

Rule for Fund of Funds Arrangements

November 11, 2020

On October 7, 2020, the U.S. Securities and Exchange Commission (the Commission or SEC) adopted Rule 12d1-4 (the Rule) and related amendments designed to create a comprehensive framework for fund of funds arrangements.¹ The Rule, which replaces most fund of funds exemptive orders, applies a uniform standard that allows a registered investment company or a business development company (an acquiring fund) to acquire shares of another fund (the acquired fund) in excess of the statutory limits in Section 12(d)(1) of the Investment Company Act of 1940, as amended (the 1940 Act). To be clear, reliance on the Rule is voluntary, and the Rule generally does not supersede other statutory or rule-based exceptions from the Section 12(d)(1) limits, which might apply.²

To rely on the Rule:

- The acquiring fund must comply with limitations on control and voting power over the acquired fund.
- The acquiring fund and acquired fund must make certain findings concerning the fund of funds arrangement.
- The acquiring fund and acquired fund must enter into an agreement memorializing the fund of funds arrangement.
- The acquiring fund must avoid certain complex fund structures.

The Commission adopted related rulemaking (together with the Rule, the New Rulemaking):

- **Rescission of Rule 12d1-2.** The New Rulemaking makes existing Rule 12d1-2 (in the view of the Commission) redundant, and the Commission, therefore, rescinded that rule. Rule 12d1-2 had allowed registered open-end funds and unit investment trusts (UITs) that rely on Section 12(d)(1)(G) of the 1940 Act to (i) acquire the securities of other funds that are not part of the same group of investment companies³, (ii) invest directly in stocks, bonds, and other securities, and (iii) acquire the securities of money market funds in reliance on Rule 12d1-1.
- **Amendment of Rule 12d1-1.** As amended, Rule 12d1-1 will allow funds that rely on Section 12(d)(1)(G) of the 1940 Act to invest in money market funds that are not part of the same group of investment companies.

- **Amendment of Form N-CEN.** A management company (meaning any registered investment company other than a unit investment trust) must report on Form N-CEN if it relies on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G).
- **Rescission of Existing Exemptive Orders; Withdrawal of Staff Letters.** The Commission rescinded a number of exemptive orders and Commission rules that provided relief to certain fund of funds arrangements from the requirements of Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act and will withdraw certain related no-action letters when the Rule becomes effective.⁴

Our Take. The New Rulemaking replaces decades of exemptive orders (sometimes with different conditions) with a uniform set of rules that will apply to all fund of funds arrangements. While not everyone is happy with the new limitations and conditions, the Rule brings a measure of certainty to funds and their sponsors when structuring fund of funds arrangements. Some funds (especially those that have relied on Rule 12d1-2 and Section 12(d)(1)(G)) likely will have to change the way they invest in other funds, and most funds with fund of funds arrangements will have to revise their compliance procedures to comply with new conditions and requirements.

Some industry stakeholders are disappointed that the Commission did not extend the exemptive relief to private funds that invest in U.S. registered funds, but perhaps the Commission will reconsider that issue another day after it evaluates how effective the safeguards of the Rulemaking are as applied. Similarly, exchange-traded funds (ETFs) that had greater latitude in reliance on their current exemptive orders may be forced to rethink their strategies when subject to the Rule's limits. Overall, the Rule creates some new challenges for chief compliance officers of funds with fund of funds arrangements that can no longer rely on individual exemptive orders.

I. *Fund of Funds Arrangements — Background*

Section 12(d)(1),⁵ which limits a registered fund's ability to invest substantially in securities issued by another fund, was enacted by Congress to address, among other things, concerns about

- (i) “pyramiding,” that is, an arrangement that allows an acquiring fund to control the assets of an acquired fund to enrich the acquiring fund at the expense of the acquired fund's shareholders
- (ii) the potential for duplicative and excessive fees when one fund invests in another
- (iii) the formation of overly complex structures that could be confusing to investors

Over time, Congress amended the 1940 Act to create three statutory exemptions to allow certain fund of funds arrangements, subject to conditions that addressed investor protection concerns⁶ and adopted Section 12(d)(1)(J), which authorizes the Commission to exempt fund of funds arrangements that it believed were consistent with the public interest and protecting investors. In turn, the Commission adopted rules that apply to acquisition of money market funds and other types of securities and that relaxed sales charge limits in certain fund of funds arrangements.⁷

The Commission also has used its authority to exempt certain other fund of funds arrangements that the 1940 Act or its rules would otherwise prohibit, when the Commission found those arrangements to be consistent with the public interest and the protection of investors.⁸

The Commission said it was motivated to adopt a uniform rule addressing fund of funds arrangements because the combination of statutory exemptions, rules, and exemptive order relief “created a regulatory regime where substantially similar fund of funds arrangement are subject to different conditions.” Recognizing the growth of innovative fund of funds arrangements, the Commission sought to address these differences and to “create a consistent and efficient rules-based regime for the formation, operation, and oversight of fund of funds arrangements.”⁹

II. Rule 12d1-4

A. Scope of Rule 12d1-4

New Rule 12d1-4 permits a registered investment company or business development company (BDC) (collectively, “acquiring funds”) to acquire securities of any other registered investment company or BDC (collectively, “acquired funds”) in excess of the limits in Section 12(d)(1), subject to certain conditions. Open-end funds and UITs (including ETFs) and closed-end funds can rely on the New Rule as both acquiring and acquired funds.¹⁰ The Commission specifically chose not to allow unregistered investment companies, such as foreign funds, to rely on the Rule as acquiring funds.¹¹ While some commenters argued that ETFs as acquired funds do not implicate the concerns that Section 12(d)(1) was designed to address, the Rule treats ETFs consistently with other open-end funds.

B. Rule 12d1-4: Affiliated Transactions Considerations

Section 17(a) generally prohibits an affiliated person of a fund, or any affiliated person of such person, from selling any security or other property to, or purchasing any security or other property from, the fund. While there are exceptions that apply to ordinary mutual fund share issuances and redemptions, ETF in-kind creation and redemption transactions raise additional questions under Section 17(a).

The Rule therefore provides an ETF-specific exemption from Section 17(a) with regard to the deposit and receipt of baskets by an acquiring fund that is an affiliated person of an ETF (or that is an affiliated person of such person) solely by reason of holding with the power to vote 5% or more of the ETF’s shares or holding with the power to vote 5% or more of any investment company that is an affiliated person of the ETF.¹² The exemption is not available when the ETF is, in turn, an affiliated person of the acquiring fund, or an affiliated person of such person, for a reason other than the power to vote.

C. Conditions

Rule 12d1-4 includes conditions designed to address the specific abuses that historically were associated with fund of funds arrangements: undue influence, complex structures, and layering of fees.

1. Control

As a condition to relying on the Rule,¹³ an acquiring fund and its advisory group¹⁴ cannot control¹⁵ the acquired fund, except in certain circumstances.¹⁶ To prevent an acquiring fund from circumventing this requirement, the acquiring fund must aggregate its investment in an acquired fund with the investment of the acquiring fund's advisory group to address control. However, the advisory group definition does not encompass funds managed by unaffiliated subadvisers.

2. Voting Provisions

The Rule includes voting conditions that differ based on the type of acquired fund.¹⁷ An acquiring fund and its advisory group are required to vote their shares of an acquired fund

- (i) using mirror voting if the acquiring fund and its advisory group (in the aggregate) hold more than 25% of the outstanding voting securities of an acquired open-end fund or UIT due to a decrease in the outstanding securities of the acquired fund
- (ii) using mirror voting if the acquiring fund and its advisory group (in the aggregate) hold more than 10% of the outstanding voting securities of an acquired closed-end fund or BDC¹⁸

The Commission said that it was persuaded by public comments that a 25% ownership threshold is appropriate for open-end funds and UITs given that these funds hold shareholder meetings infrequently and because there is less of a concern about undue influence of these funds through shareholder voting. Closed-end funds and BDCs have different considerations; such funds often are required to hold annual shareholder meetings and can be the focus of proxy contests, which make them more susceptible to influence by shareholder vote. Accordingly, the Rule includes a lower 10% voting requirement threshold specific to closed-end funds that addresses concerns with undue influence that are unique to such funds as opposed to their open-end counterparts.

The Commission acknowledged that it may be impossible to implement mirror voting in circumstances when Rule 12d1-4 or Section 12(d)(1) requires all of the security holders of an acquired fund to engage in mirror voting.¹⁹ In these cases, the Rule requires that the acquiring fund's shares be "passed-through" to the acquiring fund's shareholders for voting purposes.

3. Exceptions to Control and Voting Conditions

The Rule's control and voting restrictions would not apply when²⁰

- (i) the acquiring fund is within the same group of investment companies²¹ as an acquired fund or
- (ii) the acquiring fund's investment subadviser or any person controlling, controlled by, or under common control with such investment subadviser acts as the acquired fund's investment adviser or depositor.

These exceptions are designed to include fund of funds arrangements that are permissible under Section 12(d)(1)(G) and Commission exemptive orders within the regulatory framework of Rule 12d1-4. The Commission said that these arrangements do not raise the same concerns of undue influence as other arrangements. Among other things, a common adviser to both an acquiring fund and an acquired fund owes a fiduciary duty to both, and an acquiring fund adviser and an acquired fund adviser that are control affiliates would generally not seek to benefit one fund at the expense of another. As such, it is appropriate that such fund of funds arrangements be subject to the more limited set of conditions of adviser findings and fund of funds investment agreements, discussed in more detail below.

4. Fund Findings and Investment Agreements

To address concerns that an acquiring fund could exert undue influence over a acquired fund (e.g., by threatening a large-scale redemption) or that an acquiring fund may pay excessive fees, the Rule requires the investment adviser to an open-end fund, ETF, or closed-end fund or BDC to make certain findings before allowing an investment that exceeds the 3% limit.²² The Commission chose to require advisers to make these findings rather than to limit redemptions and require additional disclosures as originally proposed. Specifically:

- (i) An acquired management company's adviser must make certain findings focused on addressing undue influence concerns, including through redemptions, by considering specific enumerated factors.
- (ii) An acquiring fund's adviser, principal underwriter, or depositor must conduct an evaluation of the complexity of the fund of funds structure and its aggregate fees and expenses and making a finding that the fees and expenses are not duplicative.
- (iii) Both the acquiring fund and acquired funds must enter into a fund of funds investment agreement to memorialize the terms of the arrangement (including terms that serve as a basis for the required findings) when the acquiring and acquired funds do not share an investment adviser.

The findings (the Fund Findings) must be made, and the fund of funds investment agreement (the Investment Agreement) entered into, before the acquiring fund invests in the acquired fund in reliance on the Rule.²³

(i). *Fund Findings*

The Rule distinguishes Fund Findings required to be made by acquiring funds versus acquired funds.²⁴ In each case, any findings are subject to an adviser's duty to act in the best interest of the relevant fund it advises. Further, the Fund Findings requirement still applies when both funds involved are in the same group of investment companies and/or when both have the same adviser, unlike the voting and control conditions that excepted those funds from the requirement.

Management Company Acquired Fund Findings. Under the Rule, investment advisers for management companies that are *acquired funds* are required to find that any undue influence

concerns associated with the acquiring fund's investments in the acquired fund are reasonably addressed. This finding considers specific factors designed to focus the analysis on potential ways to reduce the threat of undue influence (including through redemptions) when an acquiring fund invests in the acquired fund beyond the Section 12(d)(1) limits. Because concerns regarding undue influence are more salient for acquired funds, the Commission explains in the Adopting Release, only the adviser to an acquired fund will be required to make this determination.

An acquired fund's investment adviser must consider²⁵

- 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 investment and redemptions
- the circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any redemptions in kind

In addition, an acquired fund's adviser also would need to consider any other relevant regulatory requirements when making the above findings, for example, the acquired fund's liquidity risk and how it manages that risk.

Management Company Acquiring Fund Findings. Investment advisers to management companies that are *acquiring funds* are required to evaluate the complexity of the structure associated with the acquiring fund's investment in the acquired fund. In evaluating the complexity of a fund of funds structure, an acquiring fund adviser should consider the complexity of holding interests in an investment company versus direct investment in similar assets.

The acquiring fund's adviser also must evaluate the relevant fees and expenses and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund.²⁶ Specifically, an adviser should consider whether the acquired fund's advisory fees are for services that are in addition to, rather than duplicative of, the adviser's own services to the acquiring fund. The adviser should also consider the other fees and expenses, such as sales charges, recordkeeping fees, subtransfer agency services, and fees for other administrative services.

Investment Adviser Reporting and Board Oversight. The Rule requires that the adviser to a management company report its evaluation, finding, and the basis thereon to the fund's board of directors no later than the next regularly scheduled board meeting.

The Commission noted in the release that to the extent that advisory services are being performed by another person (such as the adviser to an acquired fund), the fiduciary duty imposed on advisers pursuant to Section 36(b) of the 1940 Act²⁷ requires an acquiring fund's adviser to charge fees or expenses only for the services that the acquiring fund's adviser is

providing and not for any services performed by an adviser to an acquired fund. In addition to its reporting of specific findings pursuant to the Rule, the adviser must report the findings to the acquiring fund's board of directors as part of the board's overall review and exercise of oversight responsibilities and, specifically, as part of its evaluation of the terms of the acquiring fund's advisory contract pursuant to Section 15(c) of the 1940 Act.²⁸

UIT Findings. Rule 12d1-4 includes an alternative finding condition when the acquiring fund is a UIT. This alternative finding condition is designed to reflect the fact that UITs are unmanaged and have fixed, static portfolios. As such, such a finding is required only at the time of the UIT's creation, and re-evaluation thereafter is unnecessary.²⁹

On or before the date of the initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must find that the fees of the UIT do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit.³⁰ In making this finding, the principal underwriter or depositor must evaluate the complexity of the structure and the aggregate fees and expenses associated with the UIT's investment in acquired funds.

Certifications: Separate Account Funding Variable Insurance Contract. The Rule includes a condition specific to a separate account funding variable insurance contracts. Here, the Rule requires an acquiring fund to obtain a certification from the insurance company issuing the separate account, that it 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 1940 Act.³¹

(ii). Fund of Funds Investment Agreements

The Rule requires an acquiring fund and an acquired fund (defined here to include a management company, or an internally managed fund or UIT) to enter into a fund of funds Investment Agreement before the acquiring fund acquires securities of the acquired fund in excess of the limits of Section 12(d)(1) in reliance on Rule 12d1-4 unless both funds have the same primary investment adviser.³² Funds that have the same primary investment adviser must still otherwise memorialize the arrangements that led the relevant adviser to make the Fund Finding for each fund under the Rule, as discussed.

In the view of the Commission, the Investment Agreement is designed to work in tandem with the Fund Findings. The Investment Agreement can be designed to set the terms of the agreement to support the Fund Findings, memorialize the expectation of both parties at the outset of the arrangement, and provide a method of enforceability should one party not live up to expectations.³³

The Rule requires that Investment Agreements include three specific provisions:³⁴

- First, it must include any material terms necessary for the adviser, underwriter, or depositor to make the Fund Finding where the funds involved include management companies or UITs.

- Second, it must include a termination provision whereby either party can terminate the agreement with advance written notice within a period no longer than 60 days.³⁵
- Third, it must include a provision requiring an acquired fund to provide the acquiring fund with fee and expense information to the extent reasonably requested.

5. Complex Fund Structures

The Rule generally limits the ability of fund arrangements under the Rule to include more than two tiers. That is, an acquired fund generally cannot also be an acquiring fund under the Rule or under Section 12(d)(1)(G). The Rule also includes exceptions to this general prohibition when the arrangements that do not raise concerns underlying Section 12(d)(1).

Specifically, the Rule prohibits a fund that is relying on Section 12(d)(1)(G) or the Rule from acquiring, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of an acquiring fund (the “second-tier fund”) subject to limited exceptions for the second-tier fund to make investments permitted by Rule 12d1-4(b)(3)(ii)³⁶ (summarized in the next paragraph).ⁱ This provision does not prevent a top-level fund from investing all of its assets in an acquiring fund in reliance on Section 12(d)(1)(E) (a “master-feeder arrangement”), a three-tier structure that the Commission does not believe implicates the risks that Section 12(d)(1) was designed to address.³⁷

Limitations on investments in other funds and private funds. The Rule provides that an acquired fund may not purchase or otherwise acquire securities of an investment company or private fund if, immediately after such purchase or acquisition, the securities of investment companies and private funds owned by the acquired fund have an aggregate value in excess of 10% of the value of the total assets of the acquired fund (the 10% Bucket).³⁸ This limitation is subject to the following exceptions when an acquired fund may invest in another fund to efficiently manage uninvested cash, to address specific regulatory or tax limitations, or to facilitate certain transactions. Specifically, the 10% Bucket limitation does not apply to an acquisition of securities of another investment company that is³⁹

- (i) acquired in reliance on Section 12(d)(1)(E) (master-feeder arrangements),
- (ii) acquired pursuant to Rule 12d1-1,⁴⁰
- (iii) a subsidiary wholly owned and controlled by the acquired fund,
- (iv) received as a dividend or as a result of a plan of reorganization of a company, or
- (v) acquired pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

While the 10% bucket provides for a degree of leeway, this new provision is also something of a trap for the unwary as registered investment companies do not today limit themselves when

investing in private funds. The definition of a private fund (any issuer relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act) also can be broader than expected and capture, for example, structured finance issuers and non-U.S. issuers that do not otherwise appear to be “funds.”

6. Recordkeeping

The Rule requires the acquiring and acquired funds that participate in fund of funds arrangements in accordance with the Rule to maintain and preserve certain written records for a period of not less than five years, the first two years in an easily accessible place. These records include⁴¹

- (i) a copy of each fund of funds Investment Agreement that is in effect, or was in effect in the past five years, and any amendments thereto
- (ii) a written record of the relevant Fund Finding made under the Rule and the basis therefor within the past five years
- (iii) the certification from each insurance company required by the Rule

III. *Rescission of Rule 12d1-2 and Amendment to Rule 12d1-1*

A. Rescission of Rule 12d1-2

As discussed, Section 12(d)(1)(G) allows a registered open-end fund or UIT to acquire an unlimited amount of shares of other open-end funds and UITs that are in the same “group of investment companies.” Rule 12d1-2 includes three types of relief for fund of funds arrangements that did not conform to the Section 12(d)(1)(G) limits. Under Rule 12d1-2, a fund relying on Section 12(d)(1)(G) was permitted to

- (i) acquire the securities of other funds that are not part of the same group of investment companies, subject to the limits in Section 12(d)(1)(A) or 12(d)(1)(F)
- (ii) invest directly in stocks, bonds, and other securities
- (iii) acquire the securities of money market funds in reliance on Rule 12d1-1

Notwithstanding the opposition from most commenters, the Commission is rescinding Rule 12d1-2. As a result, acquiring funds that wish to invest in different types of funds and other asset classes will be required to do so pursuant to the Rule. (As noted below, Rule 12d1-2 will not be rescinded until one year after the effective date of the Rule).

B. Amendment to Rule 12d1-1

As part of the Rulemaking, the Commission is amending Rule 12d1-1 of the 1940 Act to provide funds relying on Section 12(d)(1)(G) with the flexibility to invest in money market funds outside of the same group of investment companies.

IV. *Amendments to Form N-CEN*

Form N-CEN is a structured form that requires registered funds to provide census-type information to the Commission on an annual basis. The Commission is adopting, largely as proposed, a requirement that a management company report on Form N-CEN if it is relying on Rule 12d1-4 or the statutory exception in Section 12(d)(1)(G) during the relevant reporting period.

V. *Rescission of Exemptive Relief; Withdrawal of Staff Letters*

A. Rescission of Exemptive Relief

As part of the Rulemaking, the Commission is rescinding the exemptive relief issued to fund of funds arrangements that fall within the scope of Rule 12d1-4. The major topical areas of fund of funds relief that are within the scope of Rule 12d1-4 are as follows:

- ***Standard Fund of Funds Relief:*** general exemptive relief from Sections 12(d)(1)(A), (B), and (C) of the 1940 Act and Sections 17(a)(1) and (2) of the 1940 Act to permit acquiring funds to invest in acquired funds in excess of the limits of in Section 12(d)(1) of the 1940 Act (“general exemptive relief”)
- ***Fund of Funds Relief for ETFs and ETMFs:*** general exemptive relief specific to ETFs and ETMFs
- ***ETFs Relying on Rule 6c-11:*** general exemptive relief provided to ETFs relying on Rule 6c-11⁴⁴
- ***Fund of Funds Relief for Nontransparent ETFs and ETMFs:*** general exemptive relief related to broader relief granted to certain actively managed ETFs to operate without being subject to the daily portfolio transparency condition included in other actively managed ETF orders
- ***Fund of Funds Direct Investment Relief:*** exemptive relief to fund of funds arrangements that rely on Section 12(d)(1)(G) to invest in assets other than funds within the same group of investment companies, government securities, and short-term paper
- ***Fund of Funds Affiliated Structures:*** exemptive relief to permit an open-end fund or UIT to invest in other open-end funds and UITs that are in the “same group of investment companies” in excess of the limits in Section 12(d)(1), subject to certain enumerated conditions
- ***Captive Funds:*** exemptive orders for fund of funds arrangements that are captive to an affiliated managed account program

The Commission is not rescinding exemptive relief granted to fund of funds arrangements outside of the scope of the Rule. Such categories of relief include these:

- ***Interfund Lending:*** exemptive relief from Section 12(d)(1)(A) and (B) granted to allow certain interfund lending arrangements
- ***Affiliated Insurance Fund Relief:*** exemptive relief allowing insurance funds to invest in fixed-income instruments issued by affiliates
- ***Transaction-Specific Relief:*** exemptive relief to funds under Section 12(d)(1) in order to engage in a transaction that might otherwise violate such provision (often, fund reorganizations)
- ***Grantor Trusts:*** exemptive order pertaining to current and future automatic common exchange security trusts
- ***Fund of Funds Arrangements With Managed Risk Provision and Other Relief Related to Section 12(d)(1)(E):*** fund of funds exemptive order that permits a “managed risk” fund structure

B. Withdrawal of Staff Letters

The staff has issued a line of letters stating that it would not recommend enforcement action to the Commission under Sections 12(d)(1)(A) or (B) of the 1940 Act if a fund acquires the securities of other funds in certain circumstances. As part of the Rulemaking, the Commission is withdrawing these letters, again in recognition of the fact that the Rule now provides a “consistent and rules-based mechanism for fund of funds arrangements” that should be relied on in lieu of such letters.

VI. *Effective Date; Compliance Dates*

Rule 12d1-4. The effective date of Rule 12d1-4 is 60 days after publication in the *Federal Register* (the Effective Date).

Rescission of Rule 12d1-2. Rule 12d1-2 will be rescinded one year after the Effective Date.

Amendment to Rule 12d1-1. The amendment to Rule 12d1-1 is effective as of the Effective Date.

Amendments to Form N-CEN. Affected funds will be required to comply with amendments to Form N-CEN by 425 days after publication in the *Federal Register*.

Rescission of Exemptive Relief. The affected exemptive orders will be rescinded one year after the Effective Date.

Withdrawal of Staff Letters. The affected staff letters will be withdrawn one year after the Effective Date.

- ¹ See *Fund of Funds Arrangements*, SEC Release Nos. 33-10871; IC 34045 (October 7, 2020) (<https://www.sec.gov/rules/final/2020/33-10871.pdf>) (the Adopting Release).
- ² However, the “complex structures” prohibition of the Rule (12d1-4(b)(3)) explicitly does override Section 12(d)(1)(G).
- ³ The term “group of investment companies” is defined in Section 12(d)(1)(G) as any two or more registered funds that hold themselves out to investors as related companies for purposes of investment and investor services.
- ⁴ The list of no-action letters to be withdrawn will be available on the Commission’s website.
- ⁵ Section 12(d)(1)(A) prohibits a registered fund (and companies, including funds, it controls) from
- acquiring more than 3% of another fund’s outstanding voting securities,
 - investing more than 5% of its total assets in any one fund, or
 - investing more than 10% of its total assets in funds generally.
- Section 12(d)(1)(B) prohibits a registered open-end fund, and any principal underwriter thereof or broker-dealer registered under the Securities Exchange Act of 1934, from knowingly selling securities to any other investment company if, after the sale, the acquiring fund would
- together with companies it controls, own more than 3% of the acquired fund’s outstanding voting securities, or
 - together with other funds (and companies they control) own more than 10% of the acquired fund’s outstanding voting securities.
- Section 12(d)(1)(C) prohibits any investment company (the acquiring company), and any company or companies controlled by the acquiring company, to purchase or otherwise acquire any security issued by a registered closed-end investment company if immediately after such purchase or acquisition the acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies own more than 10% of the total outstanding voting stock of such closed-end company.
- ⁶ Section 12(d)(1)(E) of the 1940 Act, subject to certain conditions, permits a fund to invest all of its assets in single fund (master-feeder arrangements).
- Section 12(d)(1)(F) of the 1940 Act permits a registered fund to invest in other funds provided that it does not own, immediately after the acquisition, more than 3% of the outstanding securities of any such fund.
- Section 12(d)(1)(G) of the 1940 Act permits a registered open-end fund or unit investment trust (a UIT) to invest in other open-end funds and UITs that are in the same “group of investment companies” (defined to mean “any two or more registered investment companies that hold themselves out to investor as related companies for purposes of investment and investor services”).
- ⁷ Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of Section 12(d)(1).
- Rule 12d1-2 provides funds relying on Section 12(d)(1)(G) with greater flexibility to invest in other types of securities.
- Rule 12d1-3 allows acquiring funds relying on Section 12(d)(1)(F) to charge sales loads greater than 1.5%.
- ⁸ For example, the Commission has granted a number of exemptive orders relieving ETFs and exchange-traded managed funds (ETMFs), as well as acquiring funds seeking to purchase securities of such ETFs and ETMFs, from Sections 12(d)(1)(A) and (B), subject to certain conditions.
- ⁹ See the Adopting Release at 3.
- ¹⁰ As the Commission notes in the Adopting Release, the scope of permissible acquiring and acquired funds under the New Rule is greater than the scope permitted in the Commission’s exemptive orders. This broader scope is appropriate, in the Commission’s view, as “the universe of permissible fund of funds arrangements generally should not turn on the type of funds in the arrangement. Instead, the rule should address differences in fund structures with tailored conditions that protect investors in all types of covered investment companies against the abuses historically associated with funds of funds.” See the Adopting Release at 13-14.

- ¹¹ The Commission said that it believes it is more appropriate to consider relief for private funds and foreign funds through the exemptive application process as such funds raise different concerns that do not exist in the case of registered funds, such as reporting and governance considerations. See the Adopting Release at 20-21.
- ¹² Rule 12d1-4(a)(3).
- ¹³ This Commission adopted this prohibition on control substantially as it was originally proposed. See *Fund of Funds Arrangements*, SEC Release Nos. 33-10590; IC 33329 (December 19, 2018) (<https://www.sec.gov/rules/proposed/2018/33-10590.pdf>) (the Proposing Release).
- ¹⁴ Rule 12d1-4(d) defines term “advisory group” as “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.” An acquiring fund would not combine the listed entities in clause (1) with the entities listed in clause (2).
- The Commission in the Adopting Release acknowledges that the definition of “advisory group” may capture many affiliates in a complex financial services firm and will result in monitoring and compliance burdens. The Commission notes, however, that other provisions of the 1940 Act similarly extend to affiliated persons of an investment adviser, regardless of the complexity that may arise because of the way in which a financial services firm has determined to structure itself. In the end, the Commission concluded that the Rule’s definition of “advisory group” strikes an appropriate balance between the flexibility for efficient market activity and protection of acquired funds and their shareholders. See the Adopting Release at 41.
- ¹⁵ The term “control” is defined in Section 2(a)(9) of the 1940 Act to mean the power to exercise a controlling influence over the management or policies of a company unless such power is solely the result of an official position with the company. A person who beneficially owns (directly or indirectly) more than 25% of the voting securities of a company is presumed to control that company.
- The Commission further elaborates in the Adopting Release that the existence of “control” is a facts and circumstances analysis that may exist even where an entity does not own more than 25% of the voting securities of another entity. In that regard, in addition to voting power, “controlling influence” includes a dominating persuasiveness of one or more persons, the 1940 Act or process that is effective in checking or directing action or exercising restraint or preventing free action, and the latent existence of power to exert a controlling influence. See the Adopting Release at 36.
- ¹⁶ Rule 12d1-4(b)(1)(i).
- ¹⁷ By contrast, the Proposed Rule included a 3% ownership threshold that would trigger the rule’s voting conditions regardless of the type of acquired fund.
- ¹⁸ Rule 12d1-4(b)(1)(ii).
- ¹⁹ For example, if an acquired fund is offered solely to acquiring funds relying on Rule 12d1-4, there may be no other investors to vote the acquired shares.
- ²⁰ Rule 12d1-4(b)(1)(iii).
- ²¹ By contrast to the definition in Section 12(d)(1)(G), Rule 12d1-4(d) defines “group of investment companies” to mean “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” (emphasis added). This definition is intended to clarify that BDCs and other closed-end funds are within the scope of this exception.
- ²² Rule 12d1-4(b)(2)(i)(A).
- ²³ The Proposed Rule would have required that the acquiring fund’s adviser make such findings both prior to the initial investment and with such frequency as the fund’s board deemed reasonable but in any case no less frequently than annually. The Commission agreed with commenters that mandating ongoing assessments and reporting is unnecessary.
- ²⁴ The Proposed Rule required only that acquiring funds, and not acquired funds, make the relevant findings.
- ²⁵ Rule 12d1-4(b)(2)(i)(B).

- ²⁶ Rule 12d1-4(b)(2)(i)(A). The Proposed Rule would have required that the acquiring fund’s investment adviser find that the investment is in the best interest of the acquiring fund. The Commission replaced this required finding with the duplicative fee finding, as commenters generally argued that the concept of “best interest” in this context was unclear and overly broad. See the Adopting Release at 76.
- ²⁷ Section 36(b) imposes on fund advisers a fiduciary duty with respect to their receipt of compensation.
- ²⁸ Section 15(c) requires that a board of directors of a fund evaluate any information reasonably necessary to evaluate the terms of the fund’s advisory contracts (which information would include fees, or the elimination of fees, for services provided by a fund’s adviser).
- ²⁹ The condition specific to UITs applies at the time of initial deposit for UITs formed after the Rule’s effective date. Again, given the static nature of a UIT’s portfolio, the Commission does not believe that it is necessary to exclude UITs that are already in existence from relying on the Rule as acquiring funds.
- ³⁰ Rule 12d1-4(b)(3)(ii).
- ³¹ Rule 12d1-4(b)(2)(iii). Section 26(f)(2)(A) prohibits any registered separate account funding variable insurance contracts, or the sponsoring insurance company of such account, from selling any such contract unless the fees and charges deducted under the contract, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.
- ³² Rule 12d1-4(b)(2)(iv). This exception applies only where both funds have the same primary investment adviser. The exception does not apply where the acquiring fund and the acquired fund are within the same group of investment companies. Further, while an Investment Agreement is not required where both funds have the same *primary* investment adviser, the New Rule requires an Investment Agreement when an investment adviser acts as an adviser to one fund and subadviser to the other fund or as subadviser to both funds.
- ³³ A condition to many exemptive orders granted by the Commission pursuant to Section 12(d)(1)(J) and relating to investments by acquiring funds in acquired funds that were ETFs was the requirement that the acquiring fund and acquired fund enter into a participation agreement. Investment Agreements differ from participation agreements in that they do not include contractual provisions requiring the acquiring fund to notify the acquired fund of investments in excess of the limits in Section 12(d)(1)(A). The Commission draws the further distinction that unlike participation agreements, Investment Agreements memorialize the terms of the arrangement that serve as the basis of the required finding and provide a mechanism for an acquired fund to limit an acquiring fund’s investments in reliance on the rule, a tool for protection against undue influence from an acquiring fund.
- ³⁴ Rule 12d1-4(b)(2)(iv)(A), (B), and (C).
- ³⁵ Termination of the agreement does not, unless otherwise agreed to by the parties, require that the acquiring fund reduce its position in the acquired fund but will prevent the acquiring fund from purchasing additional shares of the acquired fund beyond the limits of Section 12(d)(1).
- ³⁶ Rule 12d1-4(3)(i).
- ³⁷ See the Adopting Release at 109.
- ³⁸ Rule 12d1-4(b)(3)(ii). For purposes of calculating the 10% Bucket, investments by an acquired fund pursuant to the general exceptions in Rule 12d1-4(b)(3)(ii) are not included.
- ³⁹ Rule 12d1-4(b)(3)(ii).
- ⁴⁰ In the Proposed Rule, this exception was limited to “securities of an acquired company *for short-term cash management purposes* pursuant to Rule 12d1-1” (emphasis added). The Commission agreed with commenters’ concerns with reference to “short-term cash management purposes” and deleted such reference from the New Rule.
- ⁴¹ Rule 12d1-4(c).

⁴³ Rule 6c-11 under the 1940 Act permits ETFs that satisfy certain conditions to operate without the expense and delay of obtaining an exemptive order from the Commission.

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