.C. 80a-12(d)(1)(E)(iii)(aa));~~ to vote securities of the acquired fund in the same proportion as the vote of all other holders of such securities, the acquiring fund will seek instructions from its security holders with regard to the voting of all proxies with respect to such acquired fund securities and vote such proxies only in accordance with such instructions; and

(iii) The conditions in paragraphs (b)(1)(i) ~~and~~ (ii) of this section do not apply ~~when~~if:

(A) The acquiring fund is in the same group of investment companies as an acquired fund; or

(B) The acquiring fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as an acquired fund's investment adviser or depositor.

(2) Findings and Agreements.

(i) Management companies.

(~~2~~A) ~~*Limited redemption.* An~~If the acquiring fund ~~that holds shares~~is a management company, prior to the initial acquisition of an acquired fund in excess of the limits ~~of~~in section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) ~~does not redeem or submit for redemption, or tender for repurchase, any of those shares in an amount exceeding 3% of the acquired fund's total outstanding shares during any thirty-day period in which the acquiring fund holds~~, the acquiring fund's investment adviser must 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's shares in excess of that limit.~~fund;

~~(3) *Fees and other considerations.*~~

(~~i~~B) ~~*Management companies.*~~ If the ~~acquiring fund~~acquired fund is a management company, ~~before investing in~~prior to the initial acquisition of an acquired fund in ~~reliance on this section, and with such frequency as the acquiring fund's board of directors deems reasonable and appropriate thereafter, but in any case, no less frequently than annually, the acquiring~~ excess of the limits in section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)), the acquired fund's investment adviser must ~~evaluate the complexity of the structure and aggregate fees~~find that any undue influence concerns 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.~~ are reasonably addressed and, as part of this finding, the investment adviser must consider at a minimum the following items:

(1) The scale of contemplated investments by the acquiring fund and any maximum investment limits;

(2) The anticipated timing of redemption requests by the acquiring fund;

(3) Whether and under what circumstances the acquiring fund will provide advance notification of investments and redemptions; and

(4) The circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any such redemptions in kind; and

(C) The ~~acquiring fund's~~ investment adviser to each acquiring or acquired management company must report its ~~finding~~evaluation, finding, and the basis for ~~the finding to the acquiring~~its evaluations or findings required by paragraphs (b)(2)(i)(A) or (B),as applicable, to the fund's board of directors, no later than the next regularly scheduled board of directors meeting.

(ii) Unit investment trusts. If the acquiring fund is a unit investment trust ("UIT") and the date of initial deposit of portfolio securities into ~~a registered~~the UIT occurs after the effective date of this section, 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 such 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.

(iii) Separate ~~*account*~~accounts funding variable insurance contracts. With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company offering the separate account 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 standard set forth in section 26(f)(2)(A) of the Act (15 U.S.C. 80a-26(f)(2)(A)).

(iv) Fund of funds investment agreement. Unless 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, the acquiring fund must enter into an agreement with the acquired fund effective for the duration of the funds' reliance on this section, which must include the following:

(A) Any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the finding required under paragraph (b)(2)(i)-(ii) of this section;

(B) A termination provision whereby either the acquiring fund or acquired fund may terminate the agreement subject to advance written notice no longer than 60 days; and

(C) A requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund.

(43) Complex fund structures.

~~(i) An investment company must disclose in its registration statement that it is (or at times may be) an acquiring fund for purposes of this section;~~

(~~i~~i) No investment company may rely on section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)) or this section to purchase or otherwise acquire, in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80~~a-~~a12(d)(1)(A)), the outstanding voting securities of ~~another~~an investment company ~~that discloses in its most recent registration statement that it may be an acquiring fund under~~(a "second-tier fund") that relies on this section to acquire the securities of an acquired fund, unless the second-tier fund makes investments permitted by paragraph (b)(3)(ii) of this section; and

(~~iii~~ii) ~~An~~No acquired fund ~~must not~~may purchase or otherwise acquire the securities of ~~another~~an investment company ~~(~~or ~~companies that would be~~private fund if immediately after such purchase or acquisition, the securities of investment companies ~~under section 3(a) of the Act but for the exclusions from that definition provided for in section 3(c)(1) or section 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)) in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80a-12(d)(1)(A)) unless the acquired fund's investment is:~~and private funds owned by the acquired fund have an aggregate value in excess of 10 percent of the value of the total assets of the acquired fund; provided, however, that the 10 percent limitation of this paragraph shall not apply to investments by the acquired fund in:

(A) ~~In reliance~~Reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E));

(B) ~~For short-term cash management purposes pursuant to~~Reliance on § 270.12d1-1~~ or exemptive relief from the Commission~~;

(C) ~~In a~~A subsidiary that is wholly-owned and controlled by the acquired fund;

(D) ~~The receipt of securities~~Securities received as a dividend or as a result of a plan of reorganization of a company; or

(E) ~~The acquisition of securities~~Securities of another investment company received pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

(c) Recordkeeping. The acquiring ~~fund~~and acquired funds relying upon this section must maintain and preserve for a period of not less than five years, the first two years in an easily accessible place, ~~a written record of~~as applicable:

~~(1) The finding required by paragraph (b)(3)(i) of this section and the basis for such finding, and the reports provided to the board of directors pursuant to paragraph (b)(3)(i) of this section;~~

(1) A copy of each fund of funds investment agreement that is in effect, or at anytime within the past five years was in effect, and any amendments thereto;

(2) A written record of the evaluations and findings required by paragraph (b)(2)(i) of this section, and the basis therefor

within the past five years;

(~~2~~3) ~~The~~A written record of the finding required by paragraph (b)(~~3~~2)(ii) of this section and the basis for such finding; and

(~~3~~4) The certification from each insurance company required by paragraph (b)(~~3~~2)(iii) of this section.

(d) Definitions. For purposes of this section:

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.

Baskets has the same meaning as in § 6c-11(a)(1).

Exchange-traded fund means a fund or class, the shares of which are listed and traded on a national securities exchange, and that has formed and operates in reliance on § 6c-11 or under an exemptive order granted by the Commission.

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.

Private fund means an issuer that would be an investment company under section 3(a) of the Act but for the exclusions from that definition provided for in section 3(c)(1) or section 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)).