ALERTS

Regulated Funds: SEC Adopts New Rule Formalizing Fund of Funds Arrangements

October 16, 2020

On Oct. 7, 2020, the U.S. Securities and Exchange Commission ("Commission") adopted a new rule under the Investment Company Act of 1940, as amended ("1940 Act"), aimed at streamlining the regulatory framework for the investment by regulated funds in other funds ("fund of funds arrangements").[1] Subject to complying with certain conditions, Rule 12d1-4 ("Rule") will permit a registered investment company or a business development company ("BDC") to acquire the securities of any other registered investment company or BDC in an amount that exceeds the limits set forth in Section 12(d)(1) of the 1940 Act, without the need for such fund to obtain exemptive relief from the Commission. The Rule, which was first proposed in December 2018, is intended to provide regulated funds with investment flexibility, while at the same time protecting investors against concerns potentially raised by fund of funds arrangements.[2]

Notably, the Rule expands the scope of the types of regulated funds that may participate in fund of funds arrangements in excess of the Section 12(d)(1) limits, to include, for example, investments in unlisted closed-end funds and unlisted BDCs. In doing so, the Rule will eliminate unnecessary distinctions among fund types and create a more uniform framework for all registered funds and BDCs. In addition, the Rule is not exclusive, and regulated funds may continue to rely on other statutory exemptions under Section 12(d)(1), including Section 12(d)(1)(F).[3] Overall, the Rule's streamlined approach should create opportunities for asset managers to consider launching new fund of funds products.

Private funds, which as acquiring funds are subject to a 3% investment limit under Section 12(d)(1)(A)(i), are excluded from the Rule, and therefore cannot rely on the Rule to invest in excess of the 3% limit in a regulated fund.[4] However, as discussed below, the release of the Commission adopting the Rule ("Adopting Release") notes that the exemptive relief process would provide an appropriate opportunity for the Commission to consider fund of funds arrangements involving private funds.

Section 12(d)(1) Investment Restrictions

Section 12(d)(1)(A) of the 1940 Act prohibits a regulated fund ("acquiring fund") from acquiring securities of another regulated fund ("acquired fund") if the acquiring fund, and any company or companies controlled by the acquiring fund, immediately after such acquisition would own (i) more than 3% of the voting securities of the acquired fund, (ii) securities issued by the acquired fund having an aggregate value of in excess of 5% of the acquiring fund's total assets or (iii) securities issued by the acquired fund and all investment companies having an aggregate value of in excess of 10% of the acquiring fund's total assets. Private funds are deemed to be "acquiring funds" solely for purposes of the 3% limitation on acquisitions of voting securities of acquired funds, but are not subject to the remaining restrictions set forth under Section 12(d)(1)(A). Section 12(d)(1)(B) imposes similar restrictions on the sale of securities in violation of certain limits. As noted in the Adopting Release, the provisions of Section 12(d)(1) are intended to prevent the pyramiding of fund ownership, which can result in an acquiring fund controlling the assets of an acquired fund and enriching the acquiring fund's shareholders at the expense of the shareholders of the acquired fund.

Overview of the Rule and Related Conditions

Generally, the Rule will permit acquiring funds to acquire shares of other acquired funds in excess of the Section 12(d)(1) limits, subject to certain conditions, as described in more detail below. However, in practice, acquiring funds will be limited to acquiring up to 25% of an acquired fund's shares, due to the prohibition on controlling an acquired fund, except in certain limited circumstances. The Rule will also provide an exemption from the affiliated transaction provisions contained in Section 17(a) of the 1940 Act to permit an acquiring fund to hold 5% or more of an acquired fund's securities.[5]

Limits on Control

In order to rely on the Rule, an acquiring fund and its "advisory group" may not acquire control over an acquired fund.[6] The 1940 Act defines control as the power to exercise a controlling influence over a company and sets up a rebuttable presumption that a person who beneficially owns more than 25% of the voting securities of a company controls such company. However, a control relationship may also be found to exist depending on the facts and circumstances of the situation, even if less than 25% of the voting securities of a company is owned. Under the Rule, assuming that the facts and circumstances do not suggest the existence of a control relationship, an acquiring fund will generally be able to invest up to 25% of the acquired fund's shares.[7]

Voting Requirements

While all funds may acquire up to 25% of an acquired fund's shares under the Rule, the Rule imposes different voting requirements on acquiring funds depending on whether the acquired fund is an open-end or closed-end fund. The Adopting Release notes that closed-end funds may be more likely to be the target of proxy contests because of annual shareholder meeting requirements, and therefore they may be more susceptible to undue influence from acquiring funds. To mitigate this potential influence, an acquiring fund and its advisory group that own more than 10% of the outstanding voting securities of an acquired closed-end fund must use mirror voting to vote the shares of such fund.[8] In addition, in the event the share ownership of an open-end fund or unit investment trust exceeds 25% (which would be expected to happen only if there was a decrease in the outstanding voting securities of the acquired fund), the acquiring fund and its advisory group likewise would be required to mirror vote their shares of the acquired fund. These voting thresholds differ from the thresholds initially proposed, which would have required mirror voting at a much lower 3% threshold.

Required Findings

A key aspect of the Rule is a requirement that the investment advisers of acquired funds and acquiring funds that are management companies[9] make certain findings intended to alleviate potential concerns of undue influence by acquiring funds in fund of funds arrangements.[10] An acquired fund's investment adviser will be required to assess, at a minimum, the following factors enumerated in the Rule in order to make a finding that any undue influence concerns associated with an investment by an acquiring fund are reasonably addressed:

- 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.[11]

An acquiring fund's investment adviser similarly will be required to make a finding that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund, based on an evaluation of the complexity of the structure and the fees and expenses associated with the acquiring fund's investment in the acquired fund.[12] These findings must be made prior to investment by an acquiring fund in an acquired fund in reliance on the Rule. In addition, the investment adviser to an acquiring fund will be required to report on its evaluation and finding to the board of directors of the acquiring fund.

While the rule as proposed would have required an acquiring fund's investment adviser to make a determination that the investment was in the "best interest of the acquiring fund," the Adopting Release notes that this standard could be unclear or overly broad, and the Rule as adopted instead focuses on an evaluation of the complexity and fees and expenses of the fund of funds arrangement. Certain other differences between the proposed rule and the Rule as adopted include the requirement for the acquired fund findings and the required timing and frequency for making the findings and reporting to the board of directors. Under the Rule, an investment adviser will be required to report the applicable findings to the board one time, at the next regularly scheduled board meeting, with ongoing reporting conducted pursuant to the fund's compliance program in connection with Rule 38a-1 under the 1940 Act.

Fund of Funds Investment Agreement

The Rule will require funds that do not have the same investment adviser to enter into a fund of funds investment agreement prior to acquisition by an acquiring fund of the securities of the acquired fund in excess of the Section 12(d)(1) limits. The agreement is intended to provide the funds an opportunity to negotiate, memorialize and provide for enforcement of the

terms governing the arrangement. This requirement aims to prevent undue influence over an acquired fund, particularly in the form of the threat of large-scale redemptions by an acquiring fund, and to provide notice to an acquired fund of the investment by an acquiring fund in reliance on the Rule. The fund of funds investment agreement entered into by the acquiring and acquired funds may be tailored to the funds' circumstances, but at a minimum must include the following provisions:

- Any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the finding required by the Rule;
- A termination provision whereby either the acquiring fund or acquired fund may terminate the agreement subject to written notice no longer than 60 days in advance; and
- 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.[13]

The Adopting Release reminds investment advisers that in negotiating this agreement, advisers must ensure compliance with legal and regulatory requirements under the Federal securities laws. In addition, a fund of funds investment agreement must be filed as an exhibit to the funds' registration statements. As noted above, funds with the same primary investment adviser do not need to enter into a fund of funds investment agreement, but the agreement will be required where an investment adviser serves as an adviser to one fund and a sub-adviser to the other fund, or as sub-advisers to both funds. Advisers to both an acquiring and acquired fund also must act in accordance with their fiduciary duties to each fund.

Limitations on Complex Structures

The Rule will generally limit fund of fund arrangements to two-tier structures (i.e., one acquiring fund and one acquired fund), due to the potential for excessive fees and investor confusion posed by multi-tier arrangements. However, the Rule does contain certain limited exceptions, including an exception to allow an acquired fund to invest up to 10% of its total assets in other investment companies or private funds, without any restriction on the size of the investment in any one fund.[14] This 10% exception is intended to provide portfolio management flexibility for funds, while continuing to prevent unnecessarily complex arrangements. The

Adopting Release also acknowledges that certain existing multi-tier fund structures may be required to modify their investments in order to comply with the Rule.

Other Provisions of the Rule and Related Changes

Rescission of Rule 12d1-2

In connection with the adoption of the Rule, the Commission is rescinding Rule 12d1-2, which provides flexibility to funds relying on Section 12(d)(1)(G) to invest in other types of securities.[15] This will limit a fund relying on Section 12(d)(1)(G) from acquiring securities of other funds that are not part of the same group of investment companies and from investing directly in securities, except in compliance with the Rule. However, the Commission is also amending Rule 12d1-1 in order to permit funds relying on Section 12(d)(1)(G) to invest in money market funds outside the same group of investment companies in reliance on that rule.

Rescission of Exemptive Orders and Withdrawal of No-Action Letters

The Commission is also rescinding all orders granting exemptive relief from Sections 12(d)(1)(A), (B), (C) and (G), with certain limited exemptions, as well as rescinding the relief relating to Sections 12(d)(1)(A) and (B) contained in exemptive orders for exchange-traded funds ("ETFs"). Fund of funds exemptive relief that is outside the scope of the Rule will remain in place. No-action letters issued by the staff of the Division of Investment Management of the Commission ("Staff") stating that the Staff would not recommend an enforcement action relating to Section 12(d)(1), except those falling outside the scope of the Rule, will also be withdrawn.

Amendment to Form N-CEN

Form N-CEN, which requires registered funds to provide census-type information to the Commission on an annual basis, will be amended to require a management company relying on the Rule or on Section 12(d)(1)(G) to disclose such information in the form.

Recordkeeping Requirements

The Rule will require acquired and acquiring funds relying on the Rule to maintain the certain documentation, including copies of fund of funds investment agreements, records of the findings made by investment

advisers and records of the applicable evaluations supporting such findings.

Compliance Dates

The rescission of Rule 12d1-2, the rescission of exemptive relief, the withdrawal of no-action letters and the amendment to Form N-CEN in connection with the Rule will be effective one year after the effective date of the Rule.

Impact of the Rule on Regulated Fund Boards and Advisers

As previously noted, the Rule represents an effort by the Commission to formalize and codify positions previously established by the Commission through exemptive orders and reflects the ongoing efforts by the Commission and the Staff to streamline the requirements applicable to regulated funds. In providing a consistent framework for the formation and regulation of fund of funds arrangements under the 1940 Act, regulated funds and their advisers should benefit from the certainty provided by the Rule. Certain regulated funds will find that their existing investment structures will require modification, and the Rule will require additional effort on the part of advisers and regulated fund boards to evaluate proposed fund of funds arrangements and make appropriate findings. However, regulated funds should benefit overall from a coherent approach to fund of funds arrangements provided by the Rule. In particular, the Rule will ease the process for launching new fund of funds structures, in a manner similar to the Commission's recent efforts to streamline exemptions applicable to ETFs, which may in turn lead additional asset managers to consider launching new fund of funds products.

Impact of the Rule on Private Funds

The Rule extends only to regulated funds and, therefore, excludes reliance by private funds. As a result, unlike regulated funds, private funds are unable to rely on the Rule to permit acquisitions of regulated fund securities in excess of the 3% ownership limit set forth in Section 12(d)(1)(A)(i) under the 1940 Act. Notably, however, the Commission opted not to issue guidance on the application of the 3% ownership limitation to private funds that share a common adviser, despite numerous commenters urging the Commission to do so as part of its rule-making process. As a result, the 3% ownership limitation under Section 12(d)(1)(A)(i) applicable to

private funds will continue to be applied on a fund-by-fund basis, with no aggregation between such private funds even when managed by the same adviser.

The Adopting Release does not rule out the possibility of future rulemaking in this area applicable to private funds, but indicates that, for the time being, the exemptive order application process would be the appropriate channel for further consideration by the Commission of fund of funds arrangements involving private funds (though exemptive relief has not previously been granted to permit a private fund to exceed the Section 12(d)(1) limit). The Adopting Release notes that providing relief through the exemptive process to private funds wishing to exceed the 3% investment limit would permit the Commission to design appropriate conditions, limitations and reporting requirements, while allowing the Commission and the Staff to monitor and analyze the impact of fund of fund arrangements involving private funds, prior to considering any future rulemaking. The Adopting Release also encourages interested parties to contact the Staff of the Division of Investment Management with any input on these types of arrangements involving private funds.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Investment Company Act Release No. 34045 (Oct. 7, 2020), available here.

[2] Investment Company Act Release No. 33329 (Dec. 19, 2018), available here. The rule as adopted is generally consistent with the proposed rule, with the exception of a few material changes discussed herein, including the removal of a limitation on redemptions by acquiring funds.

[3] Section 12(d)(1)(F) generally exempts acquisitions of securities by a regulated fund from the applicable provisions of Section 12(d)(1) so long as (i) immediately after such acquisition not more than 3% of the total outstanding stock of the issuer of such securities is owned by the acquiring regulated fund and all affiliated persons of such regulated fund, and (ii) such regulated fund has not sold securities through a principal underwriter with a sales load above certain specified thresholds. In addition, the acquiring regulated fund must either seek instructions from

its own shareholders with respect to any proxies for such securities, or otherwise mirror vote such securities.

[4] In declining to include private funds in the scope of the Rule, the release adopting the Rule notes that private funds are not required to provide the Commission with the same level of reporting as registered funds, which would be necessary in order to monitor proper compliance with the Rule. In addition, private funds are not subject to 1940 Act governance and compliance requirements which can help to minimize conflicts of interest that may be present in a fund of funds arrangement.

[5] Without such an exemption, an acquiring fund holding 5% or more of an acquired fund's securities would be considered an affiliated person of the acquired fund and the funds would be prohibited under Section 17(a) from engaging in any further transactions, including making additional investments or redemptions. Under the Rule, BDCs will be exempted from analogous provisions under Section 57(a) of the 1940 Act.

[6] Advisory group is defined in the Rule as "(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." The Adopting Release acknowledges that the broad definition of advisory group may involve increased compliance and monitoring efforts by acquiring funds and other members of the advisory group. The Adopting Release also notes that the definition of advisory group does not, however, include funds managed by unaffiliated subadvisers.

[7] Where an acquiring fund is part of the same "group of investment companies" (i.e., registered funds or BDCs that hold themselves out to investors as related companies for investment and investor services) as the acquired fund, or where an acquiring fund's investment sub-adviser acts as the acquired fund's investment adviser, the control limitations, as well as the voting limitations described below, do not apply.

[8] Mirror voting entails voting in a manner that is proportionate to the vote of all other shareholders of the acquired fund. The Rule also requires that in the event mirror voting is not feasible (for example, because all of the investors in an acquired fund are acquiring funds investing pursuant to the Rule), the acquiring fund must pass through its vote to its underlying shareholders.

[9] The Rule's requirements differentiate between management companies (which include BDCs) and Unit Investment Trusts ("UITs"). While acquiring UITs are subject to certain findings requirements as described in the Adopting Release, because UITs are unmanaged they do not face the same undue influence concerns as management companies, and therefore UITs that are acquired funds are not required to make any findings. The Rule also contains certification requirements for separate accounts funding variable insurance contracts.

[10] This requirement, along with the requirement to enter into fund of fund investment agreements, takes the place of the redemption limitation and disclosure requirements originally included in the proposed rule, which would have required that an acquiring fund owning more than 3% of an acquired fund's shares not redeem more than 3% of the shares in any 30-day period. The proposed rule also would have required that a fund disclose in its registration statement its status as an acquiring fund. The Adopting Release notes several concerns raised by commenters opposing both the redemption limits and disclosure requirement, including that such redemption limits could negatively impact the ability of acquiring funds to achieve their investment objectives and could present significant operational and administrative challenges.

[11] Rule 12d1-4(b)(2)(i)(B). The Adopting Release notes that any other relevant regulatory requirements must be considered in addition to these factors.

[12] Rule 12d1-4(b)(2)(i)(A). The Adopting Release also notes the existing responsibility of an acquiring fund's board of directors to evaluate the terms of the acquiring fund's advisory agreement, including fees, pursuant to Section 15(c) of the 1940 Act, as well as the fiduciary duty of advisers with respect to the receipt of compensation pursuant to Section 36(b). An investment adviser to an acquiring fund must therefore be cognizant of the services it is providing to the acquiring fund, as opposed to services that are being performed by the adviser to the acquired fund, and ensure that fees of the acquiring fund are structured appropriately.

[13] Rule 12d1-4(b)(2)(iv)(A).

[14] Certain multi-tier arrangements will be permissible, including master-feeder arrangements pursuant to Section 12(d)(1)(E) and acquisitions pursuant to Rule 12d1-1.

[15] Section 12(d)(1)(G) permits open-end funds and UITs to purchase an unlimited amount of shares of other open end funds and UITs in the same group of investment companies in excess of the limits of Section 12(d)(1), subject to certain conditions.

Practices

INVESTMENT MANAGEMENT

Attachments

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