

October 23, 2020

BDCs and New Fund of Funds Arrangements

The SEC recently adopted new Rule 12d1-4 (the Rule) under the 1940 Act intended to streamline the regulation of registered funds that invest in other registered funds and BDCs (“fund of funds” arrangements). Among other things, **the Rule increases the limits now applicable to registered funds’ investments in BDCs.**

SUMMARY

At present, a registered fund may not (i) acquire more than 3% of the voting shares of a single BDC, (ii) invest more than 5% of its total assets in a single BDC or (iii) invest more than 10% of its total assets in other funds (including BDCs) (the **3-5-10% limits**).

Separately, at present, a group of registered funds sharing the same adviser may not acquire, in aggregate, more than 10% of the voting securities of a single BDC (the **10% voting securities limit**).

Subject to specific conditions (described below), the Rule allows a registered fund, along with other registered funds in its “advisory group,” to acquire **up to 25% of the voting securities of a BDC outside of its advisory group**, notwithstanding the 3-5-10% limits and the 10% voting-securities limit.

THE RULE’S CONDITIONS

A registered fund (acquiring fund) that relies on the Rule to acquire shares of a BDC in excess of the 3-5-10% limits and the 10% voting-securities limit, as well as the acquired BDC, must satisfy various conditions. These conditions fall into three categories:

1. **Voting.** The acquiring fund and its advisory group must employ mirror voting if they hold *more than 10%* of the voting securities of an acquired BDC that is outside of their advisory group.
2. **Required Findings.** An adviser to acquiring fund or an acquired BDC must evaluate and make certain findings regarding the arrangement (Fund Findings).
 - o The *acquiring* fund’s adviser must find that the acquiring fund’s fees and expenses do not duplicate the fees and expenses of the acquired BDC. The *acquired* BDC’s adviser must find that any concerns regarding undue influence arising from the acquiring fund’s investment in the BDC are reasonably addressed.
 - o The adviser to the acquiring fund (or the adviser to the acquired BDC) must report its evaluations and Fund Findings to the acquiring fund’s board of directors (or to the acquired BDC’s board of directors).
3. **Fund of Funds Investment Agreement.** An acquiring fund and an acquired BDC must enter into a fund of funds investment agreement. 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 certain required terms.

IMPLICATIONS FOR BDCs

BDCs as Acquired Funds. Provided the Rule’s conditions are satisfied, the Rule permits a registered fund and other registered funds in its advisory group to acquire **up to 25% of the voting securities of a BDC outside of its advisory group**. Therefore, if registered funds and BDCs satisfy the Rule’s conditions, registered funds may expand their investments in BDCs by relying upon the Rule.

The Rule does not change the requirement that any acquiring registered fund that acquires shares of an acquired BDC must include in its prospectus fee table an additional line item titled “Acquired Fund Fees and Expenses” (AFFE) to

reflect the fees and expenses incurred indirectly by investing in acquired BDCs and other acquired funds. The only exception to this disclosure requirement applies when the acquiring registered fund AFFE is no more than 0.01% (one basis point) of the acquiring registered fund's average net assets.

Therefore, while the Rule expands opportunities for registered funds to invest in BDCs, the fact that no changes were made to AFFE suggests that the Rule may be unlikely to result in significant additional investment in BDCs by registered funds concerned about fee disclosures. The impact on AFFE also remains a sticking point for many indices in incorporating BDCs.

- In August 2020, the SEC proposed rule and form amendments, including an amendment that, if adopted, would not require a mutual fund or ETF's AFFE to be presented as a separate line item in a prospectus fee table, unless more than 10% of the fund's total assets were invested in acquired funds (including BDCs) for the prior fiscal year.
- If adopted, this proposed amendment could enhance registered funds' investments in BDCs but, at present, it is not possible to predict whether it will be adopted by the SEC.

The Rule also provides BDCs greater freedom to invest in registered funds and other BDCs. However, these investments would be non-qualifying assets for purposes of the BDC's 70% qualifying-assets test.

We also note that the Rule does not provide additional flexibility for private funds to invest in BDCs. Private funds relying upon Sections 3(c)(1) or 3(c)(7) of the 1940 Act continue to be limited to acquiring no more than 3% of the voting shares of a single BDC (*i.e.*, the 3% portion of the 3-5-10% limits).

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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.